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Remarks

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In an oft-cited and presumably true incident, Harry Truman once became so frustrated by hearing so many economists telling that "on the one hand" this, but "on the other hand" that, that he asked someone to find him a "one-handed economist." My talk today will verify Truman's worst fears, for it is thoroughly two-handed. The topic is the integration of the U.S. economy into the world economy, a subject on which much has been said and written in recent years.

On the one hand, all--or rather most--of the things that have been said about the "globalization" of the U.S. economy are true. We are in fact trading much more with the rest of the world than we were a few decades ago. Direct foreign investment, both inward-bound and outward-bound, has grown rapidly. Financial capital does now move around the globe with greater speed and in greater volume than was true a decade or two ago. Nothing I am about to say is meant to deny any of this in any way. The world is indeed a smaller place, and America is less insular, than it was in, say, 1960.

But on the other hand there seems to be a tendency, especially in sophisticated circles, to exaggerate the extent to which the U.S. economy has been "globalized" and to treat globalization as a new and revolutionary phenomenon---whereas in fact it is old and evolutionary. Pundits of all kinds, perhaps in an effort to appear chic and "with-it," would have us believe that we now live in a brave--or perhaps scary--new world in which the old rules of economics no longer hold and in which America is less and less able to control its own economic destiny.

To get to the punchline right away, the moral of my story is thoroughly two-handed: While we are indeed a more open economy than we were in the recent past, while international capital markets are indeed bigger, freer, and more fluid than they were before, and while the U.S. economy is indeed buffeted by foreign forces beyond our control, we have not simply melted into the international economic crowd. While we are a decidedly more open economy now than we were in the 1950s and 1960s, we are also considerably more closed than the "globalizers" would have us believe--and therefore more able to control our own destiny.

I want to back up these assertions with some data and then briefly point out their relevance for policy--and I don't mean just monetary policy. First some facts.

International Trade in Goods and Services

The share of international trade in U.S. GDP--or in almost anything else you can think of--has indeed grown impressively in the period since the end of World War II. Nowadays, fully half of our manufacturing sector is producing and/or selling abroad.

One common measure of the importance of trade, or the openness of an economy, is obtained by expressing the sum of exports plus imports as a share of GDP. For the U.S., this trade ratio was just 8.3% in 1950, had grown to 11.2% by 1970, and reached 21.4% in 1990. (In 1994, the most recent year for which data are available, it was 22.8%.)

In some important sectors, our dependence on imports is extreme. For example, it is well known that we now import about

50% of the oil we use; that figure was just 20% in 1960. What is less well known is the extreme, and rapidly growing, importance of imported capital goods to American industry. In 1994, we imported about 45% of producers' durable equipment; in 1970, the corresponding figure was just 7%. Thus the current and much-desired investment boom has contributed substantially to the current and much-bemoaned import boom.

The factors underlying the "globalization" of the goods and services Americans use are, for the most part, obvious and well known. They include:

* Rapid economic growth in the rest of the world: After the devastation of World War II, it was pretty much inevitable that productivity and output would grow much faster in Europe and Japan than in the United States. More recently, the "newly industrializing countries" in Asia and elsewhere have been closing the gap on the industrial world. In consequence, the U.S. economy has receded from about 35% of the world economy in 1965 to about 25% today. As the U.S. becomes a smaller fraction of the world economy, it is only natural that we should both import and export more of our GDP--and we are.

* Reduced trade barriers: One notable success story of the postwar period has been the gradual lowering and dismantling of trade barriers, through the GATT and in other ways, which has spurred world trade. Since peaking at about one-third in 1930, average tariff rates on manufactured goods in industrial countries have declined steadily and dramatically to under 7%

today--and are heading even lower under the Uruguay Round. Regional free trade areas such as the European Union and NAFTA have lowered tariffs even more.

* Lower transport and communications costs: The most literal sense in which the world has become a smaller place is that it now costs much less--in real terms--to move goods from one country to another. And falling costs of telecommunications also make it easier to "ship" services (and also to move capital; I'll return to that).

