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Governing Incomplete Globalization

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Summary

In the last thirty years we have witnessed a process of deepening globalization, moving towards a world where production, trade and investment know no frontiers. If and when such a process will be completed, the world will operate as a single state. At that point we should have and would expect fully fledged global institutions, such as: a world government; global (as well as local) taxation and public expenditure re-distributing resources world-wide and catering for global public needs; a world central bank managing a single world currency and acting as lender of last resort; public agencies financing and promoting regional economic development, public authorities taking care of competition or the environment, and various other institutions of global governance.

In today's world, globalization is notable not only for its fast progress but – for better or worse – also for its incompleteness. There are still trade blocks, multiple currencies, unilateral aid; global governance institutions are missing or rudimentary and ineffective. This state of affairs reduces the net benefits actually obtained from globalization and fails to distribute fairly its gross costs and benefits across countries and groups. The development of new and stronger institutions of global governance is necessary to eliminate or at least reduce current widespread opposition to this kind of globalization.

1. Introduction

It is a commonplace that the last thirty years have seen a process of fast *globalization,* understood as increasing world economic integration[1] through international trade and investment. In the period 1970–2000 the share of exports in world GDP has risen threefold from about 8 to 24 per cent.[2] Capital flows grew tenfold over the period. Foreign direct investment by advanced to less-developed countries boomed from USD 28bn in 1970 to a peak of USD 306bn in 1997, and has only declined slightly since then. Portfolio investment grew from USD 10bn in 1970 to a peak of USD 103bn in 1996 (World Bank, 2000). Global transactions in foreign exchange are an increasingly large multiple of central banks' reserves. (See Frankel, 2000; Feldstein, 2000; DfID 2000).

Two major factors underlie this globalization process:

1. The fall of transport, communications and transaction costs in the private sector, due to the diffusion and cheapening of air freight and of containerization, the increasing importance of weightless tradeables, the development of information technology (Frankel, 2000) – all leading to what has been called "The Death of Distance" (Cairncross, 1997). The average incidence of transport costs (measured by the difference between *cif* and *fob* prices) is now of the order of only 4 per cent (Frankel, 2000).
2. The fall in policy barriers to foreign trade (tariff and non-tariff) and to investment on the part of the public sector, due to trade liberalization rounds (within GATT/WTO), to the internationalization of financial markets, the increasing importance of international financial institutions (especially the IMF and the World Bank), and the opening of former centrally planned economies in their transition to markets – which raised not so much the level but the market orientation of their economic integration in the world economy.

Both factors and their various manifestations have the equivalent, indeed identical, effect of reducing *trade costs*, therefore, from the viewpoint of their impact on globalization measured by the share of world trade in GDP, there is no reason to distinguish between them.

In this paper, after considering briefly the evolution of globalization since the late 19th century and the specific features of the current round (Section 2), it is argued that such a

[1] World Bank (2001) treats globalization and integration as synonyms: "Integration – or 'globalization' – …", p. 1.

[2] This is what President George Bush Jr. might have had in mind when he said, in the course of his presidential campaign, that "Today most of our imports come from abroad…".

process is just as notable for its incompleteness as it is for its progress. Section 3 sets a benchmark for *complete* globalization, as a world in which resources are allocated as in a single, competitive, closed economy, governed by global governance institutions. Today's global world is a far cry from such a notion of complete globalization, as witnessed by the missing or inadequate institutions of global governance (Section 4); the persistence of barriers to trade and factor movements, and especially the recent proliferation of trade blocs (Section 5); or the presence of a number of phenomena which remain "puzzles" difficult to explain in a globalized world (Section 6). This state of affairs reduces the net benefits actually obtained from globalization and fails to distribute fairly its gross costs and benefits across countries and groups, thus, at least to some extent, explaining current widespread opposition to globalization (Section 7). Section 8 concludes that the growth of global governance institutions may or may not be feasible and desirable, but ultimately constrains the continued growth of globalization.

2. The evolution of globalization

We could debate *ad nauseam* whether globalization is a new phenomenon or follow the "back to the future" view that it is a mere continuation of a secular trend, begun in the 19th century (or 1498, or 1492, or even earlier) and interrupted in the 20th century during two World Wars and the interwar period. As the current round of globalization is decisively different from its earlier incarnations (see World Bank, 2001) this issue is completely immaterial.

Nineteenth-century globalization consisted primarily in the integration of raw materials markets, so much so that historians measure its intensity by the dispersion of international prices for such materials. From 1870 to 1914, transport progress (from sail to steam) and the negotiated reduction of trade barriers allowed a better utilization of land and natural resources, with a dramatic growth of international flows of commodities, capital and labor; the share of world exports and GDP doubled to 8 per cent over the period. In less-developed countries foreign capital more than trebled, rising from 9 to 32 per cent of their income. Migrations (mostly from Europe towards America and Australia, but also within the South) involved over 10 per cent of world population. The average world income growth rose yearly from 0.5 per cent in the previous half century to 1.3 per cent, increasing inequality.

In 1914–44, globalization went into reverse, with a post-World War I world characterized by isolationism, nationalisms, monetary instability and depression, protectionism, the growth of fascism and communism. Poverty and inequality increased and

at the end of the 1940s the share of world exports in income had fallen back almost to the level of 1870; in the more advanced countries former trade shares recovered only around 1970.

