Alan Greenspan: Globalization

Remarks by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, at the Institute for International Economics' Inauguration of the Peter G Peterson Building, Washington, 24 October 2001.

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I am pleased to be with you tonight as the Institute for International Economics dedicates this extraordinary new building. I am also pleased to note that you are celebrating your twentieth year in the business of thinking critically about vital international economic issues. It hardly seems that long.

Before the tragic events of September 11, discussions of the international economy had increasingly come to be centered on issues related to the growing integration of our economies. The strife we had witnessed over economic globalization was the twenty-first century's version of debates over societal organization that go back at least to the dawn of the industrial revolution, and many of the intellectual roots of those debates go back far longer.

There has been a simmering down of the more vociferous protests against globalization since September 11. But the debate surrounding the increasing cross-border integration of markets inevitably will be rejoined. The issue elicits such strong reaction because it centers on the important question of how economies are organized and, specifically, how individuals deal with one another.

Globalization as generally understood involves the increasing interaction of the world's peoples through their national economic systems. Of necessity, these economic systems are reasonably compatible and, in at least some important respects, market oriented.

During the past half-century, barriers to trade and to financial flows have generally come down, resulting in a significant broadening of world markets. Expanding markets, in turn, have enhanced competition and nurtured what Joseph Schumpeter called "creative destruction," the continuous scrapping of old technologies to make way for the new. Standards of living rise because the depreciation and other cash flows of industries employing older, increasingly obsolescent, technologies are marshaled, along with new savings, to finance the production of capital assets that almost always embody cutting-edge technologies. This is the process by which wealth is created incremental step by incremental step. It presupposes a continuous churning of an economy in which the new displaces the old.

The process is particularly evident among those nations that have opened their borders to increased competition. Through its effect on economic growth, globalization has been a powerful force acting to raise standards of living. More open economies have recorded the best growth performance; in contrast, countries with inward-oriented policies have done less well. Importantly, as real incomes have risen on average, the incidence of poverty has declined.

Nevertheless technological advance and globalization distress those who once thrived in industries that were at the forefront of technology but which have since become increasingly noncompetitive.

In each step of incremental advance, the distance between gainers and losers is necessarily narrow. So it is understandable that our exceptionally complex system for the international distribution of goods, services, and finance is not universally recognized as successful at enhancing standards of living and promoting civil values worldwide. Indeed, those who perceived the need to protect economies from open trade have endeavored since its inception to slow or even reverse the forces supporting global expansion. It would be most unfortunate if the wheels of progress were stopped because of an incapacity or unwillingness to assist those disadvantaged by these broader gains, an issue I will address later.

In recent years, protectionism has also manifested itself in a somewhat different guise by challenging the moral roots of capitalism and globalization. At the risk of oversimplification, I would separate the differing parties in that debate into three groups. First, there are those who believe that relatively unfettered capitalism is the only economic organization consistent with individual and political freedom. In a second group are those who accept capitalism as the only practical means to achieve higher standards of living but who are disturbed by the seeming incivility of many market practices and outcomes. In very broad brush terms, the prevalence with which one encounters allegations of incivility defines an important difference in economic views that distinguishes the United States from continental Europe -- two peoples having deeply similar roots in political freedom and democracy.

A more pronounced distinction separates both of these groups from a third group, which views societal organization based on the profit motive and corporate culture as fundamentally immoral.

This group questions in particular whether the distribution of wealth that results from greater economic interactions among countries is, in some sense, "fair." Here terms such as "exploitation," "subversion of democratic choice," and other value-charged notions dominate the debate. These terms too often substitute for a rigorous discussion of the difficult tradeoffs we confront in advancing the economic welfare of our nations. Such an antipathy to "corporate culture" has sent tens of thousands into the streets to protest what they see as "exploitive capitalism" in its most visible form -- the increased globalization of our economies.

Though presumably driven by a desire to foster a better global society, most protestors hold misperceptions about how markets work and how to interpret market outcomes. To be sure, those outcomes can sometimes appear perverse to the casual observer. In today's marketplace, for example, baseball players earn much more than tenured professors. But that discrepancy expresses the market fact that more people are willing to pay to see a ball game than to attend a college lecture. I may not personally hold the same relative valuation of those activities as others, but that is what free markets are about. They reflect and give weight to the values of the whole of society, not just those of any one segment.

Market doubters sometimes respond that consumers' values are manipulated by corporate advertising that induces people to purchase goods and services they do not really want. Most corporate advertising directors would wish that were true. Instead, they will argue that the evidence suggests that only the best products in the marketplace win over time. Consumers are not foolish; indeed, it would be an act of considerable hubris to argue otherwise.

What are the dissidents' solutions to the alleged failures of globalization? They are, in fact, seemingly quite diverse. Frequently, they appear to favor politically imposed systems, employing the power of the state to override the outcomes arrived at through voluntary exchange. The historical record of such approaches does not offer much encouragement. One would be hard pressed to cite examples of free and prosperous societies that shunned the marketplace.

