

*Center for the Study
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Issue Paper

#9 “Globalization and Economic Democracy”

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“Globalization is a process that is unfinished, imperfect, and on-going...Economies prosper when a country’s capital, labor, and resources are used to optimum efficiency.... Wise governments know that trade policy in the world of globalization is based on something called comparative advantage, where the people in each country produce and sell the things they do best for a broader world market....However, shifts in the production environment have always been unsettling to workers who are impacted, and to investors with sunk costs in low wage, low skill industries...Over-investment, speculative movements of capital, and unwise policies [can also] destabilize fragile emerging economies....The American economy, too, is vulnerable to global forces. Sooner or later, the huge and growing cost of servicing our nearly two trillion dollar net foreign debt will put pressure on the dollar, and weaken it.”

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Globalization and Economic Democracy

Ambassador Richard McCormack
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This afternoon I have been asked to share with you some thoughts on the process of globalization and the challenges it poses to democracy.

Now, this is a pretty complicated subject, involving economic theory, as well as some very practical problems that happen when people begin to think of the economic process as a zero sum game, and mobilize to fight to keep their piece of the pie, as they see it.

During the past few months, my work has taken me to Moscow, Argentina, Japan, Singapore, and central Africa. Globalization has impacted each of these places, as well as the United States and rising powers such as China, a place I also visit nearly every year.

So, I thought today I would describe briefly the theory behind economic globalization, add a few words about the actual impact, for good and for ill, that globalization has had on a number of countries, and finally list some of the challenges that you will face in coping with, and shaping this process in the decades ahead.

The theory behind part of economic globalization is that economies prosper when a country's capital, labor, and resources are used to optimum efficiency. This is straight out of Adam Smith. So wise governments avoid crippling taxes and regulations and let capital find its own most efficient use. Government attempts to second guess the market for the allocation of capital on a long-term basis have a record of failure that has given socialism a bad name everywhere it has been tried.

Wise governments also make it their business to devote time, talent, and money to education, since each economy is only the sum total of the individual productivity of each contributing member of society. The better the education and training of people, the higher up the economic food chain where they will fit most competitively into the greater scheme of things, and the greater the reward for their efforts.

Wise governments also know that trade policy in the world of globalization is based on something called comparative advantage, where the people in each country produce and sell the things they do best for a broader world market. With varying educational levels, some people produce shirts and shoes, others design sophisticated computer programming, and each buys from the other.

In centuries past, countries sometimes made economic decisions to go to war to obtain captive markets for their exports and access to natural resources. Outrage over our captive market status was one of the major causes of the American Revolution against Great Britain. Captive markets and resources were also driving forces behind the Japanese and German aggression of World War II.

After the War, people felt that there had to be a better way of organizing the global economy than through military force to capture markets and resources. It was also clear that an impoverished world would be vulnerable to Soviet sponsored communism unless a way was found to spread prosperity beyond the North American continent. All this resulted in a new determination gradually to wear away the protectionist trade barriers that had hitherto blocked access to parts of the American market. It was hoped that a reciprocal process could be organized whereby countries traded access to each other's market, so American farmers could sell grain to Japanese consumers, to obtain the money to purchase Japanese electronics.

So, today, capital, goods, and services have a broad and expanding global market in which to seek outlets.

As a general proposition, this policy has worked well. Let me give you an example. During my first visit to China in 1983, Beijing was an impoverished place, with large numbers of hollow cheeked, ill nourished children in neighborhoods all over the country, including the capital. Bicycles were the main mode of transportation. It was a gray world, with a general air of poverty, paranoia and want.

By contrast today, 1.3 million cars travel the streets of Beijing, people are well dressed and well fed. I have not seen a mal nourished child in China in the past ten years.

This represents an enormous improvement in the lives of over a billion people, and it is just one of many examples of the blessings of the free movement of investment, goods, and services on a global scale. Trade not Aid was our slogan, and it worked beyond our wildest imaginings.