In the second wave of globalization (1950–80 using the periodization adopted by World Bank, 2001) the cost of maritime transport fell by about a third, there was an increase in intermediate products trade and an agglomeration of production. Economic integration increased primarily among developed countries, with a series of multilateral agreements within GATT; their economies grew rapidly, accelerating their convergence within the group. Less-developed countries continued their specialization in primary products, broadly insulated from capital flows, and developed more slowly thus diverging further from advanced economies.

In the current wave, promoted by the factors mentioned above in the Introduction, less-developed countries benefit from globalization by raising their share of manufacturing products from 25 to 80 per cent of their exports. The foreign trade share of a number of countries, such as Brazil, China, India, Mexico, Hungary, increases enormously. Twenty-four less-developed countries (with a population of 3 billion people) have doubled their share of foreign trade in GDP, significantly accelerating their income per capita growth (1 per cent in the 1960s, 3 per cent in the 1970s, 4 per cent in the 1980s, to 5 per cent in the 1990s). If we define "extreme poverty" as a per capita income below USD 1 per day (WB, 2001), in these countries the number of poor fell by 120 million between 1993 and 1998. These countries narrow their gap with respect to developed countries, where income growth is only 2 per cent, but the other less-developed countries (2 billion inhabitants) remain excluded from these processes and become marginalized; their income per capita actually falls.

Other distinguishing features of the current wave of globalization are:

1. A much greater integration of financial markets, accompanied by large-scale capital flows, while migratory flows are constrained and discouraged (see below);
2. A fall in the share of tradeables in GDP, within which traded output grows faster than its share in GDP, thus understating the measurement of globalization by trade/GDP ratios;
3. A greater share of services in foreign trade;
4. A greater geographical dispersion of individual stages (or processes) in the production of given items, as well as other forms of intra-industry trade;[3]

[3] Intra-industry trade is measured by the Grubel-Lloyd index, equal to:
1- Sum|Xi – Mi|/Sum(Xi + Mi), where Xi and Mi are respectively the exports and imports of the i-th product.

5. A drastic increase in the weight of Multi-National Enterprises (MNEs), now representing about a third of world trade;
6. The emergence of small states with an exceptionally high ratio of foreign trade to GDP;
7. The monetary and economic disintegration of post-communist economies, with the break-up of old trade blocs – Comecon, USSR and the ruble area, the Yugoslav and Czecho-Slovak federations – whose members' integration was centrally planned and is now market oriented. This has involved a very deep qualitative change in their participation in the global economy, through the transformation of their trade and exchange rate regimes, a large scale re-structuring in the composition and direction of their trade flows, and a re-integration into the world and especially European economy, with prospects of EU membership for at least ten of them (see Kolodko, 2001).

3. A benchmark for complete globalization

In spite of its fast and inexorable progress, globalization is still exceedingly far from completion. Instead of looking at what happened in the last thirty years and projecting it onto possible future paths, let us look at what the world would be like if the globalization process were 100 per cent complete. This is not necessarily likely in our lifetimes, and even if it were, it would not necessarily be desirable, but it does provide a useful insight into what might prevent us from ever getting there, and how we might interpret current events and venture conjectures – better than simple extrapolations – about the near future of globalization processes. The idea underlying this exercise is that globalization needs global governance, that the progress of globalization has already exceeded the governance capacity of existing international institutions, and that this is a major obstacle to the further progress of globalization. Hence the need – if the impetus of recent globalization is to be sustained – to strengthen global governance institutions, far beyond current projects for the reform of international institutions, which are neither radical enough nor broad enough as they are almost entirely limited to international financial architecture.

We can imagine *total or absolute globalization* as the same allocation of resources that would prevail in a world without national borders, run as a competitive, single closed economy or, rather, one of its possible allocations of resources, allowing for the possibility of multiple equilibria.

Such a fully globalized world would require a single global government (whether federal or not, with regional forms of government in what are now sovereign states), with a Ministry of Finance whose powers of taxation and expenditure provide, among other things, for world-wide income re-distribution and global public goods. There would have to be a single world currency and, therefore, a global Central Bank – whose degree of independence from global government might be debated as for any national Central Bank – with the functions of an institute of issue, manager of global government debt and lender of last resort; while the function of financial supervision might be also undertaken by or delegated to an external global agency. There would be global public agencies financing and promoting regional economic development, public authorities taking care of competition or the environment, and various other institutions of global governance.

Trade – all of which would then be internal – and factor movements would be totally unimpeded by policy measures. In such an imaginary world distance continues to be important, including the so-called "psychic distance" or "subjective resistance" that differentiates locally produced goods from those produced in more distant locations. Even trade obstacles due to cultural, linguistic or habitual factors might persist – as long as they are not due to the existence of borders. The pull of economic gravity would continue to affect economic transactions over space, indeed would be strengthened by the lack of borders. The agglomeration of production activities would continue, being a feature of economic diversification within a single country as well as across countries. There would continue to exist political links between different parts of the world, including ones of colonial/post-colonial type. Otherwise the world would operate as a single country.