Contrary to much current opinion, developing countries need more globalization, not less. Such a course would likely bring with it greater economic stability and political freedom. Indeed, probably the single most effective action that the industrial countries could implement to alleviate the terrible problem of poverty in many developing countries would be to open, unilaterally, markets to imports from those countries.

Setting aside the arguments of the protestors, even among those committed to market-oriented economies, important differences remain about the view of capitalism and the role of globalization. These differences are captured most clearly for me in a soliloquy attributed to a prominent European leader several years ago. He asked, "What is the market? It is the law of the jungle, the law of nature. And what is civilization? It is the struggle against nature."

While acknowledging the ability of competition to promote growth, many such observers, nonetheless, remain concerned that economic actors, to achieve that growth, are required to behave in a manner governed by the law of the jungle.

In contrast to these skeptical views, the ethical merits of market-driven outcomes are argued with increasing vigor by many others, especially in the United States: The crux of the argument is that because unencumbered markets reflect the value preferences of consumers, the resulting price signals direct a nation's savings into those capital assets that maximize the production of goods and services most valued by consumers. Largely unfettered markets create a consumer-led society. In such an economy, the value of reputation, capitalized as good will in the market value of companies, competitively encourages perseverance in pursuing the objectives of quality and excellence. Moreover, the limited role for government in these arrangements is conducive to greater political freedom.

Such a paradigm, however, is viewed by many at the other end of the philosophical spectrum as obsessively materialistic and largely lacking in meaningful cultural values.

But is there a simple tradeoff between civil conduct, as defined by those who find raw competitive behavior demeaning, and the quality of material life they, nonetheless, seek? It is not obvious that such a tradeoff exists in any meaningful sense when viewed from a longer-term perspective.

Clearly not all activities undertaken in markets are civil. Many, though legal, are decidedly unsavory. Violation of law and breaches of trust do undermine the efficiency of markets. But solid legal foundations and the discipline of the marketplace limit these aberrations. On net, vigorous competition over the years has produced a significant rise in the quality of life for the vast majority of the population in market-oriented economies, including those at the bottom of the income distribution.

During the past century, economic growth created resources far in excess of those required to maintain subsistence. That surplus in democratic capitalist societies has, in large measure, been employed to improve the quality of life along many dimensions. To cite a short list: (1) greater longevity, owing first to the widespread development of clean, potable water, and later to rapid advances in medical technology, (2) a universal system of education that enabled greatly increased social mobility, (3) vastly improved conditions of work, and (4) the ability to enhance our environment by setting aside natural resources rather than employing them to sustain a minimum level of subsistence. At a fundamental level, we have used the substantial increases in wealth generated by our market-driven economy to purchase what many would view as greater civility.

If the issue of a tradeoff between growth and civility were not in dispute, much of the debate that surrounds globalization today would have long since been silenced in its favor.

But even if open and free global markets are consonant with political freedom and have in the past contributed greatly to raising world standards of living, there still remains the important practical issue: Can globalization continue to work? Is it as viable a model for world economic growth now as it has been in the past? Despite globalization's patent capacity to elevate standards of living over time, we have been challenged by periodic disruptions in the system's functioning. The financial crises of 1997-98 and the stresses apparent in some emerging-market economies over the past year underscore evident structural weaknesses in our global system.

It can readily be argued that certain conditions of stress increase the probability of emerging-market country default and potential contagion. For example, extensive short-term foreign currency liabilities of financial intermediaries that are used to fund unhedged long-term lending in a domestic currency are tinder awaiting conflagration. This is especially the case if foreign currency reserves are inadequate and exchange rates are fixed.

But why has this phenomenon in different garb reappeared so frequently in the postwar era? No nation deliberately seeks to expose itself to financial distress and bankruptcy. But political pressures can lead to actions that increase these risks. In all economies, political constituencies seek to employ the powers of the state to increase their share of limited government resources. While the record of developed economies is far from unblemished, they have had greater success in fending off such demands. One indication of that success is that exchange rate regimes have not often been upended by domestic political pressures in these economies.

Although the range of outcomes has been wide, many emerging-market nations have had less success in insulating their international financial positions from domestic political pressures. Those pressures, at times, have become exceptionally difficult to deal with. To close the gap between the financial demands of political constituencies and the limited real resources available to their governments, many countries too often have bridged the difference by borrowing from foreign investors. In effect, the path of least resistance has been external borrowing rather than confronting politically difficult tradeoffs.

