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The Dangers of Turning Inward

Countries are attempting to protect their own companies and workers from the economic crisis. The financial and political damage will be severe, argues Jeffrey E. Garten.

By JEFFREY E. GARTEN

Reuters

Protesters clash with riot police in Athens Dec. 18 in the midst of the economic crisis.

Not long ago, on a visit to Bangalore, India, I made what I thought would be a 15-minute trip to the outskirts of the city. The journey took 90 minutes on roads filled with cars, trucks, bicycles, push carts, children, all kinds of animals and giant potholes. At one point my taxi was at a dead stop for what seemed like an eternity, waiting for a small group of cows to move to the side of the road. It was dusty and noisy, filled with the sounds of buzzing scooters and honking horns.

We eventually came to our destination: the campus of Infosys, an Indian technology company with major operations around the world. Here was a city within a city, with ultra-modern buildings, movie theaters, restaurants with international cuisine, workout facilities, classrooms for executive education, accommodations for workers who had to stay late and communications capabilities that I had never seen in American companies.

Two worlds. One globalized, the other not. One that had access to the world's capital, technology and management, the other stuck in another century. Many of Infosys's management and employees came from that poorer world. I wondered what it would take to pull up the millions of others.

In the next 24 hours, approximately 180,000 people in developing countries will be moving from the countryside to cities such as Shanghai, Sao Paulo, Johannesburg. The same will happen tomorrow and every day thereafter for the next 30 years, the equivalent of creating one new New York City every two months, according to the United Nations. These men and women will need everything -- electricity, water, food, heath care, shelter, schools, computers and, of course, jobs. Many have the potential to improve not just their local environments but the world. For better or worse, the forces of globalization have pushed them to urban areas to seek a better life. And it will be globalization that opens the world to them, allowing international agencies to pump in capital, multinational companies to help supply technology and management, and Western universities to transfer knowledge.

Reuters

British union members stage a rally at a power station on Feb. 11 over claims that overseas workers were being hired.

Yet if historians look back on today's severe downturn, with its crumbling markets, rising unemployment and massive government interventions, they could well be busy analyzing how globalization -- the spread of trade, finance, technology and the movement of people around the world -- went into reverse. They would likely point to the growth of economic nationalism as the root cause.

Ordinary protectionism such as tariffs and quotas would be one aspect of this problem, but it won't be the worst of it because a web of treaties and the enforcement capabilities of the World Trade Organization will constrain the most egregious behavior. Economic nationalism is more insidious because it is broader, more subtle and subject to fewer legal constraints. It is a frame of mind that casts doubt on the very assumption that we live in a single international market, and that relatively open borders are a virtue. It is based on a calculation that despite all the talk about economic interdependence, nations can go it alone, and could be better off in doing so. True economic nationalists want above all to protect capital and jobs in their own countries. They see global commerce not as a win-win proposition but as a contest in which there is a victor and a loser. They are thus not focused on international agreements to open the world economy; to the contrary, they are usually figuring out how to avoid international commercial obligations.

The last time we saw sustained economic nationalism was in the 1930s, when capital flows and trade among countries collapsed, and every country went its own way. World growth went into a ditch, political ties among nations deteriorated, nationalism and populism combined to create fascist governments in Europe and Asia, and a world war took place. It took at least a generation for globalization to get back on track. There have been some bouts of inward-looking governmental action since then, such as the early

1970s when the U.S. cut the dollar from its gold base and imposed export embargoes on soybeans and steel scrap. However, the economic conditions were not sufficiently bad for the trend to sustain itself.

The kind of economic nationalism we are seeing today is not yet extreme. It is also understandable. The political pressures could hardly be worse. Over the last decade, the global economy grew on average about 4% to 5%, and this year it will come to a grinding halt: 0.5% according to the International Monetary Fund, where projections usually err on the optimistic side. World trade, which has grown much faster than global gross domestic product for many years, is projected to decline this year for the first time since 1982. Foreign direct investment last year slumped by 10% from 2007. Most dramatically, capital flows into emerging market nations are projected to drop this year by nearly 80% compared to 2007.