While, as we noted above, there is no operational difference between the two factors that underlie globalization – the reduction of transport costs and that of policy barriers – the two types of trade costs are totally different from the viewpoint of incomplete globalization. Transport costs are inevitable in multidimensional space, but are just as harmless as the existence of a plurality of goods; their reduction appears like any other form of technical progress, which raises the share of exports in world income but does not bring any closer total globalization as defined here. Only a reduction in policy barriers to trade and production factor flows reduces the distance between the achieved degree of globalization and complete globalization.[4]

[4] Clearly a sufficient degree of transport and communications development is needed to have international trade at all, but for any given level and variation of transport and communications costs, what counts is whether the

There can be no doubt whatever that the world as we know it, global as it may seem, is extremely remote from the imaginary world of complete globalization outlined above. First, institutions of global governance are inadequate or missing altogether (Section 4); second, there is a persistence of barriers to trade and factor movements, and especially the recent proliferation of trade blocs (Section 5); third, there are a number of phenomena which remain "puzzles" difficult to explain in a globalized world (Section 5).

4. Global governance institutions

The idea that globalization progress has surpassed the progress of global governance is a recent contribution to the globalization debate. It is embodied for instance in the latest World Bank *Report on Globalisation and Poverty*: "Both global opportunities and global risks have outpaced global policy" (WB, 2000, p. 1). Kolodko (2001) argues that "Global problems are to be solved by global institutions. The point is [that] such institutions are often lacking, while the number of global problems is increasing" (p. 6). George Soros contends that "The future of globalised markets will depend on institutions capable of sustaining them" (at a conference at the Institute for International Economics in Washington, October 2001, as reported by *IMF Survey* of 12 November). Bhagwati (2001) calls for "appropriate governance" of globalization processes, though he does not develop the argument. Further analysis of global governance is needed urgently – not necessarily to promote global governance institutions, which many may find repugnant as "Big Brother-type" developments and an infringement on local autonomy and liberties, but at least to understand what are the limits of a non-governed globalization, its drawbacks and prospects for the future.

By comparison with the benchmark of complete globalization set out above (in Section 3), the globalization of institutions is a remote prospect.

In place of world government we have various United Nations agencies, without the power of taxation, indeed on the verge of bankruptcy because of member countries' failure or outright refusal to pay their dues; plus groupings/clubs/lobbies of the richer states such as the G-7/8 or the G-24, plus co-ordination agencies such as the OECD. The dominant role acquired, especially after the collapse of the Soviet bloc, by the United States – recently nicknamed the G-1 in the press – falsifies a view of the world as a single "Empire" (Hardt and Negri, 2001), dominated not by a Metropolis but by multinational companies.

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economy has or has not reached an allocation of resources that might have obtained if the world was a single country.

Instead of one world currency we have three major currencies (dollar, euro and yen) floating freely against each other, plus over one hundred other currencies which have proliferated, especially in the last fifty years, as a consequence of independence for many new states. Their exchange rate regimes represent the entire spectrum of possible alternatives; they range from freely floating to hyper-fixed (to a reference currency or a basket of currencies through a currency board or domestic currency replacement including a currency union), via an intermediate range of variously pegged rates (fixed, crawling pegs and bands, with various degrees of government and Central Bank intervention). The "bi-polar" view has now emerged that such intermediate regimes between hyper-fixed and floating are not sustainable *for countries open to international capital flows*. This is reflected in the actual experience of countries in all groups (developed, emerging, others) moving away from intermediate to extreme regimes (see Fischer, 2001). Neither extreme, however, is completely satisfactory; floating regimes maintain competitiveness at the cost of inflation and volatility; hyper-fixed rates promote stability but raise the cost of failure (see Argentina at the end of 2001).[5] One might agree with Rogoff (2001)

> that, into the foreseeable future, it would not be desirable to aim for a single world currency, and that from an economic point of view, it would be preferable to retain at least, say, three or four currencies …

[in order to reap the advantages of risk diversification] – but even by those standards there are at least a hundred currencies too many for the requirements of a fully global economy.

Instead of a World Central Bank we have a pale imitation of one of its functions by the IMF, which acts as quasi-lender of last resort to sovereign states, including, however, insolvent states that should not be bailed out – creating disincentives for debt resolution – but subjected to "orderly work-out procedures" (Portes, 1995, 2002). Occasionally, in an emergency such as the immediate aftermath of 11 September 2001, there is some co-ordination among major central banks to provide the liquidity necessary to avoid a major global crisis, but otherwise there is no monetary policy coordination on a world scale. Criticisms of the IMF (reported by IFIAC, 2000) include the following: it exercises too much power over developing countries' economic policies through conditionality, though then fails to enforce conditions; it lacks transparency and accountability; it is used by G-7 governments

[5] Each of the major international crises since 1994 (Mexico 1994, Thailand, Indonesia and Korea 1997, Russia and Brazil 1998, Turkey 2000, Argentina 2001) involved a fixed or pegged rate regime, whereas countries which did not have pegged rates (e.g. South Africa and Israel 1998, Mexico 1998, Turkey 1998) avoided that kind of serious crisis.

(read: the US) to further their political ends; it yields few benefits to recipient countries; it encourages non-sustainable pegged exchange rates; it uses defective economic techniques (modeling, forecasting, etc) and theories; it comes into conflicts with other international financial institutions; it is unable to provide liquidity during a crisis. It also performs functions which are alien to a Central Bank, such as providing long term loans at subsidized rates, including loans for poverty reduction. IFIAC (2000) unanimously recommended that 1) the IMF (and the World Bank and regional development banks) should write-off in their entirety all claims against heavily indebted poor countries (HIPCs) that implement an effective economic and social development strategy, and 2) the IMF should restrict its lending to the provision of short-term liquidity, ending long term lending for other purposes. Other recommendations involved restructuring the IMF into a smaller institution with reduced responsibilities, and ending conditionality. Streamlining the IMF along these lines, however, would leave the functions of a World Central Bank even less covered.

