

PART V

International Trade





International Trade

It is a lot easier to grow grapes and make wine in Italy than in Norway. It is easier to hunt reindeer in Norway than Italy. To the extent that Norwegians want Chianti and Italians want reindeer steaks, there is an obvious basis for international trade. Economists never needed to prove that. Nor, given climate and geography, is it hard to understand why Italians traditionally drink Chianti and eat fish, while Norwegians traditionally drink aquavit and eat reindeer and whales. But we all like to experience other peoples' traditions, tastes, and capacities. International trade allows that, to the mutual benefit of all. In this view, national production for national consumption is the cake; international trade is the icing. Of course, no one objects to trade in this sense. But this is not an accurate picture of either the reality of trade today, or the trends and goals of globalization. However, before we tackle the difficulties of globalization, let's look more closely at the classical argument for free trade, an argument that goes well beyond the common-sense picture just sketched.

■ THE CLASSICAL THEORY: COMPARATIVE ADVANTAGE

The case for free trade, like the case for exchange in general, hinges on the assumption that trade is voluntary. Both parties to a voluntary exchange must be better off, in their own estimation, after the trade than before—otherwise they would not have made the trade. Under what conditions is this happy result likely to be the case? The most obvious condition is that of **absolute advantage** in cost differences reflected in the example above. If country A can produce something at a lower absolute cost than country B, while B can likewise produce something else at a lower absolute cost than A, then there is a reason for voluntary exchange, assuming A wants some of B's product and B wants some of A's product in the first place.

A country has an *absolute advantage* if it can produce the good in question at a lower absolute cost than its trading partner. It has a *comparative advantage* if it can produce the good in question more cheaply relative to other goods it produces than can its trading partners, regardless of absolute costs.

Initially economists thought that if one country produced all goods more cheaply than another, there was no basis for mutually advantageous trade between them—the more efficient country would only harm itself by trading with the less efficient country. David Ricardo demonstrated that this was not so—that both countries could benefit from trade even if one country had an absolute advantage in all tradable goods.¹ The key to understanding this is to focus on “comparative advantage” rather than absolute advantage.

Ricardo demonstrated this using a two-country, two-goods numerical example. We will retrace his logic using just such an example shortly. But first it is worthwhile to whet our appetite by noting how proud economists are of this result. Trade theorist R. Findlay referred to comparative advantage as the “deepest and most beautiful result in all of economics.”² Surveys have shown that about 95% of economists support the policy of “free trade.” MIT economist Paul Krugman said that “If there were an Economist’s Creed it would surely contain the affirmations ‘I believe in the Principle of Comparative Advantage,’ and ‘I believe in free trade.’”³ With that fanfare, let’s bring the comparative advantage argument onstage.

Consider a world in which we have two countries, A and B, each producing two goods, coal (C) and wheat (W). Since we want to demonstrate the gains from trade without appealing to absolute advantage, confining our reasoning only to comparative advantage, let’s impose on ourselves a veil of ignorance about absolute cost differences. Specifically, let’s say that country A measures costs in terms of a-units, and country B measures costs in terms of b-units, and that we know nothing about the relation of a to b. Perhaps $a > b$, or $a < b$, or $a = b$. Therefore, we cannot compare costs across countries, as required to know absolute advantage. But we can compare the cost of C and W within each country. The comparative or relative cost of W to C in country A can be calculated and compared to the comparative or relative cost of W to C in country B. That information will be sufficient to demonstrate the possibility of mutual gains from trade between A and B. The argument will depend only on comparative advantage (internal cost ratios), and not on cross country comparisons of cost (absolute advantage) because the latter have been made impossible by assuming incomparable units for measuring costs in the two countries. Table 17-1 summarizes the unit costs of C and W in A and B.

¹D. Ricardo, *On the Principles of Political Economy and Taxation*. 3rd edition. London: John Murray, Albemarle-Street, 1821 (originally published in 1817). Online: <http://www.systemics.com/docs/ricardo/principles.html>.

²R. Findlay, “Comparative Advantage.” In J. Eatwell et al., eds. *The New Palgrave: The World of Economics*, New York: Norton, 1991, p. 99.

³P. Krugman, Is Free Trade Passé? *Economic Perspectives* 1(2): 131 (1987).

■ **Table 17.1****UNIT COSTS OF COMMODITIES**

	Country A	Country B	Total Output
Coal	1a	1b	2C
Wheat	1a	4b	2W
Total Resources	2a	5b	

Each country needs both coal and wheat, so before trade, each country allocates its resources between the two commodities and produces as much of each as permitted by its unit costs, as shown in the table. A has total resources of 2a. With unit costs of both coal and wheat equal to 1a, it can produce one unit of coal and one unit of wheat with its endowment of 2a resources. Country B has a total resource endowment of 5b. B allocates 4b resources to produce one unit of wheat, and with the 1b remaining can produce one unit of coal. Total world output before trade is $2W + 2C$.

Ricardo has a look at this situation and realizes that we can do better by allowing specialization and trade according to comparative advantage. He notices that W is four times as expensive as C in country B, and only one time as expensive as C in country A. In country B coal is cheaper relative to wheat than it is in country A. Therefore B has a comparative advantage in coal. Similarly, wheat is cheaper relative to coal in country A than it is in B. Consequently A has a comparative advantage in wheat.

Now let each country specialize in the production of the commodity in which it has a comparative advantage and trade for the other commodity. A will specialize in wheat, allocating all of its 2a resources to wheat, and with a unit cost of wheat of 1a will end up producing 2W. B will allocate all 5b units of its resources to production of coal, and with a unit cost of coal of 1b will produce 5C. Total world product after specialization and trade is $2W + 5C$. The world has gained an extra 3C with no extra resources. The world is better off. And we have shown this without ever having to compare costs of wheat in country A with costs of wheat in country B, or costs of coal in country A with costs of coal in country B. Only comparative advantage (a difference in internal cost ratios) matters, not absolute advantage. Suppose we suddenly learned that in absolute terms $a = 5b$, so that country B has an absolute advantage in both C and W. Does that change our conclusion? Not a bit.

Although the world is better off by 3C, one might still wonder which country gets the 3C, or how it is divided between them. We can see that the world as a whole is better off, but how do we know that each country

is better off? Might not one country suffer while the other gains a lot? Ricardo had an answer. How the total gains from specialization and trade, $3C$, will be divided between A and B depends on the terms of trade, the relative price at which W exchanges for C between the two countries. That will depend on supply and demand and bargaining power, so we cannot say exactly how the gains will be divided. But we can be sure, says Ricardo, that neither country will be worse off after trade. How do we know this? Because, since trade is voluntary, neither country will accept terms of trade less favorable than the terms of its own internal cost ratio, the terms on which it can “trade with itself.” A will not trade $1W$ for less than $1C$, because it could do better by reallocating its own resources back from W to C again. Likewise B will not give more than $4C$ for $1W$. So the terms of trade will fall somewhere between the limits of $1C/1W$ and $4C/1W$. Anywhere between those ratios both countries gain a part of the extra $3C$.

■ KINKS IN THE THEORY

Ricardo’s demonstration is indeed interesting and impressive. To more than double coal production, with no sacrifice of wheat production and no additional resources, is a neat trick. Within the world of its assumptions, the logic of the comparative advantage argument is unassailable. But it is time to have a closer look at the assumptions. What are the assumptions, and might they veil some costs that need to be subtracted from the gain of $3C$?

First, it is not really true that the extra $3C$ is produced with no additional resources. There is the obvious increase in the rate of depletion of coal mines and of pollution resulting from burning the coal. What the trade economists mean by “no extra resources” is simply no additional labor or capital. Recall the neoclassical production function discussed earlier, in which output is a function only of labor and capital inputs. But, contrary to the neoclassical assumptions, the resource cost of extra output cannot simply be ignored. Therefore some deduction from the value of $3C$ is required to account for extra depletion and pollution. But let us assume that is done and there are still net gains from trade and specialization.

Second, we have neglected or abstracted from transport costs, implicitly assuming them to be zero. Wheat has to be shipped from A to B, and coal from B to A. If the energy costs of that transportation were $3C$ or greater then the world would gain nothing. It is worth noting that transportation is energy intensive, and currently energy is not only directly subsidized, but, in addition, many of its external costs are not internalized in its price. Consequently, international trade is indirectly subsidized by energy prices that are below the true cost of energy. But let us suppose that there is still a net gain from trade after deducting fully counted transport costs.

Third, we also assumed that in each country the cost of specialization was negligible. But there are two important costs to recognize. First, in A all coal miners must become wheat farmers, and in B all wheat farmers must become coal miners. Making such a shift is costly to all whose livelihood is changed. Also in the future the range of choice of occupation has been reduced from two to one—surely a welfare loss. Most people derive at least as much life satisfaction from how they earn their income as from how they spend it. Economists practically identify welfare with increased range of choice among commodities, but are strangely silent about the welfare effects of the range of choice among jobs. Second, after specialization countries lose their freedom not to trade. They have become vitally dependent on each other. One's access to essential items depends on the cooperation of people on the other side of the world, who, however, admirable they may be, have different customs, different values, different interests, and different types of government. Remember that the fundamental condition for trade to be mutually beneficial is that it be voluntary. The voluntariness of “free trade” is compromised by the interdependence resulting from specialization. Interdependent countries are no longer free not to trade and it is precisely the freedom not to trade that was the original guarantee of mutual benefits of trade in the first place.

True enough, as Ricardo pointed out, if the terms of trade become too disadvantageous the country getting the worse end of the deal can opt out and despecialize—put some of its wheat farmers back in the coal mines, reinvest in mining equipment, reactivate mining legislation, re-employ exporters and importers, and so on. But this is both costly and socially disruptive in reality. The model assumes specialization is reversible, while in fact it is closer to being irreversible—that is, reversible but at a high cost. Countries specializing in non-essential products—bananas, sugar, cocoa, and so on—are especially vulnerable to hardship from having lost their freedom not to trade. It is easier to drive a hard bargain if you are selling essentials and buying nonessentials than vice versa. Clearly there should be some further deduction from the 3C resulting from the above costs of specialization.

THINK ABOUT IT!

Many countries specialize in only one or few commodities for export. For example, Ecuador specializes in bananas, Ghana in cocoa, and Cuba in sugar. What happens to the price of these commodities when lots of other countries start producing them? What happens to the price when growing conditions produce a global bumper crop? What happens to export income for each country when some regions have great growing conditions, and other regions lousy ones? Look up price trends for these commodities. Do you think specialization in agricultural commodities is a good development strategy?

■ CAPITAL MOBILITY AND COMPARATIVE ADVANTAGE

But suppose we still have a net gain. Can we then conclude that the argument for free trade on the basis of comparative advantage holds true? In fact, there is an often-overlooked provision of the theory, one of great relevance today in the debate over globalization, that suggests that it does not hold true. Note that our numerical demonstration of comparative advantage implicitly assumes factor (labor and capital) immobility between country A and B. Only coal and wheat crossed borders. Labor and capital stayed at home and were reallocated domestically between coal and wheat according to the principle of comparative advantage. Since it is usually the capitalist who makes the investment allocation decisions let us just focus on capital and its mobility or lack thereof. Clearly our model implicitly assumes that capital is mobile between sectors within each country, but immobile between countries. Capitalists cannot even compare costs or profitability between A and B because, thanks to our veil of ignorance, they cannot compare a-units with b-units. Therefore they could not possibly know whether or not investment in the other country would be profitable or not.

