The Global Economy

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It is a pleasure to be in Loveland today to participate in this forum on national economic issues. The focus of my remarks today is "globalization," the growing trade and financial linkages among nations that are reshaping the world economy. Although the rhetoric about globalization is often political in nature, I believe it is important to recognize that the forces behind globalization are fundamentally about economics and, moreover, have been with us for a very long time.

In the 13th century, long before President Nixon reestablished economic linkages with China, Marco Polo traveled the Silk Road, opening the trade doors between the East and West and opening the world's eyes to the benefits of global trade. What has changed recently is the pace of globalization and the rapid increase in the size of trade and financial flows in the world economy. It took Marco Polo years to reach Beijing from Venice and to return. Today, while Loveland is still 6,319 miles from Beijing, Colorado businesses are now only a mouse-click away from their customers and competitors in China and other parts of the world.

In my remarks today, I would like to begin by exploring some of the important dimensions of globalization and also put recent trends in historical context. Then, I will take a closer look at the economic benefits and costs associated with globalization that underlie the public debate over globalization. Finally, I will discuss what policies can help ensure that we take full advantage of the benefits of globalization while minimizing its adverse consequences.

THE SIGNIFICANCE AND SHIFTING NATURE OF GLOBALIZATION

Over the past several decades, we have seen enormous growth in world trade, both in terms of the volume of trade and in the variety of products. We have also seen

significant shifts in our major trading partners. Even more remarkable is the growth in global financial markets and cross-border trading of financial assets. Behind the increased pace of globalization are a reduction in political and economic barriers to trade and the revolution in information and telecommunications technology.

The importance of international trade to the U.S. economy has grown steadily, from 6½ percent of GDP in 1945 to 25 percent last year. Trade between nations is equally important for the world's economy. In 1940, world trade accounted for 7 percent of world GDP; today it accounts for 30 percent.

Not only has it gained in importance, but the types of goods we trade have changed. Since World War II, our exports of goods has declined from 84 percent of total exports to 78 percent more recently while our exports of services has grown from 16 percent of total exports to 22 percent. And, you may not realize it, but we are actually running a trade balance surplus in services.[1] To a large extent, this reflects the growing importance of "other private services," which includes financial, business, professional, and technical services. This change is not surprising since we are increasingly a service economy where service sector jobs account for approximately 83 percent of nonfarm employment.

We have also seen a change in our major trading partners. Following World War II, half of our top 10 trading partners were from Latin America. In this century, only

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[1] For example, the balance of trade in services was 0.46 percent of GDP in 2004 and 0.21 percent of GDP during the period 1945 – 2004. In contrast, the balance of trade in goods was -5.78 percent in 2004 and -0.78 percent during the period 1945 – 2004.

Mexico is still in that group. Following World War II, there were no Asian economies in the top 10. Today, there are four.[2]

In addition to international markets for trading goods and services, we also have international markets for trading financial assets. In fact, a larger share of global saving is now being invested in foreign countries than ever before. In other words, more of our savings is invested in foreign economies, and more foreign savings is invested in the U.S. economy.

The cross-border trading of financial assets has seen an even more rapid increase in importance than trading of goods and services. It's impossible to measure exactly how much the trading in world financial markets has grown, but we can get a good idea by comparing the increase in U.S. foreign assets and liabilities with the increase in trade and GDP. From 1980 to 2003, U.S. foreign assets rose by a factor of 13 (from $584 billion to $7.680 trillion) and foreign liabilities rose by a factor of 20. By comparison, GDP (current dollars) rose by a factor of 4 and U.S. trade rose by a factor 5.

There is another way we can look at the increasing importance of cross-border trading of financial claims. Again, we are somewhat limited by a lack of complete data. Nonetheless, the percent of U.S. long-term securities owned by foreigners has increased from about 5 percent in 1974 to 14 percent last year.

Why have world markets for goods and services and world markets for financial assets grown so rapidly? First, more and more countries have recognized the strong

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[2] The top 10 trading partners (in merchandise trade) in 1949 were Canada, United Kingdom, Bermuda and Caribbean, Brazil, Germany, Venezuela, Cuba, Mexico, France, and Columbia. During 1971-75 the top 10 included Canada, Japan, Germany, United Kingdom, Mexico, Italy, France, Venezuela, Netherlands, and Brazil. The top 10 in 2000-04 were Canada, Mexico, Japan, China, Germany, United Kingdom, Korea, Taiwan, France, and Italy.

relationship between openness to the global economy and economic growth. As a result, they have joined the global economy.

Immediately following World War II, world trade was limited. The world's economy was splintered into political spheres of influence. In addition, many industrialized countries put significant restrictions on international flows of capital, and many developing economies believed that the path to sustainable growth was through import subsidies to local industries. The facts show that the only outcome of such policies is stagnation and poverty.