Standards for credit regulations – but no actual regulation – are provided by the Basel-based Bank for International Settlements (BIS), acting as a bank for central banks (managing reserves and settlements and promoting central bank co-operation). BIS standards are purely voluntary, ineffective until adopted by each country's legislative or regulatory body.

Instead of development agencies there is the World Bank group and other regional development banks (Inter-American, African and Asian). Their importance declined in the 1980s with the explosion of international financial markets, with private lending and investment dwarfing the multilateral banks credit flows by a factor of 50 (IFIAC, 2000). Frequently raised criticisms include: lending fever and consequent poor performance; skewed lending, mostly (70–80 per cent) to a dozen creditworthy countries that already have access to international financial markets, moreover subject to government guarantees; loan subsidization; involvement in crisis lending (which is a function of the IMF); large cost to donors (USD 22bn per year); being an instrument of US policy; excessive conditionality; neglect of the environmental impact of financed projects. IFIAC recommendations included re-naming these banks as development agencies; phasing out all resource transfers to countries that already enjoy capital market access; performance related payments; poverty alleviation grants to service suppliers to replace loans and guarantees for physical infrastructure; institutional reform loans but no financial crisis lending; a clear division of geographical areas for the various agencies; concentration on the production of global public goods (See also Gilbert, Powell and Vines, 1999; Gilbert and Vines, 2000).

Lending to transition economies (currently 27) is the responsibility of the EBRD (see their *Transition Reports*, published yearly in November since 1994, and their yearly *Update* in April). It differs from the IBRD in significant respects: it is supposed to invest primarily in the private sector according to commercial criteria. This poses profound existential problems for the EBRD: 1) if it lends only to the private sector on commercial terms, its existence will make no difference; 2) it is a public financial institution whose *raison-d'être* is the inefficiency of public financial institutions; 3) its success in assisting transition can only be judged by the speed of its own demise…

International trade competition is the responsibility of the WTO (ex-GATT). It has a tiny budget, no decision-making role, only providing technical and legal support; it administers the process by which trade rules change and sanctions those rules – too slowly for effective enforcement. (For a radical view of WTO reform, on issues of trade and environment, see DfID, 2000, Ch. 4–6).

The present international "architecture" and especially financial institutions have come under increasing criticism not only from radical demonstrators in Seattle/Washington/Prague/Davos/Naples/Genoa, but also from leading economists such as the World Bank former chief economist and vice-president, Nobel laureate Joseph Stiglitz (2000), notable for his blistering criticisms of the IMF and World Bank; financiers like George Soros (2000, 2002); government bodies such as the IFIAC-International Financial Institution Advisory Commission appointed by the US government to review most of those entities (see Meltzer Report, 2000); the G-7 Finance Ministers (July 2000), the IMF acting Managing Director reporting on current progress to the IMF International Monetary and Financial Committee (April 2000), or the UK DfID Globalisation Report (2000). The list is not exhaustive (see Nouriel Roubini's website, New York University: www.stern.nyu.edu/globalmacro/, and Eatwell 2002).

5. Trade barriers and regional blocs

In spite of the progressive reduction in trade barriers (tariff and non-tariff) in the last thirty years of the 20th century, protectionism is still widespread. Developed countries have low average tariffs, but these are concentrated exactly in the areas in which less- developed countries have a comparative advantage, as in agriculture and in highly labor-intensive manufactures. It is estimated that rich countries' protectionism costs less-developed countries more than USD 100bn a year, which is twice the flow of aid from the North to the South. At the same time in less-developed countries the level of protection is three times higher than in

OECD countries and is an obstacle mainly to trade with other less-developed countries; it is estimated that its elimination would bring about another USD 50bn net benefits. Another round of multilateral trade liberalization within WTO could do a great deal to reduce, if not eliminate, these forms of protection, especially if accompanied by a discussion of environmental issues, health standards, and a less strict protection of intellectual property, particularly for pharmaceutical products.

However, "Political momentum behind the new round of global trade talks has faded, casting a shadow over the agreement to launch it, reached in Doha last November [2001]" (*Financial Times*, 3 May 2002). The decline in world trade by 1 per cent in 2001, in conjunction with weaker growth in world income, instead of encouraging further trade liberalization has revamped protectionism. For example, early in 2002, President George W. Bush could impose overnight a 30 per cent tariff on steel imports, and violate international trade rules by granting a tax break to US exporters. The European Union responded with disproportionate retaliatory sanctions amounting to 100 per cent protection on selected US goods worth USD 4bn. The US farm bill currently [May 2002] under discussion in the US Congress is another bout of US protectionism. The US is also to impose import duties of over 27 per cent on softwood timber imports (worth USD 6bn) from Canada.

The achievement of liberalization of capital flows in all their forms has not been accompanied by that of labor migration. Enormous pressure on labor flows is caused by differences in wage levels that, in 2000, ranged from USD 32 per hour in Germany to 25 cents in India, but does not find a *legal* outlet. "Compared to 100 years ago, the world is much less globalized when it comes to labor flows" (World Bank 2000, p. 11). Migrations of skilled labor, however, are not only unimpeded but actively encouraged, representing a severe "brain drain" from less-developed countries (see Commander, Kangashniemi and Winters 2002).