One other way to show the implicit assumption of immobile capital in modern texts is to note that the examples, like ours, are usually in terms of barter—wheat for coal, with no money involved. Barter trade is always necessarily balanced. No monetary or short-term capital flows are required to balance the differences in exports and imports of bartered goods. The **current account** is the difference between the monetary value of imported and exported goods and services. If imports are greater than exports, the current account is in deficit. If exports are greater than imports, the current account is in surplus. **Capital accounts** are the difference between monetary flows, used to purchase various assets, into and out of a country. Such assets include stocks, bonds, real estate, and other assets that remain in the country. When more money flows into the country than out, the capital accounts are in surplus. The current account of the balance of payments is always balanced in barter, so there is no need for a compensating imbalance on capital account. Therefore, barter examples assume balanced trade, and balanced trade means no capital mobility.

Immobile capital does not mean that producer goods cannot be exchanged on current account. Machines and tractors, “materialist capital” can be traded just like shoes and sugar. What is immobile is capital in the “fundist” sense, money, or liens on the future product of the deficit country. Immobile capital in the fundist sense is the same thing as balanced trade on the current account, or trade that requires no compensating transfer of fundist capital on capital account. In other words, immobility

of capital does not prevent Brazil from importing machines and tractors and paying for them with exports of shoes and sugar. It just prohibits Brazil from importing machines and tractors *faster* than it can pay for them by exporting shoes and sugar, and thereby paying for the extra machines and tractors by issuing liens against its future production of shoes and sugar.

The capital immobility assumption is often hidden by examples in terms of individuals who specialize and trade, rather than nations. A favorite example is the lawyer and her secretary. The lawyer happens to be a champion speed typist. She has an absolute advantage over the secretary both in typing and of course in practicing law, since the secretary is not a lawyer. But the lawyer nevertheless finds it advantageous to hire the secretary to do the typing, and both benefit from this exchange. Although the lawyer is a better typist than the secretary, she is not much better. But she is a much better lawyer. So the secretary has a comparative advantage in typing (although an absolute disadvantage), and the lawyer has a comparative (and absolute) advantage in law. So they specialize according to comparative advantage. The lawyer is not so silly as to spend her time typing when she could be billing clients at \$300 per hour. Where is the assumption of capital immobility in this example? It is hidden by the obvious fact that it is impossible for the productive energy and capacity of the secretary to be transferred to the absolutely more efficient person of the lawyer. The lawyer is not a vampire that can suck the lifeblood and energy out of the hapless secretary in order to employ it more efficiently. In other words, productive capacity, “capital” is immobile between the lawyer and her secretary, so the logic of comparative advantage works.

Between countries, however, it is not impossible for productive capacity, capital, to be transferred from one country to another in response to absolute advantage. Capital mobility has to be explicitly ruled out for comparative advantage argument to work between countries. Although each country as a whole benefits under comparative advantage trade, not every citizen or group of citizens will benefit. Everyone could benefit, but only if winners were to compensate losers—that is, only if coal miners in B compensate wheat farmers, and wheat farmers in A compensate coal miners for the costs of changing their livelihood. As we move to absolute advantage (capital mobility internationally), some entire nations may lose, but the world as a whole will gain and could compensate the losing country, just as within countries the government could compensate the losing industry. Such compensation usually does not take place within nations, and almost never takes place between nations. Within nations there are at least institutions of community that could carry out internal transfers. At a global level there are no such

institutions. The move from comparative advantage to absolute advantage seems to be part of the general retreat from the Pareto to the Hicks-Kaldor (often referred to as “potential Pareto”) welfare criterion. The latter represents a retreat from the condition that no person be made worse off to the weaker condition that winners could, if they so choose, compensate losers and still be better off. Similarly, the former is a retreat from the condition that no nation be made worse off to the weaker condition that winning nations could compensate losing nations, if they choose to, and still be better off. In both cases the weaker criterion takes compensation as only potential, not actual, and in the case of trade the compensation condition is seldom even mentioned.

■ ABSOLUTE ADVANTAGE

Ricardo, to his credit, was very explicit about his assumption of immobile capital between countries. If capital were mobile internationally, it is obvious that capitalists would seek the greatest absolute profit and consequently the lowest absolute cost of production. In our example, if capital were mobile and the capitalists knew that $1a = 5b$, so that B had an absolute advantage in both coal and wheat, they would invest in B and forget about A. Comparative advantage would be irrelevant. If capital is mobile, absolute advantage is the relevant criterion. The only reason the capitalist would ever be interested in comparative advantage is if capital were immobile internationally. If capital cannot follow absolute advantage abroad, the next best thing is to follow comparative advantage specialization at home and trade for the foreign product. Comparative advantage is a clever second-best adaptation to the constraint of international capital immobility. But without that constraint, it has no reason to be, and absolute advantage is all that counts.

Why is the capital immobility assumption so important? Because it is utterly counterfactual in today's world. Capital is mobile all over the world in trillion dollar amounts at the speed of light.

Why is this overlooked? The nice thing about the comparative advantage argument is that both countries benefit from free trade, and gains are mutual—at least in theory, if not always in fact. The problem with absolute advantage is that both countries do not necessarily gain. If one country has an absolute disadvantage in both commodities, it will lose jobs and income as capital moves abroad. But under absolute advantage, world production will still increase. In fact, it would in theory increase by more than under comparative advantage. This is because in moving from comparative to absolute advantage, we relax a prior constraint on world product maximization—namely, the condition of capital immobility. Mo-

bile capital can seek out more productive opportunities than it could when it was confined to its country of origin. But while there is certainly a case for absolute advantage, it lacks the politically very convenient feature of guaranteed mutual benefit that was part of the traditional comparative advantage argument for free trade. All countries still could be better off if there were some regulatory institution whereby winners could compensate losers. But that would no longer be “free” trade. The focus of policy has shifted away from the welfare of nations to the welfare of the globe as a whole. And that brings us to the issue of globalization, or more specifically of globalization versus internationalization as alternative models of world community.

■ GLOBALIZATION VS. INTERNATIONALIZATION

Internationalization refers to the increasing importance of relations between nations: international trade, international treaties, alliances, protocols, and so on. The basic unit of community and policy remains the nation, even as relations among nations, and among individuals in different nations, become increasingly necessary and important.

Globalization refers to global economic integration of many formerly national economies into one global economy, by free trade, especially by free capital mobility, and also, as a distant but increasingly important third, by easy or uncontrolled migration. Globalization is the effective erasure of national boundaries for economic purposes. National boundaries become totally porous with respect to goods and capital, and increasingly porous with respect to people, viewed in this context as cheap labor, or in some cases cheap human capital.

Ricardo and the classical economists who argued for free trade based on comparative advantage were basically nationalists and retained their fundamental commitment to the nation even as they advocated internationalization.

In sum, globalization is the economic integration of the globe. But exactly what is “integration”? The word derives from *integer*, meaning one, complete, or whole. Integration means far more than “interdependence”—it is the act of combining separate albeit related units into a single whole. Integration is to interdependence as marriage is to friendship. Since there can be only one whole, only one unity with reference to which parts are integrated, it follows that global economic integration logically implies national economic disintegration—parts are torn out of their national context (disintegrated), in order to be reintegrated into the new whole, the globalized economy. As the saying goes, to make an omelet, you have to

break some eggs. The disintegration of the national egg is necessary to integrate the global omelet.

■ THE BRETTON WOODS INSTITUTIONS

At the end of World War II there was a conference of nations held in Bretton Woods, New Hampshire, for the purpose of reestablishing international trade and commerce, which had been disrupted by the war. The international diplomats and economists, led by John Maynard Keynes of England, and U.S. Secretary of the Treasury Henry Morgenthau and his aide Harry Dexter White, were successful in negotiating the charter that set up the **Bretton Woods Institutions**, the **International Monetary Fund (IMF)** and the **International Bank for Reconstruction and Development (World Bank)**. These two institutions are made up of member nations. They were founded on the federal model of internationalization, as just discussed, not the integral model of globalization. Their founding, almost 60 years ago, was a wonderful achievement of international cooperation and diplomacy. It symbolized the end of an era of economic depression followed by war and destruction, and the beginning of a hopeful era of peace and production in which “swords would be beaten into plowshares.”

The atmosphere of eager optimism was expressed by Morgenthau,⁴ who envisaged: “a dynamic world economy in which the peoples of every nation will be able to realize their potentialities in peace . . . and enjoy, increasingly, the fruits of material progress on an earth infinitely blessed with natural riches.” Morgenthau went on to say that “prosperity has no fixed limits. It is not a finite substance to be diminished by division.” The same note was sounded by Keynes: “In general, it will be the duty of the Bank, by wise and prudent lending, to promote a policy of expansion of the world’s economy. . . . By expansion we should mean the increase of resources and production in real terms, in physical quantity, accompanied by a corresponding increase in purchasing power.” The “empty world” vision of the economy was dominant. Notions of ecological limits to growth were not on the horizon, much less on the agenda. The founders of the Bretton Woods Institutions felt that they had far more pressing issues to deal with in 1945, and they were surely right. But the world has changed a lot in 60 years. Population has roughly tripled, and resource throughput has increased more than ninefold,⁵ moving us a long way from the “empty” toward the “full” world.

⁴Morgenthau and Keynes quotes are from B. Rich, *Mortgaging the Earth*, Boston: Beacon Press, 1994, pp. 54–55. For an interesting history of the Bretton Woods Conference see also the biography of Keynes by R. Skidelsky, *John Maynard Keynes*, Vol. III, “Fighting for Freedom, 1937–1946,” New York: Viking Press, 2000.

⁵Calculated from data in J. B. Delong, *Macroeconomics*, Burr Ridge, IL: McGraw-Hill, 2002, chap. 5. The data are labeled GNP, but in the text Delong refers to it as “material output,” what

The division of labor between these institutions was that the IMF would focus on short-term balance-of-payments financing (the current account of the balance of payments), while the World Bank would concentrate on long-term lending (the capital account).⁶ The word “reconstruction” in the World Bank’s proper name referred to reconstruction of war-torn countries. That function, however, was largely taken over by the Marshall Plan, leaving the World Bank to focus almost entirely on lending for the development of underdeveloped countries.

One of Keynes’ ideas, rejected by the conference in favor of the present IMF, was for an International Clearing Union for settling trade balances. In Keynes’ plan, all trading countries would have an account with the Clearing Union, denominated in an international monetary unit called the “bancor,” which would be convertible into each national currency at a fixed rate, like gold. Clearing of accounts would be multilateral; that is, if country A had a surplus with B and a deficit with C, and the two partially cancelled out, then A would have to settle only the difference with the Union.

The innovative feature of Keynes’ plan was that interest would have to be paid to the Union on credit balances as well as debit balances, at least when the balances exceeded a certain amount. In other words, there would be a penalty for running a balance of trade surplus, as well as for running a deficit. All nations would have an incentive to avoid both a surplus and a deficit, to balance their trade accounts, leading to less international debt and reduced capital flows. We think this proposal merits reconsideration today. It is superior to massive IMF bailouts of debtor countries that continue to run trade deficits. It also puts pressure on countries, like Japan, that are addicted to running huge trade surpluses.