Views began to change in the late 1980s with the fall of the Berlin Wall and the adoption of market-oriented policies in many countries. The number of countries taking part in the global economy soared. The list of newly emerging countries grew to include China, India, many countries in Asia and Eastern Europe, and the former Soviet Union. In choosing to join the global economy, these countries have reduced their reliance on capital controls and other barriers to trade. You need only look at recent economic reports coming out of these countries to appreciate the benefits that have accrued to them from embracing a more open trade policy.

But the increasing importance of globalization cannot be explained simply by more countries engaging in the global economy. Improvements in the technology of transportation have reduced the costs of shipping goods and services, making global transactions faster and more affordable. At the same time, the IT revolution has yielded significant savings in both the time and cost of communications and information processing. In this way, the internet and technology has created a global marketplace for

services. This is important for the United States because services—especially those that require technology and high-skilled labor—represent our comparative advantage.

Another factor is a general trend by governments to reduce tariffs and other barriers to trade, which has reduced the cost of international trade. In 1947, one of the first postwar trade agreements was the General Agreement on Tariffs and Trade, or GATT, the predecessor of today's World Trade Organization (WTO). GATT reflected the leadership of the United States in an expanding system of world trade. Since then, the average tariff in the United States has shrunk from about 20 percent to just 5 percent, and tariff reductions world wide rival these U.S. figures.

BENEFITS AND COSTS OF GLOBALIZATION

Discussions of globalization frequently turn into a debate: Do the benefits exceed the costs? On one side of the debate are economists, who generally see globalization as positive. On the other side are various protectionist groups, which tend to emphasize the negative.

The costs of globalization are typically measured in jobs lost to foreign competitors. These costs do make for good headlines. They are quite visible and frequently concentrated in specific regions. In contrast, the economic benefits of globalization tend to be harder to measure and spread over the entire population. A proper accounting, however, suggests that the benefits far exceed the costs so that globalization should be viewed as a positive economic development.

Economists from Adam Smith on have emphasized how trade can be mutually beneficial to the countries involved. A number of efficiencies emerge when countries specialize in producing those goods in which they have a comparative advantage.

Competition translates these efficiencies into lower prices for consumers. In addition, trade may benefit consumers by providing a greater variety of products than would be available through domestic production alone.

Increased financial linkages across countries can also be beneficial by channeling savings to those areas of the world where investment opportunities are best. This is particularly true for developing countries where the return to capital is potentially quite high, making them an attractive place for foreign investors. One generally expects high rates of return in developing countries because they generally have a younger and more rapidly growing workforce with relatively little capital per worker.[3]

But, countries like the United States can also benefit if investment opportunities driven by strong productivity growth attract foreign saving as we saw in the late 1990s. Beginning in about 1995, the increase in productivity growth led to an increase in real rates of return in the United States and stronger investment spending. Such investment spending can be financed from either U.S. saving or foreign saving. Fortunately, foreign investors were willing to invest their saving in U.S. assets, thereby helping to finance our investment projects. This was particularly important because our national saving rate is low, due in part to personal saving falling from 3.4 percent to 1.7 percent of GNP. As it turns out, between 1995 and 2000, net foreign saving rose from 1.5 percent of GNP to 4.2 percent. Without the benefit of foreign investors choosing to invest in the United States, it is likely that U.S. investment spending would have been lower.

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[3] In general, this means that developing countries would be expected to be net borrowers from the industrialized economies of the world. This was generally true. However, following a series of financial crises—beginning with Mexico in 1994—many developing countries actually became net lenders rather than net borrowers on global financial markets.

While the benefits of globalization are difficult to measure accurately, we do have much evidence suggesting that they are significant. One recent economic study finds a large positive effect of openness to trade on a country's real GDP per capita.[4] A one percentage point increase in the ratio of trade to GDP increases income per person by between 1.5 to 2 percent. Another study suggests that the benefits from international trade were about $2,500 per household in 2002.[5]

Finally, a recent study from the Federal Reserve Bank of New York suggests that traditional measures of the benefits from trade may be understated by failing to include the benefits to consumers of greater product variety.[6] After correcting measures of import prices for the impact of greater product variety, the authors conclude that from 1972 to 2001, greater product variety raised U.S. welfare by $260 billion or 3 percent of (2001) GDP.

Expanding global trade has clearly benefited Colorado. A study prepared for the Denver Mayor's Office found that exports by local firms directly account for about 46,000 jobs in the Denver metro economy. If you add in indirect and induced effects, such as local firms supplying parts and services to exporters, global linkages account for about 123,000 jobs and $5 billion in income.

Colorado firms are also reaping benefits. One engineering firm is an environmental advisor for the 2008 Olympics in Beijing. Another firm has won contracts

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[4] "Does Trade Cause Growth?" Jeffrey Frankel and David Romer, American Economic Review, June 1999.

[5] "The Benefits of Free Trade to U.S. Consumers," James Langenfeld and James Nieberding, Business Economics, July 2005, pages 41 – 51.

