

THE ECONOMICS OF GLOBALIZATION: PROBLEMS AND POLICY RESPONSES

THOMAS I. PALLEY

Assistant Director of Public Policy, AFL-CIO, Washington DC

Summary

This paper explores the economic process known as globalization. This process extends to the international arena many of the processes that have driven the formation of unified national economies. Globalization is driven by the market forces of profit maximization, cross-country price arbitrage, and technological and organizational innovation. It is also driven by policy initiatives that have reduced barriers to international movement of goods and financial capital. Globalization is changing the economic environment in a manner that shifts the balance of power away from national governments and labor toward business, and makes the conduct of autonomous national economic policy more difficult. It is also changing the pattern of incentives facing private actors in a manner that resembles the infamous prisoners's dilemma. This promotes socially sub-optimal outcomes. Fixing this problem requires a range of policy interventions that involve coordinated international agreement and remove the private incentive to make socially sub-optimal choices. These interventions include coordinated cross-country macroeconomic policy, new rules for international financial markets, and the adoption and enforcement of core labor standards.

I. GLOBALIZATION AND THE RELEVANCE OF CATHOLIC SOCIAL TEACHING ON LABOR

Nations and communities around the world are today confronting the process of globalization. This process refers to the creation of a unified global economy through the breaking down of barriers between national economies. Globalization is creating both new opportunities and problems. The opportunities include the possibility of raising global economic productivity and advancing economic development in under-developed countries, thereby raising standards of living around the world. The dangers

include the introduction of new sources of economic instability, and a shift in the relative bargaining power of labor and capital that risks lowering wage incomes for the benefit of profit. These dangers have been brutally illustrated by the suffering caused by east Asia's economic crisis, and by the subsequent spread of the crisis to Russia and Brazil.

The concerns raised by globalization resonate deeply with the long history of Catholic social teaching on labor.¹ This teaching emphasizes the concept of a "right to work" at a "just wage", with work being such that it is consistent with "human dignity" and contributes to "fulfillment as a human being". Globalization has unleashed forces that potentially impinge negatively on every dimension of this teaching. Thus, increased international integration has unleashed forces of wage competition which have contributed to lowering wages in industrialized countries, and this threatens the payment of just wages. It has also facilitated companies taking advantage of retrograde employment conditions in countries where workers are denied rights of free association and collective bargaining, thereby threatening the realization of human dignity through work. Finally, international financial integration has unleashed new forces of economic instability that have undermined the ability to achieve and sustain full employment, and this threatens the notion of a right to work.

How to make Catholic social teaching on labor an economic reality is a major task. To this end, the Church has acknowledged a need for dialogue with the social sciences. In participating in this dialogue, economists are implicitly asked to adopt an instrumentalist approach whereby their understanding can be used to help make Catholic teaching a concrete reality. It is in this spirit that the current paper has been written. Thus, the paper analyzes the economic foundation of globalization, and proposes a series of policy responses designed to preserve the opportunities of globalization while curbing the threats.

II. THE ORIGINS OF GLOBALIZATION

Globalization refers to the increased international integration of national goods, financial, and labor markets. This process of integration is being driven by firms' competitive search for new markets and by the law of market arbitrage which has profit maximizing firms equalizing the price of similar goods and services across markets.

¹ The history of Catholic social teaching on labor is surveyed by Schasching (1998).

In many regards, globalization represents a logical extension of the processes that have driven domestic economic development. Thus, the formation of a unified national market in 19th century America was also driven by the search for new markets and the law of market arbitrage. Similarly, the emergence of wage competition between the U.S. economy's "sun" and "rust" belts in the 1970s, has parallels with wage competition between developing and industrialized countries today. However, globalization transcends national boundaries, whereas earlier periods of economic integration tended to take place within the context of the national unit.

The process of globalization is girded by technological and organizational innovations that enhance the mobility of capital, thereby allowing business to operate on a global scale. These innovations are the product of "Schumpeterian" market forces that reflect the workings of a dynamic capitalist economy. Business seeks to maximize and increase profits, and it does so through technological and organizational innovation. Firms can gain a competitive advantage over rival firms by capturing a greater share of the existing market, or they can create a new market that destroys the old. They can also innovate in ways that redistribute income from labor to capital. This latter form of innovation amounts to re-slicing the economic pie rather than increasing it. Both forms of innovation are visible in the process of globalization. Thus, firms use the global economy both to lower their costs to gain competitive advantage over rivals, and they also use the threat of international job relocation to win wage concessions from domestic labor.

Globalization has also been fostered by economic policy which has removed barriers to international trade, investment, and financial flows. Though these policies appear to be exogenous changes, they can also be viewed as the endogenous outcome of corporate "political" innovation. Just as business has an incentive to innovate with regard to products, technique, and location of production, so too it has an incentive to capture government policy so as to change existing laws and regulations to its competitive advantage. Such political innovation is clearly evident in business' advocacy of the North American Free Trade Agreement, "fast track" trade negotiating authority, and the Multilateral Agreement on Investment (MAI).

