

## Globalization and Public Policy

Dallas Fed chief economist W. Michael Cox discusses how the increasing integration of the world economy goes hand-in-hand with sound money, efficient regulation and other policies that promote economic growth and freedom.

**Q: What do you mean by globalization?**

**A:** The term describes the freer movement of goods, services, people and ideas across international borders. It's been going on all around us for quite some time, but it has accelerated in the last decade or two.

Trade between countries as a percent of gross world product has risen from just 15 percent in 1986 to nearly 27 percent today. As a percent of gross world product, the stock of foreign direct investment has nearly quadrupled since 1986, and the stock of portfolio investment is up by a multiple of eight.

We're not only seeing more trade and investment but also more personal contacts. In 1950, just one visitor arrived in another country for every 100 residents. By the mid-1980s, there were six; today, the number is double that.

Global communication is where we see some of the biggest advances. The spread of the Internet, e-mail, computers and cell phones connects an increasingly multilingual global economy. Since 1991, international telephone traffic has more than tripled, while cell phone subscribers have grown from virtually zero to 1.8 billion people—30 percent of the world's population—and Internet users will soon top 1 billion.

This rapid globalization is changing the way the U.S. economy works. So we have to change our thinking. The old analytical models and policy rules are no longer adequate in a world where geographic and political barriers are no longer economic barriers. When Richard Fisher became Dallas Fed president in 2005, he shifted our research focus to globalization. Over the past year or so, the economics team has begun to delve into various aspects of globalization. It's an exciting



new research world, and there is much to learn, with potentially new guideposts for the conduct of monetary policy.

**Q: How does globalization influence economic performance?**

**A:** Globalization affects economies in two broad ways. The first largely involves the private sector, where self-interest and incentives lead companies and individuals to efficiently produce what consumers want. Globalization means more competition, greater specialization and expanding markets, which increase productivity and spark innovation. They, in turn, raise living standards. Adam Smith became the father of modern economics by bringing the world this brilliant insight in his book *The Wealth of Nations*.

The second way globalization raises living standards—less heralded though no less important—is by disciplining the public sector. Because globalization entails greater mobility for factors of production, it puts governments in direct competition for the planet's productive resources—capital,

labor, businesses and ideas. Nations that run their economies more effectively will benefit by attracting more of those resources; those that shackle the private sector will see key factors of production drain away.

**Q: Can you measure globalization's impact on public policies?**

**A:** Economic performance is influenced by how governments raise taxes, spend money, regulate business, treat investment, encourage innovation, enforce the rule of law and protect property rights through the judicial system. Policies regarding money and inflation, international trade and investment, immigration, energy, education and labor—they, too, have an impact on the economy. And don't forget the issue of stability—the consistency of policies over time.

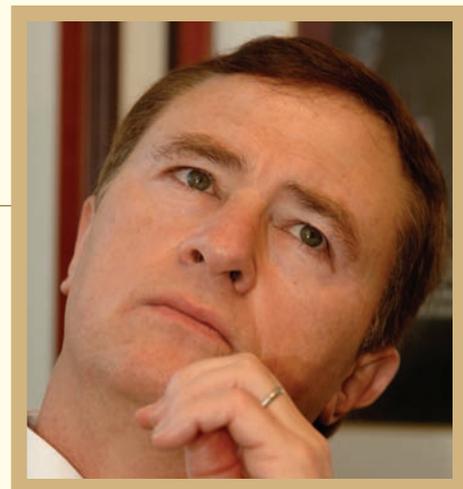
Researchers at the World Bank, the Fraser Institute, Harvard University, the Heritage Foundation, Transparency International and other think tanks have done excellent work in rating nations on a wide range of policies. Harvard's Institute for Strategy and Competitiveness, for example, tells us that the United States, the Netherlands and Singapore offer the best environment for innovation, while Bangladesh, Peru, Nigeria and Romania are the worst.

With all these data, we can probe for links between globalization and policy. The management consulting firm A.T. Kearney and *Foreign Policy* magazine publish a globalization index, ranking roughly 60 countries from least to most globalized. The U.S. comes in fourth, behind Singapore, Switzerland and Ireland. Iran comes in last.