An even more spectacular departure from the complete globalization outlined above in Section 3 is the revival and large-scale proliferation of trade blocs (RIAs or Regional Integration Agreements), especially in the 1990s after twenty years' dormancy, precisely at the time when globalization progressed as a result of post-communist transformations. Thus, instead of gradually becoming a borderless area, the world has been segmented into fenced compartments.

Baldwin (1995) talks of "domino regionalism". Frankel and Wei (1998) talk of the "wild-fire" diffusion of trade blocs. Soloaga and Winters (2001) summarize this phenomenon thus:

> During the last 10 years, regionalism has re-emerged as a major issue in the policy agenda. In the Americas, the new Common Market of the South (MERCOSUR, 1991) and the North American Free Trade Association (NAFTA, 1994) were created while old Preferential Trade Agreement (PTAs) like the Andean Pact (ANDEAN) and the Central American Common Market) started a process of renewal in the late '80s and early '90s. In Africa new PTAs were formed on the basis of old ones (e.g., in 1994 the *Union Economique et Monetaire de l'Afrique Occidentale* – UEMOA – was created out of the *Communaute' Economique de l'Afrique Occidentale* – CEAO –, and the Common Market of Eastern and Southern Africa – COMESA – revived and expanded the Preferential Trade Area for Eastern and Southern African States – PTA – and old ones were revamped (e.g., in the early '90s the *Union Douaniere et Economique d'Afrique Centrale* – UDEAC). In Asia, countries in the Association of Southeast Nations (ASEAN) formed in 1992 the ASEAN Free Trade Area (AFTA).

These are only examples: World Bank (2000) talks of a "veritable explosion of regional integration agreements" in the last fifteen years.

> Nearly every country in the world is either a member of – or discussing participation in – one or more regional integration arrangements. Such agreements have been concluded among high-income countries, among low-income countries, and, more recently, starting with … NAFTA – between high income and developing countries. More than half of world trade now occurs within actual or prospective trading blocs (p. ix).

Moreover, "In 1999 regional agreements notified to WTO were a greater number than that of its members" (p. 123), to be precise 194 agreements (of which 87 signed after 1990) for about 140 members.

The European Union figures prominently in this picture, with the implementation of the Single Market in 1992, successive rounds of enlargement and deepening, with the European Monetary Union and the introduction of the euro, and the prospective accession of another twelve countries: the European Economic Area, Europe Agreements with accession candidates, the customs union with Turkey, other agreements with Mediterranean countries (see World Bank 2000 and their Table 1.1 for more details on the numerous regional agreements in existence).

There is an official tendency to stress the political objectives and the non-economic dimensions of regional agreements, including national (intra- and extra-regional) security, the strengthening of bargaining power especially for the smaller countries (as in CORICOM, the Caribbean Community), the greater credibility of economic and political reform. Emphasis

therefore shifts from the proliferation of agreements to their design, upon which the amount and distribution of desired advantages depend. Such advantages, according to World Bank (2000), depend on the presence of economies of scale and above all on the ability to stimulate competition within the regional market, and on the minimization of incentives to trade diversion rather than creation, discouraging the use of inefficient regional producers. Thus it becomes important to open trade with partners external to the bloc, at the same time as liberalizing within the bloc.

A corollary of this approach is the recommendation to establish regional blocs made of both less-developed and high-income countries, as the latter tend to have lower barriers, greater opportunities for exploiting comparative advantages and a greater probability of reaching desired political objectives. Agreements between less-developed countries, on the contrary, tend to create additional tensions and problems. Another recommendation is to go beyond tariff reduction and include other trade-promoting policies abolishing non-tariff barriers, such as contingent protection or anti-dumping measures, as well as the construction of joint infrastructure. It is recognized that a greater integration requires an agreement on the distribution of its advantages.

Nevertheless, the World Bank official line continues to be critical of the formation of blocs. These have the merit of allowing member-countries' authorities to explore forms of greater though limited trade liberalization, but in general induce an increase in the real cost of their imports, reduce the technology flow and raise export dependence on particular markets (WB 2000). Between the lines one can read a clear negative message.

Already in 1950, Jacob Viner maintained that regional blocs mostly create trade diversion, thus reducing world welfare. However, it is likely that both bloc effectiveness in promoting trade and their presumed efficiency might have been over-estimated. De Melo, Montenegro and Panagariya (1992) find that countries that have followed this integration route have not grown faster than others once investment differences are taken into account. When testing intra-bloc trade "before and after" years of bloc revamping/creation, Soloaga and Winters (2001) find that, once "gravity" effects (of trade partners' mutual attraction based on their distance and economic mass) are taken into account, there is "no statistically significant change in the propensity for intra-bloc trade". They find convincing evidence of trade diversion only for EFTA and the EU, both for imports and exports.

Should we consider regional blocs as building blocks or stumbling blocks, ask De Melo and Panagariya (1992), or as stepping stones to progress towards multilateralism (Winters 1996)? On the positive side, regionalism to some extent can be regarded as a

substitute for liberalization, following the slow progress of the GATT Uruguay Round and the disappointment of the Seattle negotiations (December 1999). There are no countries totally insulated from these processes, everyone takes part in them. Blocs are formed mostly among neighboring countries, already attracted to one another by economic gravity, which means they are unlikely to do much harm in terms of trade diversion. Moreover, these blocs are formed and developed *simultaneously* at the world level (Frankel and Wei, 1998). Several economists believe that it is easier to negotiate trade liberalization between three commercial blocs – Europe, the Americas, East Asia – than multilaterally among over 150 countries. At continental level there should be higher probabilities of obtaining welfare improvement (Krugman 1991; Summers 1991; Frankel and Wei 1998). Within these large blocs, integration between more- and less-developed countries reduces the exclusion effects from which trade blocs usually suffer.

