⁕ *Introduction* ⁕

THE FRAGILE GLOBAL ECONOMY

CAPITALISM is the most successful wealth-creating economic system that the world has ever known; no other system, as the distinguished economist Joseph Schumpeter pointed out, has benefited "the common people" as much. Capitalism, he observed, creates wealth through advancing continuously to ever higher levels of productivity and technological sophistication; this process requires that the "old" be destroyed before the "new" can take over. Technological progress, the ultimate driving force of capitalism, requires the continuous discarding of obsolete factories, economic sectors, and even human skills. The system rewards the adaptable and the efficient; it punishes the redundant and the less productive.

This "process of creative destruction," to use Schumpeter's term, produces many winners but also many losers, at least in the short term, and poses a serious threat to traditional social values, beliefs, and institutions. Moreover, the advance of capitalism is accompanied by periodic recessions and downturns that can wreak havoc in peoples' lives. Although capitalism eventually distributes wealth more equally than any other known economic system, as it does tend to reward the most efficient and productive, it tends to concentrate wealth, power, and economic activities. Threatened individuals, groups, or nations constitute an ever-present force that could overthrow or at least significantly disrupt the capitalist system.

Revolt in the international system against a global economy characterized by open markets, unrestricted capital flows, and the activities of multinational firms appears repeatedly in the guise of trade protection, closed economic blocs, and various kinds of cheating. Individual nations and powerful groups within nations that believe the world economy functions unfairly and to their disadvantage, or who wish to change the system to benefit themselves to the detriment of others, are an ever-present threat to the stability of the system.

The international capitalist system could not possibly survive without strong and wise leadership. International leadership must promote international cooperation to establish and enforce rules regulating trade, foreign investment, and international monetary affairs. But it is equally important that leadership ensure at least minimal safeguards for the inevitable losers from market forces and from the process of creative destruction; those who lose must at least believe that the system functions fairly. Continuation of the market or capitalist system will remain in jeopardy unless considerations of efficiency are counterbalanced by social protection for the economically weak and training/education of those workers left behind by rapid economic and technological change.

With the 1989 end of the Cold War, many proclaimed the "triumph of global capitalism," and by the late-1990s, the American people were enjoying what *The Economist* of London called the "longest-ever . . . economic expansion." Unemployment (about 4 percent) was the lowest in almost thirty years, wages were up for most American workers, and inflation was low; this was indeed an economic achievement. The performance of the stock market was extraordinary as the Dow Jones index broke through the 10,000 mark in the spring of 1999; the "wealth effect" of the high stock market, which encouraged Americans to spend freely, draw down their personal savings, and go deeply into debt, fueled rapid economic growth. With the rest of the world in recession or other dire economic straits, many Americans believed that the United States in the 1990s had fashioned a new type of capitalist economy and had escaped forever from ills historically associated with the capitalist system.

This New American Economy (NAE), many declared, had been created by several important developments, including the freeing of markets from excessive government regulations, downsizing and restructuring of American corporations, and rapid technological advances (especially the computer, information technologies, and the Internet). Moreover, economic globalization, high rates of productivity growth, and the openness of the American economy to imports had kept prices down and dampened inflationary pressures, thereby allowing the Federal Reserve (America's central bank) to pursue expansionary economic policies. Moreover, reduction of the federal budget deficit, superior business management, and reinvigorated American entrepreneurship had made the American economy better suited than its Japanese and European competitors to take advantage of the Internet economy and the inevitable shift of the advanced economies from manufacturing to service industries. These developments had greatly increased the international competitiveness of the American economy.

Enthusiastic supporters of the NAE even proclaimed that the American economy had transcended the "boom and bust" of the business cycle that has historically plagued capitalist economies. It seemed that the economic boom could continue forever. Most academic economists, on the other hand, were skeptical of such claims and warned that the American economy was experiencing a "speculative bubble." Like the Japanese bubble of the late 1980s and similar bubbles of the past, the American bubble would also necessarily burst one day.

Rejoicing in their own good fortune, Americans failed to appreciate that the country's prosperity was highly dependent on the global economy and that, in international economic affairs as in other aspects of life, no person or country is an island. Few appeared to be aware that, although global capitalism had indeed triumphed, the larger global economy was in serious trouble. Nor were they concerned that the Clinton Administration and the Congress were doing very little about it. However, rapid U.S. economic growth throughout much of the 1990s was significantly assisted by exports to overseas markets and also by large amounts of imported capital as well as by inexpensive imports. The United States is one of the world's largest exporters, and long-term economic progress is dependent on these exports. Many American workers benefit greatly from the export economy because exports are associated with higher paying jobs. With the lowest rate of personal savings in the industrialized world, the American economy has also become very dependent on capital imports, and it prospered in the 1990s in part because foreign investors were contributing significantly to financing the American stock market and thus to economic growth.

