

However, the underpinning of the post-World War II global economy has steadily eroded since the end of the Soviet threat. To ensure survival of the global economy, the United States and other major powers must recommit themselves to work together to rebuild its weakened political foundations.

* CHAPTER ONE *

The Second Great Age of Capitalism

AMERICANS, other citizens of the industrialized world, and many peoples in other parts of the international economy have entered what the financial expert and economic commentator David D. Hale has called "the Second Great Age of Global Capitalism." The world economic and political system is experiencing its most profound transformation since emergence of the international economy in the seventeenth and eighteenth centuries. The end of the Cold War, the collapse of the Soviet Union, a stagnant yet enormously rich Japan, the reunification of Germany and its consequent return as the dominant power in Western Europe, and the rise of China and Pacific Asia are influencing almost every aspect of international affairs. Changes originating in earlier decades have also become more prominent; these developments include the technological revolution associated with the computer and the information economy and the redistribution of economic power from the industrialized West to the rapidly industrializing and crisis-riven economies of Pacific Asia. The worldwide shift to greater reliance on the market in the management of economic affairs, and what many call the "retreat of the state," are integrating national economies everywhere into a global economy of expanding trade and financial flows. However, it is the demographic revolution that will have the greatest long-term significance. The extraordinary population decline in the industrialized world and the explosive growth of population in China, India, other parts of Asia, and elsewhere in the developing world will continue to significantly alter the global distribution of economic and, of course, military power.

These developments are having important consequences for the lives of us all. There will be many winners as global capitalism refashions almost every aspect of domestic and international economic affairs. There will also be many losers, at least over the short term, as inter-

national competition intensifies and as businesses and workers lose the secure niches that they enjoyed in the past. Economic globalization presents both threats and challenges for the well-being of peoples everywhere. If individuals and societies are to adjust intelligently to the challenge of global capitalism, it is imperative that they understand the principal forces transforming international economic and political affairs.

THE TRIUMPH OF ECONOMIC LIBERALISM

The end of the Cold War in 1989 and the collapse of the Soviet Union in 1991 sparked an international debate on the nature of the "new world order." After the disintegration of the Soviet empire in Eastern Europe and the subsequent fragmentation of the Soviet Union itself, speculation on the transformation of the international system and the nature of the post-Cold War era reached flood tide. When disappearance of the Communist threat left the United States as the only true superpower, many commentators believed that the American liberal values of democracy, individualism, and free markets had triumphed and that the world was on the verge of an era of unprecedented prosperity, democracy, and peace. Less sanguine observers countered that the bipolar stability of the postwar world was being supplanted by a chaotic, multipolar world of five or more major powers, a world characterized by new forms of intense ethnic, political, and economic conflict; indeed, some even expected that the world might one day look back with nostalgia to the simpler and more certain bipolar Cold War world that the historian John Lewis Gaddis had called the "long peace."³

Through most of the latter half of the twentieth century, the Cold War and its alliance structures provided the framework within which the world economy evolved; now that framework has been weakened. During the Cold War, the United States and its allies generally subordinated potential economic conflicts within the alliance to the interests of political and security cooperation. Their emphasis on security interests and alliance cohesion provided the political glue that held the world economy together and facilitated compromise on important economic differences. Even though the United States did, as many European and

Japanese charged, occasionally use its political leverage to exact economic concessions from its several alliance partners, the United States also clearly emphasized its security interests and allied cooperation more than its own narrow economic interests.

With the end of the Cold War, national priorities changed and the Western allies assigned a higher priority to their own national (and frequently parochial) economic interests. A shift in American policy had already become evident during the Reagan and Bush Administrations. The new, more nationalistic emphasis was carried further in the succeeding Clinton Administration; its declaration that *economic security* had displaced the earlier concern with *military security* made the change crystal clear.⁴ Proponents of "geo-economics" argued that economic conflict had displaced traditional security and political interests.⁵ A change in American attitudes and priorities appeared in growing economic unilateralism and in ratification of the North American Free Trade Agreement. Another significant manifestation of this change was the pursuit in the early 1990s of an aggressive managed trade or "results-oriented" trade policy toward Japan.