Over the last decade, globalization has become an increasingly contested matter. The impulse behind this new found contested status is the spreading realization that globalization creates both winners and losers, that in many instances the losers are large in number, and that the winners seldom compensate the losers. On the positive side, globalization has increased international goods market competition, thereby lowering consumer prices, increasing consumer choice, and increasing productive efficiency. The integration of financial markets has also facilitated the provision

of financing to developing countries, which has opened the potential for them to grow faster. On the negative side, it has contributed to the transfer of U.S. manufacturing jobs to developing countries, wage stagnation, and the worsening of income inequality. It has also promoted the emergence of extreme financial instability in the international economy.

The fact that globalization brings both benefits and costs has made it a contested issue. Almost all agree that the process of globalization cannot be stopped, and nor is it desirable to do so. The real debate is about the balance of benefits and costs under the existing process, and the policy adjustments needed to enhance the benefits and reduce the costs. One view – call it the optimists' view – maintains that the benefits clearly outweigh the costs under existing arrangements, and that these benefits would be even larger if national economies were more open and markets more flexible. A second view – call it the pessimists' view – sees the process of globalization as problematic, with the balance of benefits and costs more finely balanced. Moreover, the costs are large, and could get larger as globalization matures. What is needed is a change in the rules and institutions of the international economy that would alter existing patterns of incentives, thereby discouraging economic actions that generate costs and promoting actions that bring benefits.

III. A VIEW FROM THE OPTIMISTS: GLOBALIZATION AS PERFECTION OF THE MARKET PROCESS

The optimists' position on globalization is eloquently stated by Tietmeyer (1998). For Tietmeyer, the existing process of globalization represents a positive and largely unproblematic development. The opening of national capital markets and their integration into the international financial system ensures that scarce capital is allocated to its globally most productive use, and this improved allocation raises global welfare. The globalization of goods markets, brought about by increased international trade, is also unproblematic. Countries are induced to specialize in the production of those goods and services in which they have comparative advantage, so that resources are used more efficiently. At the same time, there is never a shortage of demand because the act of production always ensures that sufficient income is forthcoming to buy whatever is produced.

Though much less affected than goods and financial markets, globalization is also largely unproblematic for labor markets. This is because the forces of competition guard against exploitation and ensure that workers are paid their worth. If there is a problem with unemployment, then it is to be found in imperfections and rigidities within labor markets. These result from exces-

sive minimum wages, laws granting workers excessive job protections, trade unions that price workers out of jobs, and from the immobility of workers who refuse to move where the jobs are. To the extent that globalization competes away these imperfections and rigidities, it is even more beneficial.

IV. A VIEW FROM THE PESSIMISTS: GLOBALIZATION AND THE PROBLEM OF ECONOMIC LEAKINESS²

An alternative view of globalization casts the process in terms of the creation of a "leaky" economic environment in which national economies are no longer sealed off from one and other (Palley, 1998). This new environment is marked by a pattern of incentives that can give rise to bad economic outcomes, as well as making it difficult to implement effective policy responses. Three different types of leakiness can be identified:

(1) *Macroeconomic leakiness* refers to the tendency for aggregate demand to leak out of national economies owing to a larger propensity to import. It is the result of increased international trade which has changed patterns of spending. The increase in macroeconomic leakiness is captured in table 1 which shows the degree of country "openness" as measured by the ratio of imports plus exports to total gross domestic product. A measure of 0 corresponds to a totally closed economy which has no imports or exports. Economic openness has increased almost everywhere, and in the U.S. it has increased 152% over the last thirty years.³

(2) *Microeconomic leakiness* refers to the tendency for jobs to leak out of an economy if labor markets are not sufficiently flexible, labor costs are too high relative to other countries, or profit taxes are relatively unfavorable. This form of leakiness has greatly increased owing to greater mobility of production, itself the product of reduced transportation costs and changed technologies that have facilitated new structures of production. Costs of transporting goods have fallen dramatically. In the 1960s, the cost of sea freight was 5-10% of the value of goods: today, it is around 1.5%. Costs of foreign production have fallen because tariff barriers have been reduced, thereby

² This section is based on the chapter titled 'Structural Keynesianism and Globalization' in Palley (1998).

³ For Europe as a whole, the degree of openness is similar to that of the U.S. Individual European countries engage in significant intra-European trade which raises European country levels of openness. Once these intra-European trade flows are netted out, European openness reduces to U.S., levels.

TABLE 1 - Openness of OECD countries, 1966-1995. Openness = [Exports + Imports]/GDP.