Periodically, as an economy borrows its way to the edge of insolvency with debt denominated in foreign currency, government debt-raising capacity appears to vanish virtually overnight. It is this vanishing capacity that characterizes almost all financial crises. Lending institutions will provide funds beyond the immediate visible short-term cash flow of a borrower only if they perceive that maturing debt will be capable of being rolled over. The first whiff of inadequacy in debt-raising capacity induces a run to the exits -- not unlike a bank run. Thus, an economy's necessary condition for solvency, indeed, a necessary condition for the stability of global finance, is the maintenance of significant unused financing capacity.

A developed nation's financial status is largely defined by an unquestioned capacity to roll over its debt seemingly without limit into the future. Developed nations, of course, have on occasion run into refunding difficulties and found international lending markets closed. But those occasions have been rare.

What then is an adequate buffer? What level of foreign currency reserves and tradeable real assets does an emerging-market economy need to obtain and sustain debt-capacity credibility? That level, of course, can be known only in retrospect. One measure of the probability that the current or prospective level of reserves will be adequate can be gleaned from the yield spread of dollar-denominated government debt over U.S. Treasuries. That spread reflects not only the risk of dollar credit default but also the underlying strength of the domestic currency. Exchange-market pressures on the latter obviously reduce dollar debt-raising capacity.

Debt capacity, by this model, is reached before rising nominal interest rates and, hence, payments on government debt threaten a vicious fiscal cycle of ever-growing deficits and debt. Unless debt capacity is continuously confirmed in the marketplace by modest spreads, "bank run" crises seem inevitable in such a leveraged system.

How then does an emerging-market nation obtain and sustain debt-capacity credibility? First, it needs to create a much larger relative reserve buffer than that of a developed nation -- which has a larger capacity to draw on real resources, through taxation if necessary, to make good on its obligations. Nations that have met the market test no longer need to put up "collateral" to certify their financial prudence. Of course, even adequate or outsized reserves may not be perceived as sufficient for some, if the political system is judged unstable.

In this regard, there are two critical criteria that all lenders require for government debt issuance: (1) a legal system that is presumed to protect property rights of the lender through the maturity of the debt instrument and (2) if the debt is denominated in a foreign currency, a fiscal and monetary regime that is presumed to be sufficiently responsible to ensure repayment in equivalent real resources.

To be sure, one can borrow with these conditions less than fully satisfied, but only at interest rates that price the risk. Too often these rates are at levels inconsistent with fiscal stability or ongoing debt-raising capacity.

At root, debt-raising capacity is not a technical issue; it is a profoundly political one, which means that it is driven by the values and culture of the society. Unless consensus exists within a society as to resource limits to which all must adhere, an adequate debt-capacity buffer will be difficult to achieve and maintain.

The United States has benefited enormously from the opening up of international markets in the postwar period. We have access to a wide range of goods and services for consumption; our industries produce and employ cutting-edge technologies; and the opportunities created by these technologies have attracted capital inflows from abroad. These capital inflows, in turn, have reduced the costs of building our country's capital stock and added to the productivity of our workers. It would be a great tragedy if progress toward greater openness were stopped or reversed.

Rather than inhibiting international competition to assist those displaced by "creative destruction," we should be directing our efforts at enhancing job skills and retraining workers--a process in which the private market is already engaged. If necessary, selected income maintenance programs can be employed for those over a certain age, where retraining is problematic. Protectionism will only slow the inevitable transition of our workforce to more productive endeavors. To be sure, an added few years on the job may enable some workers to reach retirement with reasonable security and dignity, but if we hinder competitive progress, we will almost certainly slow overall economic growth and keep frozen in place younger workers whose opportunities to secure jobs with better long-run prospects diminish with time.

Terrorism poses a challenge to the remarkable record of globalization. A global society reflects an ever more open economic environment in which participants are free to engage in commerce and finance wherever in the world the possibilities of increased value added arise. It fosters ever greater cross-border contact and further exploitation of the values of specialization but on a global scale.

Fear of terrorist acts, however, has the potential to induce disengagement from activities, both domestic and cross border. If we allow terrorism to undermine our freedom of action, we could reverse at least part of the palpable gains achieved by postwar globalization. It is incumbent upon us not to allow that to happen.

I trust that we will go forward expeditiously with the pending new trade round. The differences to be resolved in such talks are small relative to the larger issue of maintaining our freedoms to travel and trade on a global scale.

Globalization admittedly is an exceptionally abstract concept to convey to the general public. Economists can document the analytic ties of trade to growth and standards of living. A far greater challenge for us has been, and will continue to be, making clear that globalization is an endeavor that can spread worldwide the values of freedom and civil contact -- the antithesis of terrorism.

Globalization, in addition to its myriad material benefits, needs to be seen as a reflection of human freedom in economic terms by a vast majority of its participants. It needs to be seen as offering opportunities to raise the standards of living of all participants in the world trading system. If we fail to make that case, renewed barriers to commerce could fill the void, and the advances associated with globalization could be slowed or even reversed. Should that occur, a few might be better off. Surely, the world will not.