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GLOBALIZATION OF THE WORLD ECONOMY: ITS IMPACT ON TRADE AND SECURITY

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1. Before 1914, growing international trade and ever-closer linkages among capital markets brought increasing prosperity all over the world. Thirty years later, after the World Wars, and after the Great Depression, the world economy was in ruins. Trade and capital movements had both been destroyed in the Great Depression, the planned Soviet economy had far outperformed western economies in the 1930s, and many feared that the capitalist economies would slide back into depression.

2. The architects of the post-War international economic system who met at Bretton Woods in 1944 intended to put in place three institutions to anchor the framework in which the liberal international economic order would be rebuilt. They were:

- the IMF, to manage the international monetary system, which was to be based on a system of pegged exchange rates;
- the World Bank, to funnel international capital to both the economies reconstructing after the War, and to developing countries; and
- the International Trade Organization, to set the rules for international trade in goods, to ensure that countries liberalized their trade regimes.

3. Three elements in this design stand out. First, the overall vision: it was not obvious in 1945 that a market-based liberal trade regime was the best way to reconstruct prosperity in the global economy; it was no less plausible

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at that time to believe that a planned Soviet-style system would be more successful. Second, the designers of the system did not plan for a world in which private international flows played a key role; the IMF's mandate is one which relates only to the current account of the balance of payments -- that is to imports and exports of goods and services, rather than to international capital flows; and the World Bank was set up to do much of what private capital markets had done before World War I (note guarantee role for IBRD). Third, the creation of the ITO took fifty years. In 1947 the Congress opposed its creation; it was replaced by a treaty, the GATT; and only now is the WTO being established.

4. Nonetheless, the Bretton Woods design was an extraordinary success. The period since 1945 has seen the benefits of economic growth spread throughout most of the world -- and the growing volume of trade has been a major engine of growth. By 1973, world trade as a share of world GNP was back where it had been in 1925, and it has continued to grow since. Today total imports of goods and services amount on average to about 20 percent of world GDP, and -- with the help of the Uruguay Round agreements and the WTO -- the proportion will continue to rise as the growth of trade will outpace that of GDP.

5. The final success of the founders of the Bretton Woods system came with the collapse of the planned economies at the end of the 1980s. There is now only one economic model, the market model. To be sure, there are many variations among countries in economic structure and the emphasis they place on mitigating market forces, but the adoption of the market-friendly approach to development is almost universal.

6. Another success of the Bretton Woods system takes us closer to the topic of this session, the relationship between globalization and economic power. At the end of World War II, the United States produced almost half the world's GDP. That unprecedented dominance has disappeared, as it inevitably would once economies devastated by war began to recover. Today, depending on whether one measures output in purchasing power terms or in dollars, the U.S. accounts for close to 20 percent of world output, or -- in dollar terms -- much less than that. While it was inevitable that the relative economic power of the United States would decline after World War II, it was not inevitable that it would decline to the extent that it has.

7. Let me now draw together the threads of this story, and address the future. There are three essential elements:

- the continuing growth of world trade in goods and services;
- the increasing integration of capital markets, in the sense both that the capital markets of the major industrialized countries are closely linked -- what happens in Frankfurt and Tokyo affects New York, and vice versa, and in the sense that developing countries have succeeded in attracting major flows of capital from the industrialized countries. In 1994, private capital flows to developing countries amounted to $173 billion, about 3.6 percent of their GDP. A decade earlier, in the midst of the debt crisis, developing countries received only about 1 percent of their GDP ($35 billion) in private capital flows from the industrialized countries;
- the relative decline of the United States, the rise of Europe and Japan, and the growing economic power of Asia.

What issues do these trends pose?

8. The first thing that has to be said is that increasing trade brings potentially enormous benefits to almost everyone in the long run, as standards of living rise more rapidly around the world. In the short run, of course, those adversely affected by foreign competition fail to see the benefits, and may be politically powerful.

9. Second, although the issues are more controversial, I believe that the increasing integration of capital markets also brings potentially massive benefits. But -- as the recent Mexican crisis shows -- it can also bring short-run problems.

10. The growth of trade in goods and services binds country's economies ever closer. Almost any technologically complex product you buy has components made in many countries. The globalization of production means that workers in different countries are drawn into a global labor market, which will mean that wages for the same class of labor in different countries will become more similar. Thus relatively untrained labor in the industrialized economies will see its situation weaken, and the better trained are likely to see their situations improve. Wealth will increasingly go to the educated and the technologically superior, within countries, and between countries. Although economic research has not been able to show definitively that increasing openness has helped increase income gaps in the United States, the logic points that way. The answer is not to close off trade but to improve our educational system.

11. The potential increase in trade frictions as a source of international disputes. The potential is there, trade has certainly been an irritant to internation relations, but so far countries have generally succeeded in keeping the damage from trade disputes under control, even between China and the United States, and Japan and the United States. That tolerable situation is not guaranteed to continue, but the creation of the WTO and the increasing sophistication with which these issues are treated gives cause for hope.

12. International capital flows bring benefits. But they make it harder for countries to control exchange rates, and the extreme speed with which sentiment may reverse poses real potential problems for some countries. I will take the exchange rate issue first:

- When capital can flow freely, it is very hard for a country to hold an exchange rate fixed against the views of the market. That is why the Bretton Woods system of pegged rates broke down in 1973.

- Flows through foreign exchange markets are massive, supposedly a trillion dollars a day or more. That is why the G-3, the U.S., Japan and Germany allow rates to float. But fluctuations have been very large, and there is always concern that they will damage trade. Evidence has been hard to find, but protectionist pressures certainly were highest when the dollar was overvalued.

- There is thus no question that the growing integration of capital markets has limited the capacity of individual countries to control their exchange rates. The power of the government has in this regard been reduced. Does that matter? At one time it would have been argued that the markets were only putting the exchange rate at its correct level, but I believe that the markets do on occasion get it wrong, for instance in 1984-85.

- Methods of dealing with the size and speed of capital flows:

  intervention, not much good
  monetary and fiscal policy changes
  Tobin tax

13. Next, capital flows to developing countries, and specifically Mexico.

- These flows have become huge. Repeat the numbers. Countries that become dependent on these flows are very vulnerable. We saw that in Mexico, where the flows enabled them to sustain a very large current account deficit, but punished them severely when they could no longer hold the exchange rate. The capital markets are slow to punish, but eventually they do, and in many cases they overdo it.

- Countries certainly feel that they have lost control over their own economies, and to an extent they have. Therefore some maintain capital controls. But often the problem lies in the country's policies.

- Sometimes, as this time, the markets fail to discriminate and hurt innocent bystanders. This time it was Argentina, which was in a perfectly sustainable situation until Mexico. Then it was forced to adjust very hard.

- What to do about it?
  - Good policies
  - Improved surveillance
  - Safety net, which means larger resources for the Fund
  - Perhaps bankruptcy court

14. Yes, countries are losing control over their economies. But those with good policies are doing very well. No, integration does not automatically reduce the power of a national government. It increases the power of those countries that take advantage of the opportunities the international economy presents.

15. The declining power of the US. This is not inevitable, but a result of our not saving enough. What can we do about it? Budget; encourage private pensions.