	1966	1995	Change 1966-1995
United States	9.9%	23.6%	138%
Canada	39.1%	72.3%	95%
Japan	19.4%	16.8%*	-13%
Germany	51.1%+	63.4%*	24%
United Kingdom	37.8%	57.3%	52%
France	25.0%	44.5%	78%
Italy	28.1%	43.2%*	54%
Austria	51.4%	76.2%	48%
Belgium	73.5%	137.2%*	87%
Denmark	58.5%	63.3%	8%
Finland	41.3%	67.5%	63%
Netherlands	89.8%	100.0%	11%
Norway	83.2%	70.6%	-15%
Portugal	54.1%	61.0%*	13%
Spain	20.2%	47.3%	134%
Sweden	43.8%	75.3%	72%
Switzerland	58.7%	66.9%	14%
G-7	30.1%	45.9%	53%
Europe	51.2%	69.6%	36%

Source: Author's calculations using IMF statistics. G-7 and Europe computed using population weights. * = 1994 data.

making it less costly to produce goods in one country and sell them in another. Costs of coordinating production in different locations have also fallen owing to improved communication and production technologies. Thus, whereas factories used to be marked by management's offices sitting directly above and looking out over the factory floor, today, management can be located in New York while production takes place in Guangdong, China.

(3) *Financial leakiness* refers to the increased international mobility of financial capital. Innovations in electronic communications and money

transfer, combined with the abolition of capital controls, have made it easier to shift money between countries. As a result, financial capital now moves in response to small differences in cross-country interest rates and perceived future rates of return, and to differences in national economic policies and inflation rates.

These three forms of leakiness have changed significantly the economic structure and the pattern of incentives facing business. They have also made the conduct of domestic economic stabilization policy more problematic, as well as creating perverse incentives for policy makers to follow contractionary policies. The new pattern of incentives has similarities with the prisoner's dilemma. The market sends signals encouraging a particular type of behavior, and when one market participant adopts such behavior they are made better off: however, when all adopt the behavior, all are made worse off.

Macroeconomic leakiness

Increased international trade means that exports and imports now constitute a larger share of GDP. This has numerous important implications. First, the increased reliance on exports as a source of aggregate demand (AD) means that countries are more exposed to economic shocks originating in other countries. This is visible in the manner in which east Asia's recession has impacted U.S. manufacturing employment.

Second, increased reliance on imported goods results in a greater leakage of demand out of national economies. Consequently, expansionary fiscal policy is less effective in stimulating domestic economic activity and has a larger negative effect on the trade balance. As is discussed below, this in combination with increased financial leakiness, sets up an incentive for policy makers to shift toward less expansionary policies.

Third, with imports constituting a larger share of spending, imports also constitute a larger share of the consumer price index. Domestic inflation is therefore more subject to the vagaries of foreign inflation and movements in the exchange rate. In 1998, the U.S. inflation rate fell from 2.7% to 1.5% despite a twenty five year low unemployment rate of 4.5%. This inflation performance significantly reflected the lower price of imports resulting from a strong dollar and severe recession in east Asia. However, just as inflation can now fall when unemployment is low, so too it may rise in future when unemployment is high, thereby presenting a significant policy dilemma.

Exposure to foreign inflation and exchange rates has been further exacerbated by the stance of anti-trust policy which has allowed greater concentration of industry on the grounds that markets are now global in scope. However, the price discipline of foreign competition depends on

exchange rates, and a weakening of the dollar could result in increased monopoly pricing power for domestic producers.

Microeconomic leakiness

Increased mobility of production has increased the options available to business, and this has increased the bargaining power of firms *vis-à-vis* both labor and government. This increased bargaining power has in turn been used to win concessions from both labor and government. The result has been to shift the distribution of income in favor of profits over wages, and to shift the burden of taxes away from capital income on to wage income.

The impact of changed bargaining power on wages and the distribution of income is formally examined in the appendix using a Kaleckian mark-up pricing model. The effects of increased microeconomic leakiness operate through three different channels. The increased threat of job transfer lowers both the real wage and the wage share of income. The presence of such an effect has been documented by Bronfenbrenner (1996) who shows that after the enactment of NAFTA, American firms increased their use of the threat of relocation to Mexico to win wage and benefit concessions. The foreign price competition effect raises both the real wage and wage share. It does so by giving consumers additional choice options in goods markets, thereby reducing domestic producers' monopoly power and lowering prices. Finally, the foreign competition production efficiency effect also raises both the real wage and wage share, with enhanced foreign competition prompting domestic firms to seek out more efficient production techniques and eliminate Leibenstein (1978) X-inefficiencies.

Such an analysis shows how increased microeconomic leakiness brings both benefits and costs. The benefits are associated with the introduction of more competition in goods markets which lowers prices and stimulates productivity and quality improvements, while the costs are associated with the ability of firms to place domestic wages in competition with foreign wages. Globalization optimists tend to emphasize the former, whereas pessimists emphasize the latter.⁴

Increased mobility of production has also had negative effects on government's ability to tax capital. Increased mobility gives capital the option

⁴ The above analysis is aggregate in nature. In practice, the extent of product versus wage competition likely differs according to the countries one trades with, as well as differing by sector. Trade between developed countries likely tends to generate greater price competition and efficiency gains, whereas trade between developed and developing countries likely has a stronger wage competition dimension.

to exit, taking with it jobs. Capital can therefore use this threat to win tax concessions, and government is also given an incentive to pursue policies that lower taxes on capital with the hope of becoming relatively more attractive to business.