The aggregate figures don't tell the story of what is unraveling in individual countries. In the last quarter of 2008, U.S. GDP dropped by 6.2% at an annual rate, the U.K. by 5.9%, Germany by 8.2%, Japan by 12.7% and South Korea by 20.8%. Mexico, Thailand and Singapore and most of Eastern Europe are also in deep trouble. In every case, employment has been plummeting. So far popular demonstrations against government policies have taken place in the U.K., France, Greece, Russia and throughout Eastern Europe. And the governments of Iceland and Latvia have fallen over the crisis.


Reuters

Bulgarians demand economic and social reforms in Sofia Jan. 21.

Governments could therefore be forgiven if they are preoccupied above all with the workers and companies within their own borders. Most officials don't know what to do because they haven't seen this level of distress before. They are living from day to day, desperately improvising and trying to hold off political pressure to take severe measures they know could be satisfying right now but cause bigger damage later. Thinking about how their policies might affect other countries is not their main focus, let alone taking the time to try to coordinate them internationally.

Besides, whether it's in Washington, Brussels, Paris, Beijing, Brazilia or Tokyo, it is hard to find many top officials who wouldn't say that whatever measures they are taking that may undermine global commerce are strictly temporary. They all profess that when the crisis is over, they will resume their support for globalization. They underestimate, however, how hard it could be to reverse course.

Political figures take comfort, too, from the global institutions that were not present in the 1930s -- the IMF, the World Bank and the World Trade Organization, all of which are assumed to be keeping globalization alive. This is a false sense of security, since these institutions are guided by sovereign countries. Government officials often feel that because they are going to endless crisis summit meetings -- the next big one is in London on April 2, when the world's top 20 nations will be assembling -- that some international coordination is actually taking place. This is mostly an illusion. With a few exceptions, such as the so-called Plaza Agreements of 1984 when currencies were realigned, it is difficult to point to a meeting where anything major has been said and subsequently implemented.

But as the pressure on politicians mounts, decisions are being made on an incremental and ad hoc basis that amounts to a disturbing trend.

Classic trade protectionism is on the rise. In the first half of 2008, the number of investigations in the World Trade Organization relating to antidumping cases -- selling below cost -- was up 30% from the year before. Washington has recently expanded sanctions against European food products in retaliation for Europe's boycott against hormone-treated American beef -- an old dispute, to be sure, but one that is escalating.

In the last several months, the E.U. reintroduced export subsidies on butter and cheese. India raised tariffs on steel products, as did Russia on imported cars. Indonesia ingenuously designated that just a few of its ports could be used to import toys, creating a trade-blocking bottleneck. Brazil and Argentina have been pressing for a higher external tariff on imports into a South American bloc of countries called Mercosur. Just this week, the E.U. agreed to levy tariffs on American exports of biodiesel fuel, possibly a first shot in what may become a gigantic trade war fought over different environmental policies -- some based on taxes, some on regulation, some on cap and trade -- being embraced by individual countries.

Reuters

Demonstrators call on the government to protect workers in St. Petersburg, Russia, Feb. 7.

Much bigger problems have arisen in more non-traditional areas and derive from recent direct intervention of governments. The much-publicized "Buy America" provision of the U.S. stimulus package restricts purchases of construction-related goods to many U.S. manufacturers, and although it is riddled with exceptions, it does reveal Washington's state of mind. The bailout of GM and Chrysler is a purely national deal. Such exclusion against foreign firms is a violation of so-called "national treatment" clauses in trade agreements, and the E.U. has already put Washington on notice that it will pursue legal trade remedies if the final bailout package is discriminatory.

