RECALIBRATING THE MARKET OPENNESS PARADIGM: MAKING GLOBALIZATION WORK FOR ALL

Thomas I. Palley
Assistant Director of Public Policy, AFL-CIO

Globalization and the integration of national economies into the international economic system remains a contested area of policy. The OECD has just released a study titled "Open Markets Matter: The Benefits of Trade and Investment Liberalisation" (OECD, 1998a) which extols the benefits of openness. While trade and foreign direct investment can undoubtedly generate benefits, the extent of these benefits and the manner in which they are distributed depends critically on the institutional context in which liberalization occurs. It is the design of this institutional context that is missing from the current debate, and it is the absence of this feature that underlies many of the existing policy disagreements.

Trade and investment liberalization result in a reconfiguration of production and changed patterns of competition amongst countries. By changing the set of economic options available to business, increased market openness changes the pattern of relations amongst business, labor and government. These changes can be positive sum with all benefitting, zero sum with benefits to one group coming at the expense of another, or negative sum with all losing. Positive sum outcomes should be actively sought out, while negative sum outcomes should be actively avoided. The type of outcome that market openness actually realizes depends on the rules governing the international economic system. Attempts to construct the debate over globalization as one of free trade versus protectionism, openness versus autarky, or capital mobility versus capital immobility fundamentally miss the point. The real challenge is to design institutional rules that make market openness work for all.

This challenge echoes those confronting domestic economic policy. Many are now beginning to talk of a "third way" which breaks with the first way of laissez-faire and the second way of state control of the means of production. The third way advocates designing systems of rules and regulations that prompt markets to work for the benefit of all. Just it has helped recalibrate the domestic economic policy conversation, so too it can help recalibrate the international economic conversation.

Rethinking the economics of market openness

Proponents of market openness maintain that it can enhance standards of living by exploiting the principle of comparative advantage. Critics maintain that it also has adverse effects on the distribution of income, with capital often benefitting at the expense of labor.

The above arguments are widely recognized and are of vital significance. Unfortunately, they have also tended to promote a mentality in which open markets are pitted against closed markets, and this has boxed in the debate over globalization. An alternative construction of the issue that potentially offers an escape from the free trade - protectionist dichotomy is one that focuses on the "rules governing market openness". If the rules are right, market openness can benefit countries: if they are wrong, it can injure them.

Market openness and national policy autonomy

Market openness changes the economic balance of power. As the mobile factor of production, capital benefits from the increased options that it provides, and capital can leverage this additional mobility to win concessions. In recent years, attention has tended to focus on the impact of openness on labor - business relations and the distribution of income within industrialized countries.

However, the balance of power between government and business is also affected by market openness, and this holds for both developed and developing countries. Trade and investment liberalization make it easier and less costly for business to shift the location of jobs and production facilities. This means that business can use the threat of flight to scare policy makers away from taxation and regulation measures that corporations deem against their interest. As a result, policy makers in both industrialized and developing economies may find their ability to pursue autonomous sovereign policies reduced.

The increased mobility of capital conferred by market openness can give rise to undesirable re-fashionings of domestic economic policy. One refashioning concerns the shifting of fiscal burdens from corporations and capital incomes on to households and labor incomes. With capital more mobile, firms can threaten governments that they will exit unless they are given tax relief. The result is that corporate taxes are lowered, thereby requiring either a balancing decrease in government spending or a balancing increase in taxation of households.

This is a problem that stands to affect both industrialized and developing countries. Within the European community the problem has been evident in the competition over tax subsidies intended to attract foreign investment: within the U.S., state governments have engaged in similar tax competition. Developing countries stand to be afflicted in similar fashion, as multi-nationals can place countries in tax competition with one another, thereby reducing governments' abilities to raise revenues to fund public investments that are a necessary part of successful development.

In one regard, the Multilateral Agreement on Investment (MAI) stands to reduce such competition by requiring equal treatment of domestic and foreign nationals. However, at another level it stands to aggravate tax competition since it will facilitate capital mobility by standardizing treatment of property. Such considerations illustrate a need not only for standardization, but also a need for accompanying rules that prevent the emergence of a fiscal race to the bottom that is injurious to both industrialized and developing countries.