There is solid evidence that such a process is underway. Rodrik (1996) documents the decline since the early 1980s of tax rates on capital relative to labor in France, the U.S., the U.K., and Germany. Palley (1998) details how European governments and state governments in the U.S. have engaged in tax auctions to attract new investment. These auctions involve giving tax relief to companies in return for new investment. The key feature is that business plays one government off against another, thereby engaging them in a tax relief bidding war.

Such tax competition has significant macroeconomic and distributional effects. The governments budget constraint is given by

$$(1) \quad D = G - T_w - T_k$$

where D = budget deficit/surplus G = government spending

T_w = taxes on labor incomes T_k = taxes on capital incomes

Tax competition drives down T_k . If government is constrained in its ability to deficit finance, then spending (G) must decrease or taxes on wages (T_w) increase. If T_w increases, then capital's ability to move results in a shifting of tax burdens that lowers after tax wages and worsens the distribution of income. Alternatively, government can cut down on its provision of services. However, both reduced G and increased T_w have deflationary macroeconomic consequences. Reduced government spending reduces aggregate demand, while lower wages depress household consumption demand.⁵

Analytically, tax competition corresponds to a prisoner's dilemma. It is illustrated in figure 1.

Countries can choose either to hold capital taxes at existing levels or to lower them. If one country lowers and the other holds, then it gains investment from the other country and is made better off, while the country that holds loses investment and is made worse off. The optimal outcome is if both hold, as tax revenues are maintained and neither country loses investment. The sub-optimal outcome is when both lower, as both lose tax rev-

⁵ The net effect of such tax shifting depends on the relative marginal propensities to consume out of wage and profit income. Palley (1997a) provides several theoretical arguments as to why the MPC out of wage income likely exceeds that out of profit income.

		Country A	
		Hold the line on taxes	Cut taxes
Country B	Hold the line on taxes	A. Tax harmonization	B.
	Cut taxes	C.	D. Tax Competition

Figure 1. The tax competition as an example of prisoner's dilemma.

enues and neither gains investment from the other. Unfortunately, the structure of incentives is such that each country has a private incentive to lower, thereby realizing the sub-optimal equilibrium.

Microeconomic leakiness also promotes a tendency which can be termed "systems competition".⁶ Economies are complex social systems that embody different forms of labor market governance and social protection. Examples of difference include the scope of employee rights and employment protections, work place safety regulation, environmental protection legislation, and requirements on firms to provide health and pension benefits. These system differences significantly impact upon costs of production, and they can confer a competitive disadvantage on firms in international markets. To stay competitive, firms in countries with higher systems costs will try to lower costs, and this can unleash pressures for the undoing of arrangements that provide social protections. Capital will either tend to exit so as to avoid meeting requirements, or it will blame such requirements for loss of jobs in the hope of generating political momentum for their repeal. This possibility is evidenced in Europe where there is much debate over the viability of the European model of social protection. Lastly, the proclivity toward systems competition rises as the degree of economic openness increases because gaining international cost advantage becomes ever more important. This indicates how different types of leakiness may interact synergistically.

⁶ The notion of systems competition is introduced in Palley (1998a).

As with tax competition, systems competition also partakes of the prisoner's dilemma. Each country has an incentive to try and attract capital and win a competitive advantage in international markets by lowering standards. This is the hallmark of the "race to the bottom".

*Financial leakiness*⁷

The third form of leakiness is financial leakiness. It too has been driven by technological innovations and policy changes. Improvements in electronic communications and money transfer technologies have greatly lowered the cost of transferring funds between countries, which has hugely increased the extent of such transfers. Elimination of official controls on capital flows between countries has also increased the extent of transfers. Thus, according to the Bank of International settlements, the ratio of foreign exchange (FX) trading to world trade was 10:1 in 1980; by 1992 it was 50:1, and by 1995 it was 70:1.

This expansion of international financial flows has increased the risk of financial instability and reduced the scope for economic policy autonomy. The increased risk of instability arises because of greater speculation in capital markets. Sudden changes in portfolio preferences can cause abrupt changes in asset prices. A loss of investor confidence in one country can cause a capital outflow, and as investors sell off their holdings they drive up interest rates while their currency sales drive the exchange rate down. Such shifts are particularly problematic if a country is a net foreign debtor whose debts are denominated in foreign currency. In this case, the fall in the exchange rate increases the burden of foreign debt service.

Moreover, it is not just the country from which investors are exiting that suffers. The exchange rate rises in countries experiencing capital inflows, and this can profoundly affect their competitiveness in international goods markets. Consequently, employment in trade related sectors may be severely impacted despite no change in factory floor productivity.

