Globalizing trends and Canada' s economic future

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Of the many factors that will shape Canada' s economic future, the central ones are identified by Bradford De Long. They are growing interdependence and our own abilities to sustain economic growth. A third trend is growing concern about striking a balance between the benefits of interdependence and the perceived costs of reduced domestic policy autonomy, the unease many individuals feel about loss of control over their lives and the unequal burdens faced, for example, by marginalized productive factors like immobile unskilled labour.

Since many of the participants in this conference will focus on the productivity challenge which is central to our ability to sustain economic growth, I will focus on a particular aspect of interdependence -- the increasing significance of financial instability -- and on the future of the nation state. De Long wrote before the Asian financial and economic crisis; since then concerns about the costs of interdependence for states and individuals have grown.

1. Growing interdependence

The speed of onset and the magnitude of the 1997-98 world financial crisis dramatized the impace of cross-border capital flows on interdependence. Up to now, we have become familiar with the effects of goods, services, technology and information moving more freely because of three major influences:

- throughout much of the postwar period, western governments have dismantled barriers to trade and FDI which move goods, services and technology across borders;
- since the 1970s the macroeconomic revolution has reduced the size of public sectors, producing smaller governments, balanced budgets and a wave of privatization, stimulating FDI flows and cross-border acquisitions;
- since 1989, the erasure of the divisions between the two deeply different economic systems with the end of the cold war has propelled hungry new competitors into world markets.

Today, a fourth factor, the information and communications technology (ICT) revolution, is transforming global linkages. As De Long points out, it is not globalization itself that is new. It is the ICT revolution which is changing the way we do business, and during the past decade has made it possible to move capital almost instantaneously across borders in large amounts.

The impact of capital flows on economic linkages and the transmission of economic disturbances has changed the face of external adjustment from adjustment on the current account, with which we are familiar, to adjustment on the capital account which moves swiftly beyond borders. Up to the 1990s integration occurred primarily through trade and FDI flows, particularly among neighboring economies, which grew faster than economies did. Intraregional trade exploded, helped along by trade agreements and rapid growth. Forty percent of North American trade is intra-regional. In the European Union, this number is 70 percent. In East Asia it is around 50 percent. Since the FTA was implemented in 1989, Canada' s exports to the United States have grown 196 percent while US exports to Canada have grown 154 percent (Dobson 1999). FDI flows have also burgeoned. As production internationalized in the 1986-95 period, global FDI stocks grew to twice the size of gross fixed capital formation. The top 100 MNEs now control over 20 percent of global foreign assets. China and the United States are the top recipients of FDI, with more than 80 percent of China' s inward FDI stock originating within East Asia (UNCTAD 1998).

Adjustment in this kind of world used to occur primarily through the current account as economic disturbances were transmitted through trade flows and commodity prices. But the ICT revolution has occurred first and fastest in the financial sector. Private capital now flows rapidly around the globe and, before the recent crisis, to emerging market economies from capital surplus economies in Japan and the European Union. Economic disturbances in the emerging market economies are transmitted across borders and regions through capital markets. In this kind of world, countries that attend diligently to the economic fundamentals, that in the past would have implied exchange rate stability, today can be overwhelmed by short term capital surges and reversals. Financial and economic crises have become systemic rather than localized.

Thus, the open economy "trilemma" is re-emerging as integration of capital markets limits nations' choices of exchange rate regimes and monetary policies. Countries cannot simultaneously fix exchange rates, have open capital markets and independent monetary policies. Sooner or later independent monetary policy will require either capital constraints or floating exchange rates. Or if a country chooses open capital markets and fixed exchange rates, it must give up monetary policy independence.

For the foreseeable future, we will see renewed debate about exchange rate regimes and international monetary cooperation. The mainstream conclusion from the recent financial crisis is that integration into world capital markets is irreversible, so floating exchange rates should be the norm of the new financial "architecture". Unless they are locked into a permanently fixed arrangement such as a monetary union. Relative to the resources available to central banks, market forces are now overwhelming.