However, there remains a very substantial risk that the formation and enlargement of trade blocs might stop much sooner than universal liberalization. Bloc enlargement raises the incentive to exercise the improved market power vis-à-vis third countries, rather than following a co-operation policy – especially "given that the dispute settlement mechanism of the WTO is weak at best" (Dimova 2002). Regionalization cannot represent an optimal solution from the viewpoint of economic efficiency, yet "… there is little hope of a convergence of existing trade blocs into one global bloc, thereby *de facto* ushering in free trade" (Dimova 2002).

It seems impossible to understand the formation and growth of trade blocs without reference to the costs and benefits of globalization, and the lack of global governance institutions that might reduce or recompense such costs in a way that is acceptable to commercial partners. The supra-national – though still regional – governance institutions of trade blocs fill this institutional vacuum and provide a good, perhaps the best explanation of trade blocs' diffusion, otherwise an amazing and contradictory phenomenon. Rather than a brake on globalization, trade blocs complement it, filling a systemic vacuum.

6. Six puzzles

Obstfeld and Rogoff (2000) raise and discuss six major phenomena in international macroeconomics that appear to be "puzzles", i.e. they are difficult to reconcile with the progress of globalization:

First, the home-bias-in-trade puzzle: Why do people seem to have such a strong preference for consumption of their own goods?

Second, the so-called Feldstein-Horioka puzzle: Why do observed OECD current-account imbalances tend to be so small relative to saving and investment when measured over any sustained period?

Third, the home-bias portfolio puzzle: Why do home investors overwhelmingly prefer to hold home equity assets?

Fourth, the consumption correlations puzzle: Why is consumption not more highly correlated across OECD countries?

Fifth, the purchasing power parity puzzle: How is it possible that the half-life of real exchange rate innovations can be only three to four years?

Sixth, the exchange rate disconnect puzzle: Why are exchange rates so volatile and so apparently disconnected from fundamentals?[6]

Obstfeld and Rogoff argue that all that is required to explain these phenomena simultaneously and coherently is a

> significant but plausible level of international *trade costs* in goods markets. These *trade costs* may include transport costs but also tariffs, non-tariff barriers, and possibly other broader factors that impede trade (p. 340, emphasis added).

Basically, these *trade costs* introduce a wedge between real rates of return in different countries, and this provides a possible and plausible explanation for the six puzzles.

This ingenious and elegant argument is weak in two major respects. First, in monetary economies with different, mutually convertible currencies, what needs to be equalized is not real rates of return but those rates plus (minus) real exchange rate appreciation (depreciation) with reference to any common currency. Second, since these kinds of puzzles are either absent or much weaker within countries, no matter how large, it must be presumed that the so-called puzzles are related more closely to the policy barriers that we have illustrated in the previous section than to transport costs. Thus lumping the two together into a hybrid category of "trade costs" is more misleading than enlightening. *The observed phenomena cease to be puzzles in a world characterized by* incomplete *globalization and can be regarded as additional evidence – if it were needed – of such incompleteness.* Financial markets *are still* segmented – though less so now than in 1970; there is a massive gross turnover in foreign exchange markets, but small net flows (the divergence being due partly to hedging); "National

[6] This puzzle comes in two versions: the Meese and Rogoff (1983) forecasting puzzle and the Baxter-Stockman (1989) neutrality-of-exchange-rate-regime puzzle; see Ostfeld and Rogoff (2000) for an illustration.

savings tend to remain at home" (Feldstein 2000). In view of globalization incompleteness, the opposite would be puzzling.

7. Globalization benefits and costs

Markets are necessary and irreplaceable mechanisms for automatic adjustment, for the mobilization of entrepreneurship and for efficient and innovative change. They also have associated costs in terms of 1) inter-temporal inefficiency, in the form of associated unemployment and fluctuations; 2) adverse impact on the distribution of income and wealth; and 3) possible divergence of market prices from public values (understood as government valuations). The global market is no exception.

In the first instance, globalization is expected to yield the classic benefits of international division of labor, both from "static" comparative advantages and from the "dynamic" advantages derived from greater competition and mutual reduction of trade barriers: the impact of trade openness on income per capita is estimated to range from 0.3 to 3.0 per cent for each percentage point increase in trade shares (Frankel 2000). Second, there are benefits derived from capital flows and (increasingly) FDI which, besides providing capital, embodies new technologies, provides management and know-how, and facilitates the export of its production. This may explain the association between trade openness and the growth of *average* per capita incomes (see above, Section 2); the direction of causation is not unambiguous but there is evidence to encourage the presumption that such growth benefits from globalization.

Inter-temporal inefficiency is a recognized feature of any economy where markets for future goods and services (futures or forward markets, as well as markets for "contingent" goods and services associated with particular uncertain states of the world) are missing, or where in any case markets are "sequential", i.e. do not close and shut for ever as in the Arrow-Debreu model of general inter-temporal equilibrium, but are repeatedly reopened (see Stiglitz 1995). In the world as we know it, future markets are the exception and exist only for a handful of primary products over a short time horizon and for money and some financial assets. Moreover markets are not just sequential, they actually *never close*: the sun never sets over the global market. In such a world nobody needs to express a demand for, or a supply of, a future good today at a prefixed price: all economic agents act at all times and on the basis not of market prices but of *expectations* of prices and quantities. We live in a Keynesian instead of a neo-classical world. Hence the possibility of self-fulfilling expectations, or wrong expectations, or what Alan Greenspan calls "irrational exuberance" of markets, or equally

plausible irrational despondency and panic, liquidity preference (as in today's Japan), volatility, involuntary unemployment, economic fluctuations.