■ THE WORLD TRADE ORGANIZATION

The **World Trade Organization (WTO)** is of more recent birth than the IMF and World Bank, having its origins in the General Agreement on Trade and Tariffs (GATT) rather than in the Bretton Woods conference.⁷ The purpose of GATT was to reduce tariffs and other barriers to international trade. The WTO is frequently lumped together with the World Bank and IMF, however, because the three institutions have common

we call throughput. There is not a 1:1 correlation between GNP and throughput, but Delong’s figures show a nearly tenfold increase in GNP from 1950 to 2000. A ninefold increase in throughput from 1945 to the present is probably in the ballpark.

⁶Current accounts and capital accounts are described in detail in Chapter 18.

⁷An international trade organization was proposed at Bretton Woods but was ultimately rejected by the U.S. and replaced by GATT.

policy goals of free trade, free capital mobility, and export-led growth—in other words, globalization. To the extent that the World Bank and the IMF push a policy of globalization, they run into conflict with the internationalist model of world community underlying their charter, a model very different from that of globalization, as we have already emphasized. The WTO's commitment to globalization is evident in the statement of its former director-general, Renato Ruggiero: "We are no longer writing the rules of interaction among separate national economies. We are writing the constitution of a single global economy."⁸ This is a clear affirmation of globalization and rejection of internationalization as defined earlier. Of course, different directors-general may alter policies.

But meanwhile, if the IMF-WB are no longer serving the national interests of their member countries, according to their charters, whose interests are they serving?

What are the advantages of an internationalized economic system over a globalized one? One is that nation-states that can control their own boundaries are better able to set their own monetary and fiscal policy, as well as such things as environmental standards and a minimum wage. Markets hate boundaries, but policy requires boundaries.

It is worth remembering that international free trade is not really trade between nations, but rather trade between private firms or individuals residing in different nations. Their transactions are carried out for the private benefit of the contracting parties, not for the larger benefit of their national communities. The policy of free trade represents the assumption that if these transactions benefit the private contracting parties, then they will also benefit the larger collectives (nations) to which each party belongs. "What's good for General Motors is good for the USA," to recall a famous statement.

Let's apply the assumption to another collective, the corporation. Do corporations allow their individual employees to freely contract with employees of another corporation in pursuit of their own self-interest? This happens, but if the employees are caught, they are usually sent to jail. All transactions initiated by employees are supposed to be in the interests of the corporation, not the employee, and must be judged so by officers of the corporation. Corporations regulate the trades negotiated by their employees. Why should nations not regulate trade negotiated by their citizens? Advocates of an internationalized economy argue that nations must have the ability to regulate their corporate citizens, just as a corporation regulates the behavior of its employees.

⁸From a speech to the United Nations Conference on Trade and Development's (UNCTAD) Trade and Development Board in October 1996. Online: <http://r0.unctad.org/en/special/tb43pr05.htm>.

Advocates of a globally integrated economy argue that nations are obsolete, and that they have been responsible for two world wars in the twentieth century. True enough, it is important to remember the real evils of nationalism. We agree with the Bretton Woods delegates, however, that the answer to nationalism is internationalism, not globalism. “A world with no boundaries” is a good song lyric, but taken literally, it makes policy in the interest of local community impossible. We see world community as a community of local and national communities—as a community of communities. Consequently, the problems we see with the Bretton Woods Institutions arise not from their historical charter, but from their institutional tendency to forget their charter and substitute globalism for internationalism.

■ SUMMARY POINTS

What are the critical points to take home from this chapter? First, globalization is entirely different from internationalization. Under globalization, all national economies are integrated into one global economy and must obey the laws laid down by a global economic institution—currently the WTO. Under internationalization, relations between countries grow increasingly important, but the nation remains the basic unit of community and policy.

Second, the concept of comparative advantage is largely irrelevant in a world of mobile financial capital. We must instead look at absolute advantage. While absolute advantage is likely to lead to greater overall gains, it will also produce both winners and losers on an international level. Without the elegant theoretical conclusion of comparative advantage that free trade is a win-win affair for all countries, it is necessary that we look at the empirical evidence regarding each country’s absolute advantage to determine winners and losers under a regime of global integration. In the next chapter, we focus on globalization and its likely consequences.

BIG IDEAS to remember

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|---|---|
| ■ Comparative vs. absolute advantage | ■ Globalization vs. internationalization |
| ■ Capital mobility and comparative vs. absolute advantage | ■ Bretton Woods Institutions (IMF and World Bank) |
| | ■ World Trade Organization (WTO) |



Globalization

Why are so many smart people such ardent advocates of globalization? Mainly, it is because **globalization** results in more efficient use of resources, resulting in faster rates of global economic growth. But there are other consequences, also intended: (1) an increase in international competition, in which countries must compete against each other for a share of global markets; (2) more intense national specialization according to the dictates of competitive (not comparative) advantage; (3) worldwide enforcement of “trade-related intellectual property rights”; and (4) control over local and national affairs by an international institution. Empirical evidence suggests another important consequence, an unintended one: an increased concentration of wealth within and between countries. It is this last consequence, perhaps, that has sparked the strongest opposition to globalization.

In this chapter we look at each of these consequences in a bit more detail within the context of the policy goals of ecological economics: efficient allocation, just distribution, and sustainable scale.

■ EFFICIENT ALLOCATION

Advocates of globalization claim that free trade is efficient, producing the much-touted “gains from trade.” But efficiency depends on a number of critical assumptions and conditions, including these:

1. There must be a large number of nearly identical firms.
2. Information must be relatively freely shared.
3. There must be strong incentives to internalize costs.

Are the conditions for efficient production being met? We address this question for each condition listed above. We also ask whether

globalization maintains the opportunity for satisfying employment, and the role that opportunity plays in enhancing human welfare.

Perfect Competition vs. Transnational Corporations

The assumption of perfect competition, which requires a very large number of nearly identical firms, is a cornerstone of neoclassical economic theory. Perfect competition weeds out the inefficient and ensures the efficient allocation of resources within both national and international markets.

Globalization forces firms to compete against other firms worldwide. However, in general, only very large businesses have the resources to enter foreign markets. WTO rules actively forbid countries from promoting national small businesses if this can be construed as discrimination against large foreign corporations. Large corporations with economies of scale, or willing to accept low profits in an effort to gain market share, can easily underprice local businesses and either bankrupt or acquire them, thereby reducing the total number of firms. In fact, global mergers and acquisitions have been most intense in the areas of financial services and telecommunications, precisely those economic sectors in which WTO agreements have been completed.¹

Global competitiveness may therefore be incompatible with market competition in a given nation. As a rule of thumb, many economists agree that if 40% of a given market is controlled by four firms, the market is no longer competitive. Such concentration is not at all unusual in the agricultural sector: in the U.S. Midwest, four firms control well over 40% of the trade in most major agricultural commodities,² and the top four agrochemical corporations reportedly control over 55% of the global market.³ Nonetheless, in 1999 the U.S. government approved the merger of the two largest international grain trading corporations, Cargill and Continental Grain, in spite of explicit concerns that the merger might result in monopsony power⁴ (over 80% of international trade is controlled by only ten firms⁵). Ironically, the U.S. assistant attorney general in charge of re-

¹L. Wallach and M. Sforza, *Whose Trade Organization?: Corporate Globalization and the Erosion of Democracy*, Washington, DC: Public Citizen, 1999.

²W. Heffernan, Report to the National Farmers Union: Consolidation in the Food and Agriculture System, Columbia: University of Missouri, 1999. Note that it can be very difficult to assess market concentration.

³Action Group on Erosion, Technology and Concentration, Concentration in Corporate Power: The Unmentioned Agenda, ETC communique #71, 2001. Online: http://www.rafi.org/documents/com_globlization.pdf.

⁴Monopoly is a single seller, and monopsony is a single buyer. In this case, the U.S. Department of Justice was more concerned about prices to farmers than prices to consumers.

⁵G. van Empel and M. Timmermans, "Risk Management in the International Grain Industry." In *Commodities Now*, December 2000. Online <http://www.commodities-now.com/cnonline/dec2000/article3/a3-pl.shtml>.

viewing the merger reportedly suggested that even more consolidation would be required to maintain the competitiveness of American agriculture in global markets.⁶

If mergers are indeed required for firms to remain “competitive” in a global economy, will this lead to a more efficient allocation of resources? As Chicago School economist and Nobel laureate Ronald Coase pointed out, firms are islands of central planning in a sea of market relationships.⁷ The islands of central planning become larger and larger relative to the remaining sea of market relationships as a result of mergers. More and more resources are allocated by within-firm central planning, and less by between-firm market relationships. Of the 100 largest economic organizations, more than half are corporations. One-third of the commerce that crosses national boundaries does not cross a corporate boundary; it is an intra-firm, nonmarket, transfer. Is there any reason that central planning should work better for a large corporation than it does for a nation?

Patents and Monopolies

At the global scale, intellectual property rights are tied to trade. Why? It is hard to trade property if the legal right to the property is in dispute. As a result, the Agreement on Trade Related Aspects of Intellectual Property (TRIPs) requires all WTO signatories to protect intellectual property rights (IPR) for 20 years,⁸ with violators subject to trade sanctions and fines.

In chapter 10, we discussed two major inefficiencies associated with patents. First, information is a nonrival good, and making it excludable leads to inefficiencies. Second, patents are nothing more than temporary monopolies, and monopolies are inherently inefficient. We also discussed the counterargument for patents, that unless we provide the economic incentive of monopoly ownership for a significant period of time (20 years, they suggest), little new knowledge and innovation will be forthcoming.

THINK ABOUT IT!

Do you remember why it is inefficient to make nonrival goods excludable? Do you remember why monopolies are inefficient?

Although patents have existed in England since the seventeenth century, in the United States and France since the 1790s, and in most of Europe since the 1880s, international patents are a fairly recent

⁶Reported in A. Cockburn, and J. St. Clair, “How Three Firms Came to Rule the World.” In *Counterpunch*, November 20, 1999. Online: www.counterpunch.org. A competitive market is defined as one with enough firms that all firms are price takers and none are price makers. Mergers in highly concentrated markets by definition make those markets less competitive, not more.

⁷R. Coase, The Nature of the Firm, *Economica* 4(16): 386–405 (1937).

⁸Wallach and Sforza, op. cit.

phenomenon. They have been practical only since the International Patent Institute was established at the Hague in 1947. Until the 1980s, patents played a relatively unimportant role in international commerce. Empirically it seems to be the burst of inventions that has stimulated demand for greater patent protection, more than vice versa.

In 1790 Samuel Slater, the “Father of American Industry,” essentially stole the design for the first American textile factory from Richard Arkwright, the English industrialist.⁹ Currently corporations and individuals from developed countries own 97% of all patents, and the WTO provides mechanisms for enforcing these patents globally. Is this likely to encourage or discourage a new Samuel Slater, a father of industry in a country that truly needs it? At the very least, it is difficult to argue that technology has foundered so much since the 1970s that we need a substantial expansion of patent protection under the WTO to stimulate its advance.

THINK ABOUT IT!

Make a list of the most important contributions, discoveries, or inventions in your major field of study. How many of them were motivated by patentability of intellectual property? There might be interesting differences between fields of study.

As economist Joseph Schumpeter emphasized, being the first with an innovation already gives one a temporary monopoly by virtue of novelty. In his view, these recurring temporary monopolies were the source of profit in a competitive economy whose theoretical tendency is to compete profits down to zero. This is the very condition of economic efficiency—why thwart it?

This is not to say that we should abolish all intellectual property rights. Such an action would create more problems than it would solve. But we should certainly begin restricting the domain and length of patent monopolies rather than increasing them so rapidly and recklessly. And we should become much more willing to share knowledge. Shared knowledge increases the productivity of all labor, capital, and resources—things that are inherently scarce, rival, and excludable. Knowledge is not inherently scarce and is the quintessential public good—nonrival and nonexcludable—even though patents make it artificially excludable.