Although the changes associated with the NAE provide part of the explanation of America's good economic fortune in the 1990s, equally important contributing factors included skillful management of the economy by the Federal Reserve under the chairmanship of Alan Greenspan and just plain good luck. And the United States benefited from highly favorable international developments. The victory over inflation and low interest rates was due in large part to the fact that the rest of the world economy was experiencing slow growth or recession throughout much of the 1990s; this situation led to lower import prices, especially for petroleum, other raw materials, and consumer goods. For the same reason, the United States has been able to import huge amounts of capital on highly favorable terms; with few other places to invest their capital, both American and foreign investors inflated the American stock market or purchased Treasury bills. As Greenspan has warned, the resultant accumulation of foreign debt could cause the dollar to fall significantly and cannot continue forever.

Resumption of economic growth in Europe and Asia would lessen these favorable conditions and, in the short term, would slow U.S. economic growth, even though over the longer term a revival of global economic growth would immensely benefit American exports. Furthermore, it is not clear that the revival of productivity in the late 1990s can be sustained. During the Reagan boom of the early 1980s, a similar jump in productivity occurred; that boom dissipated by the end of the decade. The increase in productivity in the 1990s could be due to the fact that Americans have been working harder and longer during the boom years rather than be a consequence of the computer and information economy.

Throughout the 1980s and 1990s, America's trade/payments deficits reached record highs. Since the early 1980s, in fact, Americans have borrowed approximately $5 trillion from the savers of the world, especially the Japanese, to finance their consumption and investment. In the mid-1980s, the United States went from its post–World War I position as the world's largest creditor nation to become its largest debtor. If one discounts American investment overseas, the net American international debt in the late 1990s stood at approximately $1 trillion; as a consequence, a sizable portion of the federal budget must be devoted to interest payments on this huge and increasing debt. Furthermore, throughout the 1990s, Americans had emptied their personal savings accounts to fuel "seven years of good times," leaving too little for the "seven years of bad times" that many and perhaps most economists believe loom ahead; the spending spree left 20 percent of American households net debtors. And the "good times" of the 1990s left many behind as the income of the least skilled lagged.[1] Americans appeared to be unaware that one day the nation's huge accumulated debt will have to be repaid and serious adjustments in the American standard of living will be necessary.

If Japan, Western Europe, and the “emerging” markets of East Asia had also grown rapidly throughout the 1990s, world commodity prices (e.g., for oil, food, and raw materials) would have soared and increased inflationary pressures, and thus would have dampened American economic growth. However, America’s unprecedented good economic fortune will one day run out, and when it does the United States must confront its low personal savings rate, deteriorating education system, and accumulated foreign debt, and it must also adjust to a rapidly changing global economy characterized by intensifying competition, exclusive regional arrangements, and an unstable international financial system. The developments transforming the global economy pose a significant challenge to the United States.

Propelled by a number of political, economic, and technological developments, the world has moved from the sharply divided international economy of the Cold War to an increasingly integrated global capitalist economy. The end of the Cold War in 1989 and the subsequent disintegration of the Soviet empire were, of course, extremely important to this change. The rapid industrialization in the 1980s and 1990s of the emerging markets of East Asia, Latin America, and elsewhere shifted global economic power and created an increasingly competitive international economy. Furthermore, the continuing technological revolution associated with the computer and the emergence of the information economy accelerated the shift of the advanced industrialized countries from manufacturing-based toward service-based economies. Enormous increases in international trade, financial flows, and the activities of multinational corporations integrated more and more economies into the global economic system in a process now familiarly known as “globalization.” However, by the end of the decade these developments had also produced upheaval in both domestic and international affairs.

The global economic turmoil of the late 1990s, which began in Thailand in July 1997, reflected the growing impact of global economic forces on international economic and political affairs. Spreading quickly throughout the industrializing economies of Pacific Asia, and even to Japan (already afflicted by serious economic and political troubles), this turmoil soon engulfed much of the world. By the fall of 1998, a quarter of the world economy, including that of Japan, which is the world's second-largest economy, was in recession. Evaporation of wealth in Pacific Asia and elsewhere was enormous, and commodity-exporting countries, including the United States, suffered huge losses as their export markets dried up. Although the Russian economy constituted only a small portion of the international economy and its troubles were largely of its own making, disturbing economic news from Russia in the late summer of 1998 roiled international financial markets, and a large drop in the American and other national stock markets followed. The psychological impact of these developments caused worried investors to withdraw from Brazil and other emerging markets.

