Frederic S Mishkin: Globalization - a force for good?

Remarks by Mr Frederic S Mishkin, Member of the Board of Governors of the US Federal Reserve System, at the Weissman Center Distinguished Lecture Series, Baruch College, New York, 12 October 2006.

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It is a great pleasure, for very personal reasons, to be here at Baruch College to deliver my first speech as a Federal Reserve Governor. My now-deceased father, Sidney Mishkin, whom I still miss every day, proudly graduated more than seventy years ago from Baruch, then called City College. Indeed, you might have noticed the Sidney Mishkin Gallery when you came into the building. The gallery was part of a gift that my father made to this institution upon his death fifteen years ago. The education he got at Baruch during the depths of the Great Depression - attending class at night because he had to work to support not only himself but also his parents - helped give him the opportunity to become a successful businessman. I hope that the students here will likewise take advantage of the opportunities bestowed by their education and make important contributions to our economy.

Now, let me turn to the topic at hand: Can more globalization - in particular, financial globalization - be a force for good?

The globalization of trade and information over the past half century has lifted vast numbers of the world's people out of extreme poverty. Despite the doom and gloom that you often hear, world economic growth since the Second World War has been at the highest pace ever recorded. What we are seeing in countries that are export oriented, and thus able to take advantage of the present age of globalization, is a reduction in poverty and a convergence of income per capita toward industrial-country levels. In India and China, for example, globalization in recent years has lifted the incomes of more than 1 billion people above the levels of extreme poverty.

Although economic globalization has come a long way, in one particular dimension – finance - it is very far from complete. As documented in the superb book by Maurice Obstfeld and Alan Taylor, *Global Capital Markets*, financial globalization has made its greatest strides in rich countries. Gross international capital flows, which have risen enormously in recent years, move primarily among rich countries. The exchange of assets in these flows is undertaken to a large extent to enable individuals and businesses to diversify their portfolios, putting some of their eggs in the baskets of other rich countries. International capital is generally not flowing to poor countries and is thus not enhancing their development.

The gross amount of capital flowing each year to emerging-market economies increased dramatically in the 1990s and is now more than $600 billion. That amount may sound like a lot, but it is only one-seventh of total international capital flows excluding official reserves. The situation is even more remarkable when one adds into the picture the capital flows out of developing countries, especially the governmental acquisition of international reserves; then we see that emerging-market economies have, on net, actually been sending capital to rich countries. The United States is currently running very large trade and current account deficits - more than $800 billion - because Americans are buying more goods and services from abroad than they are selling overseas. These deficits are being financed by the foreign acquisition of U.S. assets, especially bonds, with emerging-market economies providing the United States with about $300 billion per year. The Chinese government, for example, has accumulated nearly $1 trillion of foreign assets; much of this is invested in the United States, and China is now one of the largest holders of U.S. Treasury securities in the world.

Also remarkable is that capital flows from rich countries to developing countries relative to total capital are far smaller than they were in the first age of globalization, during the late nineteenth and early twentieth centuries. By 1914, about half of the stock of capital in Argentina was supplied by rich foreign countries, particularly the United Kingdom. Today, less than 6 percent of Argentine capital has been supplied by foreigners. And this change in the pattern of capital flows has not been confined to Argentina.

As Nobel laureate Robert Lucas has pointed out, this feature of international capital flows is a paradox: Why doesn't capital flow from rich to poor countries? We know that labor is cheap in poor countries, and so we might think that capital would be especially productive there. Just think of how hugely profitable a factory might be in a country where wages are one-tenth of those in the United States. Capital should, therefore, have extremely high returns in such countries, and we should expect massive flows of capital from rich countries (where the returns on capital should be relatively low) to poor countries (where they should be far higher). In fact, there has been a big increase in the amount of capital moving to emerging-market economies in recent years, but capital primarily still flows from one rich country to another, where the returns on capital are similar.

Thus, financial globalization is far from complete, and that fact raises a set of questions. Should financial systems in developing countries become more integrated with the rest of the world? If so, what should be done to accomplish that integration?

Let me pause here to address an underlying issue that obscures much of the debate about financial globalization. The important role of the financial system in the economy is not well understood by the average person, and even many economists are shocked by the high salaries paid to investment bankers and other financial professionals. "After all," many wonder, "what do these financial professionals produce? Nothing concrete comes from their highly paid work."

This view, although common, betrays a fatal misunderstanding. Getting the financial system to work well is critical to the success of an economy. To understand why, think of the financial system as the brain of the economy: That is, it acts as a coordinating mechanism that allocates capital, the lifeblood of economic activity, to its most productive uses by businesses and households. If capital goes to the wrong uses or does not flow at all, the economy will operate inefficiently, and ultimately economic growth will be low. No work ethic can compensate for a misallocation of capital and the resulting failure to invest in the most profitable ventures. Hard work will not be productive unless it is accompanied by the right amount and kinds of capital. Indeed, workers in poor countries often work longer hours than their counterparts in rich countries, and yet they remain poor. When they emigrate to countries with a developed financial system and the resulting superior endowment of capital, they often become rich.