Financial market integration facilitates not only foreign investment but also capital flight, excessive indebtedness in less-developed countries, financial crises. If there is a presumption that trade and FDI globalization is "good on average", there must be an equally strong presumption that the unrestricted globalization of short-term capital flows is "bad on average". By way of examples we can think of the 1992–3 European ERM crisis, the 1994 Mexican "Tequila" crisis, the July 1997–January 1999 world-wide crisis in East Asia and other emerging markets, the August 1998 Russian crisis, the Argentinian crisis of end-2001. The ultimate causes of such crises were exchange rate misalignments, mismatch between short-term foreign exchange liabilities and foreign exchange reserves, weakness and poor supervision of national banking systems, and so on; but their depth and diffusion was strictly related to financial markets globalization, at a cost likely to be higher than its advantages of international diversification of risk (see Eatwell, 2002). FDI and (to some extent) equity investments are less volatile than short-term debt, but they can also be liquidated – though at a higher cost.

The second drawback of globalization – as with any market development – is its adverse distributional impact on income and wealth. It is officially recognized that "Globalization produces winners and losers, both among countries and within them" (World Bank 2001, p. 1).

Losers include those countries which are marginalized – for whatever reason, geographical or political, due to climate or economic policy, weakness of institutions, lack of infrastructure or diffused corruption. Labor and capital operating in sectors that are no longer protected also lose out: it is estimated that China's trade liberalization following WTO membership will raise unemployment by 50 per cent, i.e. by 40 million. Unskilled workers in industrial countries are likely to lose out (though see Wood (2002) for some qualifications due to the diversity of relative endowments in a world with more than two production factors). Even if in the long run everybody stood to gain, in the short run losses may be substantial; the creation of new jobs is slow and delayed whereas losses can be instantaneous.

Three reflections are in order here. First, as long as there are *some* net losers from globalization, it is not enough for there to be positive net benefits *on average*, it is necessary for *all* losers to be compensated for their loss. *Potential* over-compensation of losers by winners is not sufficient to infer a social welfare improvement, *actual* compensation and over-compensation is necessary. Second, even if *everybody* gained from globalization *over time*,

some people might lose with respect to what their alternative position *would have been* without it. Such losses, whether absolute or relative to an alternative time path, are easy to imagine: it is enough to think of the trend towards factor price equalization induced by international trade even without factor mobility, or of short term displacement of resource employment patterns. Finally, even if all unambiguously gained from globalization, the overall distribution of net gains might be regarded as unfair, resulting in an adverse change in relative distribution – within or across countries. On a world scale the Gini coefficient (ranging from 0 to 1, with 0 = complete equality) rose from 62.5 per cent in 1988 (in USD PPP) to 65.9 per cent in 1993. In the 1980s the coefficient rose by 0.5 percentage points per year in the UK and USA. The bottom 20 per cent of the world's population received 2.3 per cent of total world USD PPP income in 1988; this proportion was down to 2 per cent in 1993. Overall, the richest 1 per cent of people in the world (50m) receive as much as the bottom 57 per cent (2.7bn people; see Milanovic (1998), based on worldwide household survey data not yet available for subsequent periods).

Robert Kaplan (2001) describes today's world as bifurcated and uses the image of a stretch limousine driving trough an urban ghetto. Its passengers are western Europe, North America, Australasia, Japan and the emerging Pacific Rim; all the others are outside. In 1999 world average real income per head at purchasing power parity – i.e. the most benign accounting convention that might be used in the measurement of inequality – was USD 7,000; the combined population of 900m in high income countries had an average income of USD 26,000 whereas 5.1bn people in the less developed countries had average incomes of USD 3,500, of which 2.4bn people had an average of USD 1,900. In 1965–99 average incomes in sub-Saharan Africa fell, while those of the Middle East and North Africa stagnated. Moreover, according to the US Bureau of Census, in the first half of this century, 99 per cent of population increase is likely to take place in the less-developed countries, thus exacerbating current trends.

> In Mr Kaplan's dark view, the combined stresses of population, urbanization, environmental degradation and failed development are creating a world of gangster states and states eaten out by gangs, both with a terrifying capacity for anarchic violence (Martin Wolf's review in the *Financial Times*, November 2001).

It follows that globalization must be accompanied by satisfactory mechanisms of world-wide re-distribution not only of current income but also inter-temporally, not only at a national level but also internationally, whereas global re-distribution opportunities are

lacking, being left primarily to inadequate unilateral charity. Kolodko (2001) compares the 0.7 per cent of GDP recommended by the UN for transfer from rich to poor countries, with the actual current level of 0.24 per cent, most of which is appropriated not by the intended recipients but by various organizations, intermediaries and consultants.