**Q: And you found?**

**A:** In general, the countries that are more globalized tend to pursue better economic policies. They don't do it because they're more enlightened, although they may well be. They do it because it is the way to hold

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and attract the mobile factors of production that will make their economies more competitive, spur growth and job creation, and improve their living standards.

**Q: Can you give us a specific example?**

**A:** Inflation. From 2001 to 2003, the most globalized quarter of nations had average annual inflation of just 2.3 percent. The average inflation rate rose to 3.1 percent for the second group, 6.2 percent for the third group and 10 percent for the least globalized quarter. This is no accident. The much-respected Economic Freedom of the World index, developed by the Fraser Institute, shows that more-globalized nations tend to pursue sounder monetary policies.

Inflation is largely a monetary phenomenon, but globalization changes the economic environment in which central banks operate. Money is probably the most mobile factor of production—it can now cross borders with a click of a computer mouse. Open capital and foreign exchange markets allow investors to move funds quickly in search of the highest rates of return, *net of inflation*. Nations that don't want to lose out wisely toe the line by adopting new anti-inflationary policies.

**Q: What about other public policies?**

**A:** Globalization raises the bar. The world's most globalized nations tend to have fewer restrictions on international trade, more open capital markets, fewer and better-administered regulations, a more favorable corporate tax environment and better policies to promote innovation.

Where you find the greatest degree of globalization, you also find policies that support more accountability in the private and public sectors, courts that recognize property rights and enforce the rule of law, governments that are run more effectively and are less corrupt, and government policies that tend to be more stable.

The pattern is remarkably regular—step by step, as countries become more

globalized, they are more likely to pursue the policies that contribute to successful market economies. Of course, there is a chicken-and-egg question of whether globalization improves public policy or nations with better policies are more successful at globalization. It's probably both.

**Q: Are all policies positively linked to globalization?**

**A:** An important exception is labor policies. In general, labor market flexibility doesn't improve with globalization, although the United States and other countries at the very top of the globalized rankings tend to have better policies, with the fewest restrictions on hiring and firing.

The United States doesn't penalize companies when workers lose their jobs, while employers in many other countries face significant burdens. The cost of giving advance notice, severance and other penalties, measured in terms of workers' pay, is 165 weeks in Brazil, 112 weeks in Turkey, 90 weeks in China and 79 weeks in India. The importance of nimble labor markets in today's increasingly interconnected world is still something policymakers in many countries must learn.

Other exceptions involve fiscal policy. Government transfers and subsidies become more common as nations become more globalized, and personal income taxes become more burdensome as well. The most globalized nations have had some success in reducing the size of government. Beyond that, though, governments tend to get bigger as nations become more globalized.

Why does fiscal policy tend to worsen with globalization? There are no definite answers, but the explanation might be as simple as factor mobility. When immigration laws prevent workers from voting with their feet, governments can tax individuals, then use the money for transfers and subsidies to attract more mobile resources. Such policies aren't sustainable in the long term, and many governments need to get their fiscal act under control.

We don't know about some other policies—immigration, energy and education, for example. Indicators on these don't exist. On balance, though, the world does have the answer about globalization, factoring in both the private and public sectors.

**Q: So why are so many people in America and elsewhere uneasy about globalization?**

**A:** It's partly because globalization, like new technology, brings economic change. Whether we're talking about innovation or opening markets, economic change creates anxiety because it means some jobs, companies and industries will fade while others rise to take their place.

It's also because globalization isn't well understood. People often can see the downside of globalization—in, say, lost jobs—but even when they see an economy growing strongly with low inflation, they don't necessarily attribute the good times to globalization.

Using data from the World Bank and Fraser Institute, we can show that, for the world as a whole, per capita income and economic freedom have both been increasing as globalization has spread in recent decades. We should celebrate, not denigrate, globalization because it generally reflects better government policies, leading to higher living standards and freer people.

*A more detailed exploration of this topic can be found in “Racing to the Top: How Global Competition Disciplines Public Policy” in the Dallas Fed's 2005 annual report. It's available on the Bank's web site at [www.dallasfed.org](http://www.dallasfed.org).*