Whereas the emerging markets had been hailed in the early 1990s as a source of huge profits for American investors, by the end of the decade they were considered a major source of global economic and political instability. In the 1980s, it would have been unthinkable that a financial crisis originating in a minor Southeast Asian economy could bring harm not only to the United States but also to the rest of the world. Indeed, during the Reagan and Bush Administrations (1981–1993), the United States had been celebrated as the only true superpower; President Bush (following victory in the Gulf War) proclaimed the "New World Order" of peace, prosperity, and democracy with, of course, the United States at its core. A decade later, however, serious doubts had arisen about the prospects for a prosperous and peaceful new world order based on American leadership.

At the beginning of the twenty-first century, the increasingly open global economy is threatened. Although the East Asian and global financial troubles have significantly moderated, the vulnerability of the international financial and monetary system threatens the stability of the global economy; although financial crises appear to be an inherent feature of international capitalism, only half-hearted measures have been taken to prevent future financial crises. In addition, the unity and integration of the global economy are increasingly challenged by the spread of regional economic arrangements; both the European movement toward greater economic and political unity and the North American Free Trade Agreement (NAFTA) represent important shifts away from an open global economy. And, most important of all, the political foundations of the international economy have been seriously undermined since the end of the Cold War.

Even though the globe has become increasingly integrated both economically and technologically, it continues to be politically fragmented among independent, self-interested states. The forces of economic globalization—trade, financial flows, the activities of multinational corporations—have made the international economy much more interdependent. At the same time, the end of the Cold War and the decreased need for close cooperation among the United States, Western Europe, and Japan have significantly weakened the political bonds that have held the international economy together. As a consequence, the rule-based international economic system laid down at the Bretton Woods Conference (1944) has greatly eroded. Despite some important reforms, including the 1995 creation of the World Trade Organization (WTO), the rules governing trade, money, and other international economic matters are no longer adequate for a highly integrated and fragile global economy.

The problems arising from increased economic integration of national economies necessitate new rules or modification of older rules to deal with pressing economic issues and ensure the continued existence of an open and stable global economy. The international integration of financial markets, the increasing importance of multinational corporations and foreign direct investment, and the spread of regional economic blocs call for action by the major powers and the rising economies of East Asia and elsewhere. Continuing failure of the international community to address crucial international economic matters threatens the stability of the global economy. Improved governance and management have become imperative.

Atrophy of the political cooperation that characterized the post–World War II international economic order has undermined the foundations of that order. A stable and prosperous international economy (like a domestic economy) requires strong and stable political foundations to undergird the institutions and rules governing the system and to prevent problems from escalating into crises like the post-1997 financial crisis. Strong international leadership, cooperative relations among major economic powers, and a commitment by citizens to an open world are all crucial elements. From 1945 to the 1980s, strong and generally prudent American leadership, close cooperation among the United States and its major allies, and a domestic consensus in the major capitalist economies favoring free trade and an open world economy provided a firm base for the development of the integrated international economy. However, the foundations first laid down at Bretton Woods have been weakened as have the shared political interests, mutual understandings, and cooperative arrangements of the Cold War decades.

By the beginning of the twenty-first century, American leadership of the world economy had been significantly weakened by a number of developments. The faltering domestic consensus on economic affairs contributed to that decline. Whereas, during most of the Cold War, the federal government had been expected to assume an important role in management of both domestic and international economic affairs, the market became ascendant with the presidency of Ronald Reagan, and many began to believe that the market alone could govern the world. The end of the Cold War has undermined America's ability and willingness to pay the economic and other costs of world economic leadership. Throughout the Cold War, Americans believed that partisan political concerns and other divisive issues should be set aside in the interest of national unity in foreign affairs; collapse of the Soviet threat greatly weakened this belief. In the economic realm, the American domestic consensus supporting free trade was weakened by ideological and political schisms regarding economic policy and by growing fears that economic globalization was threatening American economic well-being.

In the 1990s, many constituencies in the United States protested expansion of trade and foreign investment, arguing that they harmed the American worker, the environment, and human rights. Simultaneously, more and more Americans attributed the country's economic and other problems to globalization, and accused imports and corporate investments overseas of hurting American workers, small businesses, and the overall society. Many, for example, began to believe that increased economic inequality, declining real wages, and increasing job insecurity had been caused by increased competition from Mexico, Pacific Asia, and other low-wage economies. This shift in thinking was well illustrated by the acrimonious 1997 debate over and the failure of Congress to approve "fast track" authority to facilitate new trade negotiations, and by the lengthy 1998 delay of congressional approval of an appropriation ($18 billion) for the International Monetary Fund (IMF).[2] Attacks from both the political right and left on the evils of the global economy have become symptomatic of America's retreat from international leadership.