Power relationships are altered by globalization, within and across countries. Internationally, trading nations increase their power (see for instance India and China). Internally, in theory the power of capital should be reduced by increased competition, but in reality it is strengthened with respect to both labor and national governments, thanks to its greater capacity to move across countries, to sell to the whole world from a single location and at the same time to disperse production stages all over the world. True competition is between governments seeking to attract foreign capital, rather than between capitalists. With the exception of the USA, no government can adopt anti-cyclical policies any longer. Globalization extends to terrorism and to the fight against it, with equally devastating results.

A further disadvantage of globalization – again, of a kind associated with the existence and expansion of any market – arises from a possible divergence of market prices from social values as expressed by the preferences of democratically elected governments. Opportunities created by globalization include “social dumping”, i.e. competitiveness originating in labor conditions regarded as unacceptable by trading partners (for instance, child labor, though in the longer term its incidence may be reduced by globalization). Such labor conditions can be unacceptable not only by the standards prevailing in partner countries, but also in principle, regardless of where they occur; thus the fact that foreign investors usually pay higher wages than those prevailing locally (as pointed out by Graham, 2000) does not make the practice necessarily acceptable. Globalization opportunities may also be generated by the accompanying environmental destruction in the exporting country, in addition to the exacerbation of environmental problems in the world at large through the enhancement of economic growth associated with liberalization. The protection of intellectual property may impede health care in the poorer parts of the world, as noted above.

Pollution and the depletion of natural resources are simply a transfer, current or deferred, from poorer to richer countries. The decision not to ratify the Kyoto protocol, taken by the president of a country that accounts for 23 per cent of world energy consumption, whose electoral campaign was financed by oil companies, indicates the difficulties of a global solution to environmental problems that of course would exist even without globalization, but which are made much worse by the acceleration and concentration of growth associated with it.

The divergence between market prices and social values as defined above, plus inter-temporal inefficiency/instability and distributional issues, are at the root of widespread and strong anti-global movements. Some of the antiglobalists' arguments seem overblown, such as the emphasis on multinational corporations and their logos (Klein 2001) or debt cancellation. Multinational corporations' turnover being compared to countries' GDP (Anderson and Cavanagh, 2000) is a biased comparison between respectively gross and net magnitudes (as pointed out by de Grauwe, 2002), which also neglects the much broader scope of state and government authority vis-à-vis that of corporations (see Wolf (2002) – although companies large and small may successfully undertake "state capture" (World Bank, 2002)). Size and its adverse impact on competition matters more than multi-nationality. Regardless of globalization, advertising can and does become a form of pollution that must be regulated and taxed (Meade, 1995), but brands make producers identifiable also for consumers' benefit (see *The Economist*'s leader and special report on brands, 8 September 2001). Some standardization and choice reduction is unavoidable in the process of economic growth, also regardless of globalization; and "the world that is expected to suffer from cultural uniformity is not so monolithic, defenseless and rigid as it is believed to be" (Baricco, 2002). Cancellation of public creditors' claims towards less-developed countries does not benefit them but their private creditors. Still, even if these particular aspects of anti-global opposition were ignored or rejected, there still remain quite enough claims to justify and sustain anti-global movements and action.

8. Conclusions

Globalization of trade and investment (unlike that of financial markets) can be presumed to yield positive net benefits *on average*. Also, its further though not unlimited growth is probably unstoppable. But there is a sense in which globalization may have "gone too far" (as suggested by Rodrik (1997) and emphasized by the book's title), in that the development of global institutions is now seriously lagging behind the growth of foreign trade and investment, not to mention financial markets. Like all markets, the global market is a major, if not the ultimate source of economic vitality, but it may have to be tamed (through international regulation, policy coordination, and re-distribution).

Kolodko (2002) asks whether globalization is really as irreversible as it seems: "We cannot exclude *a priori* a regress from the degree of globalization already achieved" (p.15). Some reversal has already taken place, if only to the tune of a 1 per cent decline in world trade in a sluggish but positively growing world economy in 2001; capital flows trends have

also reversed for both FDI and financial investment at the end of the last decade (see the Introduction above). It is too early to judge whether the reversal will be a lasting trend – but it would be foolhardy to rule out this possibility.

The problem is not globalization *per se*, but the lack of agencies and instruments capable of governing it, not only at national but above all at international level, and of means for their placing under democratic control. The most important task for global governance is probably that of worldwide distribution. Kolodko (2001) argues that:

> Globalization stands no chance of total success, because it will be unable to win the political support of the inhabitants of the world (to speak of a 'world community' would be premature) as long as the re-distribution channels operate like before. What is necessary is worldwide institutions and a worldwide policy and strategies to rectify the global redistribution system that has evolved thus far (all set in bold in the original; p.18).

It is no accident that world leaders now regard the fight against poverty as an integral part of the fight against terrorism.

Without significantly greater global governance, the net benefits potentially obtainable from globalization are reduced, gross costs and benefits are not redistributed so as to avoid having net losers across and within countries, and any pretence of a presumed superiority of a global world and of a mythical role of globalization in our planet's development is irredeemably falsified. Trade blocs will be revamped or created, with regional government institutions supplementing both the inadequacy of national governments (which cannot re-distribute costs and benefits on a supra-national scale) and that of missing global institutions. It is enough to think of the increasing role of the Brussels and Frankfurt institutions in the governance of the European Union member states. Under these circumstances we can expect further opposition to globalization to become more and more vocal, diffused and powerful, not just by anti-global demonstrators but by no less than the US President, who, with his recent opportunistic protectionism and his successful fight with Bayer over the anthrax vaccine patent, appears decisively to have joined the ranks of the anti-global movement.

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