One important and practical policy implication of these considerations is that international development aid should consist far more of freely shared knowledge, and far less of foreign investment and interest-bearing loans. Let’s recall the following words from John Maynard Keynes, one of the founders of the Bretton Woods Institutions:

⁹The Story of Samuel Slater, Slater Mill Historic Site, Website, <http://www.slatermill.org/html/history.html>.

Box 18-1**DISCOVERIES NOT MOTIVATED BY PATENT
MONOPOLY PROFITS**

No doubt many important inventions have been stimulated by patent rights. However, the heliocentric view of the universe, gravity, the periodic table of elements, electromagnetic theory, as well as the laws of optics, mechanics, thermodynamics, and heredity were all discovered without the benefit of intellectual property rights and the profit motive. Mathematics has been called the language of the universe. Where would our technology be without it? While no culture has ever allowed a patent on mathematical theorems, mathematicians keep producing new ones.^a Nor has anyone ever had intellectual property rights to the English language, or to fire, the wheel, or money. Yet all these things somehow came into being. The invention of the shipboard chronometer, necessary for navigational calculation of longitude, was stimulated by a one-time prize, not a 20-year patent monopoly. Even economists work long and hard to produce economic theories that are not patentable. Alfred Marshall got no royalties from users of supply and demand and elasticity. J. R. Hicks expected no royalties, and got none, for developing the IS-LM model, and the proper concept of income.

In fact, it is difficult to name a single modern invention that does not depend on ideas freely shared from their first conception. While patent rights have stimulated important inventions, that is less than half the story. In the words of Lawrence Lessig:

Free resources have always been central to innovation, creativity and democracy. The roads are free in the sense I mean; they give value to the businesses around them. Central Park is free in the sense I mean; it gives value to the city that it centers. A jazz musician draws freely upon the chord sequence of a popular song to create a new improvisation, which, if popular, will itself be used by others. Scientists plotting an orbit of a spacecraft draw freely upon the equations developed by Kepler and Newton and modified by Einstein. Inventor Mitch Kapor drew freely upon the idea of a spreadsheet—VisiCalc—to build the first killer application for the IBM PC—Lotus 1-2-3. In all of these cases, the availability of a resource that remains outside of the exclusive control of someone else—whether a government or a private individual—has been central to progress in science and the arts. It will also be central to progress in the future.^b

^aD. S. Evans, *Who Owns Ideas? The War Over Global Intellectual Property*, *Foreign Affairs* 81(6): 160–166 (November/December 2002).

^bL. Lessig, *The Future of Ideas: The Fate of the Commons in a Connected World*, New York: Random House, 2001. Online: <http://music.barrow.org/2002/Q3/free/page3.htm>.

*I sympathize therefore, with those who would minimize, rather than those who would maximize, economic entanglement between nations. Ideas, knowledge, art, hospitality, travel—these are the things which should of their nature be international. But let goods be homespun whenever it is reasonably and conveniently possible; and, above all, let finance be primarily national.*¹⁰

Externalizing Costs

As we also discussed in Chapter 10, a necessity for efficient markets is that producers pay the costs of production, and they produce to the point where marginal costs are just equal to marginal benefits. This condition is not met when externalities exist, and there are several ways in which economic globalization increases the quantity and severity of externalities.

The goal of the WTO is to increase economic growth and the transport of goods between countries, and both growth and fossil fuel-based transportation are accompanied by significant externalities. At the national level, laws exist to reduce externalities, but the WTO has the power to challenge these laws, and the ability to enforce its decisions. While technically countries are allowed to pass environmental legislation, the WTO frequently declares such laws barriers to trade, and even the threat of a WTO ruling can deter lawmakers. For example:

1. Challenged by Venezuela, the United States was forced to allow the import of gasoline that does not comply with U.S. Clean Air Act regulations.
2. The WTO ruled against the U.S. Endangered Species Act, which prohibits the import of shrimp from countries that do not mandate turtle excluder devices.
3. Under GATT, Mexico won a decision against the U.S. Marine Mammal Protection Act's dolphin-safe tuna provision. Under threats by Mexico of WTO enforcement action, President Clinton and Vice President Gore took the lead in getting Congress to weaken the offending law.
4. Australia's law strictly limiting the import of raw salmon, designed to prevent domestic stocks from contamination with foreign bacteria, was declared a barrier to trade. Scientific studies showed that the risk of infection existed, but the WTO ruled that the probability of infection also had to be shown to justify import restrictions.¹¹

¹⁰J. M. Keynes, "National Self-Sufficiency." In Donald Muggeridge (ed.), *The Collected Writings of John Maynard Keynes*, vol. 21. London: Macmillan and Cambridge University Press, 1933.

¹¹Unfortunately, many of the ecosystem goods and services threatened by economic growth and free trade are characterized by uncertainty and ignorance, in which case by definition probabilities of possible outcomes cannot be determined.

In each of these cases, the overturned regulations had been put in place by relatively democratic governments to reduce negative externalities affecting nonmarket goods and services. A number of other environmental laws are currently threatened by the WTO.¹²

Standards Lowering Competition

At the same time that the WTO makes it difficult for countries to legislate against externalities, the need to compete for market share reduces national incentives to legislate against externalities in what is known as standards-lowering competition (a race to the bottom). The country that does the poorest job of internalizing all social and environmental costs of production into its prices gets a competitive advantage in international trade. More of world production shifts to countries that do the poorest job of counting costs—a sure recipe for reducing the efficiency of global production. As uncounted, externalized costs increase, the positive correlation between GDP growth and welfare disappears, or even becomes negative. Recall the prescient words of John Ruskin: “That which seems to be wealth” becomes in verity the “gilded index of far reaching ruin.” The first rule of efficiency is “count all the costs,” not “specialize according to comparative advantage.”¹³

One way to confront the race-to-the-bottom tendency is to argue for harmonization of cost-accounting standards across countries. This is certainly logical and in line with global integration. If all countries internalized external social and environmental costs to the same degree, there would be no incentive for mobile capital to move to the country that did not internalize these costs because such countries would not exist. It would be hard to negotiate such a global harmonization agreement. There are, in fact, good reasons why different countries have different cost-accounting practices. In any case, it might be argued that countries should measure costs according to their own values, not “international standards.” The traditional comparative advantage argument is compatible with each country’s measuring costs as it pleases. As we saw in Table 17.1, a-units and b-units, which might reflect totally different theories of value, need never be compared in the comparative advantage system. But with capital mobility and absolute advantage comes the necessity to compare a-units to b-units, and the problem of standards-lowering competition to attract mobile capital.

¹²All examples are from Wallach and Sforza, op. cit.

¹³J. Ruskin, “Unto This Last.” Online: <http://www.nalanda.nitc.ac.in/resources/english/etext-project/economics/Ruskin.pdf>.

Box 18-2 WEALTH, POWER, AND EFFICIENCY

Another potential problem with economic globalization is an increase in rent-seeking behavior in the form of lobbying by large corporations and wealthy individuals to influence policy.^a If large corporations are “islands of central planning,” showing less growth than smaller corporations probably as a result of the inefficiencies of central planning, why do they continue to thrive? One possibility is that the concentrated wealth of large corporations readily translates into political power, and large corporations can use this power to promote policies that allow them to thrive in spite of any inefficiencies inherent to centrally planned economies.

Large corporations routinely help politicians set not only domestic rules of the game but also international rules. The trade advisor to President Nixon was a vice president of Cargill, the world’s largest grain exporter. President Reagan relied on a Cargill employee to draft the U.S. agricultural proposal for GATT.^b President Clinton appointed Monsanto CEO Robert Shapiro as a trade representative to the WTO. President George W. Bush relied on Enron CEO Kenneth Lay when designing energy policies. The WTO meetings in Seattle in 1999 were primarily sponsored by large corporations. Can we be sure that this advice and assistance come with no strings attached?

^aRecall that rent is profit over and above the normal profits of operation.

^bK. Lehman and A. Krebs, “Control of the World’s Food Supply.” In Mander and Goldsmith, eds. *The Case Against the Global Economy*, San Francisco: Sierra Club Books, J. Mander and E. Goldsmith (1996).

Specialization and Diminished Well-Being

If an important goal of economic systems is to increase human well-being, then the specialization accompanying globalization is another source of inefficiency. Free trade and free capital mobility increase pressures for specialization according to competitive (absolute) advantage. Therefore, as noted earlier, the range of choice of ways to earn a livelihood becomes greatly narrowed. In Uruguay, for example, everyone would have to be either a shepherd or a cowboy in conformity with the dictates of competitive advantage in the global market. Everything else should be imported in exchange for beef, mutton, wool, and leather. Any Uruguayan who wants to play in a symphony orchestra or be an airline pilot should emigrate.

Most people derive as much satisfaction from how they earn their income as from how they spend it. Narrowing that range of choice is a welfare loss uncounted by trade theorists. Globalization assumes either that

emigration and immigration are costless or that narrowing the range of occupational choice within a nation is costless. Both assumptions are false.

While the range of choice in earning one's income is ignored by trade theorists, the range of choice in spending one's income receives exaggerated emphasis. For example, the United States imports Danish butter cookies and Denmark imports U.S. butter cookies. The cookies cross each other somewhere over the North Atlantic. Although the gains from trading such similar commodities cannot be great, trade theorists insist that the welfare of cookie connoisseurs is increased by expanding the range of consumer choice to the limit.

Perhaps, but could not those gains be had more cheaply by simply trading recipes? One might think so, but recipes (trade-related intellectual property rights) are the one thing that free traders really want to protect.

■ SUSTAINABLE SCALE

While globalization advocates laud efficiency, their goal is not simply more efficient production of what we now produce, but rather ever greater production. If the sole purpose or even the major priority of international trade is to promote growth in GDP with little or no attention paid to scale, in the long run, a “successful” trade regime will lead us beyond the sustainable scale for the global economy. This is true no matter how efficient the allocation of resources between countries. It should already be clear that greater externalities and standards lowering competition pose threats to sustainable scale.

Two other issues bear mentioning. First, the integration into one global system gives us only one chance to see if the system works—we cannot learn from our mistakes. Second, the negative environmental impacts of our consumption may occur in another country, where they are that much more likely to be ignored.

Learning from Our Mistakes

In the past, numerous civilizations have crumbled as they have surpassed ecological barriers. Examples are the civilization on Easter Island, the Mayan empire, and the early civilizations of the Fertile Crescent. Fortunately, these were isolated incidents in which only the local carrying capacity was overwhelmed, and today they can serve as examples of mistakes we cannot afford to make. However, as trade expands, local limits to scale become less relevant and global limits more so. While trade may decrease the chances of surpassing sustainable scale in any one area, it also means that if we do surpass it, we are more likely to do so for the planet as a whole. Consequently, it becomes more difficult to learn from

our mistakes as we go. Thus, globalization requires us to get it right the first time.

Out of Sight, Out of Mind

Even if globalization did not lead countries with high environmental standards to lower them, international trade can make it easier to ignore the costs of economic growth. In recent decades, as the most developed nations saw their environments deteriorating, they passed laws to control some types of pollution and resource depletion. To some extent this led to greater efficiency, decreased consumption of polluting products, and improved technologies for controlling pollution, but in many cases it seems to have led to the relocation of polluting and resource extracting industries to countries without such laws.¹⁴ The environments in the developed countries improved at the expense of the poorer countries. With the spatial connection between economic growth and environmental damage severed, many people seem to believe that the causal connection has been severed as well. Indeed, many economists now claim that environments in the developed countries improved precisely because of economic growth.