Perhaps because of all this evidence, people seem to forget, however, that:

* The U.S. trade ratio, which was 22.8% in 1994, was already 21.2% by 1980. It has just inched up since then.

* As best we can tell from admittedly imperfect historical data, the U.S. trade ratio was about the same in 1970 as it was in 1890 and about the same in 1980 as in 1920!

Thus the internationalization of U.S. trade in goods and services is not a new phenomenon. To a significant extent, all that has happened in recent decades is that international trade has returned to the relative position it held in the distant past. Viewed through the wider lens of history, it is the period from about 1930 to about 1960 that looks aberrant.

Nor has the process of internationalization been proceeding at an accelerating pace: the data I just presented show that the trade ratio grew much more rapidly in the 1970s than in the 1980s

and 1990s. This is not entirely surprising once you realize that:

* Much of the trade liberalization came relatively early in the postwar period. Those average tariff rates on manufactures, which were about one-third in 1930, were already down to about one-sixth by 1950 and below one-tenth when the Kennedy Round cuts were fully phased-in in the early 1970s.

* Ocean transport costs fell faster in the 1920-1950 period (-64% in real terms) than in the 1950-1980 period (-29%); and they have actually risen since 1980. Even air transport costs fell more rapidly from 1930 to 1980 than they have since.

International Capital Flows

There is simply no doubt that financial markets are growing both more globalized and more fluid every year. Examples are legion:

* Between 1980 and 1994, foreign holdings of US securities rose more than 11 fold--an extraordinary compound growth rate of 19% per year.

* During that same period, US holdings of foreign securities rose more than 8 fold, an almost-as-astounding 17% growth rate.

* At the end of 1973, foreign banks in the US accounted for only 3.8% of US banking assets; at the end of 1994, the foreign share was 21.3%--a figure, by the way, that is higher than for any other G-7 country except the UK.

* It is often remarked that hundreds of billions of dollars move almost instantly around the globe at the flick of a

keyboard. One oft-repeated, but nonetheless amazing, statistic is that the daily volume of foreign exchange transactions is over \$1 trillion.

I could go on and on citing such figures. Here, once again, the reasons for rapid internationalization are less than mysterious:

- * The huge growth in the volume of trade carries with it corresponding financing needs.

- * Although hard to define precisely, the role of "financial capitalism" as opposed to "industrial capitalism" has almost certainly increased in all advanced countries, especially the English-speaking ones. Internal financial liberalization probably played a key role in this development in most countries.

- * Barriers to international financial flows have probably come down even more dramatically than barriers to movements of goods and services.

- * Advances in telecommunications and computers have quickened the pace of all financial markets, most especially including international markets.

Once again, I do not want to dispute the truth in any of these obvious facts, nor deny their importance. But, still, there are a few facts worth reciting on the other side. For example, despite all this international capital mobility:

- * As of the end of 1994, over 94% of the stocks owned by US investors were US stocks.

* As of the end of 1994, over 97% of the bonds owned by US investors were US bonds.

* As of the end of 1994, foreigners owned:

-- only about 6% of US stocks

-- about 14% of US corporate bonds

-- virtually no US municipal bonds

-- about 22% of the Treasury securities outstanding.

This last looks to be a large share, but almost 60% of it was official reserves held by foreign central banks.

In a word, despite the undisputed fact that financial capital can jump around the globe almost instantly, the overwhelming majority of the assets owned by Americans are still American assets, and the overwhelming majority of American-based assets are still owned by American citizens. Thus the trend toward globalization of portfolios has not gone nearly as far as some people think. You can still tell an American by his or her portfolio. There is still a sense in which you can speak of "American" financial markets.