Keynes (1936) described speculation through a metaphor whereby financial investing was akin to the newspaper beauty contest in which contestants picked the person they thought other contestants thought the most beautiful, rather than the person they truly thought the most beautiful. The same may hold in stock markets where the trick is to buy stock that others are buying rather than the stock of the soundest company. The theory of

⁷ The problems of financial leakiness and possible solutions are examined in detail in Palley (1998c).

rational asset price bubbles explains how asset price bubbles can be self-sustaining through expectations that become self-fulfilling. De Long *et al.* (1990) explain how “noise” traders, who trade randomly and disrupt market signals, can survive in the long run: all that is needed is that noise traders be less risk averse than “fundamentals” traders and therefore purchase assets with slightly higher expected returns. The problems of speculation are compounded by herd behavior that is rooted in rational maximizing behavior. Banerjee (1992) presents a model of herd behavior in which the actions of others are believed to convey information that is valuable in one’s own private decision making, and this results in “follow the leader” behavior. Palley (1995) presents an alternative “safety in numbers” model of herd behavior whereby managers have an incentive to behave like other managers to avoid the risk of being singled out for bad performance. All that is needed is some degree of risk aversion and that pay be based on relative performance.

These microeconomic accounts of speculation and herd behavior provide the behavioral foundation that explains why international financial speculation can be a significant threat to economic stability. This claim is strongly supported by recent events in east Asia. In the early 1990s, financial investors acquired a taste for “emerging markets”. They were initially rewarded with spectacular rewards, which attracted even larger flows of funds and produced a herd-like move into east Asia. These moves were facilitated by the elimination of controls on capital flows into and out of many countries in the region. In 1997, a combination of growing current account deficits and a realization that much of the capital inflow consisted of short term lending that was up for repayment, prompted investors to begin to exit. This then triggered a rush for the exits, with investors seeking to protect the value of their holdings by reconverting them back into hard currencies. This selling drove asset prices down and depreciated east Asian exchange rates, thereby raising the burden of east Asia’s foreign currency denominated debt. The increase in debt burdens caused widespread bankruptcy and pushed east Asia into deep recession.

Another problem resulting from increased financial leakiness is loss of national policy autonomy. The precise nature of the limitations on policy depend importantly on the exchange rate regime. In the Fleming (1962) - Mundell (1963) model, when exchange rates are fixed international financial capital mobility neutralizes monetary policy but leaves fiscal policy intact. Conversely, when exchange rates are flexible, fiscal policy is neutralized but monetary policy remains effective.

Fixed exchange rates mean that monetary policy is ineffective. The gain is supposed to be that they bring exchange rate stability. However, financial

leakiness can undo this and render a system of fixed exchange rates highly unstable. One source of difficulty is that countries differ in their rates of inflation and productivity growth, and this necessitates periodic exchange rate adjustments to ensure that countries do not become internationally uncompetitive. These adjustments in turn open the door to speculation. In effect, speculators are offered a "one-way" option. The weak currencies are easily identifiable on the basis of economic fundamentals. Consequently, there is an incentive to sell these currencies and buy back-in after the devaluation. If a devaluation occurs, speculators win big; if not, all they lose are the transactions costs which are increasingly negligible. This one-way option is what Mr. Soros exploited in 1992 when he speculated against the pound sterling.

The above argument is that speculation can force premature abandonment of a fixed exchange rate, but fundamentals would have required this anyway at a later date. Morris and Shin (1998) show that speculation can force abandonment of a fixed exchange rate even where it would have been sustainable on a fundamentals basis. Given the finite holdings of reserves by central banks, speculators can simply out-sell the bank forcing a devaluation. Moreover, this has become easier to do given the decline in transactions costs and the growth in financial markets' capacity to leverage assets. Thus, under current procedures for defending currencies whereby each central bank defends its own currency, fixed exchange rates may no longer be a viable option.

Flexible exchange rates preserve the effectiveness of monetary policy, but here too financial leakiness is problematic. Increased economic openness means that countries are more prone to imported inflation caused by sudden exchange rate depreciation. To guard against depreciation, governments are prompted to follow policies that are viewed favorably by financial markets. Given financial markets' dislike of inflation, policy makers therefore incline toward policies that are more anti-inflationary and carry slightly higher unemployment. Moreover, to the extent that financial markets dislike budget deficits, policy makers also incline toward greater fiscal austerity. To the extent that financial markets dislike trade deficits, this provides an additional incentive toward austerity. Moreover, this incentive is strengthened by increased macroeconomic leakiness because now expansionary policy has a smaller impact on domestic employment, so that the benefits foregone are smaller. Finally, there may also be a prisoners' dilemma regarding interest rate policy. Each central bank has an incentive to raise interest rates marginally above the global average to guard against capital flight and support its exchange rate. However, when all pursue this policy, the result is higher interest rates everywhere. None gain a relative advantage, and all are pushed in a deflationary direction.