Increased market openness can also prompt refashionings of domestic systems of labor, social and environmental protections. To the extent that such protections raise domestic costs, they will tend to put domestic producers at a cost disadvantage relative to foreign competitors. If this cost disadvantage results in job loss, it can unleash domestic political pressures for the repeal of these protections. In this fashion, market openness can lead to a remaking of civil society. This is the foundation of the race to the bottom: rather than competing on product quality and factory floor productivity, inappropriate trade and investment liberalization can lead to "systems competition" (Palley, 1998a) whereby countries compete with regard to labor and social protections.

Once again, the race to the bottom problem is one that afflicts both industrialized and developing countries. Industrialized countries are put under pressure to lower their standards. Meanwhile, developing countries are given an incentive to pursue development paths that result in a degraded environment and disregard work conditions. Many of the costs of this path are implicitly borne by the public, while the benefits accrue as private profit. Rules are therefore needed to ensure that market openness does not produce systems competition, and that competition is restricted to those dimensions which are appropriate.

Market openness and financial capital mobility: lessons from east Asia

Another dimension to the market openness debate concerns international financial capital mobility. As with trade, proponents of liberalization maintain that financial market openness can increase global output by ensuring that scarce capital is allocated to its most productive use. Instead of being restricted to just domestic investment opportunities, financial capital can select the globally highest rate of return, thereby making investors better off.

However, a full consideration of the effects of financial openness reveals a serious downside that affects both developed and developing countries. In developed countries the problem concerns reduced scope for domestic economic policy since capital may flee in response to monetary and fiscal policies it deems too expansionary. In particular, to the extent that financial markets believe in the notion of a natural rate of unemployment, they can make it a self-fulfilling prophecy by selling out and bidding up interest rates whenever unemployment gets too low. In developing countries the problem is one of speculatively induced capital inflows that generate asset price bubbles, which in turn wreak economic havoc when they burst. Moreover, both developed and developing countries are subject to undemocratic political discipline, with financial capital threatening to vote with its feet whenever governments try to implement expansionary or progressive economic policies not to its tastes.

The problems that financial market openness can cause for industrialized countries are evident in the higher interest rates and massive currency swings of the last fifteen years. In 1992 the Swedish Krone was subjected to speculative attack and Sweden was forced to raise interest rates thereby initiating a period of permanently higher unemployment. In the mid-1980s, capital inflows caused the U.S. dollar to become significantly over-valued, leading to a major deindustrialization of the American economy. A similar problem afflicted the British economy in the early 1980s. For the last fifteen years, France has defensively tied its interest rates to German rates in order to protect against currency disorder and imported inflation, and the result has been massive unemployment.

International financial markets are deeply implicated in all of these events. In the case of the Reagan dollar and Thatcher sterling over-valuations, portfolio flows responded to tight domestic monetary policy in a fashion that appreciated the exchange rate and caused de-industrialization. In the case of France, the government has had to capitulate to the threat of an exit of financial capital and raise interest rates. Thus, international financial flows have either directly contributed to the making of economic instability, or they have acted in a way that has frustrated the conduct of domestic monetary policy. Moreover, to the extent that industrialized countries have been compelled to adopt higher interest rates to appease financial markets, this has meant that developing countries have also suffered as they have had to pay higher rates on their borrowings.

The problems for developing countries of ill-conceived financial openness are illustrated by the current east Asian financial crisis. Though the IMF initially sought to place the blame for the crisis on excessive east Asian government intervention, it has now become clear that an integral cause of the crisis is the current operation of international money markets. These markets permitted excessive short term foreign currency denominated lending, and also encouraged extensive foreign portfolio investment. In combination with uncontrolled international capital mobility, this produced a combustible mix.

The origins of the crisis are intimately connected with the globalization of finance. In the early 1990s there developed a new taste for "emerging markets". This new taste was rewarded with spectacular returns, which attracted even larger flows of funds and produced a herd driven move by investors and banks into east Asia. Moreover, this development was actively promoted by the IMF, which encouraged governments to eliminate controls, remove domestic ownership restrictions, and open domestic financial markets.

Portfolio investors hold equities denominated in local currencies, and are therefore concerned with the exchange rate since it determines the dollar value of their investments. Believing that the exchange rate was about to fall, equity investors sought to protect their funds by selling out and repatriating them back home. However, this selling then drove the exchange rate down. In doing so, it increased the burden of foreign debts which are denominated in foreign currency, thereby giving portfolio investors additional reason to sell. In this fashion, east Asia found itself locked in a spiral of exchange rate depreciation.