Since the end of the Cold War, economic cooperation among the United States and its allies has eroded considerably, and American foreign and economic policy has become more unilateral and self-centered. This shift away from international cooperation began in the mid-1980s when the Reagan Administration abandoned the postwar commitment to economic multilateralism in favor of a "multitrack" trade policy that included managed trade and NAFTA; the United States became converted to economic regionalism. The Clinton Administration's aggressive economic offensive against Japan in the early 1990s underscored America's abandonment of multilateralism and of its prior emphasis on international cooperation with its Cold War allies. The Administration's "managed trade" policy toward Japan would never have been launched during the height of the Cold War.

Meanwhile, the Europeans also became much more parochial in their economic and political concerns than in the past. Their energies have been focused on intensified efforts to create a European economy and polity. They have wanted to stabilize the Continent politically, create a globally competitive European economy, and strengthen their economic and political position vis-à-vis the United States and, to a lesser extent, Japan. Led by the French-German economic alliance, the West Europeans have concentrated on achieving economic unification of the Continent and strengthening the European Union.

The Japanese have also reoriented their economic and foreign policies. Following the 1985 Plaza Agreement and the consequent substantial appreciation of the yen, the Japanese political and economic elite increased their attention to Pacific Asia, and renewed interest in the region led to efforts to fashion a regional economy tightly linked to Japan. Japanese multinational corporations, strongly backed by the Japanese government, created integrated production networks of Japanese and local firms to strengthen the competitiveness of Japanese firms in the global economy. Although this effort has been set back by the East

Asian financial crisis and Japan's own economic problems, the concerted effort to forge a Japanese-led Pacific Asian economy has continued and signifies Japan's increasing assertiveness and independent stance within the global economy.

Failure of the major capitalist powers to launch any coordinated effort to deal with the post-1997 instability in international financial markets revealed the extent to which international cooperation had receded. The weakness of American leadership was painfully evident in President Clinton's speech at the Council on Foreign Relations on September 14, 1998, and in subsequent discussions among the major economic powers (G-7) following the October 1998 annual joint meeting of the World Bank and International Monetary Fund. The centerpiece of the President's Council speech—a proposal for a global cut in interest rates—met a cool reception. The Bundesbank, more concerned with fighting inflation than with the health of the global economy, turned the President's proposal aside; Japan, with nearly zero percent interest rates already and weighed down by its own enormous troubles, appeared to do little to stimulate its economy. Although agreement to create a new loan fund in the IMF was reached by the G-7, there has thus far been inadequate progress in safeguarding international financial matters.

Many political leaders, business executives, and scholars, especially in the United States, dismiss concerns about the future of global capitalism. The world economy, they point out, has become market dominated, and free markets can successfully guide the global economy to ever higher levels of prosperity and stability. According to this argument, the failure of the former command economies and the closed economies of the less developed countries caused governments everywhere to turn toward market solutions to economic problems. Among developed countries, deregulation, privatization, and other reforms have reduced the role of the state in the economy and have led many to proclaim the triumph of international capitalism and the economic ideas on which it rests. This belief in the secure victory of liberated capitalism may turn out to be valid, but it is important to recall that the world passed this way once before in the laissez-faire era prior to the outbreak of World War I and the subsequent collapse of that highly integrated world economy. Although the threat of another major war is very small, other developments could bring down or at least seriously damage the contemporary international capitalist system. As the revolt against globalization in the United States and other countries reminds us, capitalism creates its own internal enemies.

Throughout this book I shall argue that international politics significantly affects the nature and dynamics of the international economy. Although technological advance and the interplay of market forces provide sufficient causes for increasing integration of the world economy, the supportive policies of powerful states and cooperative relationships among these states constitute the necessary political foundations for a stable and unified world economy. The international rules (regimes) that govern international economic affairs cannot succeed unless they are supported by a strong political base.

Since the end of the Cold War, all the political elements that have supported an open global economy have considerably weakened. Both the ability and the willingness of the United States to lead have declined, and although the formal framework of anti-Soviet alliances has continued, the Cold War allies' political unity has eroded as the United States, Western Europe, and Japan have emphasized their own parochial national and regional priorities more than in the past. Furthermore, the domestic consensus in both the United States and Europe has been worn away by years of increased income inequalities, job insecurity in the United States, and high levels of unemployment in Western Europe. Although major structural changes driven by technological change and ill-considered national policies carry a large share of responsibility for these social and economic ills, more and more people in the United States and Europe blame globalization and competition from foreign low-wage labor. Growing concern over economic globalization and increased competition have intensified the movement toward economic regionalism and the appeal of protectionism.

A number of books proclaim that, whether we like it or not, global capitalism and economic globalization are here to stay. Unfettered markets, they argue, now drive the world and all must adjust, however painful this may be. Yet, as I argue, despite the huge benefits of free trade and other aspects of the global economy, an open and integrated global economy is neither as extensive and inexorable nor as irreversible as many assume. Global capitalism and economic globalization have rested and must continue to rest on a secure political foundation.

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