Financial globalization - opening a country's financial markets to foreign capital and financial institutions - will confer several important benefits on developing countries. First, by bringing in new capital, financial globalization will lower the cost of capital, thereby encouraging investment, which in turn promotes growth. Second, when foreign capital and financial institutions are allowed to enter a country, they improve the allocation of capital. Third - the most important benefit and one not usually emphasized - globalization of a country's financial system, if it is designed to promote competition in domestic financial markets, helps promote the development of better property rights and institutions. Better property rights and institutions make the domestic financial sector work better. They facilitate the movement of capital to productive uses and prepare the domestic financial sector to better handle the increased capital flows that would come with the opening of the country's financial sector.

The benefits of globalization of trade in goods and services are not controversial among economists. Polls of economists indicate that one of few things on which they agree is that the globalization of international trade, in which markets are opened to flows of foreign goods and services, is desirable. But *financial* globalization, the opening up to flows of foreign capital, is highly controversial, even among economists, despite benefits of the sort I just mentioned.

For example, in his best-selling book *Globalization and its Discontents*, Nobel laureate Joseph Stiglitz is very critical of globalization because he sees the opening up of financial markets in emerging-market economies to foreign capital as leading to economic collapse. Even Jagdish Bhagwati, one of the leading economists defending globalization of trade (after all, his book is titled *In Defense of Globalization*), is highly skeptical of *financial* globalization, stating that "the claims of enormous benefits from free capital mobility are not persuasive."[1] George Soros, the prominent financier, opens his book *On Globalization* with a chapter entitled "The Deficiencies of Global Capitalism."

One reason for the controversy is that opening up the financial system to foreign capital flows has led to some disastrous financial crises causing great pain, suffering, and even violence. These crises can arise when bad policies encourage excessive risk taking by financial institutions, policies that rich elites in the developing countries often advance for their own profit. There are those (including Stiglitz and Bhagwati) who put the primary blame for the failures of financial globalization in emerging-market economies on outsiders, specifically on the International Monetary Fund, or what they refer to as the

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1 Jagdish Bhagwati (2004), "The Capital Myth: The Difference between Trade in Widgets and Dollars," *Foreign Affairs* 77, no. 3 p 7.

Wall Street-Treasury complex. The evidence has brought me to the conclusion that institutions like the IMF or the U.S. Treasury are not primarily to blame, although neither are they blameless - public and private financial institutions active in the international capital markets have often aided and abetted poorly designed financial globalization, although that was not their intention.

Another objection to focusing on financial development and globalization as key factors in economic growth is that it is far from clear that emerging-market economies are finance constrained: In other words, they often do not have trouble getting money for investments. But throwing money at investments does not work. Indeed, as the experience of recent years indicates, too much money flowing into these countries often resulted in bad loans and investments, which led to financial crises. The argument for the importance of developing a good financial infrastructure in these countries is not so much that it increases investment but that it promotes the allocation of investment to the uses that will do the most good for the economy.

That result - improving the allocation of investments - is something that foreign aid has generally not been able to accomplish. Although many people lament the paltry amount of aid that rich countries provide to poor countries, and although aid tightly focused on technical assistance or the financing of local projects has often had important successes, large aid projects have generally not worked well in promoting development because typically they have not provided the right incentives. In his book *The Elusive Quest for Growth*, William Easterly cites the extraordinary example of Zambia: If the $2 billion of aid Zambia received from the advanced countries and international aid organizations since its independence had gone into productive investments, Zambia would now have an income of more than $20,000 per capita, putting it in the club of rich nations. Instead, Zambia has a per capita income of $600, one-third lower than its per capita income at independence.

I noted that globalization designed to promote competition in domestic financial markets helps promote the development of better property rights and institutions. How do better property rights and institutions improve investment outcomes? Well, consider the opposite: If you live in a country where it is easy for others to take your property away, either by force or through government corruption, you would be crazy to invest there. Without these investments, workers in your country will be unable earn high wages because they won't have sufficient capital - buildings, machines, and other infrastructure - to make them highly productive. Poverty will be severe. Hence, the most basic set of growth-promoting institutions are those that promote property rights - a strong judiciary enforcing the rule of law and a government free of corruption. Beyond these basic arrangements are others that specifically promote an efficient financial system through regulation and oversight of financial institutions. With the protection of property rights, honest government, and financial oversight and enforcement, would-be investors with the best projects will be the ones who actually get external funds to invest - and this is the crucial role of the financial system.

We have seen that the repression of the financial system is a great obstacle to economic growth and the reduction of poverty in poorer countries. Yet, if financial development offers such tremendous benefits, why doesn't every country jump on the path to growth and prosperity by imitating the institutions of the advanced economies? Part of the answer is that good institutions need to be home-grown; institutional frameworks that have been developed in the rich countries frequently do not translate well to poorer countries. This is a lesson that many in the advanced economies of the world have yet to learn. The development of good institutions in the advanced countries took hundreds of years; as they grew, they adapted to local conditions. Poor countries must develop their own institutions, and the citizens of these nations must feel they have ownership of the institutions or the institutions will be ineffective and short lived.