[6] "Are We Underestimating the Gains from Globalization for the United States," Christian Broda and David Weinstein, Current Issues in Economics and Finance, Federal Reserve Bank of New York, April 2005.

to build water and wastewater plants in China and is working on the Three Gorges Dam on the Yangtze River. And high-tech firms in Colorado are serving large corporate clients across the globe. One data storage firm recently facilitated the merger of two of the largest banks in South Korea.

Of course, these benefits don't come without costs. The principal costs of increased globalization are the job losses and plant shutdowns that result from changing trade patterns. While these losses have traditionally been associated with manufacturing, over the past two years, more attention has been focused on the outsourcing of service jobs. Without attempting to minimize the difficulties faced by individuals and communities affected by outsourcing, I would note that most economic studies find that outsourcing has been small relative to the overall size of the U.S. labor market.[7] Moreover, since increased trade results in more exports as well as more imports, jobs lost through outsourcing need to be balanced against jobs gained through increased exports to get an accurate measure of how globalization affects overall employment.[8]

Another potential cost of globalization comes via the increased financial linkages among countries. Investor funds that flow into a country in search of attractive investment returns can flow out very rapidly at the first signs of an economic downturn, exacerbating the magnitude of the downturn. Moreover, as we saw on a number of occasions over the past decade, volatile financial flows can cause financial difficulties in one country to spill over into financial markets in other countries. Developing countries

[7] "Offshoring in the Service Sector: Economic Impact and Policy Issues," C. Alan Garner, Economic Review, Federal Reserve Bank of Kansas City, third quarter, 2004.
[8] "U.S. Jobs Gained and Lost Through Trade: A Net Measure," Erica Groschen, Bart Hobijn, Margaret M. McConnell, Current Issues in Economics and Finance, Federal Reserve Bank of New York, August 2005.

with underdeveloped domestic financial markets are likely to be especially vulnerable to these events, but larger industrialized countries could also be affected.

In evaluating the economic benefits and costs of globalization, it is important to remember that the benefits continue to accrue over time, while the costs tend to be of more limited duration in an economy as dynamic as that of the U.S. Thus, on a long-term basis, the benefits will certainly outweigh the costs. In this light, it is important for policymakers to take actions to promote and enhance the positive effects of globalization while working to manage and minimize the associated costs.

POLICY IMPLICATIONS

In my view, globalization is both inevitable and beneficial. Consequently, we are likely to be better off by adapting to the changes it brings rather than by attempting to resist its progress.

From this perspective, the key question is how to manage the globalization process to maximize its benefits and minimize its costs. Certainly, we need to continue to support the lowering of trade barriers both on a multilateral basis through the WTO and on a bilateral basis with important trading partners. Conversely, while we must insist on achieving fair agreements with our trading partners, we need to resist pressures to adopt protectionist measures for those industries that are most exposed to increased global competition.

The emergence of new players in the world economy has increased the competitive pressures facing U.S. firms—both exporters and those that compete with imports. To address this issue, we must insure that we remain competitive in those sectors in which we have a comparative advantage. I would suggest that those sectors

involve capital-intensive technologies and skilled labor. In this regard, a strong general and advanced education system is important. In addition, incentives for R&D (but not industrial policy) may also play an important role in enhancing our comparative advantage.

At the same time, we cannot ignore the fact that some workers will lose their jobs as the result of intense foreign competition. I believe the proper policy response is to ease the transition costs through retraining, upgrading, and acquisition of new skills.

One way to ease the transition costs is to provide assistance to workers that have lost their jobs. The Trade Adjustment Assistance program is one program that provides training and income support to workers that have been hurt by international trade.

Our system of community colleges, by giving students important new job skills, also can play an important role. For example, over half of the healthcare, life science, physical science, and social science technicians in the United States have an associate's degree.

We also can take steps to ensure that increased financial market integration does not lead to financial instability. In this regard, it is particularly important to help developing and emerging market economies create strong and resilient banking systems so that they do not become a source of systemic instability. We can encourage this by assisting these countries in developing appropriate systems for financial supervision and regulation and best accounting practices. At the same time, we need to ensure that appropriate facilities are available at the international level to assist in the event that a crisis occurs and help minimize damage to the international financial system.

CONCLUSIONS

I would like to conclude with a brief summary and then respond to your questions. Globalization will probably always have its skeptics and detractors. But, Marco Polo had detractors too. For centuries, in fact, many people doubted that he actually went to China. But, he did, and Europe and Asia benefited greatly.

In considering the economic benefits and costs, I would conclude that the benefits—which are long lasting—outweigh the costs. In arriving at this conclusion, I do not mean to minimize the hardship caused by workers losing their jobs or firms shutting down their factories. But, it is important to remember that these costs can be managed and made transitory as workers and firms adjust to the new economic realities. There is a role for government policy in minimizing these transition costs. And there is an even larger role for a strong educational system which will allow us to maintain our competitive edge in products that require technology and high-skilled labor.