The priorities of Western Europe and Japan also changed in the 1990s. Both became less willing to follow American leadership, much less tolerant of America's disregard of their economic and political interests, and more likely to emphasize their own national priorities. Reunited Germany assigned greater importance to European regional issues and less to its alliance with the United States and began to lead in creation of an economically and politically united Europe. Japan rediscovered its "Asianess" and gave growing emphasis to the development of an integrated Pacific Asian regional economy under Japanese leadership. During the 1990s, regional concerns began to take precedence over North American, trans-Atlantic, and trans-Pacific issues.

These shifts in national priorities and foreign policies have extraordinarily important ramifications for the future of the world economy. Since World War II, the principal foundations of the international economy with its free markets and trade liberalization have been America's international leadership and the willingness of Western Europe and Japan to follow America's lead. However, in the 1990s, the most prosperous and economically successful era in world history was threatened by changes. The close cooperation of previous decades had

weakened, and there could be serious negative consequences for world peace and prosperity. The global economic turmoil of the century's final years warns that there are serious threats to the health and stability of a liberal global economy.

The Achilles heel of the post-Cold War liberal world order is the poor public understanding of economic liberalism, of the functioning of the market system, and of how capitalism creates wealth. The acrimonious debate over the North American Free Trade Agreement (NAFTA), for example, revealed that many American citizens and even some very successful business executives failed to comprehend the rationale for trade liberalization. Economists' arguments that open markets are very beneficial and that trade protection can be very costly are frequently overwhelmed by popular misconceptions and self-serving demands for protection against "cheap" imports and "unfair" trading partners.

Economists themselves must assume part of the responsibility for public misunderstanding. Too many American economists are content to continue writing their frequently incomprehensible technical papers and to remain aloof from public discussions of crucial issues of economic policy. A notable exception to this detached attitude is found in *Globo-phobia* (1998), where Gary Burtless and his colleagues use conventional economic analysis in a comprehensible manner to dispel strident and unfounded attacks on globalization.⁶ Without a better understanding by the average citizen of how the market economy works, including its strengths and its weaknesses, the liberal economic order will continue in jeopardy.

ECONOMIC GLOBALIZATION

Since the early 1980s, economic issues and the global economy have become more central to international economic and political affairs than at any time since the late nineteenth century. Many commentators have noted a profound shift from a state-dominated to a market-dominated world. The market's increased importance, reflected in increased international flows of goods, capital, and services, has been encouraged by declining costs of transportation and communications,

the collapse of command-type economies, and the increasing influence of a conservative economic ideology based on the policy prescriptions of economics. This resurgence of the market is really a return to the pre-World War I era of expanding globalization of markets, production, and finance.

At the turn of the century, issues arising from economic globalization confront national societies and the international community. Immediately after the end of the Cold War almost every economist, business executive, and political leader in both industrialized and industrializing countries expected that economic globalization would lead to a world characterized by open and prosperous economies, political democracy, and international cooperation. However, as the 1990s progressed, and especially in response to the post-1997 global economic turmoil, a powerful negative reaction to globalization arose in both developed and less developed countries. Reflections of globalization and its alleged negative consequences became especially strident within the United States, Western Europe, and some industrializing economies. Globalization has been blamed for everything from growing income inequality to chronic high levels of unemployment and even to the oppression of women, and critics have favored such nostrums as trade protectionism, closed regional arrangements, and severe restrictions on migration. Certainly the future of the international economic and political system will be strongly affected by the relative success or failure of the proponents and opponents of globalization.

According to the "globalization thesis," a quantum change in human affairs has taken place as the flow of large quantities of trade, investment, and technologies across national borders has expanded from a trickle to a flood. Political, economic, and social activities are becoming worldwide in scope, and interactions among states and societies on many fronts have increased. As integrative processes widen and deepen globally, some believe that markets have become, or are becoming, the most important mechanism determining both domestic and international affairs. In a highly integrated global economy, the nation-state, according to some, has become anachronistic and is in retreat. A global capitalist economy characterized by unrestricted trade, investment flows, and the international activities of multinational firms will benefit rich and poor alike.