If it was difficult and time consuming for the advanced economies to develop a good financial infrastructure, it will be even harder in many developing countries because to do so they must overcome what is often a far more dysfunctional political environment. The benefits that accrue from financial development are dispersed over a wide range of people - to those who could then buy houses with the help of a mortgage, obtain an automobile loan to buy a car, get capital to start a new business, and finance new investments in existing businesses. These potential beneficiaries have little power to demand these benefits. In contrast, the costs would be focused on rich elites and special interests, who often have a lot of political clout and have much to lose from institutional development that encourages an efficient financial system and promotes competition.

For an example of dysfunctional institutions that obstruct economic growth while benefiting certain narrow interests, consider the importance of collateralized loans. The use of collateral is a crucial tool that helps the financial system make loans because it reduces losses when loans go sour. A person who would pledge land or capital for a loan must, however, legally own the collateral. Unfortunately, as Hernando De Soto has documented in his book *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*, legalizing the ownership of capital is extremely expensive and time consuming for the poor in developing countries. To give just one of De Soto's many astonishing examples, obtaining legal title to a dwelling on urban land in the Philippines can require taking 168 bureaucratic steps through 53 public and private agencies over a period of 13 to 25 years.

The high cost of setting up a legal business or legally purchasing land is another barrier to establishing clear property rights in many developing countries. Businesses that are not legally established cannot get legally enforceable loans. Setting up a simple business in the United States generally requires only filling out a form and paying a nominal licensing fee. In contrast, De Soto's researchers found that legally registering a small garment workshop in Peru required 289 days, at 6 hours per day; the cost was about $1,200, which was about 30 times the monthly minimum wage. The lack of property rights for all but the very rich, as documented by De Soto, is a serious impediment to financial development.

Government is often the primary source of financial repression in developing countries. Strong property rights, a crucial element in financial development, severely constrain a government's ability to expropriate land, factories, or ideas whenever it wants to profit from them. Rapacious governments whose rulers treat their countries as personal fiefdoms are not uncommon: We have seen these governments in Saddam Hussein's Iraq, Robert Mugabe's Zimbabwe, and Ferdinand Marcos's Philippines. Even officials in less tyrannical governments have been known to use the power of the state to get rich. Not surprisingly, then, many governments pay lip service to property rights but do not encourage a rule of law to protect them.

So how can emerging-market economies harness their financial systems to make financial globalization work for them and help them get rich? The short answer is, Develop good institutions that allocate capital efficiently. The next question is, How?

We know something that developing countries have done and can do to successfully promote development: Pursue an external orientation and create a successful export sector. That strategy not only forces the economy to become more efficient but also creates a demand to improve institutions that encourage financial development. It can do so by weakening the profits and power of the rich elites and special interests who oppose institutional development, and it can even encourage them to support institutional reforms to restore their profits. Globalization can therefore help generate the political will for institutional reform. We have seen this happen in emerging-market economies that have experienced rapid growth, such as China, India, Singapore, South Korea, Taiwan, and Chile.

What can the rich countries do? Besides providing technical assistance and incentives for institutional development, advanced countries can help by opening up their own markets to exports from poorer countries - much needs to be done in that regard, particularly in agricultural products. Opening up rich-country markets to goods and services from developing countries is far more important than financial aid in alleviating world poverty, and such openness also promotes financial development and stability in poorer countries. Those who are against opening up markets in the advanced economies are in effect against reducing poverty abroad and even at home, although they often don't realize it. True, closing off markets in rich countries may help *some* workers in the short run (although in the long run it will make the *average* worker worse off because it will lower productivity growth), but this help comes at the expense of the far-poorer worker in the developing world. Those in advanced economies who lose their jobs from this opening of markets certainly deserve our sympathy and our support, but that support should come in ways other than trade restrictions.

I will conclude by saying that those who oppose any and all globalization have it completely backward: Protectionism, not globalization, is the enemy. It is true that, by itself, globalization in both finance and trade is not enough to ensure economic development and that economies must position themselves to handle foreign capital flows. But as I said, to be against globalization as such is most assuredly to be against poor people, and this is presumably not the position antiglobalizers want to take. Developing countries cannot get rich unless they globalize in both trade and finance. Making financial flows truly worldwide and creating robust, efficient financial markets in developing countries is not optional: It needs to be the focus of the next great globalization. In sum, I want to challenge those who oppose globalization to rethink their objections. As Kofi Annan, the Secretary General of the United Nations, has put it, "The main losers in today's very unequal world are not those who are too much exposed to globalization. They are those who have been left out."[2] Rather than opposing or limiting globalization, we in the rich countries and those in the developing countries must, as a moral imperative, work together to make globalization work for the general good of people all over the world.

[2] From remarks at an UNCTAD conference in February 2000, in Johan Norberg (2003), *In Defense of Global Capitalism* (Washington: Cato Institute), p. 155.