Uncle Sam is not the only economic nationalist. The Japanese government is offering to help a broad array of its corporations -- but certainly not subsidiaries of foreign companies in Japan -- by purchasing the stock of these firms directly, thereby not just saving them but providing an advantage over competition from non-Japanese sources. The French government has created a sovereign wealth fund to make sure that certain "national champions," such as car-parts manufacturer Valeo and aeronautics component maker Daher, aren't bought by foreign investors.

Government involvement in financial institutions has taken on an anti-globalization tone. British regulators are pushing their global banks to redirect foreign lending to the U.K. when credit is sorely needed and where it can be monitored. Just this past week, the Royal Bank of Scotland announced it was closing shop in 60 foreign countries. Western European banks that were heavily invested in countries such as Hungary, the Czech Republic and the Baltics have pulled back their credits, causing a devastating deflation throughout Eastern Europe. The Swiss are reportedly considering more lenient accounting policies for loans their banks make domestically as opposed to abroad.

This de-globalizing trend could well be amplified by Washington's effort to exercise tight oversight of several big financial institutions. Already AIG's prime Asian asset, American International Assurance Company, is on the block. As the feds take an ever bigger stake in Citigroup, they may well force it to divest itself of many of its prized global holdings, such as Banamex in Mexico and Citi Handlowy in Poland. It appears that new legislation under the Troubled Asset Relief Program will also restrict the employment of foreign nationals in hundreds of American banks in which the government has a stake.

Whether or not it goes into bankruptcy, General Motors will be pressed to sell many of its foreign subsidiaries, too. Even Chinese multinationals such as Haier and Lenovo are beating a retreat to their own shores where the risks seem lower than operating in an uncertain global economy. The government in Beijing is never far away from such fundamental strategic decisions.

Then there is the currency issue. Economic nationalists are mercantilists. They are willing to keep their currency cheap in order to make their exports more competitive. China is doing just that. A big question is whether other Asian exporters that have been badly hurt from the crisis -- Taiwan, South Korea and Thailand, for example -- will follow suit. Competitive devaluations were a major feature of the 1930s.

It's no accident that the European Union has called an emergency summit for this Sunday to consider what to do with rising protectionism of all kinds.

There are a number of reasons why economic nationalism could escalate. The recession could last well beyond this year. It is also worrisome that the forces of economic nationalism were gathering even before the crisis hit, and have deeper roots than most people know. Congress denied President Bush authority to negotiate trade agreements two years ago, fearing that America was not benefiting enough from open trade, and an effort to reform immigration was paralyzed for years. Globally, international trade negotiations called the Doha Round collapsed well before Bear Stearns and Lehman Brothers did. Concerns that trade was worsening income distribution were growing in every major industrial nation since the late 1990s.

Whenever countries turned inward over the past half-century, Washington was a powerful countervailing force, preaching the gospel of globalization and open markets for goods, services and capital. As the Obama administration works feverishly to fire up America's growth engines, patch up its financial system and keep its housing market from collapsing further, and as its major long-term objectives center on health, education and reducing energy dependence on foreign sources, the country's preoccupations are more purely domestic than at any time since the 1930s.

In the past, American business leaders from companies such as IBM, GE, Goldman Sachs and, yes, Citigroup and Merrill Lynch beat the drum for open global markets. As their share prices collapse, some voices are muted, some silenced. It is not easy to find anyone in America who has the stature and courage to press for a more open global economy in the midst of the current economic and political crosswinds.

And given that the global rot started in the U.S. with egregiously irresponsible lending, borrowing and regulation, America's brand of capitalism is in serious disrepute around the world. Even if President Obama had the mental bandwidth to become a cheerleader for globalization, America's do-as-I-say-and-not-as-I-do leadership has been badly compromised.

If economic nationalism puts a monkey wrench in the wheels of global commerce, the damage could be severe. The U.S. is a good example. It is inconceivable that Uncle Sam could mount a serious recovery without a massive expansion of exports -- the very activity that was responsible for so much of America's economic growth during the middle of this decade. But that won't be possible if other nations block imports.