In reality, the net impact of relocation of environmentally damaging industries on scale can be highly negative. For example, when Australia's wet tropical rainforests were declared a World Heritage site (largely due to pressure from environmentalists) and the region's reasonably well-managed logging operations were shut down, total timber consumption in Australia did not decrease. Instead, Australia has substituted its own tropical timber supply with timber from tropical countries with worse logging practices. The net outcome is likely a greater loss of ecosystem services worldwide.

Similar, and perhaps more threatening, is the relocation of waste from toxic industries. Russia is currently discussing the establishment of nuclear and toxic waste processing facilities. These facilities will allow the overdeveloped countries to reduce further degradation of their environments.¹⁵ However, they may well result in less careful waste disposal than would have occurred in the country where the waste originated. In this case, simply transporting the wastes would increase the danger of negative environmental impacts.

We already know that markets fail to signal many environmental costs. In a democracy, when people are exposed to environmental externalities,

¹⁴D. Rothman, Environmental Kuznets Curves—Real Progress or Passing the Buck? A Case for Consumption-Based Approaches, *Ecological Economics* 25: 177–194 (1998).

¹⁵Overdeveloped countries are defined as those whose level of per-capita resource consumption is such that if generalized to all countries could not be sustained indefinitely. See H. Daly, *Beyond Growth: The Economics of Sustainable Development*, Boston: Beacon Press, 1996.

they can signal their preferences through political institutions. If people in the developed democracies export their wastes or environmentally damaging industries to less democratic countries, we lose this signal of environmental scarcity. The first rule of cost internalization is to internalize costs to the firm that generates them. If we fail to do this, then we must at least internalize costs to the country under whose laws the firm was operating when it generated the externalities. The second rule could be enforced by prohibiting the export of toxic waste.

Positive Aspects of Trade with Respect to Scale

We have thus far presented an incomplete picture of the impacts of globalization on scale. In the absence of international trade, appropriate scale (in terms of economic activity and human populations) would be determined at the national level and by the most limiting factor. For example, one country might have abundant agricultural land but inadequate mineral resources. In other countries, scale might be limited by land area, mineral resources, or fuel supplies, in yet others by waste absorption capacity, rainfall, or agricultural productivity. International trade can help alleviate the most limiting constraints on scale within each country. If international trade suddenly ceased, some countries would find themselves well beyond sustainable scale, and even beyond desirable scale in the short term.¹⁶

Efforts to sustain a high standard of living for too large a population with limited resources would no doubt force some countries to liquidate natural capital—for example, extend the agricultural frontier to lands that cannot sustain it, or burn their forests to meet energy needs. Other countries might be forced to mine low-quality, highly polluting fossil fuels.

International trade can help sustain larger populations with higher levels of material consumption than isolated national economies alone could sustain. Unfortunately, this happy outcome is likely only if sustainable scale and equitable distribution are explicit and are the principal goals of international trade. It is more likely to occur under internationalization than globalization.

■ JUST DISTRIBUTION

Finally, we turn to the impact of globalization on distribution. Proponents of globalization claim that it will bring about “a world free of poverty” (the professed goal of the World Bank). Will globalization achieve this goal?

¹⁶Surpassing sustainable scale means that the sustaining ecological system must eventually collapse, and surpassing short-term desirable scale means that the costs of additional growth outweigh the benefits for the current generation.

Next we examine the empirical evidence and explore some theoretical reasons that trade liberalization might not reduce poverty. We conclude with a brief look at the most important of commodities—food.¹⁷

Absolute Disadvantage

In the presence of capital mobility, money will logically flow to wherever there is an absolute advantage of production. The world's poorest countries may be poor precisely because they are inefficient at producing nearly everything. If this is true, then the countries most likely to suffer from globalization are in fact the very poorest.

Does this conclusion have any empirical support? According to the IMF, most developing countries have failed to raise their per-capita incomes toward those of industrial countries. United Nations Development Programme statistics show that in the three decades prior to 1996, the share of income received by the world's poorest 20% fell from 2.3% to 1.4%, while the share going to the world's richest 20% increased from 70% to 85%. Still, these statistics refer only to relative income, not absolute income. The world's poorest 20% have seen some gains in income over the past 40 years.¹⁸ Globalization on a significant scale, however, is a fairly recent phenomenon. What has happened to the poorest of the poor more recently?

Using the World Bank's Global Development Network Growth Database,¹⁹ we calculated the average increase in per-capita income from 1989 to 1999 for the 15 poorest countries at the start of that period²⁰ for which data are available.²¹ All of these countries are sub-Saharan African nations, and with the exception of natural resource endowments in some of them, they have few absolute advantages in global competition. We found that real per-capita income in these countries (as measured by GDP) ac-

¹⁷In spite of the recent trend toward privatization of water, we do not consider water a commodity. Water is not produced for sale; it is produced by nature. Privatization is basically an enclosure of the commons, and a very inefficient one since it invariably creates a monopoly. (How many different water companies can you buy water from? How many water lines lead into your house?)

¹⁸E. Kapstein, "Distributive Justice as an International Public Good: A Historical Perspective." In I. Kaul, I. Grunberg, and M. Stern, eds. *Global Public Goods: International Cooperation in the 21st Century*. New York: Oxford University Press, 1999.

¹⁹W. Easterly and M. Sewadeh. Online: <http://www.worldbank.org/research/growth/GDNdata.htm>.

²⁰Per-capita incomes are measured in real GDP in 1989. We conservatively used 1989 instead of 1999, as the later date would automatically select for countries that were less likely to have experienced growth.

²¹Ethiopia, Chad, Democratic Republic of the Congo, Niger, Burkina Faso, Malawi, Burundi, Tanzania, Uganda, Mali, Comoros, Central African Republic, Myanmar, Togo, Madagascar, and Guinea-Bissau.

tually *decreased* by an average of 5.5% over that period. Concerned that war in two of these countries might bias results, we looked at the 15 poorest countries that had not experienced war.²² We still found that these countries suffered on average a 3.2% *decrease* in income. In contrast, the wealthiest 15 countries in 1989 experienced an average increase in per-capita income of 15.5% by 1999. In absolute terms, the same amount of money required to boost per-capita income in the U.S. by 1% would double the per-capita income of the 24 poorest countries (for which we have data) in the world today.

If we lived on an infinite planet in which one person's consumption had no impact on anyone else, and if human nature did not lead us to measure our wealth in comparison to others, it would make no difference to the poor countries what happened in the wealthy ones. The fact is, however, that we do live on a finite planet. The increase in income in the wealthy countries is fueled by nonrenewable resource consumption (including nonsustainable depletion of potentially renewable resources), which means that these resources are not available for future improvements in the well-being of the poorest. And resource use generates a corresponding amount of waste and accompanying damage to public good ecosystem services that would otherwise benefit these poorest countries.

This observation draws our attention to a fact otherwise obscured by the data. Most of these poorest countries were involved in international trade in the one area where they might have an absolute advantage: the extraction and export of natural capital. The revenue they received from both export and domestic sales of these resources counted as part of their income. Without this revenue, income as measured by GDP would have fallen even more. Yet as you will recall, we earlier defined income as the amount you can consume in one period without affecting your ability to consume in subsequent periods. Thus, revenue from nonrenewable natural resource extraction cannot be counted entirely as income, and the situation of these poorest countries is even worse than it appears.

Of course, the evidence presented here says nothing conclusive about globalization. One could argue, as economists often do, that the problem was insufficient liberalization. Perhaps things would have been even worse in the poorest countries without globalization. What happened in the countries that most avidly pursued economic liberalization?

Many countries have shown periods of economic growth as their economies have liberalized. For example, Argentina was considered one of the most avid converts to economic liberalization in Latin America in recent years, and in real terms, per-capita income increased by over 40%

²²We dropped Ethiopia and the Democratic Republic of the Congo and replaced them with Zambia and Guinea.

from 1990 to 1998.²³ Yet between 1987 and 1997, the income gap between the richest 10% and the poorest 10% increased from 15 to 1 to 24.8 to 1. The proportion of people in urban areas living below poverty fell for the first few years of the 1990s, coinciding with the control of inflation, but from 1993 to 1998, poverty rates increased from 27.3% to 35.8%. With the collapse of the economy in December 2001, poverty rates soared to over 50%. For Latin America as whole, trade liberalization has been accompanied by an increasing income gap between the richest 10% and the poorest from 37 to 1, already the worst in the world, to 48 to 1. Poverty rates in Mexico, Argentina, and Venezuela, among others, have soared over the last 7 years.²⁴ Just as importantly, the growth that has occurred there has been marked by intense instability resulting from the volatility of international capital flows, as we will discuss below.

While there is no proof that globalization has been the culprit in this decline, there is even less evidence that globalization is a cure for poverty.

Standards Lowering Competition and Labor

We discussed above how countries pressured by global competition may ignore external costs to the environment in a race to the bottom. To remain competitive, countries may similarly need to accept or even promote lower labor costs.

In the United States and Europe, an implicit social contract has been established to ameliorate industrial strife between labor and capital. Specifically, a just distribution of income between labor and capital has been taken to be one that is more equal within these countries than it is for the world as a whole. Global integration of markets necessarily abrogates that social contract. There is pressure on American and European wages to fall because labor is relatively much more abundant globally than nationally. By the same logic, returns to capital in these countries should increase because capital is relatively more scarce globally than nationally. This could lead U.S. income distribution, already approaching Third World ranges of inequality, to become even more unequal. Theoretically, one might argue that wages would be bid up in the rest of the world. But the relative numbers make this a bit like saying that, theoretically, when I jump off a ladder, gravity not only pulls me to the ground, it also moves the ground toward me.

In general, if a country pursues economic growth by developing the ex-

²³World Bank's Global Development Network Growth Database. GDP in nominal dollars increased by 260%.

²⁴A. Faiola, "Argentina's Lost World: Rush into the New Global Economy Leaves the Working Class Behind," *Washington Post*, December 8, 1999. Argentina's poverty rate has skyrocketed since the collapse of its economy in December 2001.

port sector, it must be able to sell what it produces on the highly competitive global market, and costs must be kept low. In a world of mobile capital, absolute advantage in production is what counts. Most less-developed countries (LDCs) do not have advanced technologies that can lower production costs, a well-developed infrastructure that can lower transportation costs, or institutions that make investments particularly safe. Instead, they have two sources of absolute advantage: abundant labor and (in some cases) abundant natural resources.

For export-oriented industrial production, the only absolute advantage LDCs generally have is the low wages they can offer. Until these countries develop some other source of absolute advantage, wages and benefits must be kept down to remain competitive on the world market. This does little to help alleviate poverty, and it frequently requires the suppression of labor rights.

What happens if instead a country seeks to industrialize to serve the needs of the domestic market? Obviously the prerequisite for this to occur is that a domestic market actually exists. A market can only exist if there is purchasing power, and purchasing power requires wages. This is why Henry Ford (no friend of labor) chose to pay his workers \$5.00/day (at the time an exceptionally high wage)—he wanted them to be able to afford the cars they were producing. Thus, for LDCs, a focus on liberal international trade will tend to push wages down, while a focus on production for the domestic economy may tend to push wages up.