Yet not everyone is convinced. The small open export-oriented economies in Southeast Asia which before the crisis had de facto pegs to the US dollar and were forced to set their currencies afloat (with the exception of Malaysia which pegged its currency to the dollar during the height of its crisis) are studying the possibility of a new common basket peg. In Latin America, the Argentinian government has proposed dollarization in order to achieve greater policy credibility.

Others are debating regional monetary cooperation: in Latin America, a southern cone monetary union has been proposed. In Canada (but not the United States) North American monetary union is being debated. Still others argue that reduced volatility among the G-3 currencies, the yen, dollar and euro, is the most fundamental route to greater currency stability among their closest neighbors and trading partners.

I will return to the implications of these developments below.

2. The nation state and geoeconomics

The second trend is a growing concern that national sovereignty is being eroded by the discipline imposed on governments by financial markets (Thomas Friedman' s (1999) golden strait jacket). This is a common theme in the globalization debate. Some have enthused about the global economy as one in which the border is erased; others gloomily predict the withering away of the nation state.

Three points stand out about these concerns. First, a monotonic trend towards complete globalization (and economic homogenization) is by no means inevitable. Governments do have political choice. They may not (and perhaps should not) accept the golden strait jacket. The role of government has been pruned back in a number of countries, often with very positive consequences for dynamism in the private sector. But governments will have to respond to shifts in comparative advantage and competitiveness by providing assistance to groups who must adjust, or cannot adjust, or governments will face a growing backlash against further openness. For demographic reasons, government' s role will also be focused on providing for the health and social needs of aging populations. Thus, governments' propensity to tax will persist, but there will be competitive pressures to restructure tax systems to broaden them and make their impacts on incomes, payrolls and consumption more neutral (Mintz 1998).

Second, there may be limits to the strength of international linkages through trade or capital flows, and to their advantages. There is no systematic evidence that increasing trade integration *among* economies to levels seen *within* economies will lead to substantial productivity improvements. Furthermore, as Feldstein and Horioka demonstrated in the 1980s, domestic savings rates are closely correlated with national investment rates, which implies that capital flows are not tightly integrated across borders. Helliwell and McKitrick (1998) confirm those results among OECD data a decade later. At least among the industrialized countries, the existing degree of openness may suffice. National economic fabrics may be "a much tighter weave" than the globalenthusiasts first thought (Helliwell 1998).

Third, these points suggest that in looking ahead we should ask ourselves which states will dominate the global economy? The current strength of the US economy will be undermined in the years ahead by the current account imbalance that is currently building and by the prospect, with the birth of the euro, of greater currency instability due to substantial portfolio movements. The United States will be still be a world leader 25 years hence, but its population, GNP and currency primacy will be eclipsed by the EU. China and India will be major players -- as well as muslim central Asia (which has the fastest-growing populations and may well possess a major share of the world' s oil reserves). So we will be in a different world from the one we have been used to in which no one was particularly concerned about these players.

3. Implications

There are two major implications. First, for the forseeable future, we will live with more financial volatility than in the recent past. Second, global institutional solutions will be limited by continued demand for national political autonomy, which, with other factors, will limit the trend to complete globalization of goods, services and capital.

Continued financial volatility will put more pressure on the international financial institutions, the International Monetary Fund, Bank for International Settlements and the new Financial Stability Forum as well as a host of sectoral coordinating bodies, to cooperate in encouraging sound domestic policies and less crisis-prone types of capital flows.

For countries, the search for restored financial stability will be through exchange rate arrangements. This is an old debate which quickly becomes theological and to which there is no one answer since we don' t have a world central bank. The choices are essentially political. The debate has two levels, global and regional. Should we try to nail down the three major currencies since their volatility affects the rest of us? Fixed arrangements are out of the question but some sort of target zone arrangements are possible, depending on whether there is the will to coordinate monetary policies in the three major economies. There is no sign of the political will to make this happen outside of Japan which has major problems conducting macroeconomic policy. The durability of the euro has yet to be demonstrated and Europeans are still preoccupied with adapting their new administrative arrangements to international diplomacy. Finally, the United States has shown no official interest in closer monetary cooperation.