Reuters

A peaceful protest in Reykjavik, Iceland, on Jan. 24. Iceland's government collapsed in the economic crisis.

For generations, the deficits that we have run this past decade and the trillions of dollars we are spending now mean we will be highly dependent on foreign loans from China, Japan and other parts of the world. But these will not be forthcoming at prices we can afford without a global financial system built on deep collaboration between debtors and creditors -- including keeping our market open to foreign goods and services.

The Obama administration talks about a super-competitive economy, based on high-quality jobs -- which means knowledge-intensive jobs. This won't happen if we are not able to continue to bring in the brightest people from all over the world to work and live here. Silicon Valley, to take one example, would be a pale shadow of itself without Indian, Chinese and Israeli brain power in its midst.

More generally, without an open global economy, worldwide industries such as autos, steel, banking and telecommunications cannot be rationalized and restructured efficiently, and we'll be doomed to have excessive capacity and booms and busts forever. The big emerging markets such as China, India, Brazil, Turkey and South Africa will never be fully integrated into the world economy, depriving them and us of future economic growth. The productivity of billions of men and women entering the global workforce will be stunted to everyone's detriment.

Of course, no one would say that globalization is without its problems. Trade surges and products made by low-priced labor can lead to job displacement and increasing income inequality. Proud national cultures can be undermined. But these challenges can be met by reasonable regulation and by domestic policies that provide a strong social safety net and the kind of education that helps people acquire new skills for a competitive world. With the right responses of governments, the benefits should far outweigh the disadvantages. For thousands of years, globalization has increased global wealth, individual choice and human freedom.

The point is, economic nationalism, with its implicit autarchic and save-yourself character, embodies exactly the wrong spirit and runs in precisely the wrong direction from the global system that will be necessary to create the future we all want.

As happened in the 1930s, economic nationalism is also sure to poison geopolitics. Governments under economic pressure have far fewer resources to take care of their citizens and to deal with rising anger and social tensions. Whether or not they are democracies, their tenure can be threatened by popular resentment. The temptation for governments to whip up enthusiasm for something that distracts citizens from their economic woes -- a war or a jihad against unpopular minorities, for example -- is great. That's not all. As an economically enfeebled South Korea withdraws foreign aid from North Korea, could we see an even more irrational activity from Pyongyang? As the Pakistani economy goes into the tank, will the government be more likely to compromise with terrorists to alleviate at least one source of pressure? As Ukraine strains under the weight of an IMF bailout, is a civil war with Cold War overtones between Europe and Russia be in the cards?

And beyond all that, how will economically embattled and inward-looking governments be able to deal with the critical issues that need global resolution such as control of nuclear weapons, or a treaty to manage climate change, or help to the hundreds of millions of people who are now falling back into poverty?

To say that there is an obvious antidote to the rise of economic nationalism is to brush off the powerful pressures that have created it. It wouldn't be enough for President Obama to make a great speech demonstrating his determination to head off anti-global trends. Neither can any one summit turn the tide, nor any one piece of legislation.

It would be an achievement if the WTO publicized and named and shamed anti-global measures that governments were taking. Shoring up the IMF and the World Bank to help poorer countries deal with economic stress would be a good idea, too. Developing far-reaching trade adjustment policies consisting of education, training, wage insurance and other forms of community support for those people clobbered by imports will be valuable, because it would reduce protectionist pressure. Making a Herculean effort to conclude the global trade agreement that now languishes in Geneva and designing and implementing a treaty on climate change would also be a great shot in the arm. And if the efforts under way in Europe and in the U.S. to reform banking regulation could be brought under one roof -- a new global banking regulator -- in place of what could otherwise turn out to be competing and conflicting systems, that would be a breakthrough.

But the most powerful medicine for the disease of economic nationalism would be a short-lived recession. Under any circumstances, it will take years of work for government and business leaders to get the world back on the globalization train. The sooner that work can begin, the better.

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