Others, however, emphasize the alleged downside of economic globalization, including the increase of income inequality both among and within nations, high chronic levels of unemployment in Western Europe and elsewhere, and, most of all, the devastating consequences of unregulated financial flows. These critics charge that national societies are being integrated into a global economic system and buffeted by economic and technological forces over which they have very little control. For them, the global economic problems of the late 1990s offer proof that the costs of globalization are much greater than its benefits.

Although the term "globalization" is now used broadly, economic globalization has entailed just a few key developments in trade, finance, and foreign direct investment by multinational corporations. Since the end of World War II, *international trade* has greatly expanded and has become a much more important factor in both domestic and international economic affairs. Whereas the volume of international commerce had grown by only 0.5 percent annually between 1913 and 1948, it grew at an annual rate of 7 percent from 1948 to 1973.⁷ As figure 1.1 shows, international trade has grown much more rapidly than the global economic output. Over the course of the postwar era, trade has grown from 7 percent to 21 percent of total world income. The value of world trade has increased from \$57 billion in 1947 to \$6 trillion in the 1990s. In addition to the great expansion of merchandise trade (goods), trade in services (banking, information, etc.) has significantly increased during recent decades. With this immense expansion of world trade, international competition has greatly increased. Although consumers and export sectors within individual nations benefit from increased openness, many businesses find themselves competing against foreign firms that have greatly improved their efficiency. During the 1990s, trade competition became even more intense as a growing number of industrializing economies shifted from an import-substitution to an export-led growth strategy. Nevertheless, the major competitors for most all American firms are other American firms.

Underlying the expansion of global trade have been a number of developments. Since World War II, trade barriers have declined significantly due to successive rounds of trade negotiations.⁸ For example, over the past half century, average tariff levels of the United States and other industrialized countries on imported products have dropped

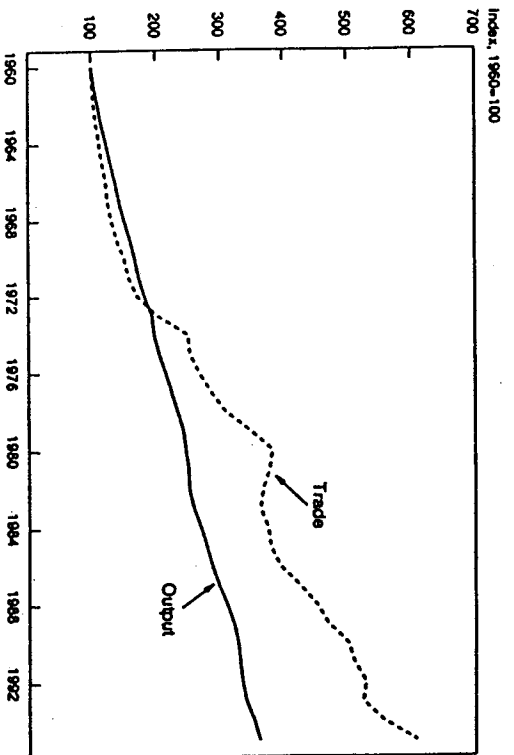


Fig. 1.1. Growth in World Output and Trade. Trade has expanded much faster than output, especially since the early 1970s.
Source: U.S. Council of Economic Advisors.

from about 40 percent to only 6 percent, and barriers to trade in services have also been lowered. In addition, since the late 1970s deregulation and privatization have further opened national economies to imports. Technological advances in communications and transportation have reduced costs and thus significantly encouraged trade expansion. Taking advantage of these economic and technological changes, more and more businesses have expanded their horizons to include international markets. Despite these developments, most trade takes place among the three advanced industrialized economies—the United States, Western Europe, and Japan, plus a few emerging markets in East Asia, Latin America, and elsewhere. Most of the less developed world is excluded, except as exporters of food and raw materials. It is estimated, for example, that Africa south of the Sahara accounted for only about 1 percent of total world trade in the 1990s.

