Preserving the open economy at times of stress

By Martin Wolf

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Is the spread of prosperity in the interests of citizens of today's high-income countries? Is globalisation of their economies in their interest?

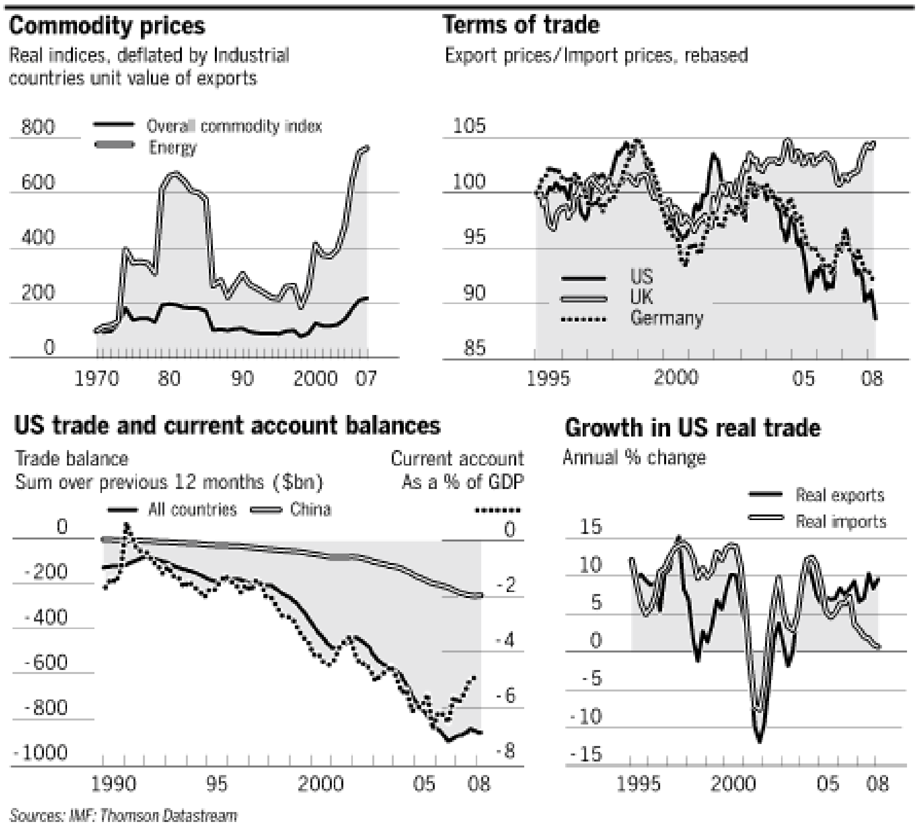
These distinct questions are raised in my mind by two important columns from Lawrence Summers ("America needs to make a new case for trade" on April 27 and "A strategy to promote healthy globalisation" on May 4). In these, Mr Summers argues that the international economic policies of the US need to be coupled more closely to the interests of its workers. Many Europeans will concur.

This is not to argue that the interests of citizens of high-income countries are more important than those of others. On the contrary, the view that increases in incomes of the poor offset equivalent losses for the rich is morally compelling. But politics is national. Unless or until a global political community emerges, politics will respond only to perceptions of national interest.

So is the rising prosperity of China, India and other emerging economies in the interests of today's high-income countries? The correct answer to this is: not necessarily. It would be absurd to pretend otherwise.

The big advantages of the spread of prosperity include a wider distribution of innovation and bigger opportunities for profitable exchange. The rise of the US brought such benefits to the UK. Also valuable (though not certain) is greater political stability in previously impoverished countries.

The big disadvantage is greater competition for scarce resources. Power is a scarce resource: if country A has more, country B has less. Resources are also limited. If commodity prices rise, the terms of trade (the relative prices of exports and imports) of net importers will deteriorate: countries have to sell more exports to obtain given imports.



Since the end of 2001, US terms of trade have deteriorated by an eighth, as commodity prices have soared and the currency devalued. This has turned an 18 per cent increase in real gross domestic product between the last quarter of 2001 and the fourth quarter of 2008 into a 16.4 per cent increase in real national income. The difference is not huge. But it is worth some $220bn in today’s dollars. So countries may indeed be harmed by the prosperity of others. (See charts.)

The answer to this is: so what? As Willem Buiter has pointed out (Economic Internationalism 101, Maverecon, May 5), nothing can be done to halt the diffusion of “knowledge, skills, technology, management systems” and so forth.* Or at least nothing rational or decent can be done. Of course, the US could launch an unprovoked blockade or even war against China or India. To mention such ideas is to reveal their strategic and moral bankruptcy.

The US could, it is true, try to halt the flow of ideas. The UK tried to halt the spread of technology to the US in the early 19th century: it failed. The Chinese empire once made it a capital crime to export silkworms: that failed, too. Similarly, protectionism against the emerging countries might slow their growth, but would not halt it. Yet it would guarantee a breakdown in international relations that threatened hopes of a peaceful future.

To repeat, nothing can be done about the rise of emerging countries, as they follow the lead of the west. What cannot be helped must be accepted. This takes us to my second question. Given the rise of the emerging world, should the developed world limit the globalisation of its own economies? Of course, so long as high-income countries depend on imports of commodities, trade will be essential. Self-sufficiency is a mirage. It is a question rather of how much openness to trade and movement of capital and labour there should be.

One issue has been the huge current account deficits of the US. Yet these are at last contracting, as export growth explodes (see chart).

On trade more narrowly, the basic point is well known: free trade is in the interests of the country adopting the policy, unless it has monopoly power. But – an important “but” – the benefits and costs are likely to be unevenly distributed. The latter is particularly likely for trade between rich and poor countries. Free movement of capital or labour may also harm important interest groups within a country even if it raises aggregate incomes. The freer movement becomes, the harder it may also be to impose taxes and regulations on those able to move.

As Mr Summers argues, it is hard for a democracy to proceed with policies that a large minority believes are against their interests. If the fall-back position is not to be protectionism, itself no more than an inefficient tax and subsidy programme, more creative options must be chosen. The most obvious point, at least for the US, is the need to shift the provision of security from employers to the state. Corporate welfare states are unsustainable in a dynamic and open economy.

Yet if the US is to have a more generous welfare state, including universal health provision, as in every other high-income country, taxes will have to be raised. Indeed, they will have to be raised even to meet existing commitments. Mr Summers argues, in response, for international action against harmful tax competition. He argues, too, for greater international agreement on regulation. In some areas, notably finance, the latter makes sense. But the view that the US must obtain such agreements if it is to raise some of the lowest levels of taxation and weakest regulation in the advanced world is unpersuasive. If Sweden's taxes can be 56 per cent of GDP, it is not tax competition that keeps the US at just 34 per cent. The mobility of capital and people is an excuse, not a justification, for low US tax levels.

What is desperately needed is an honest debate about these issues. Such a debate would, I believe, reach four fundamental conclusions. First, whether or not citizens of the US (or other high-income countries) welcome it, the global spread of economic development is ineluctable. Second, protection against imports is a costly and ineffective way of dealing with the consequences. Third, parties of the centre-left should argue for redistributing the spoils of globalisation, not sacrificing them. Finally, a necessary condition is higher taxation of the winners. But the chief obstacle to that is a lack of domestic political will. Globalisation is not a reason for low taxes, but an excuse. It should be discarded.

Everybody should remember, above all, that the opening of the world economy is the west's greatest economic policy achievement. It would be a tragedy if it were to turn its back on the world when the rest of humanity is at last turning towards it.

*Follow the debate at the Economists' Forum

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