At the regional level, East Asians and Latin Americans are debating ways to tie down floating exchange rates, but these are no panacea to prevent financial crises. They are part of a package of reforms necessary in emerging market economies, in particular curbing borrowing in foreign currencies, sequencing the integration of domestic financial markets into world markets, creating procedures for orderly settlement of international debts and conducting sound macroeconomic policies.

Second, one of the major conclusions from the recent financial crisis is that global solutions will be limited by continued preferences for domestic autonomy. Outside of North America and the European Union, governments are reluctant to grant central banks independence, which is essential for effective international monetary cooperation; the goals of monetary policy are diverse; trade patterns among potential partners are still quite diverse and the effects of common external shocks are diverse. Thus, while the economic case for fixing exchange rates rather than leaving them to float is relatively straightforward to make, the politics imply “not now”.

NAMU is inevitable if the rest of the world moves towards three main currency areas. But that condition is far from becoming a reality. NAMU is also a long way off. Asymmetry between Canada and the United States is one reason; Canadians would prefer a regional central bank with political accountability, which Americans currently consider unthinkable; Canadian monetary and exchange policies have served Canada’ s economic objectives rather well. It is useful to remind ourselves that EMU would not have happened if there had not been a clear political goal (eventual political union) and strong political will to make it happen. Latin Americans are willing to forego monetary autonomy, not in order to integrate, but because they are unable to conduct sound monetary policy on their own. The NAMU debate is even possible because Canadians have come to realize that interdependence has reduced economic policy autonomy. And the prospect of a weakened United States with huge current account imbalances and a more volatile dollar suggests the possibility of a resurgence of protectionism, which could also influence Canadian attitudes in favor of faster policy-induced integration.

Finally, even as Canada’ s economy becomes more integrated -- or because it becomes more integrated -- with the US economy, Canada should diversify its economic diplomacy beyond the US. Japan, our second largest trading partner, is and will continue to be world’ s second largest wealthy market. Two-way trade with Japan is 2/3 what a gravity model predicts it should be between two such economies; US trade is 2 times what the model would predict. Japan is going through a unique period of restructuring and review of its place in the world. It is now open to bilateral trade arrangements. We should elevate the level of interaction to a strategic level (from one preoccupied with irritants) and seek to remove most obstacles to trade and FDI by 2010, the APEC target for free trade in the area.It is time to replace the traditional “rocks and wood for cars and electronics” exchange with an ICT-based exchange of services as well as goods (Dobson 1999).

We already have a special relationship with China, but we should have no illusions; it will be a medium-sized economy for the forseeable future; two-way trade will be much less sophisticated than that with Japan. China’ s short term prospects are sobering, although it is possible to be quite optimistic about the longer term. China is experiencing an environmental meltdown; it has growing internal strains from unemployment, income inequality and corruption. And its increasingly vocal populace is intensely nationalistic.

Less is known about Central Asia, but we continue to neglect it at our peril. The muslim republics have some of the world’ s highest population growth rates; it is likely that they have substantial oil reserves and their nationalism is growing. They will influence world oil markets, which will affect Canadian interests, and nationalism in the Central Asian region will be a source of political uncertainty for the foreseeable future.

4. Conclusions

The “new” ICT-driven globalization is not necessarily unstoppable if its costs, in terms of increased volatility, inequality and unfairness, are perceived to outweigh its benefits. Canadians benefit from their economic openness, but need to invest more in creating the conditions for long term success. We have reduced our vulnerability to financial volatility with public sector reforms. But we will experience more shocks, such as rising US protectionism and greater dollar volatility in the next few years. These shocks could increase the political attractiveness of closer economic links to the US dollar or a regional currency, but ways will have to be found to ensure the accountability of the regional monetary authority. At the same time, we should invest in developing counterweights to US economic dominance, with the wider links we are already forging in the western hemisphere, but also by deepening our linkages with the Asian economies, particularly Japan.

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