Since the mid-1970s, the removal of capital controls, the creation of new financial instruments, and technological advances in communications have contributed to a much more highly integrated *international*

financial system. The volume of foreign exchange trading (buying and selling national currencies) in the late 1990s has been approximately \$1.5 trillion per day, an eightfold increase since 1986; by contrast, the global volume of exports (goods and services) for all of 1997 was \$6.6 trillion, or \$25 billion per day! In addition, the amount of investment capital seeking higher returns has grown enormously; by the mid-1990s, mutual funds, pension funds, and the like totaled \$20 trillion, ten times the 1980 figure. Moreover, the significance of these huge investments is greatly magnified by the fact that foreign investments are increasingly leveraged; that is, they are investments made with borrowed funds. Finally, derivatives or repackaged securities and other financial assets play an important role in international finance. Valued at \$360 trillion (larger than the value of the entire global economy), they have contributed to the complexity and to the instability of international finance. It is obvious that international finance has a profound impact on the global economy.

This financial revolution has linked national economies closely to one another, significantly increased the capital available for developing countries, and, in the case of the East Asian emerging markets, accelerated economic development. However, as a large portion of these financial flows is short-term, highly volatile, and speculative, international finance has become the most vulnerable and unstable aspect of the global capitalist economy. The immense scale, velocity, and speculative nature of financial movements across national borders have made governments more vulnerable to sudden shifts in these movements. Governments can therefore easily fall prey to currency speculators, as happened in the 1992 European financial crisis (which caused Great Britain to withdraw from the Exchange Rate Mechanism), in the 1994–1995 punishing collapse of the Mexican peso, and in the devastating East Asian financial crisis in the late 1990s. Whereas for some, financial globalization exemplifies the healthy and beneficial triumph of global capitalism, for others the international financial system seems “out of control” and in need of improved regulation.

The term “globalization” came into popular usage in the second half of the 1980s in connection with the huge surge of foreign direct investment (FDI) by multinational corporations (MNCs). As shown in figure 1.2, FDI expanded significantly in the late 1980s, increasing much

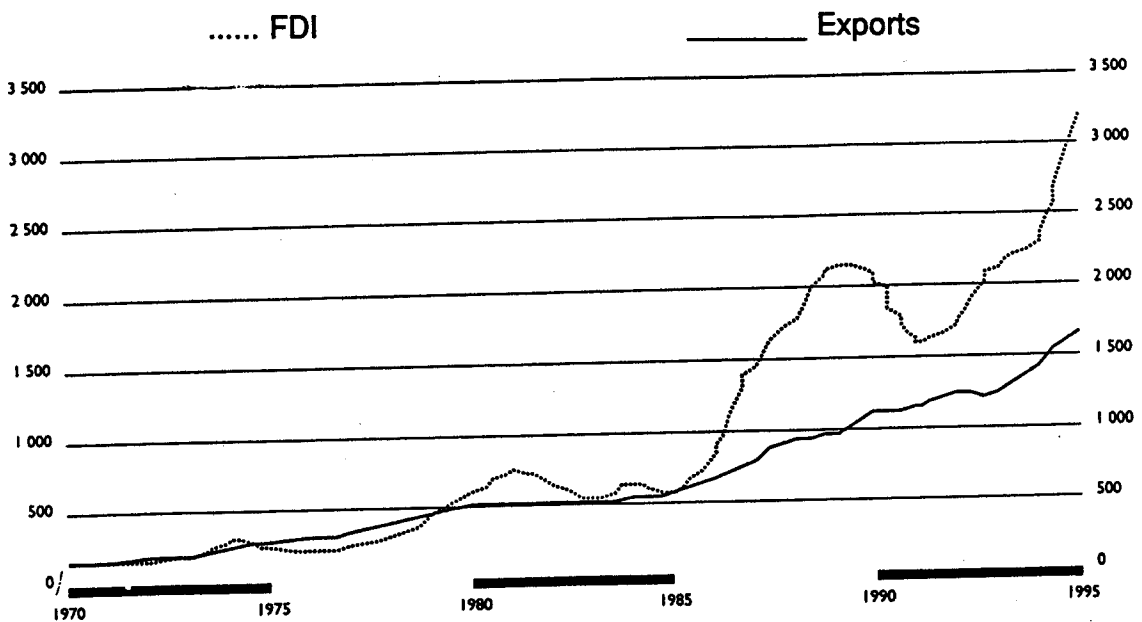


Fig. 1.2. Globalization Trends: Trade and Investment Flows (1970 = 100).
Source: Organization of Economic Cooperation and Development (OECD).