Nor is the globalization of capital flows as new a phenomenon as some people think. It has been estimated that, in 1914, over 25% of British wealth was invested abroad--a vastly greater share than any country has invested abroad today. This foreign-based wealth yielded returns to British citizens that amounted to almost 10% of national income, an astounding sum by modern standards. To acquire such a large overseas position, the UK had to invest, on average, about 40% of its savings abroad for

four decades. By contrast, during the 1980s, the period in which Japan was allegedly "buying up the world," only about 11-12% of Japanese savings were devoted to acquiring foreign assets.

Finally, ask yourself what technological innovation did the most to speed up the international flow of capital? Was it computers? Satellite hookups? Fax machines? Certainly not. In 1866, when the transatlantic cable was laid, the time needed to move capital from New York to London was cut from perhaps a week to perhaps five minutes. Now that really did shrink the financial world!

So What Does This All Mean?

Does all this mean that the world economy is not really globalizing? Absolutely not. It does mean, however, that:

- * The process is evolutionary, not revolutionary.

- * To a significant extent, the industrialized nations of the world have only recently reattained the levels of economic integration that had been reached by World War I.

Does it mean that our economy is not thoroughly integrated into the world economy? Certainly not. But it does mean that:

- * Roughly 90% of what Americans buy is made at home and about 90% of what we make is for home consumption.

- * Well over 95% of the assets Americans own are domestic assets.

To me, all this means that, despite all the talk about globalization:

* It still is meaningful to speak about "the U.S. economy" as a distinct entity, not just a corner of some bigger "world economy."

* Neither U.S. fiscal policy nor U.S. monetary policy is powerless to affect the U.S. economy, as is sometimes suggested. Indeed, it is not even clear that these policies are less powerful than they were 30-40 years ago. For example, the greater openness and fluidity of world capital markets may increase the impact of Federal Reserve policy on world interest rates.

* If America manages to generate more domestic saving, whether by increasing private saving or by reducing the government budget deficit, domestic investment in the United States will rise. The funds will not just flow abroad (though some of them will).

* The slow growth of productivity and real wages in the United States since 1973 cannot and should not be blamed on increasing foreign competition. The more likely culprits are domestic, as are the most promising remedies.

Finally, to redeem the promise that this talk would be thoroughly two-handed, if not indeed three-handed, let me make one final and simple point: There is no going back.

Regarding trade: Even if we wanted to, we probably could not close our borders to international trade--and we most certainly should not want to. The voices of protection that you still occasionally hear in this country and others are not only

counsels of despair, bad economics, and often the worst kind of special pleading. They are also relics of a past that, I am pretty sure, will never return.

Regarding international finance: Even though the world's financial markets are sometimes maddening, sometimes frustrate the plans of governments, and are sometimes driven by speculative frenzies that bear little relation to reality, they are with us to stay. So we had better learn to live with them. Many of you may recall Churchill's wise observation that democracy is the worst form of government--until you consider the alternatives! In precisely the same sense, open, competitive markets in which participants seek profits is the worst way to allocate capital--until you consider the alternatives.

But as we admire and extol the achievements of these magnificent global capital markets, we bankers and regulators should keep a few elementary points in mind:

First, markets will get carried away from time to time. This has been true at least since the South Sea bubble, and the Internet does not prevent it.

Second, the "global information village" not only spreads information with amazing speed and efficiency, it also spreads disinformation and rumors with dismaying speed.

Third, markets need rules and supervision. Much of this comes directly from the private sector--market participants and the exchanges themselves. But the public sector also has a role to play. Since the markets are global, the regulations should

presumably be global. But, of course, regulatory authorities are nationally based. This is why international cooperation, such as through the Basle Supervisors Committee, is so important. While we have no natural metric, it is probably true that financial regulation has "globalized" less rapidly than financial markets.

Fourth, despite our best efforts, financial accidents will happen from time to time. Some will be large, like Barings and Orange County. Some will spread globally, like the stock market crash of 1987. It is the job of the world's central banks to ensure that such events are rare and relatively well contained. And if we succeed, the global economy will continue to prosper and grow in the next 50 years as it has in the last 50.