The Next Globalization

The biggest challenge of globalization isn't trade. It's reining in health care and energy costs—and preparing American workers and business to compete.

by Robert Shapiro

It's a safe bet that every economic policy adviser in Washington has some version of the following fantasy. The president-elect calls and asks you, confidentially, to explain the current state of the American economy. Leave all political considerations at the door, he says, or leave them to me. Just tell me: What works, and what doesn't?

In my version, I tell him that the answer to both questions is globalization–and unless he understands why, his economic record won't be much better than George W. Bush's. I tell him that globalization, and America's responses to it, have helped drive not only the extraordinary economic progress of China and other developing nations but rapid productivity gains in the United States as well and, until very recently, healthy growth and low inflation. But there's bad news, too. Globalization is also implicated in the historic slowdown in U.S. job creation, the flat incomes of most American working families, and the recent roller-coaster prices of many assets and commodities, from housing to oil.

Globalization on the scale required to produce those large effects is a fairly recent development. In 1990, 18.5 percent of everything produced in the world was exported across a border; last year, those levels reached 31.6 percent, or 70 percent greater than the economic output of all of Asia and 21 percent larger than America's GDP. There has never been another time when trade has expanded so much and achieved the dimensions that can affect the conditions and paths of virtually every economy. There is nothing the next President can do to turn back or divert these developments. Nor should he, even if he could, want to turn America away from a process that has helped propel the most rapid modernization ever seen in many developing countries, the fastest global growth of any five or ten-year period on record, and, here in the United States, the largest productivity gains in 40 years.

While the sheer dimensions of these developments would hold any President's attention, he would be dangerously mistaken to think of this as traditional trade, writ very large. The full nature of globalization has become apparent in perhaps only the last 10 years, and the next president needs first to understand precisely how it works. This is not just a matter of U.S. companies outsourcing jobs to foreign subsidiaries or native firms in low-wage countries. Rather, the salient political factor of contemporary globalization is that it has become so pervasive as to affect every aspect of the economy, even seemingly unrelated elements like health care and energy costs.

As a result, improving most Americans' futures will mean responding to the new demands that globalization makes well outside the traditional concerns of trade. What will determine whether

the next President presides over better economic times will be the depth of his political commitment to rein in fast-rising health care costs, make Americans work and live more energy efficiently, see to it that every worker who wants to can work well with computers and the Internet, and help new businesses get started and survive. This agenda will be harder to carry off than election-year favorites like taxing foreign profits, restricting offshore outsourcing, and slapping duties on foreign producers who dump their goods on U.S. markets at below cost. But globalization is creating a new world that demands new responses. If American policymakers understand its forces, they can harness them to advance the central economic mission of progressive politics, higher living standards for all.

Old and New Globalization

For centuries, trade was mainly a matter of large companies in Europe–and, later, America–buying commodities and other resources in Asia, Africa, and Latin America, bringing them home to use in their own manufacturing, and then selling the finished goods at home or to consumers and businesses in other developed countries. That pattern was established through colonization and persisted well into the postwar period, when it was reorganized through the General Agreement on Tariffs and Trade (GATT) and the Bretton Woods pact on fixed exchange rates for currencies.

In the 1970s, these arrangements began to give way to the forces that would bring on modern globalization, beginning with the floating exchange rates that replaced Bretton Woods and a threefold increase in the price of oil by OPEC. Companies, especially American ones, began to look hard for places where everything except oil would be cheaper, and soon they were contracting to produce slag steel, footwear, apparel, and other basic goods in places like Korea, Taiwan, and Brazil. At the same time, Germany, Japan, France, Italy, and others had finally rebuilt their own manufacturing capacities to U.S. standards–much of it financed through U.S. foreign direct investment. These two developments hit American manufacturing workers hard that decade, costing more than two million jobs.

Most American political debates and policy prescriptions are stuck in that period, with globalization understood as something operating purely at the institutional and corporate level, and on balance a drain on American workers (as in the debates over offshore outsourcing). Whether the charge is "hollowing out of U.S. manufacturing" (Pat Buchanan) or "encouraging companies to leave the country" (Senator Sherrod Brown), it usually depends on a traditional view of trade dominated by low-priced imports of basic goods. But the world has moved on. As Western companies began moving basic steel and garment plants to Asia and Latin America, many of these developing countries were investing furiously to upgrade their infrastructures beyond a basic production capacity. The Asian Tigers were first, producing the so-called miracles in Taiwan and Korea. By the 1980s, they and others were creating business environments and skilled workers in large numbers that could do more than mine ore, smelt metals, sew clothes, and grow rice–and they also began generating incomes that could buy the electronics, automobiles, and pharmaceuticals that advanced economies produced.