When confronted with this argument, people might point to the Asian Tigers (Taiwan, Korea, Singapore, Hong Kong, and more recently, Thailand and Malaysia). These countries, like Japan, pursued export-oriented industrialization and saw dramatic increases in their standards of living. Yet on closer examination, the historical record of the Asian Tigers actually bolsters the argument for developing the domestic market. First, these nations are characterized by highly protectionist policies and a high degree of government intervention, not by open markets. More to the point, their initial successes were greatly facilitated by strong domestic markets. In Korea, Taiwan, and Japan, agrarian reform preceded industrialization. In these predominantly agrarian societies, the transfer of land to small farmers allowed the farmers to accumulate and spend the surplus they generated. As Dr. Sun Yat-Sen stated in the *Son Mm Chu-I* (the Three Principles of the People), “industrialization should follow, not precede, the building up of the internal capacity to consume.” Successful land reform in Taiwan doubled the purchasing power of the farmer at a time when Taiwan was an agricultural economy.²⁵ In their early

²⁵Quoted in F. Harrison, *Five Lessons for Land Reformers: The Case of Taiwan*. Reprinted from *Land & Liberty* May–June (1980). Online: http://www.cooperativeindividualism.org/harrison_taiwan_land_reform.html.

industrialization efforts, the Asian Tigers focused on import-substituting industrialization (ISI). Captive markets allowed them to develop the skills necessary for global competition.²⁶

On the other hand, production for the domestic economy can have a negative impact on real wages as well. If a country currently importing industrial goods decides instead to replace them, the new industries will have a hard time competing against established producers. Thus, ISI generally requires tariffs and quotas on imports. Such tariffs will stimulate demand for domestic goods (benefiting the producer) but drive up the price of imports in order to make the import substitute more competitive, and lower real wages.

In terms of distribution relative to export-oriented economies, however, this impact may not be as dire as it seems. First, export-oriented countries typically undervalue their currencies to make exports cheap and imports expensive, so there may be little difference between ISI and export promotion with respect to consumer prices. In addition, the easiest goods to produce are often the cheapest, those purchased by the working masses (soap, aspirin, matches, etc.). With simple production technologies, the LDCs are not at a serious disadvantage when producing these goods, and tariffs can be kept quite low. Luxury goods, on the other hand, tend to be more technologically sophisticated and may require higher tariffs. However, it is the wealthier classes that purchase these goods, and they can better afford to pay the tariffs.

As the industry develops, two things happen. First, efficiency should improve, and tariffs can be reduced—especially if the producers know that tariffs will be reduced and therefore have an imperative to improve efficiency. Second, any market based solely on a wealthy minority will quickly become saturated. Further industrialization will depend on larger markets, which can be created through higher wages for the labor force. Once industrial capacity is well developed and production techniques have been refined, a country may be able to compete on the export market without forcing wages down to the global minimum. This is essentially the strategy that was pursued by the newly industrialized Asian economies.²⁷

It is also worth remembering that in the 1960s and 1970s, the countries engaged in ISI often showed the highest growth rates, and they were touted as examples for others to follow. Brazil's economic growth under this strategy was considered miraculous. Economic wisdom is surprisingly fickle.

Probably the most important lesson to take from this discussion is that

²⁶E. Vogel, *The Four Little Dragons: The Spread of Industrialization in East Asia*, Cambridge, MA: Harvard University Press, 1991.

²⁷Ibid.

one size never fits all. Different cultures are likely to require different approaches to development, and what works under one set of global economic conditions might fail miserably under another. Economists would do well to keep this in mind.

Food Security and Free Trade in Agriculture

Potentially the most serious source of unfairness in the liberalization of trade is the threat it poses to food security. “Free” trade in food threatens security in two important ways. First, the market system provides goods and services to those who have the money to purchase them. If in the future the WTO or other international agreements succeed in liberalizing trade in agriculture, poor citizens of LDCs will be competing with the rich citizens of ODCs (overdeveloped countries) for food. In his groundbreaking study of famines, Amartya Sen has shown that famines are generally the result of a lack of entitlements to food rather than a lack of food itself.²⁸ In the market economy, this simply means a lack of money to purchase food, even when actual supplies are abundant. The situation can occur because of unemployment or a decrease in the value of the goods some group produces relative to food. In the presence of international trade, the domestic sector must bid against the rest of the world for food purchases. If the economy suffers a recession or there is a currency devaluation, local ability to purchase food decreases relative to global ability, and food may be exported even as the local population starves. Clearly, international trade can be critical in addressing famines that are caused by food availability decline, but only if countries have the resources to purchase that food. If agricultural markets are completely liberalized, it is easy to imagine Western nations importing food for their cattle from nations suffering famine.

The fact that farmers are typically the most disadvantaged group in many LDCs brings a second source of unfairness if agriculture is liberalized. LDC costs of agricultural production tend to be higher than those of large agro-industrial farms in ODCs (in part because so many negative externalities of industrial agriculture are not internalized). This means that trade liberalization will often decrease prices for food in LDCs. While lower food prices may help the urban poor and wage earners, it can also cause lower incomes and declines in welfare for the poorest group, namely farmers. Low food prices reduce incentives for domestic agriculture. Theoretically, under trade liberalization, these poor farmers should be able to grow cash crops for export. Unfortunately, cash crops often

²⁸A. Sen, *Poverty and Famines: An Essay on Entitlement and Deprivation*, 6th ed. New York: Oxford University Press, 1992.

require higher levels of inputs and are far riskier than traditional food crops that have been bred for millennia to minimize the risk of failure. While average returns over several years may be higher with cash crops even with more frequent failures, people do not eat “on average”—they eat every day.

Box 18-3 PUBLIC LAW 480 AND FOOD SECURITY

If one country becomes dependent on others for food supply, they run serious risks to their autonomy. For example, the U.S. Public Law 480 provides food at subsidized cost to LDCs. While nominally a gesture of benevolence, American politician Hubert Humphrey once said in reference to this law: “I have heard . . . that people may become dependent on us for food. I know that was not supposed to be good news. To me that was good news, because before people can do anything they have got to eat. And if you are looking for a way to get people to lean on you and to be dependent on you, in terms of their cooperation with you, it seems to me that food dependence would be terrific.”^a

Secretary of Agriculture Earl Butz also referred to food as a weapon and “one of the principal tools in our negotiating kit.”^b Understandably, countries that come to depend on food imports may not share Humphrey’s enthusiasm for that dependence.

^aSen. Hubert H. Humphrey, in naming P. L. 480 the “Food for Peace” program, Wall Street Journal, May 7, 1982.

^bUSDA Secretary Earl Butz, 1974 World Food Conference in Rome.

SUMMARY POINTS

We are better served by a process of internationalization in which countries are free to act on their own information to address local problems of scale and distribution (areas where the market manifestly fails) in a culturally sensitive manner. We must also carefully analyze the actual and potential impacts of globalization on scale, distribution, and efficiency.

Evidence suggests that globalization may be undermining the conditions required for efficient market allocation, by creating fewer, bigger firms, more negative externalities, and more monopolies on nonrival information. More negative externalities and increased economic growth, coupled with a limit on the national ability to regulate externalities, is a threat to sustainable scale. Empirical evidence also suggests that globalization under the principle of absolute advantage may simply reinforce existing patterns of winning and losing, leading to even greater concentration of wealth, both within and between countries.

BIG IDEAS to remember

- Perfect competition vs. mergers, patents, and transnational corporations
 - Trade vs. environment in the WTO
 - Standards-lowering competition
 - Wealth and power
 - Specialization and welfare
 - Trade and scale
 - Distribution and globalization
 - Food security and international trade
-



International Flows and Macroeconomic Policy

National policies require national boundaries. Yet, as globalization eradicates boundaries, even its advocates agree that “the world will move from closed, nationally controlled systems toward one open, global system under no one’s control.”¹ If no one is in control, no one makes policies. We have already discussed some of the ways in which globalization undermines the ability of nations to determine their own policies concerning the environment. We will now turn our attention to the impact of globalization of financial capital on macroeconomic policy.

Most financial capital flows are in the forms of electrons flitting from one computer to the next, but such flows can have serious impacts not only on the output of real goods and services, but also on the ability of governments to enact economic policies. According to the IMF, “globalization may be expected to increasingly constrain governments’ choices of tax structures and tax rates.”² The IMF also claims that it is the nation-state that must address issues of distribution and social welfare. Yet the pursuit of global free markets weakens the national policy levers necessary to achieve these goals. We will explain in greater detail how this happens, but an adequate explanation first requires a certain amount of background material on the balance of payments and exchange rate regimes.

¹L. Bryan and D. Farrell, *Market Unbound: Unleashing Global Capitalism*, New York: Wiley, 1996.

²International Monetary Fund, *World Economic Outlook*, Washington, DC: IMF, 1997.

■ BALANCE OF PAYMENTS

There are two basic types of economic transactions between residents of different countries: the exchange of real goods and services and the exchange of assets. The net outcome of these transactions is measured by the **balance of payments (BOP)**. The BOP has two components, current accounts and capital accounts, corresponding to the two types of transactions.

The **current account** measures the exchange of real goods and services as well as transfer payments. Goods and services are generally consumed in the current period, which is why it is called the current account. Real goods, of course, are market goods. Services include interest payments on loans, royalties on intellectual property, profits earned on investments abroad, and similar transactions. Transfer payments include money workers abroad send home to families, grants to foreign countries, and similar transactions. **Capital accounts** include stocks, bonds, and property abroad. These items are not consumed. They are a stock of capital yielding a flow of revenue.

Money flowing into a country increases the balance on current account or capital account, and money flowing out of a country decreases it. If a country imports more goods and services than it exports, it runs a deficit in its current account, and if it exports more than it imports, it runs a surplus. Similarly, if foreigners purchase more assets in the home country than the home country purchases abroad, the home country runs a capital account surplus, and if the opposite is true, it runs a deficit. Note that a surplus in the current account can balance out a deficit in the capital account, and vice versa, to keep the balance of payments neutral.

In general, countries try to keep their balance of payments neutral, running neither a surplus nor a deficit. In an accounting sense, formal balance (capital plus current account) is guaranteed by a residual balancing item, formerly gold under the gold standard, but is now guaranteed by changes in a nation's foreign exchange reserves, short-term IMF credits (special drawing rights or SDRs), and IOUs from deficit countries called short-term capital flows.

■ EXCHANGE RATE REGIMES

An **exchange rate** is the amount of one currency you would have to pay to receive a given amount of another. For example, in May 2003 one U.S. dollar could purchase about 70 Angolan kwanza. Any international exchange of goods, services, or assets requires an exchange of currencies, as those who sell generally want to be paid in their own currency. How the exchange of currency takes place depends on the exchange rate regime

The *balance of payments* (BOP) is the sum of the current account and capital account.

The *current account* measures the exchange of real goods and services as well as transfer payments—things consumed in the current period.

The *capital account* measures stocks, bonds, and capital abroad—stocks of capital yielding flows of revenue.

used by a particular country, and this regime also determines how economic globalization affects domestic policy levers. There are two basic types of regime: fixed and flexible. When discussing exchange rates, “floating” is synonymous with “flexible.”

In a **fixed exchange rate regime**, the value of one country’s currency is pegged to that of another country. For example, from 1991 to 2002, the Argentine peso was pegged to the U.S. dollar at a one-to-one ratio; that is, the Central Bank of Argentina agreed to sell as many dollars as anyone wanted for one peso each. Obviously, the central bank needed to have foreign currency on hand to make this exchange. Ideally, this currency came from demand for Argentine products. When an American wanted to buy beef from Argentina or Argentine bonds, the central bank would also sell the required pesos for \$1 each.

