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The Global Economy: Implications for Management

Today, industries face a more global economy than at any time since the turn of the century. At that time the world economy was much more open than it is now. One could travel through most countries without identification papers. And gold coins from one country could be used in another to purchase goods and services. But two World Wars and the economic collapse of the 1930s led to a closing of the world economy. The progress of the past 45 years towards the ideal economic organization, open markets, and the free flow of goods, capital, and ideas is indisputable.

Many economists, myself included, believe that markets are inherently stable, and consequently, tend to gravitate back towards equilibrium after experiencing financial, real, or political "shocks." This natural resiliency of markets tends to build pressures to modify or sweep away institutions that limit exchange and production opportunities. The alternative view is that markets are unstable and need the constant action and intervention of government policymakers to smooth and fit the outcome closer to political and social objectives. This latter view seems to have lost credibility in the economics profession and in political circles, at least during the last decade.

Has there been a fundamental shift in the world's thinking? Have policymakers realized the benefits of relying on markets rather than interfering in them. From the days of Adam Smith, economists and philosophers have praised the glories of free trade. "No nation was ever ruined by trade," declared Benjamin Franklin three years after Smith published his <u>Wealth of Nations</u>. And, indeed, from an economic standpoint he is right.

Historians have long noted the coincidence between economic growth and the free flow of resources. It is impossible to ignore the gains that the world has made in the postwar era of renewed international trade. In the U.S., real income and wealth have more than doubled, the number of poverty-level families has been halved, and the percentage of the adult population that is employed is currently at historical highs. Recent votes of confidence have been expressed in international and bilateral agreements such as GATT, and the U.S.-Canadian Free Trade Agreement. Even more encouraging, inclinations are displayed in the communist block by China's efforts to expand markets and Mikhail Gorbachev's perestroika.

Technological development might be the gravitational force toward international markets. Technology opens up new opportunities for gain. As the Asian experience shows, the smallest countries can participate in these gains, as producers and as consumers, with open markets. Large interrelated and self-reinforcing blocks of technological development require the existence of large, open markets. Consider the development of microelectronics. The great increase in circuit-element density, leading to dramatic improvements in the capabilities of an integrated circuit chip, has been inseparable from the introduction of more complex production equipment. But such developments are expensive and risky propositions. For example, the processing equipment alone raised the fixed costs of a wafer fabrication plant from about $2 million to $50 million during the 1970s. While these plants are able to produce more sophisticated chips with increased applicability at a cheaper price, they need the support of very large markets.

Poltical bodies will always be tempted to assume a certain omnipotence and take uncertainty and risk into their own hands. Shocks around the world could lead to a closing of the world economic order and an increase in state intervention in economic affairs. Financial collapse, wars, ecological disasters, world recessions or broad-based ideological concerns could be catalysts. But while progress may not be as rapid or as even as I would like, but the forces operating towards an international marketplace are strong and will continue.

We may rightfully question whether governmental gestures toward further reliance on market resources are being upheld in spirit. Are governments doing enough? Are they doing the right things? Today I will argue that deregulation and actions to promote a freer exchange of resources are good for businesses and the economy. I also discuss some of the implications that globalization has had for management. Realizing that we have only scratched the surface of the benefits arising from globalization of markets, what can we expect the future to hold?

Europe 1992

The European Economic Community (EEC) is initiating some 300 actions to remove physical, technical, and fiscal barriers to freer markets. The removal of these barriers to the free flow of products, services, labor, and capital promises enormous gains from specialization, competition, and economies of scale. Already firms in Europe are consolidating and investing to take advantage of wider markets. Nevertheless, the removal of barriers among member states is not, in itself, enough to guarantee overall efficiency gains. These require that the EEC go beyond the removal of barriers among its individual members and adopt more general policies that liberalize markets and that allow prices to convey information about relative scarcities. Two widely discussed issues along these lines have to do with the "leveling up" of regulation and the creation of barriers to external trade.

