Is Liberalization Reversible?

On the eve of the millennium, "globalization" has become a catch-phrase throughout the world. The nation-state, the driving force of the past two centuries, is dissolving under the pressure of cross-national integration. Despite its many benefits, however, globalization is unsettling, and those who feel most threatened by it may try to turn back the clock.

Harold James

THE MOST dramatic features of globalization—the liberalization of trade in goods and services and the increasingly unrestricted flow of capital across borders—were by no means inevitable. Indeed, they have surprised many students of political economy, which offers numerous examples of powerful interest groups successfully pushing for policies that restrict trade and depress national incomes.

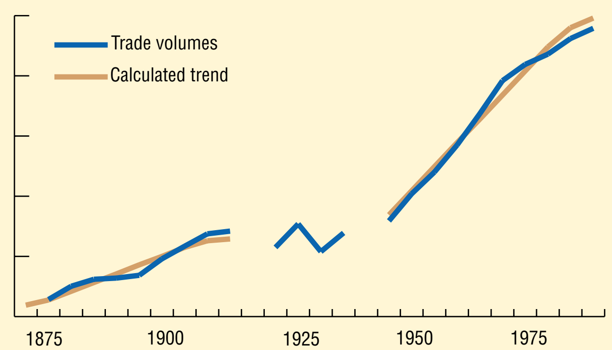
Free trade has rarely been a popular cause. The history of trade has been full of disappointments, even during the past five decades, a period of remarkable growth for world trade (see chart). The General Agreement on Tariffs and Trade (GATT), which was signed in 1947, was a compromise. It achieved its biggest successes in the early 1960s, largely by reducing its scope to exclude two of the most contentious trade items—textiles and agricultural products. By the 1970s, it was generally agreed that the GATT was moribund. The Tokyo Round of trade negotiations, launched in 1973 by the major trading countries with the intention of achieving substantial tariff cuts, was erratic and protracted, coming to a close in 1979. In the mid-1980s, leading trade experts concluded once again that the GATT was "in a state of breakdown." The Uruguay Round of trade negotiations, which began in 1986, seemed doomed to fail as the European Community and the United States found themselves locked in a politically complex struggle over agricultural pricing and subsidies. As late as 1993, on the eve of the Uruguay Round's conclusion, Patrick Low, a former GATT official, discussed "the weakening of a multilateral approach to trade relations" and "the creeping demise of GATT," and attributed the "GATT's decline" to "the accumulated actions of governments."

Nonetheless, some of the Uruguay Round's achievements were remarkable: principles were extended to intellectual property and trade-related investment; a more complete procedure for conflict resolution was created; and the World Trade Organization (WTO), the GATT's successor, was established in 1995. At the time, many believed that the United States would ignore the WTO and continue to exercise power unilaterally through the application of the Super 301 provision of the U.S. Omnibus Trade and Competitiveness Act of 1988. (Under Super 301, the U.S. administration was required to publish a list of companies engaged in unfair trade practices vis-à-vis the United States, negotiate the elimination of these practices, and take retaliatory action if negotiations failed.) But they were wrong. The United States accepted the WTO's first ruling against it. In 1997, despite widespread skepticism about the possibility of a multilateral agreement on financial services, such an agreement was indeed realized.

Free capital movements, associated in the public's mind with destabilizing speculation and the subversion of important national policy goals, are even less popular than free trade. Although the major industrial countries began, tenta-

Volume of world trade in manufactured products

(logarithmic scale, with calculated trends)



Source: Harold James, 1996, *International Monetary Cooperation Since Bretton Woods* (New York: Oxford University Press for the International Monetary Fund).

tively, to liberalize their capital accounts in the late 1970s, many EC countries did not complete the process until 1990. In the 1990s, a number of developing countries began to liberalize their capital accounts in an effort to attract inflows of foreign capital. Because capital account liberalization raises the serious issue of financial governance, there has been some discussion as to whether the IMF should amend its Articles of Agreement to cover it.

The wisdom of liberalizing trade and capital movements was again called into question when the East Asian financial crisis erupted in 1997, threatening to unleash what financier George Soros termed a full-fledged global crisis of capitalism.

The swinging pendulum

Analysts of globalization often present the process as irreversible—a one-way road to the future. But a more sober and pessimistic assessment would be more realistic. History is studded with examples of highly developed and integrated international communities that dissolved under the pressure of unexpected events. Momentum was lost, the pendulum swung in the opposite direction, and the clock was turned back. The universal Erasmian world of Renaissance Europe, for example, was destroyed by the Reformation and the Counter-Reformation, and Europe was once again blighted by separatism, provincialism, and parochialism.

In economic history, the late nineteenth century was a similar universal age, in which integration and progress went hand in hand. But this dynamic and self-confident world also broke apart. The breakup shattered the optimistic belief in the possibility of cooperation across national boundaries—indeed, in the possibility of human progress. The world's first attempt at globalization and the tragedy of its collapse hold important lessons for us.