With wage and other costs still rising fast in America and Europe, by the 1990s large Western companies figured out that they could shift trillions of dollars, pounds, and yen into new

subsidiaries or joint ventures, especially across Asia, to take advantage of the developing world's skills and infrastructure upgrades. At the same time, technological advances created radical new opportunities to deconstruct the manufacture of complex products into dozens or hundreds of discrete parts. Together, these developments made it possible, for the first time, for Western companies to turn their manufacturing businesses into networks, with each part produced wherever in the world it could be done most efficiently, then brought together and assembled somewhere else, and finally distributed and sold in both advanced and developing markets. These developments have become the hallmarks of modern globalization: the far-flung distribution of production, the transfer of entire modern business organizations to developing countries, and the integration of their economies into the markets for the products.

These developments, however, would not have produced modern globalization as we now know it, with all of its implications for the next president's agenda, but for equally far-reaching political changes. Most obviously, the collapse of the Soviet Union vastly extended the reach of globalization by spelling the end of a world divided into two great, virtually exclusive economic blocs. Equally portentous, the epochal collapse of socialist economics left market capitalism as the only economic model left standing, one which even China would soon move towards. Finally, the Clinton Administration drove an international process to establish the World Trade Organization (WTO) and then used it to nudge and guide developing nations to adopt the U.S. version of the model.

From its beginning, the WTO has had much more far-reaching ambitions than the GATT it replaced. Instead of just negotiating more cuts in trade tariffs and quotas, it laid down new, market-friendly rules for reorganizing developing economies: To become part of global capitalism, China, India, Brazil, and all the rest had to roll back most of their domestic restrictions and subsidies, sector by sector, and open themselves to foreign direct investment, foreign competition, and much greater domestic competition. As country after country has adopted these rules in some form, the transfers of advanced business organizations have accelerated, complete with their technologies, managers, ways of conducting business, and networks for financing, marketing and distributing what they produce–and not only to Asia's two largest countries but to nearly a dozen other economies with low-wage skilled workers on Western Europe's doorstep and many of the Latin countries in America's backyard.

The Double-Edged Sword

For all its tumult, globalization has been fundamentally good for the U.S. economy. The country has grown faster and racked up larger productivity gains over the last decade than other large advanced nations. Much of this can be traced to U.S. companies wholeheartedly casting their lots with globalization: Last year, 44 percent of U.S. exports went to developing markets and 50 percent of U.S. imports came from developing countries, while 28 percent of all U.S. foreign direct investment is now located in the developing world. By contrast, Europe's big-three economies–Britain, France, and Germany–lag far behind, with only 16 percent of their exports, 20 percent of their imports, and just 9 percent of their foreign direct investment involving developing nations. America's much greater economic engagement in the world's fastest-growing and lowest-cost countries exposes U.S. companies to greater and more varied

competitive pressures that make them more efficient and innovative, and which in turn has supported the country's stronger growth and productivity gains.

America's leading position in globalization is evident in other ways. As the world's sole superpower, the United States finds itself the guarantor of the sea and air lanes that carry most of the world's oil and burgeoning trade. America is also the leading practitioner of the market-based arrangements that now dominate most countries, as well as the source of the reserve currency that most central banks need to stave off potential financial crises.

Beyond that, for some time the United States has been the main source of the new technologies and organizational innovations now driving productivity gains in other advanced countries and propelling modernization in many developing nations. Important innovations come from scores of countries; yet, Germany, France, Britain, Japan, and China have not produced counterparts to trail-blazers like Microsoft, Google, Wal-Mart, and Amazon, which reconfigured aspects of the global economic landscape. And with an economy three times larger than Japan's, four times that of China or Germany, and five times that of France or Britain, Americans are the world's consumers of last resort. U.S. imports–some $2.2 trillion in 2007–help sustain jobs and profits in scores of countries, where many businesses and workers now identify their economic interests with the United States.

Even so, globalization also poses the most daunting challenges any president has faced since the Great Depression, particularly as it begins to unravel the American social mission of broad upward mobility. As China and a score of other developing nations become production-and-assembly platforms for much of the world's manufacturing, that sector has declined precipitously in the United States. Now, America's critical contribution in the global economy is the development and application of new ideas, including not only new technologies, materials, products and processes, but also new ways of financing, marketing, and distributing goods and services, and new ways of organizing a business and managing a workplace.