Many observers, especially the British, have expressed concern that, in the drive toward a unified Europe, a pattern of supranational regulation and subsidization will supplant the concept of a single liberalized market. Instead of breaking down barriers, restrictions, and controls, the European Community could "level them up," creating a new bureaucracy and competition-stifling patronage within the Community. This kind of policy coordination would limit potential gains in production, employment, and exchange opportunities in Europe. Replacing 12 individual markets with a single market does not, in itself, diminish rent-seeking, as we have seen with Europe's Common Agricultural Policy.

Similarly, some of us from outside the European Community wonder whether the Community will restrict external competition. Over the past 40 years, the trading world -- often led by the EEC -- has lowered tariffs and removed quotas. But after substantial gains during the 1950s and 1960s, the progress slowed. Although the overall level of import restraint might not be higher now than 40 years ago, trade restraints remain an important feature of European and worldwide trade. Moreover, these restraints have become more sophisticated, more discretionary, less visible, and even less responsive to market forces than the traditional tariffs that they replaced.

All current rhetoric aside, the trading world lacks a firm commitment to the principles of free trade. We live in a neo-mercantilist environment where market access often is more a function of bilateral, product-specific negotiating skills than the result of competitive strengths. Such types of policy coordination have enormous costs.

Competitiveness of U.S. Firms

What does a more global economy mean for the U.S.? Can America compete? For the past several years we have been running very large trade deficits. The U.S. has gone from a trade surplus of $7 billion (current account) in 1981 to a deficit of $153 billion in 1987. Last year we began to see some improvement in our trade situation, but we are still running a deficit. In 1988, the U.S. imported over $440 billion in merchandise, but exported only $320 billion, leaving a trade deficit of $120 billion. That is, imports exceeded exports by almost 40 percent.

Do these figures indicate that the U.S. cannot compete in world markets? I don't think so. The trade deficits we have been accumulating since the early 1980s are primarily the fault of poor economic policies -- high inflation, high interest rates, high exchange rates, and large budget deficits. These economic policies, especially the high inflation rates of the late 1970s, also made our firms less competitive. Needed investments in plant and equipment to modernize operations were postponed because of high interest rates, brought on by high inflation. The high exchange rates of the 1980s greatly exacerbated the underlying problem.

The United States is the largest economy in the world and also the largest trading nation. Each year, the U.S. imports more than the entire Canadian economy produces. However, U.S. merchandise exports amount to only about 6 percent of our GDP. There are only two countries in the world whose export ratio is as low as that of the U.S.: India and Yemen. The export ratio for Germany is 30 percent, Canada's is 28 percent, and Japan's is 15 percent. Some of the world's smaller countries have even larger export ratios: Belgium's is 73 percent, Ireland's is 63 percent, and the Netherlands' is 62 percent.

These data debunk the myth that foreign markets are closed and that this is a key trade problem facing the U.S. Nevertheless, many Americans argue that U.S. industry must be protected because of our inability to compete and the loss of jobs that would result. According to recent polls, the American public overwhelmingly believes that Japan is the world's leading economic power. What's more, Americans seem to believe that U.S. products rate behind those of Japan and Germany. Fortunately, the poll found that government and business leaders do not agree. American firms like Ford and IBM have been successful in European markets for years. The impenetrable Japanese market has been cracked by IBM, ServiceMaster (contract hospital cleaning), 7-Eleven, A.T. Cross (pens), and Weaver Popcorn. The secret is a strategy of longevity in foreign markets, a commitment that takes time, effort, and money.

Today, pessimism about America's ability to compete is in vogue. I believe that America's industries are able to compete worldwide, and we have already seen some progress. In 1987, exports increased by 12 percent and by 27 percent in 1988. We can do better, and policymakers can help; not by adopting protectionist measures, but by doing more to allow the markets to work.

Role of Governments

What role should governments play in a global economy? Very simply, governments should create an environment which is consistent with good resource allocation decisions. An environment of free exchange allows managers and other market participants to rely on market principles and the free flow of resources and information to guide their decisions. In this way, businesses and entire economies can pursue their comparative advantage and expand overall output and welfare. Governments will always be called on to set the rules of the game within which markets operate -- such as protect property rights and other individual liberties. However, government policy should not strive to supplant markets and limit their discipline.