At the end of the last century, the world was highly integrated economically, through the mobility of capital, goods, and people. Capital moved freely between states and continents. Trade was largely unhindered, even in such apparently protectionist countries as the United States and the German Empire. Nontariff barriers hardly existed and quotas were unheard of. Above all, people moved. They did not need passports. There were hardly any debates about citizenship. In a search for freedom, security, and prosperity—three closely interrelated values—the peoples of Asia and Europe left their homes, braving the discomforts of long journeys across continents and oceans. To the countries that welcomed them, the immigrants brought substantial economic growth. And those they left experienced large productivity gains as their populations shrank; migration eased the desperate poverty of countries like Ireland and Norway. The great streams of capital, trade, and migration were linked. Without capital flows, it would have been impossible to construct the infrastructure—such as railways and cities—needed to welcome the new migrants; migration, in turn, created large overseas markets for European engineering products as well as for textiles, clothing, musical instruments, and other consumer goods.

The integrated world of the late nineteenth century bears a close resemblance to today's world, in which globalization is so hotly debated. Economists who have tried to find a statistical basis for a comparison of the first era of globalization with our own are usually struck by the similarities: indeed, the volume of capital flows was relatively greater a hundred years ago than in our own decade.

From the beginning, however, growing integration aroused anxiety and triggered demands for control. Central banks—whose existence is not required for the operation of a gold standard—were charged with using the instruments at their disposal (discount rates, reserves) to modify or prevent volatile short-term capital movements. As countries opened up, they introduced welfare policies designed to compensate citizens who would be hurt by change. Starting in the late 1870s, more and more countries imposed protective tariffs. During the last decade of the century, attitudes to migration became increasingly hostile and policies, more restrictive.

In the interwar period, when policymakers tried to restore the gold standard, they found that short-term capital movements were much more volatile than they had been before World War I, for several reasons: severe structural problems caused by the conflict, the political imbroglio over war debts and reparations, and major policy inconsistencies between the largest countries. Policymakers thought the old mechanisms used to safeguard the system before the war could be pressed into service once again. So tariffs went up; the United States led the way with the Fordney-McCumber Tariff Act of 1922 and the catastrophic Smoot-Hawley Tariff Act of 1930. Immigration was dramatically curtailed. Central banks became more actively interventionist in trying to manage capital flows. When these measures failed to produce prosperity—they made the world more crisis prone instead—calls for more radical intervention became louder.

Now everything was to be national—not only labor and goods but also capital. John Maynard Keynes brilliantly described this development in his 1933 essay, "National Self-Sufficiency": "Let goods be homespun whenever it is reasonably and conveniently possible; and, above all, let finance be primarily national." Even leading financiers and businessmen believed that economic integration had failed. The collapse of the world economy brought about a turning away from the market. Even moderate and pragmatic analysts, such as the director of the League of Nations' Economic and Financial Section, Sir Arthur Salter, believed that the future lay in regulation and control. With the papal encyclical *Quadragesimo Anno* in the crisis year 1931, the Catholic Church looked for a "third way" between capitalism and socialism.

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Increasing regulation and planning encouraged those who believed the state's function was to externalize the costs of economic adjustment—to impose them on those outside the national community. The state's duty lay in protecting its citizens and ensuring that the inhabitants of other national communities suffered as much as possible. This position was, of course, the opposite of classical economic liberalism, with its faith in the possibility of a mutuality of gains.

The supposed cure for the crisis of capitalism turned out to be much worse than the crisis. The path away from the market and toward control was also a path to political dictatorship. Keynes was painfully concerned that the move to national self-sufficiency would be accompanied by the "silliness of the doctrinaire," "insane and unnecessary haste," and "intolerance and the stifling of instructed criticism." The most obvious examples of these evils were in Germany and Russia. But the sentiment that democracy had failed to meet basic social needs was widely shared. In February 1940, even as politically liberal a figure as the French writer André Gide noted in his diary that, "We should be prepared that after the War, even if we are the victors, we will be in such a morass that only a decisive dictatorship can pull us out."

Reactions against globalization

The current reaction against globalization stems from four major sources, all of which have historic parallels:

• The market economy and rapid economic change are anti-elitist. The position of an entrenched elite defending privileges arising from state control of economic activity—characteristic not only of Soviet-style economies but also of many societies in Asia and Latin America—has become increasingly untenable. Such elites do not deserve our sympathy, nor are they likely to succeed in hanging onto the doctrines that made them powerful. Indeed, their main hope now is lawlessness—the phenomenon of *nomenklatura* privatization, which, amid the anarchy of transition, allows the old elite to build up a property position for the future. The threat in states that once had centrally planned economies, from the former Soviet Union to several African countries, is not a revival of Marxism but chaos fomented by the elite.