The "idea-based economy" has been a popular metaphor for decades, but globalization and its critical technologies are making it a hard reality. Federal Reserve data show that for the first time ever, American businesses since 1995 have invested less in new physical assets than in intangible things–principally patents and copyrights, databases, brands, organization, training, and so on. These intangibles now give the American economy most of its actual value. In 1984, the book value of the 150 largest U.S. companies–what their physical assets could be sold for on the open market–was equal to 75 percent of their market capitalization. By 2005, the book value of America's 150 largest firms was equal to just 36 percent of their market value. In other words, roughly two-thirds of the value of large U.S. companies now lies in intangible assets.

In such a world, the only Americans who will get ahead in the coming decades will be those who can work effectively with the ideas that create value and wealth, in workplaces dense with the technologies that organize, transmit and communicate those ideas. Yet, by one recent estimate, nearly half of Americans cannot handle basic computer and Internet-based systems. The results are evident in patterns of growing inequality. Over the last five years, the American economy generated income increases totaling nearly $2 trillion (adjusted for inflation). Yet, real wages are lower today than five years ago for the 75 percent of Americans who work at what statisticians

call "non-supervisory" jobs–basically, everybody but professionals and managers. The other 20 to 25 percent who have claimed all of the economy's income increases–and especially the top 5 percent–have jobs organized around the use of those intangible assets or own the companies that develop and use those intangibles.

The next president has to make computer- and Internet-related skills universally available, because decent-paying jobs that do not require these capacities are becoming increasingly rare. The good news is that it won't be hard to do. In 1996, I urged the White House to support a new initiative to give grants to community colleges to keep their computer labs open and staffed in the evenings and on weekends, for any adult to walk in and receive computer and Internet training for free. It wouldn't even cost very much–perhaps $150 million a year today–because the facilities, equipment, and instructors are already in place. The Clinton Administration took a pass, though Tony Blair's government in the UK adopted it on small scale a few years later. Senator Barack Obama recently endorsed this approach; if he's elected, the challenge will be to make it a priority enacted on a national scale and expand its scope. The 2009 version could use the community college system to offer any worker advanced as well as basic computer and Internet training. And to close the IT gap between poor children and those from more affluent families, the next president could provide funding to purchase an inexpensive laptop for every sixth grader in America, an approach now promoted by two Washington-based organizations, One Economy and NDN. Finally, an idea-based economy demands universal access to high-speed Internet service, much as two generations ago the government created programs to provide universal telephone service.

Globalization and Stagnating Incomes

But these initiatives won't get most Americans' incomes moving up again unless the United States also faces up to the deeper, structural challenge posed by globalization. Essentially, globalization is interfering with two basic economic dynamics that have been a major source of progress and security for generations of Americans: the links between how fast the economy grows and how many jobs it creates, and the links between how much productivity increases and how much wages rise.

The first evidence that something important was happening with these connections came in the job numbers following the brief, mild downturn of 2001: Employment kept on falling, and it took 43 months to get back to pre-recession job levels. (In contrast, it took less than 12 months to do that after the recessions of the 1960s, 1970s and 1980s, and 24 months following the 1990-1991 downturn.) And when job creation finally kicked in again in 2005, it did so at half the rate of the 1970s, 1980s, and 1990s. The long-standing connection between productivity gains and wage increases is also breaking down. In the 1990s, productivity grew by on average 2.5 percent a year, and the median wage of American workers followed by increasing 2.2 percent a year. This time, labor productivity has risen 3 percent a year for five years, the best record since the 1960s, while the real median wage has actually declined.

These developments are distinct from the falling wages of those without the skills to work well in IT-dense work places. They come instead from a sharp intensification of competition that has accompanied globalization and affects the entire workforce, not just those in the export and

import industries. According to the wage and jobs data, it also affects areas of the economy not directly involved in trade at all, such as business or food services, as they compete for the capital and expertise freed up from firms that can't make it in globally competitive industries such as telecommunications or air travel.

The first effect is something most people welcome: More intense competition makes it harder for companies to raise their prices, what economists call a loss of "pricing leverage." The result, according to the International Monetary Fund, is that inflation in the United States and most of the world for the last decade has been lower, relative to both growth rates and increases in money supplies, than any comparable period on record.

Intense competition has less welcome effects, however, when sharply rising costs hit companies with limited leeway to raise their prices. In America, the main culprits are health care and energy, whose costs to employers each have more than doubled in the past six years. As the intense competition engendered by globalization has made it harder for companies to pass along these higher costs in higher prices, they have cut other costs, particularly jobs and wages.