Inflation: A policy issue that has not received enough attention concerns price-level stability. Inflation involves costs in terms of misallocated resources. It adds "noise" to prices, which distorts the information about relative scarcities conveyed through price changes. Through interactions with tax systems, inflation can affect firms' investment and financial decisions. While these costs are greatest when inflation is high and variable and difficult to predict, they are also present at moderate levels of inflation.

Inflation also leads to the creation of socially inefficient institutions, designed to protect individuals against inflation-induced losses on money and financial assets. In an inflation-free world we would see far fewer transactions in futures markets for exchange rates and interest rates.

Evidence from a large set of countries, with very different institutions and economic conditions, indicates that persistent inflation erodes long-term economic growth. The inefficiencies and distortions associated with inflation reduce resources available for capital formation and encourage investments that have quick payback periods, rather than longer-term growth potential.

Exchange Rates: Governments should also avoid influencing capital flows by fixing exchange rates. Critics of floating exchange rates argue that the volatility impedes the free flow of resources. Exchange rate volatility, it is argued, increases uncertainty which raises the cost of doing business and raises the required rate of return for undertaking risky projects. Exchange rate changes, though, compensate for differences in inflation, savings rates, productivity growth, and costs of production between individual countries. By fixing exchange rates, or setting a narrow band, governments force adjustments to take other forms, including inflation in some countries. Exchange rates, like prices, are indications of relative scarcities. In an uncertain, changing world they must be allowed to adjust to new events.

Trade Restrictions: Governmental restrictions on trade is another way of stifling healthy resource flows. Although legal trade restrictions and tariffs have declined in recent years, effective restraints have taken more sophisticated, more discretionary, and less visible forms. Goods have been turned away from foreign markets through the enforcement of various product standards, packaging requirements and foreign government subsidies. We have learned that such policies can be extremely damaging for trade and growth.

Regulation: Finally, regulation is a form of intervention where governments attempt to guard against the normal risks of a competitive marketplace and prohibit the most efficient use of resources. Such meddling has adverse effects on long-term decisionmaking and, ironically, tends to hurt those it was intended to help. The examples are plentiful. Railroads, sheltered by rate-of-return regulation, eventually whithered into near-complete decay. The U.S. steel industry, once protected from the rest of the world by a government-guaranteed price floor, soon became a world leader in inefficiency. In similar fashion, deposit insurance, designed to protect depositors and banks from the risk of failure, only served to shift risk from bank management to the insurance fund.

Importance of Regulatory Reform: The Financial Industry

For years the U.S. has treated banking like a public utility, controlling its activities through regulation. Bank charters, which screen new entrants, typically call for minimum capital holdings and broad restrictions on portfolios. Banks have been precluded from certain kinds of activities deemed to be too risky, including general insurance and securities underwriting. In the past, competition was further limited because banks could not offer interest on regular checking deposits and a ceiling was set on other deposits (Regulation Q). Further, geographic expansion of retail banking was limited to state boundaries. As a result, our banking system is more fragmented and compartmentalized than that of any other country.

Legislated changes have loosened some restrictions on financial services activity and encouraged more competition in the industry. The abolishment of the regulatory restraint on interest rate ceilings for bank deposits (Regulation Q) recognized the competitive forces already in place and enabled banks to compete for funds. One-bank holding company legislation cracked the door to product expansion by permitting a holding company to offer a slightly broader set of products than its bank subsidiary could offer directly. Rapid advances in the computer and telecommunication industries also spurred competition. Previously only available to banks, information essential for financial intermediation was made available widely and cheaply.

We have also seen some increased geographic competition. All but six states have adopted some form of interstate banking. But while we are struggling with adopting nationwide interstate banking, the rest of the world is allowing their banks to compete globally. As a consequence, a small- or medium-sized manufacturer in Ohio will not get the support from his local bank that he needs in his attempt to export. Contrast this situation with that prevailing in Canada, England or Germany where the hometown banker will also have branches and representative offices in key cities around the world. These offices are in place to support the international trade efforts of their domestic customers. When a factory owner from a small German village steps off the plane in New York, he will be met by a representative of his own bank, ready to offer his services and advice on the American market.