East Asia's financial crisis has clearly revealed the deficiencies in the existing approach to globalization. Rather than just pursuing a policy of wholesale abolition of controls on capital mobility and opening of economies to financial flows, there is a need for well designed rules that promote growth and avoid instability. Capital account governance has become a significant problem that is undermining industrialized countries' abilities to use expansionary macroeconomic policy to ensure full employment and developing countries' abilities to grow. New measures such as Tobin taxes and Chilean style speed bumps are needed to correct the underlying deficiencies in the system of capital account governance. Once again, it is not a matter of preventing markets from working, but rather a matter of designing rules that constructively harness the strengths of markets. Simply deregulating markets and relying on market discipline means that economies will be subject to periodic crashes, the costs of which are often unfairly distributed. It is possible to do better by appropriate design of rules that preserve the beneficial allocational effects of international capital markets while minimizing any tendency to promote deflation or economic instability.

Labor standards and economic development

Another area of controversy concerns the role of labor standards in the new global order. All too often such standards have been interpreted as a form of market distortion, and some have sought to label calls for such standards as implicit protectionism. However, the reality is that labor standards contribute positively to political and economic development, and they are good for both developed and developing countries.

The potential contribution of such standards can be illustrated by reference to east Asia's experience. Though east Asia's economies grew rapidly without any deterioration in the degree of income inequality, developments in civil society failed to keep abreast (except for South Korea). This failure contributed to the emergence of widespread economic cronyism, and the IMF has rightly identified such cronyism as a contributory factor in the crisis as it gave rise to misallocation of borrowed resources. In response, the IMF has advanced two solutions. One is to increase market transparency by requiring improved accounting and reporting standards. The other is to increase the extent of financial liberalization by giving foreign companies increased domestic market access. The argument is that market competition will compete cronyism away.

This belief is mistaken. The reality is that these behaviors are politically sponsored, and changing them requires political reform. Ending cronyism and political corruption demands political reform that puts in place the countervailing forces needed to block such behavior. Human and labor rights are the foundation of such reforms. Crony capitalism distorts the behaviors of borrowers: it also distorts the actions of lenders, who all too easily get sucked into its malpractices. It is this logic that has prompted the OECD to adopt the Convention on Combatting Bribery (1997). Bribery distorts economic outcomes and reduces welfare, and hence the push to outlaw it. Political cronyism has the same effect, but the only way to end it is by establishing well-functioning democracies predicated on human and labor rights. The lesson is that fair and free markets cannot function in a corrupt and unconstrained polity.

Another economic advantage of insisting on human and labor rights concerns economic growth and wages. Palley (1998b) documents how countries that have instituted improved rights of free association have had significantly faster economic growth in the ensuing five year period. Rodrik (1998) documents how greater democracy goes hand-in-hand with higher wages. This can help transform developing economies from being export dependent into mature economies in which their own citizens are the principal consumers. The current emphasis on export led growth has given rise to a situation in which a few countries run large trade surpluses, and drain demand from the global economy. This chase for exports is contributing to global deflation. Having wages rise in newly industrialized countries would remedy this by creating the conditions whereby these countries could grow their industrial capacities on the basis of their own domestic demand.

Labor standards exemplify how well designed rules can make globalization work for all. Such standards enhance market efficiency by deterring cronyism, and they also promote sustainable growth and equitable development by fostering wages that rise with productivity. Unfortunately, the existing market openness paradigm seeks to represent such standards as market distortions, and in doing so it stands to erode existing standards and promote a race to the bottom. As with environmental standards, worker protections can become identified as a source of international cost disadvantage, thereby unleashing a dynamic for their repeal. This is the hallmark of the "low road" path.

The low road path represents the bad equilibrium in a prisoner's dilemma game. This equilibrium is socially sub-optimal for both developed countries and developing countries. Moving the world economy onto the socially optimal "high road" path requires market rules that compel countries to compete on the basis of product quality and productivity, rather than on the basis of eroded worker rights and protections. This is the economic logic behind common internationally enforceable labor standards.

The limitations of export-led growth

The push for market openness is accompanied by a corollary proposition about the benefits of export-led growth. This proposition now dominates economic policy making in both developed and developing countries. Developed countries see exports as filling in for the missing domestic demand that results from restrictionary fiscal and monetary policies, while developing countries are told that export-led growth is the path to faster economic growth and rapid modernization.