In the United States, we gained access to inexpensive clothing and all sorts of other goods, as those with relatively inexpensive labor used their comparative advantage to produce goods for export. We have also had a revolution in retailing in the U S. The purchasing power of the dollar, discounted for inflation, is indescribably greater at Walmart today than was the case in America's small retail establishments fifty years ago, where large profits on small volume of sales was the rule.

That is the positive picture of globalization, a process unfinished, imperfect, and on going. In the forty years since this has gained more and more steam, tremendous shifts in production and investment have occurred. We have also seen countries such as Japan and Korea enter the globalized economy, at first with low wage, low skill exports such as shirts and shoes, and gradually develop the skills to produce fine cars and computers. Living standards and wages have gradually risen, and these countries' earlier low wage export industries have shifted to other countries just beginning to participate in the global economy. It is an on going and highly dynamic process, transforming countries all over the globe.

Shifts in the production environment, however, have always been unsettling to workers who are impacted, and unsettling to investors with sunk costs in low wage, low skill industries.

The more rapidly this process unfolds, the more painful it is to those impacted. And the impact is much greater than merely the workers whose factory is closed. It impacts the whole local economy. Insurance companies, grocery stores, housing values, etc. are all dragged down when a major local employer is forced out of business. Youngstown, Ohio was a classic case in point. Industries impacted by foreign competition turned that city and whole regions into what was called "The Rust Belt." Whole new skills had to be learned by the labor force, something that older workers found difficult and unsettling.

But over time, the Rust Belt developed whole new high tech industries, and a new wave of prosperity unfolded. That was the market at work.

Technological breakthroughs, investment, and the shift abroad of much of our dirtier industry, such as mining and smelting, have had a positive impact on the U.S. physical environment. When I was a youngster in Pennsylvania, executives in Pittsburgh often carried an extra shirt with them, because the air in the city was so laden with soot and pollution that by lunchtime, their white shirts were unsightly and needed to be changed. Many of Pennsylvania's streams were polluted by oil, coal drainage, industrial chemicals, and raw sewage. One famous river in Cleveland, the Cuyahoga, periodically actually caught fire.

New technologies and the wealth accumulated by generations of productive efforts helped allow America gradually to clean up much of our air and water.

And today, many of the industrial areas of Asia and the Third World are going through the same process of grappling with environmental problems that once blighted part of America's landscape. As they grow wealthier, they too will clean up their rivers and air.

I have given you what I believe are the overwhelming advantages that the world has achieved via gradual globalization: a freer movement of goods, services, and investment capital, and a rise in global living standards, which after all, is the point of economic activity.

But there are also serious problems associated with globalization, problems that cannot be ignored, and will require the labors of your generation to mitigate and overcome.

The free movement of capital and investment has on occasion encouraged countries to import more capital and investment than they could wisely use. Over-investment, speculative movements of capital, and unwise policies helped destabilize some fragile emerging economies, such as Thailand's. Market based foreign investment, which is seen as a blessing when it enters an economy, is seen by many as a curse when it gets nervous about deteriorating local economic conditions and takes flight.

And when local people see economic policies being followed by their government which threaten the economic health of the country, and feel powerless to change those government policies, they take their money out of the country to safer locations. This is part of what happened in Argentina recently.

When hedge funds start to speculate against local currencies in small countries, mayhem can also result. South Africa's currency has been the latest to experience instability as local conditions made investors nervous. When these local capital outflows happen, they are detected by currency speculators and hedge funds, and sometimes a rapid acceleration of a trend takes place.

The so-called Tobin Tax is one of many ideas that has been advanced to retard destabilizing speculative currency dealings—but often the cure is worse than the disease. Investment will not take place where it faces the potential of becoming an unwilling hostage to an incompetent, corrupt, or demagogic government's flawed economic policies.