Finally, these arguments reveal how the three different types of leakiness interact in a negative fashion. Macroeconomic leakiness reduces the scale of the employment multiplier which reduces the benefit while raising the cost of expansionary macroeconomic policy. It also makes economies more subject to imported inflation. Financial leakiness, in combination with macroeconomic leakiness, then gives policy makers an incentive to tilt policy in a deflationary direction. This includes an incentive to reduce budget deficits in order to placate financial markets. Reduced budget deficits then amplify the problem of tax burden shifting posed by microeconomic leakiness, requiring either less government spending or higher taxes on labor.

V. POLICY RESPONSES TO INCREASED LEAKINESS

Increased economic leakiness poses serious challenges for policy makers. Each type of leakiness is a problem in its own right, but the problem is worsened by the fact that the different forms of leakiness interact synergistically. This means that a comprehensive policy response is required.

The benefits of globalization are real. They result from increased international trade, and from the channeling of funds to worthwhile investment projects in the developing world. Such investments are profitable for investors and contribute to economic development. However, absent a response to the problems of leakiness, these benefits of globalization may be overwhelmed by costs. Increased leakiness threatens to exert a deflationary influence on economic policy that raises unemployment through higher interest rates and lower government spending. It also threatens to shift the burden of taxes away from capital income on to labor income, and this may occur at a time when the wage share of income is already subject to downward pressure. Systems competition also threatens to gradually degrade national systems of social protection. Lastly, there is evidence that increased financial openness has created greater financial instability.

Increased macroeconomic leakiness means that economic activity is more inter-linked across countries, and this calls for improved macroeconomic policy coordination. This need is further increased owing to greater financial leakiness which makes financial capital more responsive to small interest rate differentials. In this new environment, coordinated interest rate adjustment becomes particularly important in order to avoid destabilizing capital inflows and outflows.

Increased macroeconomic leakiness has also made it more difficult to unilaterally pursue policies of domestic demand-led growth, and this has

encouraged a switch to policies of export-led growth. However, though such policies can work for one country acting in isolation, they cannot work when all pursue them. One country's exports represent another's imports, so that not all can run trade surpluses. If all try to grow on the basis of demand in other countries, none expand demand and the result is a global shortage of demand and recession.⁸ Furthermore, export-led growth also tilts firms' strategic focus toward wage cutting to gain a competitive cost advantage, and it exacerbates "race to the bottom" systems competition for similar reasons. Work place standards, employee protections, and environmental standards can raise costs, giving firms an incentive to lobby for their elimination on the grounds that they result in reduced international competitiveness.

For these reasons, policy makers should abandon their focus on export-led growth and switch to policies encouraging domestic demand-led growth. This applies particularly forcefully to the IMF which has consistently recommended that developing countries pursue export-led growth strategies. This has contributed to job loss in developed countries, enhanced the extent of global wage and systems competition, and aggravated the long-standing trend deterioration in developing country terms of trade. A new policy mix that fosters economic development through domestic demand growth is needed.

One component of this new policy mix must include debt relief and the provision of credit on easier terms. This is necessary to finance the import of capital goods needed for development, and to provide relief from interest service payments which force countries to export to earn the necessary income. There are also benefits to developed economies in the form of increased demand for exports of capital goods.

Having developing countries move to a domestic demand-led growth path also requires rising wages to support domestic consumption, and this necessitates leveling the playing field between business and labor. Core labor standards that give workers rights of free association and allow them to form unions and bargain collectively are essential. Rather than being a market distortion, independent trade unions are the private sector solution to the current imbalance of power created by capital's new found mobility. Evidence that democracy and labor standards positively affect economic outcomes is provided by Rodrik (1998) and Palley (1998b). Rodrik reports clear evidence that democracies pay higher wages. Palley reports evidence

⁸ Once again, the incentives correspond to the prisoners' dilemma. Export-led growth is favorably received by financial markets, and it therefore has a private incentive to shift toward export-led growth, but when all do it becomes mutually destructive.

showing that countries instituting changes giving workers the right of free association experience faster growth.

Core labor standards also benefit workers in developed countries by lessening the incentive for firms to engage in systems competition. This stands to subtly alter the dynamics of trade in a welfare improving fashion since the focus of competition would be pushed away from wages and workplace standards toward labor productivity, product quality, and business mark-ups.

Finally, labor rights and the right to form strong independent trade unions are also vital for reasons of governance. The IMF has increasingly emphasized the problem of political corruption and economic cronyism, which has given rise to misallocation of borrowed resources. It has proposed solving this problem through greater market discipline imposed by increased financial transparency and further financial liberalization. The argument is that market competition will compete cronyism away. However, to the extent that cronyism is politically sponsored, eliminating it requires political reform that puts place counter-veiling forces that can block it. Human and labor rights, that give workers the right to free association and confer the ability to organize independent trade unions, are the foundation of such reforms.

Microeconomic leakiness also pits business against government, and it endangers the public sector by undercutting governments ability to tax capital income. This also worsens the distribution of income, as well as giving a deflationary tilt to fiscal policy. Tax competition is the problem, and eliminating such competition requires greater harmonization of tax rates across countries.