However, there is a major problem with such thinking, which is that not every country can engage in export-led growth. One country's exports are another country's imports, and this ultimately makes it impossible for all countries to run balance of payments surpluses. This adding-up constraint reveals the logical failing of the export-led growth paradigm. Attempts by all countries to pursue export-led growth must inevitably result in a form of beggar-thy-neighbour economics that risks plunging the world economy into a deflationary mire. Relying on growth of demand in export markets risks sucking demand out of those markets, thereby causing a shortage of demand that contracts incomes and in turn reduces the demand for exports. In recent years the U.S. has acted as the global buyer of last resort and this has created a mistaken impression about the long-term viability of export-led growth. The accumulation of U.S. international indebtedness means that this state of affairs is likely unsustainable, and there is now a need to move to a policy configuration in which demand grows in all countries. Only under such conditions can market openness work.

There are also other problems with export-led growth. By leading countries to focus on international competitiveness, it in turn leads to a focus on costs. Whereas maintaining competitiveness through increased productivity is desirable, a focus on costs can unleash an uncivilized dynamic that turns market openness into a race to the bottom. Thus, labor and environmental protections become perceived as costs, and this results in pressures for their repeal. Wages and benefits also become perceived as costs that undermine national competitiveness, and this gives legitimacy to corporate strategies aimed at cutting wages and benefits. In perverse fashion, rather than seeking to raise workers' standards of living, an export-led growth strategy can lead to an outlook in which holding wages down becomes the primary goal. This is a problem that is applicable to both developed and developing countries.

For developing countries the failure to generate rising domestic wages ultimately threatens to undermine the transition into mature industrialized economies. Once again, this can be illustrated by reference to east Asia's problems. The economic success of the industrialized countries is ultimately predicated upon the existence of mass consumer markets. In the U.S., consumer spending accounts for approximately two-thirds of economic activity, and this activity is built upon high wages and household access to credit. Developing countries need to develop the same mass markets by adopting a development path based upon a growing domestic market. Export-led growth mitigates against such an outcome, and it leaves developing economies vulnerable to the vicissitudes of demand in other economies. In this fashion, developing countries can remain trapped in a pattern of economic dependency.

Conclusion: beyond the myth of a natural economy

At the most abstract level, the debate over market openness remains guided by a philosophy of economic naturalism. This philosophy encourages the belief that there exists a natural economy, and that government interventions in the economy are distortions of this natural economy. As a result, economic naturalism promotes a policy outlook that encourages deregulation of markets, the weakening of unions and labor rights, the weakening of environmental protections, and the promotion of unrestricted free trade and capital mobility.

Economic naturalism is built upon the myth of a natural economy. The OECD has been persuaded by this myth, which explains why it is committed to reducing labor market protections in the name of labor market flexibility (OECD, 1994), and why it is committed to reducing barriers to trade and capital mobility in the name of international liberalization. However, eliminating labor market protections has not created a natural labor market: instead, it has created an employment climate in which business dominates labor. Similarly, allowing unregulated flows of financial capital has not created a natural capital market: instead, it has created an "unstable" market in which livelihoods and prosperity are put needlessly at risk.

Economic naturalism is a deeply misleading guide to policy. The reality is that all economies are always and everywhere based on rules. The challenge facing policy makers is not to recover the natural economy through deregulation and the abandonment of policy activism, but rather to design sets of rules that preserve the incentive to enterprise while seeing that prosperity is fairly shared. Exactly, the same logic applies to the international economic order, where the challenge is to design rules that promote growth with equity while avoiding international instability.

References

OECD (1994). The OECD Jobs Study: Evidence and Explanations, OECD, Paris.

---- (1997). Convention on Combatting Bribery.

---- (1998a). Open Markets Matter: The Benefits of Trade and Investment Liberalization, OECD, Paris.

Palley, T.I. (1998a). Plenty of Nothing: The Downsizing of the American Dream and the Case for Structural Keynesianism, Pinceton University Press: Princeton, .

------------ (1998b). "The Beneficial Effects of Core Labor Standards on Economic Growth," AFL-CIO Public Policy Department, Washington, D.C.

Rodrik, D. (1998) "Democracies Pay Higher Wages," NBER Working Paper 6364.