There are other problems with globalization. Governments are usually happy to sign trade agreements opening their neighbors' markets to their exports. They are usually less happy to sign agreements admitting foreign goods to their own market, particularly where large locally owned and inefficient industries exist, which are politically powerful.

America has been relatively generous in its trade agreements over the past 40 years. Without any question, we have the most open markets in the world. Lingerings remnants of protectionism in the U.S. pale by comparison with protectionist practices elsewhere. Defending this protectionism has become an art form by trade negotiators in some places.

Secondly, where tariffs have fallen, non-tariff barriers have risen in some places, including competitive devaluations of the currencies. This makes exports cheaper and imports much more expensive. It is accomplished by manipulating currencies, printing money, and encouraging surplus money to be invested in foreign bonds and stocks. Competitive devaluation was once called "Beggars Thy Neighbor", which helped give the economic policies of the 1930s a bad name. Some companies also sell dearly in their own captive domestic markets, and then sell cheaply in foreign markets, undercutting domestic producers. This is what the Bush Administration has declared has happened with part of the global steel industry.

Thirdly, too much investment and production capacity can inflict deflationary pressures on entire industries, something Kondratieff noted decades ago. Much of the Japanese economy is suffering from this, due to excess investment in the 1980s both in Japan itself and elsewhere in the region. When too much production capacity exists, companies sometimes sell under cost merely to keep the labor force employed, and the factory operating. Governments sometimes subsidize this practice with favorable tax treatment, soft loans, and other measures.

China has greatly complicated this process. Its vast pool of cheap labor and potential domestic market has attracted huge amounts of foreign investment from Taiwan, Japan, the U.S. and other countries. But this new investment then competes directly with existing plants in China and elsewhere for available markets.

This process of over-investment then sometimes results in a situation where profits are sacrificed by everyone, merely to survive. This then undermines the stock and bond markets, which depend ultimately upon growth and profits in individual industries.

Eventually, there has to be a shake out in industry, or new global growth has to take place to create new demand. Usually, it involves some combination of the two. But, two years ago, China's exports grew by 34% in a single year. And all over Asia, other countries are worried by the implications of China's entry on global markets. But the more we all invest in China, the more there will be pressure on global markets until China's domestic market grows wealthy enough to create more local demand. Eventually this will happen, but it might not happen in sufficient amount a decade or two. In the meantime, China's new presence on global markets will contribute to powerful deflationary pressures on pricing all over the world.

For the American economy, there are a number of concerns.

We are gradually accumulating an enormous net current accounts imbalance. We are buying more from abroad, than foreigners are buying from us. And some surplus countries are loaning us the money for this consumption. The loans come in the form of investments and bond purchases. But these require long-term interest payments and servicing, adding to our current accounts problem.

Sooner or later, the huge and growing servicing cost from our nearly two trillion dollar net foreign debt will put pressure on the dollar, and weaken it. Indeed, in the next two years we are projected to add nearly another trillion dollars to our net foreign debt, via trade deficits. Eventually, we will have to sell more goods and services abroad to service our debt.

So, out there sometime in the decade ahead, there will be interest rate and dollar instabilities. Nobody knows exactly when, since there has been so much weakness in the Japanese economy, and in part of Europe's economy, that investment money has flowed into the United States at an extraordinary rate, allowing us to continue and expand our rate of imports. But this can't go on forever.

Right now, thanks importantly to a trillion dollars of new liquidity the FED has pumped into the U.S. economy last year, and to inventory liquidations, we are coming out of a mild recession. And there have been predictions that American economic growth this year will be a respectable 2.1%. The only question analysts have is whether the huge past global over-investment in production capacity will allow U.S. profits to materialize sufficiently to allow financial markets to maintain their current strength. This is an important question, however, for the year ahead.

Finally, where does democracy fit into all this?