For decades now, presidents of both parties have done little to tame health care or energy inflation, although Jimmy Carter tried in energy and Bill Clinton in health care. Yet if the next President aims to preside over a period of upward mobility for most people, he will have to do better; and fortuitously, other developments will increase the political pressures to do so. Already, the public's growing concerns about climate change and this year's sharp increases in energy prices are ratcheting up concerns about making everything more energy efficient and expanding the use of alternative fuels. The first steps could be relatively easy–raise fuel-efficiency standards and provide additional tax breaks for more energy efficient technologies. These steps will raise some initial costs, since more fuel-efficient automobiles and appliances usually cost more; but over time, they also produce energy-cost savings and could make the households and businesses that adopt them less vulnerable to future oil price hikes.

The harder steps will involve changes targeted specifically to climate change, because a commitment to reduce greenhouse gas emissions necessarily will involve even higher energy prices for the carbon-intensive fuels used in electricity and transportation. Whether the next president adopts the cap-and-trade approach promoted by both Barack Obama and John McCain or the carbon-based tax that most economists favor, his final strategy almost certainly will involve cushioning the impact of those higher prices by recycling the revenues raised by a carbon tax or by auctioning emissions permits for tax relief.

The effort to slow fast-rising health care costs could also get a big political boost from the need to keep Medicare solvent over the next decade, as tens of millions of baby boomers become eligible. The ultimate sources of Medicare's financing problem are beyond anyone's control, as the historical anomaly of a baby boom followed by a baby bust leaves us (and every other advanced country) facing, year after year, rapid increases in the numbers of Medicare-eligible elderly people and much smaller increases in the workers who pay most of the taxes to finance it. And here as everywhere else in the world, the most expensive common medical problems, heart disease and cancers, are highly concentrated in people of the age covered by Medicare.

This historic demographic shift would be more manageable, but for one of globalization's side-effects. By driving faster growth and rising incomes in much of the world, globalization has expanded the market for new medical treatments and technologies, which in turn has increased medical R&D and accelerated the pace of medical advances. The catch is that these advances are typically very expensive, especially in the United States, where health care prices are not government-controlled. Less than 10 years ago, for example, the two principal drugs for colon cancer cost about $500 per regimen and extended people's life spans by an average of eight months. With recent advances in chemotherapy, colon cancer patients now receive new treatments that extend life for an average of 13 to 20 months, at a cost of $300,000 to $500,000. Similarly, deaths from heart attacks are down by half since the 1980s, mainly because surgery for heart attack patients and the real cost per-patient are both up by more than 50 percent. And after a decade of breakthroughs in genome sciences, a new industry of biologic treatments has produced some 300 candidates in second- or third-stage clinical trials, with biologic treatments priced on average 20 times as much as traditional pharmaceuticals.

The next President's health-care agenda will likely start not with these cost issues, but with universal access to insurance coverage for non-elderly Americans. But while universal coverage is a social goal beyond debate, the roots of the problem lie in decades of fast-rising costs, and whatever politicians promise, achieving universal coverage will further raise national costs. If a new president wants to bring about changes that Americans will still believe in in a few years from now–in both health care and wages and jobs–he would be well-advised to use the occasion of phasing-in universal access to advance other measures to slow those rising costs.

And the costs are significant: 16 percent of national income to health care, compared with 11 percent to 12 percent in France and Germany, where quality and outcomes are comparable. Driving this disparity is the fact that virtually every government but the United States strictly controls most prices and wages across health care. While such an approach would be alien to American political and economic culture, Americans do respect efforts to control costs, and much stricter cost controls would be easier than some expect. The 2008 Dartmouth Atlas of Health Care study, sponsored by the Robert Wood Johnson Foundation, tracked the care and cost of Medicare patients with nine serious chronic conditions. Among five of the nation's top medical centers, the Mayo Clinic and the Cleveland Clinic Foundation produced the same outcomes in comparable patients for at least one-third less than Johns Hopkins Hospital or the UCLA Medical Center. To realize similar savings, the next President should create a national institute to identify best-practice cost controls and persuade Congress to mandate that hospitals and clinics receiving federal funding adopt them.

Capital and Crises

Beyond health care and energy, the other critical part of the economy redefined by globalization has been finance. For some time, the global capital pool has been growing much faster than global production or trade, with a fair estimate of that pool today reaching $165 trillion, or three times its estimated size 15 years ago. This enormous growth of global capital and its international flows ultimately reflect the rapid increases in the value of savings and assets in China, India, Malaysia, and other developing countries that cast their lots with globalization. Moreover, the globalization of advanced financial services has exchanged much of this new

wealth for corporate paper, bank deposits, stocks, and other financial assets that flow into national capital pools where, under the rules of the WTO, they can make their way into the larger, global capital pool. This process ends up bringing much of the real wealth created through globalization into the world's monetary base, where it gives rise to yet more credit or money.