A problem can occur when nationals of a fixed rate country consistently want to buy more (or fewer) goods, services, and assets from other countries than other countries want to purchase from them, that is, when the fixed rate country is running a BOP deficit (or surplus). If the fixed rate country runs a BOP surplus, it will accumulate excess reserves of foreign currency for which there is insufficient demand. This will put pressure on the country to revalue its currency—for example, offer more dollars per Argentine peso. If the fixed rate country runs a BOP deficit for too long, it will run out of foreign reserves. In this case, there will be pressure to borrow money from abroad and/or devalue its currency—offer fewer dollars per Argentine peso. This is what happened to Argentina when it was forced to devalue its currency in January 2002.

In a **flexible exchange rate regime**, exchange rates are determined by global supply and demand for currencies, and central banks play no direct role. The only foreign currency available for purchase for foreign goods, services, and assets is that which foreigners spend on the purchase of domestic goods, services, and assets. If there is more demand for foreign currency than national currency, the national currency depreciates, and when the opposite is true, the national currency appreciates.³ Market forces determine the exchange rate. This means that the BOP must always be zero—a current account deficit must be financed by a capital account surplus, and vice versa.

Most of the developed countries have flexible exchange rate regimes, but in reality, they are not perfectly flexible. In many cases, countries will

³Under a fixed exchange rate regime, when the domestic currency loses value it is known as devaluation, and when it gains value it is known as revaluation. In either case, this happens directly as a result of central bank policy. Under a flexible exchange rate regime, when market forces cause a currency to lose value, it is known as depreciation, and a gain in value is known as appreciation.

grow concerned that their currencies are overvalued or undervalued, and will buy or sell currency to correct the perceived imbalance. For example, in September 2000, the central banks of the G7 countries⁴ coordinated policies to prop up the euro, which had fallen 30% against other currencies in the year since its release.⁵ Some countries try to keep their exchange rate within a certain range, which is known as a managed float, somewhat of a hybrid between a fixed and flexible exchange rate.

Potentially, countries can manipulate the supply and demand for their own currencies. For example, high tariffs on imports will reduce the demand for imports, and hence the demand for foreign currencies. Alternatively, a country may simply control capital flows, directly determining the supply of its own currency and the demand for foreign currencies. In this case, national policies can determine the BOP under a fixed rate regime or affect the exchange rate under a flexible rate regime.

■ CAPITAL MOBILITY AND NATIONAL POLICY LEVERS

What happens to countries with these two types of exchange rate regimes under economic globalization, when there are no barriers to international exchange of goods, services, and assets (perfect capital mobility)?

Fixed Rate Regimes

Let's take the case of a country in recession. As we discussed in Chapter 16, a country that wants to stimulate economic growth can use either fiscal policy or monetary policy. This is not true, however, in an open economy, where perfect capital mobility means that interest rates between nations cannot vary by much, as money will simply flow to the country offering the highest returns.⁶

For example, what happens when a country with a fixed exchange rate regime wants to stimulate the economy by increasing the money supply? Normally, this approach would lower interest rates, stimulate consumption and investment, and hopefully revive the economy. However, in the absence of restrictions on international capital flows, people can respond to lower interest rates by moving their savings to a country that offers higher rates. To do so, they will sell domestic currency to the central bank in exchange for foreign currency. This reduces the money supply in a process that will theoretically continue until domestic interest rates are ap-

⁴G7 stands for the Group of 7, the seven most powerful industrialized nations in the world—the U.S., Canada, Germany, Japan, Italy, England, and France.

⁵BBC News, September 23, 2000. G7 Ready for Further Euro Action. Online: http://news.bbc.co.uk/1/hi/english/business/newsid_936000/936917.stm.

⁶In reality, investors are also concerned with risk and look to risk-adjusted returns.

proximately equal to interest rates available elsewhere, thereby reducing foreign reserves in the process. Similarly, if the monetary authority in a fixed exchange rate country tries to reduce the money supply to curb inflationary pressures, it cannot do so. A higher interest rate attracts foreign investors, who purchase domestic currency, driving the money supply back up and the interest rate back down.

What about fiscal policy? What happens if the fixed rate country instead decides to pursue an expansionary fiscal policy to stimulate economic growth and increase employment? Theoretically, an expansionary fiscal policy (i.e., the government spends more than it taxes) will increase domestic interest rates. If high capital mobility means that global interest rates must be approximately equal, an increase in interest rates will lead to an increase in foreign investment in domestic assets. This will increase the surplus in the capital accounts, thus leading to a balance of payments surplus. Moreover, the central bank will be forced to sell domestic currency, increasing the money supply, and driving interest rates back down, further stimulating the economy. By purchasing international currency, the central bank accumulates foreign reserves. It seems then that fiscal policy is particularly effective in the presence of fixed exchange rates and open markets.

Unfortunately, global investors may punish countries that run fiscal deficits. Such countries may be perceived as pursuing unsound macroeconomic policies, increasing the risk of economic instability. Investors dislike risk, and may withdraw money in spite of the higher interest rates. “Risky” countries generally must offer very high interest rates to attract foreign currencies. The higher interest rates, of course, dramatically increase the debt burden on the government, forcing even greater fiscal deficits and subsequent instability (increasing the risk premium once again, in a vicious cycle), or else dramatic cuts in other government programs, which are of course likely to have recessionary impacts. In addition, if the fixed rate country has previously borrowed money from the IMF to maintain its balance of payments, conditions on the loan probably forbid the borrower from increasing its fiscal deficit.

Flexible Rate Regimes

Continuing with our assumption of perfect capital mobility and hence a common international interest rate, what is the impact of a perfectly flexible exchange rate regime on fiscal and monetary policy levers? To understand this scenario, we must make explicit an intuitively obvious point. Under open market regimes, demand for domestically produced goods is determined by domestic demand plus foreign demand for domestic goods. When the domestic currency is highly valued relative to other currencies, foreign goods and services will be cheap relative to domestic ones.

Thus, a strong national currency (a high exchange rate relative to other currencies) increases the demand for imports and reduces the demand for exports, thus reducing national income, and a weak currency decreases the demand for imports and increases the demand for exports, increasing national income. When a currency appreciates or is revalued, it will be similar to a contractionary fiscal policy (i.e., a decrease in government spending, or a shift to the left of the IS curve), and when a currency depreciates or is devalued, it will be similar to an expansionary fiscal policy (i.e., an increase in government spending, or a shift to the right of the IS curve).

Now let's take a look at monetary policy in a country with perfectly flexible exchange rates that wants to stimulate the economy by increasing the money supply and lowering interest rates. Investors then want to transfer domestic currency out of the domestic economy to seek higher returns elsewhere, and they must buy foreign currency to do so. The increased demand for foreign currency drives up its price relative to the domestic currency, which then depreciates. Depreciation of the domestic currency makes domestic production cheaper relative to imports and increases global demand for domestic production. The net result should be greater national income at the same interest rate. It appears, then, that under a flexible exchange rate regime, monetary policy should be highly effective. We should note, however, that global demand has really not changed. Depreciation of the domestic currency implies an appreciation of foreign currencies and reduced income in those countries.

Fiscal policy under a flexible exchange rate regime is a different story, however. If a country in recession attempts to stimulate its economy through government expenditure or tax cuts, this will drive up interest rates. As soon as interest rates increase above the international level, foreign investment in domestic assets will increase. Flexible exchange rates immediately lead to appreciation of the currency, driving up the price of exports and reducing the price of imports. People stop consuming domestic products and purchase imports instead. Firms reduce investment, lay off workers, and/or reduce wages to compensate, lowering the increased interest rates and counteracting the effects of increased government expenditure. In this simplified world, fiscal policy is completely ineffective in the long run.

■ ECONOMIC STABILITY

We now turn to the question of economic stability. Much of the above discussion implicitly assumed perfectly informed, rational actors, who would respond to changes in investment opportunities (such as interest rates) instantaneously and appropriately. Yet global financial capital markets are

characterized by extreme volatility. We frequently see sudden, unpredicted changes in international capital flows in and out of countries that have dramatic impacts on real economic variables in those countries. These impacts tend to spread from country to country and can even lead to global economic crises. Here are some examples:

1. The Latin American debt crisis, which started in 1982 when Mexico found itself unable to make payments on its debt, and quickly spread to 39 other countries.
2. The Tequila crisis, which began in Mexico in December 1994 and required emergency loans of \$52 billion from the U.S. Treasury and the IMF.
3. The Asian flu, starting in Thailand in 1997, quickly spreading throughout South East Asia, then on to Africa, Russia, Poland, and Argentina.

All of these crises had certain elements in common. They caught the global markets by surprise, lowered economic output in the affected countries without any change in physical productive capacity, spread from country to country, and had triggers beyond the control of the affected countries. Such crises have occurred at regular intervals for literally hundreds of years. While this means that crises are not solely a consequence

Box 19-1

PETRO-DOLLARS AND THE LATIN AMERICAN DEBT CRISIS

One of the causes of the Latin American debt crisis was almost certainly the recycling of “petro-dollars,” the high profits from the 1973 and 1979 oil price increases invested in banks by the OPEC countries. These petro-dollars were loaned at very low interest rates to LDCs. Unfortunately, the interest rates were floating; that is, they moved up and down with changes in the global interest rate.

In 1981, the U.S. Federal Reserve Bank implemented a tight monetary policy in the U.S. to curb inflation induced by increased oil prices. Simultaneously, the Reagan government engaged in record levels of deficit spending. Both actions drove up interest rates on the dollar, from about 3% in the early 1970s to more than 16% a decade later. At the same time, these high interest rates in the U.S. increased demand for dollars, driving up the value of the dollar relative to other currencies by 11% in 1981 and 17% in 1982, further increasing the dollar denominated debt burden.^a Not surprisingly, the debtor countries had considerable difficulty repaying their loans under these terms.

^aFederal Deposit Insurance Corporation, *History of the Eighties—Lessons for the Future*, 2001. Online: <http://www.fdic.gov/bank/historical/history/index.html>.

of the current push for globalization, it is likely that the increase in the speed and quantity of global financial transactions can dramatically increase their frequency and impacts. Unfortunately, no one understands the dynamics sufficiently to predict the next occurrence.⁷ Not only does such volatility reduce the ability of national policy makers to manage the economy, but it can have seriously negative impacts on human well-being.

Financial Crises

Why do such financial crises occur? There are a number of theories. While it is beyond the scope of this text to present them in great detail, we'll mention them briefly. Some crisis may occur as a result of speculative bubbles. Some asset is increasing in value, which attracts investors. The increased demand drives the price of the asset up further, bringing in yet more investors. Investors may know the asset is overvalued, but in any period there is a probability the price will increase and a probability it will crash, so many rational investors risk continued investment. Most economists consider the eventual crash a "market correction."

Other crises result from **moral hazard**. Investors believe they will be bailed out by someone (e.g., by the IMF, as happens frequently) and hence make risky investments. It is a case of a gamble in which the investor keeps the winnings if it succeeds, yet risks little loss if it fails, so investment in the gamble is far higher than it should be.

Yet other crises occur when the "fundamentals" are wrong. Countries allow their exchange rates to become overvalued, run current account deficits that are too high, or print too much money. Speculators see these signs and bet money that corrective action will be taken. Yet again, many economists view the resulting crash as a "market correction"—though many also recognize that the market may take the "correction" too far.