more rapidly than world trade and economic output. Throughout much of the 1990s, FDI outflows from the major industrialized countries to industrializing countries rose at approximately 15 percent annually. FDI flows among the industrialized countries themselves rose at about the same rate. In the late 1990s, the cumulative value of FDI amounts to hundreds of billions of dollars. The greatest portion of this investment has been in high-tech industries, such as those of automobiles and information technology.

These general statements, however, hide noteworthy aspects of FDI and MNC activities. Despite much talk of corporate globalization, FDI is actually highly concentrated and distributed very unevenly around the globe. Most FDI takes place in the United States, China, and Western Europe because firms are attracted to large or potentially large markets. FDI in less developed countries, with a few notable exceptions, has been modest. In addition to that in a few Latin American countries, and particularly in the Brazilian and Mexican automobile sectors, most FDI in developing countries has been placed in the emerging markets of East and Southeast Asia, particularly in China. When one speaks of corporate globalization, only a few countries are actually involved.

Despite the limited nature of corporate globalization, multinational corporations (MNCs) and FDI are very important features of the global economy. The increasing importance of MNCs has profoundly altered the structure and functioning of the global economy. These giant firms and their global strategies have become major determinants of trade flows and of the location of industries and other economic activities around the world. Most investment is in capital-intensive and technology-intensive sectors. These firms have become central in the expansion of technology flows to both industrialized and industrializing economies. As a consequence, multinational firms have become extremely important in determining the economic, political, and social welfare of many nations. Controlling much of the world's investment capital, technology, and access to global markets, such firms have become major players not only in international economic, but in political affairs as well, and this has triggered a backlash in many countries.

Economic globalization has been driven by political, economic, and technological developments. The compression of time and space by advances in communications and transportation has greatly reduced

the costs of international commerce while, largely under American leadership, both the industrialized and industrializing economies have taken a number of initiatives to lower trade and investment barriers. Eight rounds of multilateral trade negotiations under the General Agreement on Tariffs and Trade (GATT), the principal forum for trade liberalization, have significantly decreased trade barriers. Since the mid-1980s, Latin American, Pacific Asian, and other developing countries have initiated important reforms to reduce their trade, financial, and other economic barriers. More and more firms have pursued global economic strategies to take advantage of these developments.

Elimination of capital controls and movement toward a global financial system along with removal of barriers to FDI have also accelerated the movement toward both global and regional integration of services and manufacturing. In both industrialized and industrializing economies, spreading pro-market thinking has strongly influenced economic policy to reduce the role of the state in the economy. The collapse of the Soviet command economy, the failure of the Third World's import-substitution strategy, and the growing belief in the United States and other industrialized economies that the welfare state has become a major obstacle to economic growth and to international competitiveness have encouraged acceptance of unrestricted markets as the solution to the economic ills of modern society. Sweeping reforms have led to deregulation, privatization, and open national economies. In the late 1990s, the debate over the costs and benefits of economic globalization became highly acrimonious.

Meanwhile, the increased openness of national economies, the enlarged number of exporters of manufactured goods, the more rapid increase in trade than in the growth of the global economic product, and the internationalization of services have greatly intensified international economic competition. Growth of the proportion of world output traded on international markets has been accompanied by a significant change in the pattern of world trade. Many less developed countries (LDCs) have shifted from exporting food and commodities to exporting manufactured goods and even services. As indicated in figure 1.3, since 1965 the developing economies' share of world trade has increased considerably. Manufactured goods have begun to provide a growing proportion of this LDC trade at the same time that the United States and