Globalization creates cheaper goods for more people at the expense of unsettling individual industries and communities which are impacted by the process. People feel powerless in the face of these large impersonal forces. And they are inclined to vote for those politicians who promise relief from the uncertainties. This was a factor in President Bush's narrow defeat in 1992 when Reagan's blue-collar supporters defected in large numbers to Clinton and Perot.

The problem is that permanent relief from imports is not possible to deliver except at great cost, namely the inefficient use of the nation's capital and labor. Japan, for example, has a policy of lifetime employment for its workers. So do some other countries. But as conditions shift, people are telling the Japanese that exporting their unemployment to other countries, particularly during recessions, is an untenable process. By the same token, the Japanese are discovering that lower wage economies such as China's are pricing them out of many markets that they had dominated for years, with not the slightest sign that this process will abate any time soon.

The living standard of the American people is higher than any other place I have visited with the possible exceptions of parts of Western Europe. Japan has efficient export industries, but you can easily pay 50 dollars or more for a haircut in Japan, and the taxi meters start to run at \$5.00. Virtually every industry including the little shops that sell apples at a dollar apiece is subsidized in one form or another. Japan is therefore using its capital and labor most inefficiently, and as a consequence its actual living standards are far below what we enjoy in America.

What are the challenges that we face in the next phase of globalization?

1. We have to explain to our fellow citizens the benefits that we all receive from globalization, and provide some training and transitional relief to those who are negatively impacted by the process.
2. We will need to consider more intelligently supply and demand world wide as we make our investment decisions.
3. We need to make sure that we continue to use our capital, our labor, and our resources most efficiently, since this is the basis of our entire relative prosperity.
4. We need to make sure that smaller emerging economies understand the dangers of free movement of capital, and encourage them to follow economic policies that will make foreign investment a growth factor, not an additional element of destabilization in crises.
5. We need to keep the spirit of entrepreneurship alive and well rewarded in our economy, since new small and medium sized businesses create $\frac{3}{4}$ of our new jobs.

6. We need to make the effort necessary to bring the lagging parts of our own society and the globe into the prosperity that today's technology makes possible, including and especially parts of Africa.

7. We will need to continue efforts to see that market access agreements from past and future trade negotiations are actually enforced, and that licensing restrictions, competitive currency devaluations, hidden export subsidies and various other non-tariff barriers are not allowed collectively to undermine fatally the U.S. current accounts position.

8. Finally, we need to make sure that terrorism is not allowed to destroy the environment in which our economies exist. For a \$500,000 investment, the Al Qaeda network's attack and the war to deal with it have cost us hundreds of billions. We need to finish the job of rooting them out, and put them out of business before they escalate with weapons of mass destruction, inflict even worse damage, and force us to abandon the civil liberties that make America a unique place in the world.

America's economic success is intimately bound up with several important U.S. advantages.

America is an opportunity society. If you are willing to work and make short term sacrifices, you can succeed hugely in this country as in no other place on earth. The rewards of this process have created our unprecedented standard of living.

We have an educational system that is open and mass based, arming all American youngsters who are willing to work with the tools they need to succeed in the field of their choice.

We are incredibly flexible as a society. If the local factory shuts down, we move to Texas or Wyoming where the economy is doing better. Labor mobility is one of our greatest assets.

Democracy has its problems, but as Churchill once said: democracy is the worst form of government, except for all the others. Democracy is a constant means by which our imperfections, injustices, and opportunities are put under the spotlight, and addressed. But democracy requires an informed citizenry, so that intelligent decisions are made by the electorate. It also requires a leadership class willing to devote time to the interests of the country as a whole.

Those of us who have been spending time with you feel that we have been making an investment in America's future. You are part of our future leadership class.

This afternoon, I have said a few words about the theory of economic globalization, its practical advantages, and its inevitable friction points. I have also listed for you the challenges that you will face to overcome some of these friction points as you move forward into leadership positions in this country in the decades ahead. You will find it an exciting and rewarding undertaking.