None of these theories adequately explains what happened in Mexico in 1994 and in Asia in 1997, or to a lesser extent in Brazil in 1997–1998.⁸ In all of these countries, the evidence points to a self-fulfilling panic. In such a panic, some investors begin to fear that a government will be unable to service its debt because of rising interest rates, falling exchange rates, and/or economic recession. If a government is unable to service its debt, investors will lose on holdings of dollar denominated assets (which are all essentially a form of debt). If the country is unable to maintain its

⁷D. M. Roodman, *Still Waiting for the Jubilee: Pragmatic Solutions for the Third World Debt Crisis*, World Watch paper 155, Washington, DC: World Watch, 2001.

⁸Brazil reacted quickly to prevent the spread of the flu, but raised the question if the cure was worse than the disease. The country spent some \$35 billion in foreign reserves to defend its currency, increased interest rates to over 40%, and introduced budget cuts and tax increases. Economic growth slowed and unemployment increased, but a nearly 70% depreciation of the Brazilian currency since December 1998 was not prevented.

exchange rate, foreign investors will lose on assets denominated in local currency. As some investors withdraw, others become more jittery.

A chain reaction occurs. Capital flees the country *en masse*. With fixed or managed exchange rates, capital flight forces governments to buy local currency and sell dollars, depleting foreign reserves, depriving them of the resources required to pay the foreign debt and maintain exchange rates. While the initial decision to flee was irrational before it was taken, it now becomes a rational decision for any remaining investors to join the panic. Investment in the affected country is now very risky, and national bonds are rated as “junk bonds.” Desperate to attain capital, governments are forced to offer higher interest rates to attract the dollars needed to meet short-term obligations, increasing the likelihood that they will be unable to repay this new debt. With higher interest rates and no foreign capital available, local businesses collapse, and the domestic economy spirals downward. Now governments lose the tax revenue necessary to meet debt obligations. Governments are forced to turn to a floating exchange rate, which is almost inevitably accompanied by massive devaluations. Everything the speculators feared comes to pass, but only because investors acted on their fears.

Self-fulfilling panics are basically instances of multiple equilibriums. If speculators withdraw their capital, the rational thing for others is to withdraw capital also, leading to one equilibrium. If speculators leave their capital in place or invest more, then this also becomes the rational act for others, leading to a different equilibrium.⁹ The point is that the decision to remain or withdraw is based on imperfect knowledge.

Compounding the problem, when one country devalues its currency, it becomes more competitive in the export market against similar countries. Speculators are then justified in believing that those similar countries will lose access to the resources required to meet their debt obligations. As more economies succumb, the demand for exports decreases. Financial crises clearly generate negative externalities affecting other countries, and economic stability is thus a public good. The instabilities associated with large foreign debt is one reason we like Keynes’ rejected idea of the International Clearing Union (discussed in Chapter 17) that penalized both surplus and deficit countries, giving all countries an incentive to avoid large balance of payments deficits that cumulate into foreign debt.

Economic stability is a public good and an important objective of economic policy. If having a larger economy in the distant future is the only goal, then instability does not matter a great deal as long as the long-run

⁹J. A. Sachs, A. Tornell, and A. Velasco, The Mexican Peso Crisis: Sudden Death or Death Foretold? *Journal of International Economics* 41: 265–283 (1996); P. Krugman, Are Currency Crises Self-Fulfilling?, *NBER Macroeconomics Annual*, 345–378 (1996).

Box 19-2 SELLING SHORT

Another factor contributing to financial instability is when speculators sell the local currency short. To sell short, a speculator essentially borrows the currency from someone else and sells it at the going price, betting that the price will fall (i.e., the government will be forced to devalue) and the local currency loan can be paid back at a lower dollar cost.^a Simplifying greatly, selling short increases the supply of domestic currency, putting downward pressure on the price. Governments are forced to sell dollars to cover these short positions. If the banks lack the resources, they cannot cover the positions and are forced to devalue. If enough people sell short, devaluation is inevitable, and the speculators profit. If someone highly respected for their financial acumen makes a big speculative investment to sell short another currency, other speculators will take notice and put their money alongside his. Currency speculators can often outspend national governments, forcing even developed countries to devalue their currencies, as happened to England in 1992. This type of herd behavior can turn selling short into a self-fulfilling prophecy.

The perversity of this type of profit from speculation is that the speculators increase their entitlements to real goods and services by controlling more financial resources, yet the production of real goods and services actually declines. When greater wealth goes to those who produce, we call it earned income. What should we call it when greater wealth goes to those who destroy productive capacity?

^aFor example, you borrow pesos and use them to buy dollars. You then hold the dollars waiting for a peso devaluation. Then you use the dollars to buy pesos. You get a lot more pesos than you originally borrowed, thanks to the devaluation. You pay back your loan and have a lot of pesos left over!

trend is toward growth. But a richer future cannot be the only goal for LDCs. When a country's income falls, that means the incomes of people within that country fall. For many people, no income means no access to the basic necessities of life. Governments will find it difficult to defend an economic policy that lets people starve this year by claiming that those starving people will be able to eat three times as much next year. Indeed, it is a fairly well established fact that people react differently to gains than losses, even when they are of the same magnitude. This, in fact, is a basic implication of the theory of diminishing marginal utility. Yet too many economists still seem to miss this point.

THINK ABOUT IT!

Can you explain why the law of diminishing marginal utility suggests we should give more weight to the loss of something than to a gain of equal magnitude?

Box 19-3 IS RISK AVERSION IRRATIONAL?

It is telling that advocates of globalization complain that “U.S. households show an irrational preference for ‘safe’ bonds, bank deposits, and money market funds over ‘risky’ equities, especially where their retirement savings are concerned.”^a The same advocates would have us believe that a desire for stability and security for countries is as irrational as for retirees, as they go on to assert that

We are about to enter into an era of explosive growth and change as a result [of globalization], but the journey to prosperity will not be entirely smooth. The capital market will force governments to cut unsustainable entitlement policies including pensions, subsidized healthcare or welfare, and force businesses dependent on government protection to restructure or perish. There are likely to be massive job losses and great social and personal dislocations as these changes take place. The turmoil will be the greatest in Europe and in the developing countries. . . .^b

In spite of assertions to the contrary, it is not irrational to favor a small but secure income over a gamble between starvation and fabulous wealth, even if the risk of starvation is small. Nor is it evident that the benefits of explosive growth will compensate for massive job losses, social and personal dislocations, and general turmoil—to say nothing of potential ecological impacts.

^aL. L. Bryan and D. Farrel, *Buy Stocks, Shun Bonds (Opportunities in the Global Capital Market)*, *The McKinsey Quarterly* 167 (1996).

^b*Op. cit.*

Along with the public good/externality problem, two other market failures in financial markets deserve mentioning. Moral hazard, as briefly described above, is widely recognized as a market failure. Yet financial crises are contagious not just between countries, but also between financial institutions. When some banks started to fail during the great depression, this triggered panic that caused other banks to fail. When a financial institution is “too large to fail,” governments feel obliged to bail them out, so moral hazard is difficult to avoid if large financial institutions are unregulated. Yet regulated financial sectors have fewer investment opportunities than unregulated sectors, and are likely to be less profitable and attract fewer investors. After all, if the added safety of regulation compensated for the diminished profits, then the financial sector would regulate itself, yet this is clearly not the case. Thus, countries may pursue a “race to the bottom” in terms of financial regulation.

Another serious market failure is the information asymmetry that always exists between lenders and borrowers, which is aggravated when capital crosses international boundaries. Lenders price loans according to

the risks involved, but the borrowers generally have a much clearer understanding of the risks than the lenders. This can lead to adverse selection. If lenders raise interest rates to compensate for unknown risks, then the only borrowers will be those engaged in the riskiest activities.

What has been the global policy response? In both Asian and Mexican crises, the IMF response was to impose tight fiscal and monetary policies on the affected countries. The IMF saw this as imposing discipline on those economies; however, the effect of such policies is to plunge them even further into recession. The IMF is also pursuing further deregulation of global financial movements. In an official communiqué of the IMF Interim Committee issued in April 1998, the IMF declared that it will amend its articles to “[make] the liberalization of capital movements one of the purposes of the Fund and [extend], as needed, the Fund’s jurisdiction for this purpose.”¹⁰ This in spite of the fact that Michel Camdessus, then president of the IMF, predicted that “a number of developing countries may come under speculative attacks after opening their capital account” as a result of their unsound macroeconomic policies.¹¹ This, of course, ignores the possibility of self-fulfilling panics and contradicts the original IMF charter to protect the stability of national economies.

Why does the IMF stubbornly pursue such policies, in the face of so much evidence that they are wrong? IMF economists are almost all trained in neoclassical economics. They believe well-informed people make rational choices based on rational expectations. As a result, they believe market prices are rational and lead markets to general rational equilibrium. Where effective markets don’t exist, they must be created in order to achieve these harmonious results. The IMF routinely bets billions of other people’s dollars that this is the case. In contrast, George Soros, a renowned international financier, routinely bets billions of his own dollars that this is not the case. In his own words, he believes that “people act on the basis of imperfect understanding and equilibrium is beyond reach,” and as a result, “market prices are always wrong, in the sense that they present a biased view of the future.”¹² Soros frequently wins his bets, while the IMF record speaks for itself. Finally, Soros further claims that

¹⁰International Monetary Fund, Communiqué of the Interim Committee of the Board of Governors of the International Monetary Fund, Press Release No. 98/14, Washington, D.C., April 16, 1998. Cited in M. Chossudovsky, *Financial Warfare*. Online: <http://www.corpwatch.org/trac/globalization/financial/warfare.html>.

¹¹Communiqué of the IMF Interim Committee, Hong Kong, September 21, 1997. Cited in *ibid*.

¹²Quoted in W. Greider, *One World, Ready or Not: The Manic Logic of Global Capitalism*, New York: Simon & Schuster, 1997, p. 242.

“extending the market mechanism to all domains has the potential of destroying society,”¹³ a belief with which we strongly concur.

BIG IDEAS to remember

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| ■ Balance of payments (BOP) | ■ Fiscal policy under different exchange rate regimes |
| ■ Current account | ■ Petro-dollars and debt |
| ■ Capital account | ■ Financial crises |
| ■ Fixed vs. flexible exchange rates | ■ Speculation |
| ■ Monetary policy under different exchange rate regimes | ■ Economic stability as a public good |
| | ■ Moral hazard |
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¹³See Society Under Threat—Soros, *The Guardian*, London, October 31, 1997. Cited in Chosudovsky, op. cit.



Conclusions to Part V

Globalization has been proposed as a panacea for economic problems, because it is expected to bring economic growth and wealth to all. This conclusion is based on flawed assumptions. With free international capital flows, globalization favors absolute advantage and not comparative advantage. While globalization may bring greater economic growth, the growth will not benefit all countries, and the costs of growth could outweigh the benefits at the margin. Empirical evidence shows that the benefits of growth go to the already wealthy, while the costs, in terms of lost ecosystem services, are borne by all—and perhaps by future generations most of all. Globalization also weakens the policy levers governments have to address issues of scale and distribution on their own, and unregulated flows of financial capital can create serious economic instability. While trade can be desirable, it is more likely to be so if it takes place between independent nations with the ability to make their own policies, and these nations recognize that economic growth brings costs as well as benefits.

We now turn our attention to some of the policy tools such independent nations could utilize to attain the goals of sustainable scale, just distribution, and efficient allocation.