The good news is that these vast increases in available capital have kept interest rates historically low, even in countries with dismal saving rates such as the United States. The bad news is that when capital and credit grow more quickly than the goods and services they're ultimately used to purchase, fast-rising inflation usually follows. On the other hand, globalization is also intensifying competition in ways which dampen inflation nearly everywhere in the world. In economic life, all costs come out in the end, and as a result most of the normal inflationary pressures coming from all the new liquidity sloshing around the world have gone instead into new global asset bubbles, notably housing. From 1997 to 2007, housing prices marched up 92 percent in Italy and 103 percent in the United States (175 percent by another measure), 137 percent in France and 126 percent in Sweden, 184 percent in Spain, 205 percent in Britain, and 251 percent in Ireland. By 2006, the bubbles in the most overheated housing markets–such as Britain and Ireland–were beginning to burst, and last year housing prices in the United States began falling, too. Japan, where housing prices soared in the 1980s, provides a glimpse of what homeowners in other countries may expect: When the bubble finally burst there in the 1990s, prices fell 40 percent.

Current asset bubbles are not limited to housing. From 1997 to 2004, stock markets around the world rose and fell at roughly twice the rate of any comparable period since World War II–by an average of 20 percent a year in the United States, for example, and 24 to 27 percent a year in France, Italy, and Germany. All the global liquidity looking for outlets is also a factor in the recent run-ups in the prices of oil, food and other commodities. Already, the fallout from the housing bust has sharply slowed the economy, particularly from homeowners whose incomes were already stagnating and highly leveraged financial institutions who had speculated in risky mortgage-backed securities.

The next president will likely find that this time the usual approaches cannot deliver a strong recovery. The United States normally pulls itself out of recessions by cutting interest rates; the leading interest-sensitive sectors, housing and business investment, then recharge growth. But housing cannot drive an expansion as long as housing prices are falling, a process likely to continue for another one to two years. As for business investment, the severe financial strains triggered by the mortgage-backed-security fiasco have done real damage to the balance sheets of hundreds of financial institutions, forcing them to limit lending for the near future to the most gold-plated, credit-worthy borrowers.

Even if housing and finance were in better shape, the globalization of capital limits the Federal Reserve's ability to use its power over certain short-term interest rates to move the long-term rates that drive most borrowing. From June 2004 to June 2006, for example, the Fed raised its short-term rate by four percentage points in 17 steps; yet, the rate for AAA corporate bonds was 6 percent in June 2004 and 6 percent in June 2006, and the rate for a conventional mortgage rose just four-tenths of 1 percent. With the principal means of hot-wiring a recovery out of reach, we face real prospects of an extended downturn.

Stimulus and Responses

Given the hand globalization has dealt the next President, the best advice to get the economy moving involves large doses of stimulus targeted to the particular needs of businesses and people. That should start with a big new commitment to public investments in twenty-first-century infrastructure, especially energy-efficient light rail systems for all metropolitan areas and, if he's serious about increasing the use of climate-friendly public transit, large grants to drastically cut the fares and make them as near as possible to free. The combination could produce thousands of new jobs directly–and many more indirectly, by increasing the disposable incomes of millions of people willing to get from place to place in a climate-friendly way.

A similar model could be applied to broadband: Create new jobs and get a jump on the next-generation Internet by freeing up spectrum and providing tax incentives to promote the further rapid deployment of fiber and wireless systems on the scale that a more advanced Internet will require. Here, if the next President is also serious about opening America's idea-based economy to everyone, he will take additional steps to promote universal broadband service, develop inexpensive laptops for all public school students, and provide free training in computer and Internet-based applications for any adult. Each of these reforms could help boost demand and create jobs in an extended downturn. And for the longer haul, their combination should help raise productivity and incomes by enabling millions of more workers to be IT-efficient, and help create new jobs and wealth by expanding Internet-based markets and strengthening the foundations for new, next-generation Internet-based businesses.

Globalization is here to stay. It cannot be rolled back. But that does not mean that we must allow it to roll over American businesses and workers. The forces that have shaped and unleashed this phenomenon can be harnessed to create even more opportunities and a better life for all Americans. It's up to the next President to do just that. D