Financial leakiness is the third area demanding a policy response, and east Asia's financial crisis has clearly shown the dangers of such leakiness. The conventional wisdom is that the crisis resulted from inadequate financial transparency, and the problem can be fixed by improved accounting standards, increased transparency, and further capital account liberalization. However, this diagnosis fails to recognize the problems of increased financial instability and loss of policy autonomy posed by increased financial leakiness.

Improved transparency and accounting standards are desirable, but they do not address the problem of financial leakiness. There is a need to reduce speculation and get investors to invest with an eye to the long term with proper regard to risk. Tobin taxes (Tobin 1978) that reduce currency market speculation are needed, as are Chilean style speed bumps that oblige investors to commit for a minimum time period. Not only do these measures reduce the incentive for destabilizing speculation, they can also help restore

domestic policy autonomy. By adding a small friction, financial capital will be rendered less mobile and therefore less able to veto policies it dislikes. Asset based reserve requirements (Palley, 1997b) can also help enhance domestic monetary control, as well as being useful for discouraging short term international lending which has proved so destructive in east Asia.

Finally, new arrangements are needed for defending currencies against speculative attack. Under the existing system, each central bank is responsible for defending its own currency, and this places the onus of defense on weak currency central banks. Given their finite holdings of foreign reserves, and given the capacity of modern financial markets to leverage positions, central banks can now be bankrupted of foreign reserves by market speculators. A new system is needed. If the onus of defense were placed on central banks whose currency is appreciating, then central banks would be restored to a dominant position. In place of defending a currency with limited supplies of foreign reserves, central banks would have the unlimited supply of the printing press, thereby restoring dominance over foreign currency speculators.⁹

VI. ESTABLISHING THE FOUNDATION FOR CONSENSUAL RESPONSE TO GLOBALIZATION

In many regards, the process of globalization is a logical extension of the economic process that created unified national economic systems. In the U.S., the creation of a successful national economy that delivered widespread and stable prosperity required national economic institutions. Labor law was codified through the Wagner Act, the National Labor Relations Board was established to govern relations between business and labor, a national minimum wage was established to prevent worker exploitation, and national child labor laws were established to prevent exploitation of children. The Occupational Health and Safety Administration was established to ensure work place safety, while the Environmental Protection Agency works to secure a clean environment. In financial markets, the Securities Exchange Commission helps ensure probity in financial markets, while the Federal Reserve is responsible for the governance of the banking system. These institutions contributed to the making of an efficient unified national economy. In a sense, they addressed the problems of macroeconomic, microeconomic, and financial leakiness as they applied within the domestic economy. Just as the creation of a unified national economy

⁹ A comprehensive reform program for addressing the problem of international financial flows is detailed in Palley (1998c).

required new institutions of economic governance, so too does the new global economy. Such institutions are needed to bar unacceptable dimensions of competition and behaviors which generate destructive instability.

Recognition of this need leads to recognition of a larger abstract point. Proponents of the existing model of globalization argue for more open trade, greater deregulation, reduced government involvement in the economy, and more liberalized financial markets. These calls are couched in terms of creation of a global free market, which carries great rhetorical appeal. However, the reality is that they too aim to establish new institutions and rules such as the World Trade Organization and the Multilateral Agreement on investment. All economies require rules, and this applies as much to a global economy fashioned under the Washington consensus as it does to the economy fashioned under the New Deal. The implication is clear: globalization is not a natural process that has to be fatalistically accepted. In the words of John Sweeney, President of the AFL-CIO, "The global economy is not a natural outgrowth of the workings of an invisible hand. It is an act of man, not of God". The problem is that the new global economy has been made to benefit some at the expense of others. Hence, President Sweeney notes that it has been "created by government muscle, wielded behind closed doors, largely on behalf of the most powerful corporate and financial interests".

This leads to a closing point. The new institutions required by the global economy depend critically on how we understand the economic world. Economists tend to assume that markets are perfectly competitive, and in such markets power is absent. It is not a matter of agents being equally powerful, but rather a matter of complete absence of power on the part of all. In such an environment, market competition serves to protect market participants from exploitation. Agents get paid their economic worth because perfect information ensures competitors will bid for their services, and because perfect mobility allows them to move and do business with others if they face exploitation. In this world, frictions are undesirable because they inhibit mutually beneficial exchange and because they inhibit mobility. It is this thinking that has prompted economists to push for elimination of tariff barriers, capital market openness, and deregulation of labor markets that includes lowering minimum wages and weakening unions.

However, if the real world is characterized by power and bargaining rather than perfect competition, frictions and transactions costs acquire a totally different economic significance. Simply eliminating frictions, as has been the policy recommendation of the Washington consensus, does not create an efficient perfectly competitive market. Instead, it serves to redistribute bargaining power and alter patterns of incentives. In this environ-

ment, frictions can be a good thing that remedy market failure arising from grossly unequal distributions of market power. The forces of technological and organizational innovation have been tearing down barriers and frictions that previously restrained capital, and policy makers have indiscriminately abetted this process. However, in a world of bargaining power, the proper policy response is to discriminate between frictions, distinguishing between those that diminish public well-being and those that enhance it. In some areas policy should aim to reduce friction, in other areas it may need to augment them. This is an intellectually very different conception of the economy from that which guides policy today.