There is a precise analogy between this elite and the aristocracy of preindustrial Europe. Where the aristocracy did nothing but cling to its political power, as in France, it was rapidly overwhelmed. But where it used the remnants of its political power to move into the new industries of the age, such as coal mines and steel mills, as in Britain and parts of Germany, the social order endured. The only way the elite could save itself during a period of political and economic upheaval was by relinquishing its monopoly over political power and acquiring economic power—a lesson well learned by the *nomenklatura*.

• More important, during a period of rapid technical and economic transformation, it is often easier to see who the losers are than who the eventual winners will be, given the unpredictability of the future and the impossibility of knowing what types of occupations and activities will emerge and who will be good at them. Thus, there is always the possibility that the losers will revolt. Like the displaced hand-loom weavers of nineteenth-century Europe, who found it very hard to envisage what the future might hold in store for them, those displaced by today's technology are unlikely to be able to reshape politics.

• Some critics of globalization may be motivated by *schadenfreude*—that is, they would like to see the cooperative process of mutually beneficial development collapse, not because a collapse will benefit them but because it will harm some hated external figure. This might be termed the Zhirinovsky reaction, after the extremist Russian politician. Vladimir Zhirinovsky is not much of a politician, but he is a fine inventor of malicious aperçus. One of the most revealing is the question he asks of Russians, cited in an article in the *Financial Times* on December 9, 1993: "Why should we create suffering for ourselves? We should create suffering for others." Such a reaction was, in the past, a source of conflict and war. It is surprising and perhaps gratifying how rare this reaction is today; it is widely appreciated that the world economy is not a simple zero-sum game. Even in the peculiarly dramatic and colorful world of Russian politics, Zhirinovsky is treated as a clown, not a prophet.

• When unexpected and unpleasant events take place, many blame the "system" as a whole and begin searching for alternative systems. This is the "banana skin" effect: we slip and curse the whole world. Slipping on the banana skin is sometimes unavoidable. It is quite conceivable—indeed, inevitable—that the new economic consensus will be challenged by dramatic fiscal and financial crises. Market economies are dynamic but also disruptive.

There is, moreover, an underlying political problem. In particular, states today are subject to opposing pressures: on the one hand, pressures to reduce taxes because tax cuts enhance the mobility of the factors of production (labor and capital); on the other, pressures to raise additional revenues to finance traditional expenditures. Since the 1970s, the international capital markets have made it easier to finance deficits. Although the markets react sharply to unsustainable fiscal policies, they do not react immediately, at the first sign of trouble, but usually fairly late in the game. As a result, an economically integrated world is likely to see more and more generalized financial and banking panics, which are always frightening and therefore evoke demands for a halt to liberalization. The extent to which the response to crises will actually turn back the clock depends on how we are prepared to think about the problem. It is possible to view crises as opportunities for adaptation. Indeed, many societies find it impossible to overcome inefficiencies and redirect resources to more productive uses without a major shock to entrenched interests and established wisdom.

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Angst of the millennium

Today, the case for free trade and unrestricted capital movements is, perhaps, generally understood. But some commentators have begun to chip away at it, presenting the outcomes of certain special situations as yielding lessons with a broad application. One example, taken from strategic trade theory, is a situation in which, because of the existence of an oligopoly, some measure of trade protection may be beneficial. Another example is the abundant literature published since the Asian crisis on the dangers of herd behavior and volatility associated with short-term capital movements.

The turbulence of the mid-1990s has led to increased skepticism about liberalization. As in the 1930s, the smart money is on control, not deregulation. Some major market participants, such as George Soros, have begun to advocate capital controls. Even moderate and pragmatic analysts, such as the World Bank's Chief Economist, Joseph Stiglitz, believe that the future lies in control and regulation of capital markets. Politicians in Europe and America are engaged in an intensive search for a "third way." In his reflections on the dangers of free capital transactions, MIT economics professor Paul Krugman is following directly in the steps of John Maynard Keynes.

The Great Depression, which put an end to the world's first experiment with globalization, was the consequence of financial vulnerability stemming—ironically—from the very institutions created to provide protection against the impact of globalization. Globalization was rapid in the nineteenth century, but almost immediately met with resistance. The interventionist state derived a great deal of its legitimation from globalization and increasingly became an impediment to integration. It was during the Great Depression that those who opposed unrestricted migration and the free movement of goods and capital across borders saw the opportunity to turn back the clock. At that time, and again today, the nation-state and its control mechanisms are supposed to give guarantees against threats from the world economy. But was not and is not the protection more dangerous and destructive than the threat?

Are we now living in an age in which the attempt is being made to use not a real Great Depression, but simply its shadow—the fear of one—as justification for backing away from the integration of the world economy? If so, we might really produce a depression and, with it, the complete reversal of liberalization. F&D

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