APPENDIX

The appendix presents a simple Kaleckian mark-up pricing model that illuminates how changes in bargaining power impact the distribution of income. The definition of variables is as follows:

- P = price level
 m = mark-up
 W = nominal wage
 w = real wage
 a = average product of labor y = real output n = employment
 t_1 = job relocation threat effect on labor
 t_2 = effect of foreign competition on pricing in goods market
 t_3 = effect of foreign competition on production efficiency

Signs above functional arguments represent signs of partial derivatives. Prices are a mark-up over average unit labor costs, and are given by

$$(1) P = [1 + m(t_1, t_2)]W/a(t_3)$$

Output is determined by a linear production process given by

$$(2) y = an$$

Rearranging equation (1) yields the real wage which is given by

$$(3) w = a(t_3)/[1 + m(t_1, t_2)]$$

Combining (2) and (3) then yields the wage share which is given by

$$(4) s_w = 1/[1 + m(t_1, t_2)]$$

The effects of increased microeconomic leakiness are captured by the variables t_1 , t_2 , and t_3 . These effects operate through three different channels. The increased job threat effect resulting from increased mobility of production operates through t_1 , and it serves to lower both the real wage and the wage share of income. The foreign price competition effect operates through t_2 , and it raises both the real wage and wage share. It does so by giving consumers additional choice options in goods markets, thereby reducing domestic producers' monopoly power and lowering prices. Finally, the foreign competition production efficiency effect operates through t_3 , and it also raises both the real wage and wage share.

REFERENCES

- A.V. Banerjee, 'A Simple Model of Herd Behavior', *Quarterly Journal of Economics*, 108, (1992), pp. 797-817.
- K. Bronfenbrenner, *Final Report. The Effects of Plant Closing or Threat of Plant Closing on the Right of Workers to Organize*, New York State School of Industrial and Labor Relations, (Cornell University, Ithaca, NY, 1996).
- J.B. De Long, A. Shleifer, L.H. Summers and R.J. Waldman, 'Noise Trader Risk in Financial Markets', *Journal of Political Economy*, 98, (1990), pp. 703-38.
- J.M. Fleming, 'Domestic Financial Policies Under Fixed and Under Flexible Exchange Rates', *International Monetary Fund Staff Papers*, 9, (Nov. 1962), pp. 369-79.
- J.M. Keynes, *The General Theory of Employment, Interest, and Money* (London, Macmillan, 1936).
- H. Leibenstein, *General X-Inefficiency Theory and Economic Development* (London, Oxford University Press, 1978).
- S. Morris and H.S. Shin, 'Unique Equilibrium in a Model of Self-Fulfilling Currency Attacks', *American Economic Review*, 88, (June 1998), pp. 587-97.
- R. Mundell, 'Capital Mobility and Stabilization Policy Under Fixed and Flexible Exchange Rates', *Canadian Journal of Economics and Political Science*, 29, (Nov. 1963), pp. 475-85.
- T.I. Palley, 'Safety in Numbers: A Model of Managerial Herd Behavior', *Journal of Economic Behavior and Organization*, 28, (1995), pp. 443-50.
- 'Keynesian Theory and AS/AD Analysis', *Eastern Economic Journal*, 23, (Fall 1997a), pp. 459-68.
- *Asset Based Reserve Requirements: An Unappreciated Instrument of Monetary Control*, Technical Working Paper, T007, AFL-CIO Public Policy Department, Washington, D.C., 1997b.
- *Plenty of Nothing: The Downsizing of the American Dream and the Case for Structural Keynesianism* (Princeton, Princeton University Press, 1998a).
- *The Beneficial Effect of Core Labor Standards on Economic Growth*, Technical Working Paper, T010, AFL-CIO Public Policy Department, Washington, D.C., 1998b.
- *International Finance and the Problem of Capital Account Governance*, Economic Policy Paper, E017, AFL-CIO Public Policy Department, Washington, D.C., 1998c.
- D. Rodrik, *Trade, Social Insurance, and the Limits to Globalization*, NBER Working Paper Nos. 5905, 1997.

-
- *Democracies Pay Higher Wages*, NBER Working Paper Nos. 6364, 1998.
- J. Schasching, 'Catholic Social Teaching and Labor', in *The Future of Labor and Labor in the Future*, Pontificiae Academiae Scientiarum Socialium Acta, 2, (1998), pp. 53-80.
- H. Tietmeyer, 'Financial Markets in Relation to Employment and Unemployment', in *The Future of Labor and Labor in the Future*, Pontificiae Academiae Scientiarum Socialium Acta, 2 (1998), pp. 211-44.
- J. Tobin, 'A Proposal for International Monetary Reform', *Eastern Economic Journal*, 4 (1978), pp. 153-59.