Therefore, if we expect businesses, large and small, to realize the benefits of trade, financial as well as real resources must be mobile. A particular concept of Europe 1992, if adopted, could be a formidable hurdle for the movement of American banks to Europe. The EEC is considering a principle of "mutual recognition" which would allow a financial institution to exercise the same powers it has in its home country. Over time, pressures will develop to replicate the structure of the country that permits the broadest powers. But before this can happen in the U.S., the deposit insurance system must be reformed. Market risk must be shifted from deposit insurance and the taxpayers back to the bank, its stockholders, managers, and ultimately its depositors. In short, the domestic financial system must be allowed to be more responsive to the rapidly-changing needs of the marketplace.

Implications For Business and Its Managers

Just as policymakers can take some steps to improve American competitiveness, American firms can also take some steps to improve their competitiveness in this growing global economy.

American industries are doomed if they do not adapt to the new world marketplace. Firms can no longer behave as they used to. Adapting to this new marketplace requires a more flexible organization. We are beginning to see new organizational configurations, new management styles, and an increased commitment by workers to quality.

Businesses around the world are finding it necessary to revise their view of the world. Rapid technological growth, freer exchange of labor, capital, and knowledge, and a change in economic conditions in the last decade have caused some firms to alter their strategies and resources. In response to increased uncertainty, organizations are finding it vital to become more flexible and responsive.

One way businesses are increasing flexibility in the development and production of products is through increased automation. The introduction of microelectronics and sophisticated software has revolutionized the design and development of products and has made available much more flexible manufacturing systems. This streamlining helps Honda develop and manufacture an auto twice as fast as the American automakers. However, automation has also taught manufacturers that the workers are still the heart of any process.

Proper organizational structure and employee involvement are also important to flexibility and increased responsiveness. Organizations are finding that the quickness and nimbleness of a smaller, less hierarchical structure is paying off. Flattening the traditional pyramid, though, may not be enough. Like banks, firms are decentralizing to move their decisionmakers closer to the market which is crucial in a rapidly-changing environment. The declining costs and increased abilities of communication and transportation systems are making decentralization much more feasible than in the past.

A corporation that is interested in expanding into international markets may decentralize for other reasons. By locating some of its operations or using subcontractors in foreign markets, the multinational reduces the possibility that it will be shut out of that market; for example, the U.S. and Japanese fear of being boxed out of Europe in 1992. In addition, the firm can provide a "structural hedge," against adverse movements in exchange rates.

However, the firm must be careful not to subcontract everything away. A company, whether it is globalizing or not, must identify the unique things that it contributes to the creation of value - its higher margin activities. The successful firm will maintain proprietary control over those parts of the product that distinguishes it in the marketplace and use the broadest possible array of standardized inputs for the rest. In this way, sourcing can be shifted, dictated by market conditions and relative prices of suppliers.

In such a market-driven, niche-oriented world, the corporation cannot rely exclusively on its president or CEO for direction. Rather, the firm's managers must become, to some extent, entrepreneurs. A manager must clearly understand the business strategy and pursue that activity or set of activities in the most effective (high-quality) and efficient (low cost) way possible. In a fast-changing international environment, the successful manager must keep abreast and even anticipate market developments. The focus is changing from someone who knows every detail of the operation to someone who has a broader view of the world and has the ability to apply this view to plant operations.

A more decentralized structure poses problems of coordination. Executives and administrators high in the organization must surrender some control in the running of operations. Organizations are finding that frequent flows of information are vital for the meshing of once centralized functions. It will be the job of managers to gather and disseminate information within and outside the organization. With increased autonomy, managers must understand and communicate the impact that a change in one area, say production, has on the activities of other areas, like marketing. Corporate goals and objectives must be understood and, to some extent, embraced by employees at all levels.

In such a decentralized, market-driven system of control, the employee is the most important resource. Firms are more directly tying their business strategy to the selection and continued development of their employees. Instead of emphasizing the notion of "climbing the corporate ladder," firms are treating organizational growth and individual growth as partners. Employers have experimented with flexible working patterns (flexible hours, part-time work, sabbaticals for further education and training, job rotation, etc.) and flexible reward systems (for example, employees can choose between a pay raise, time off, particular benefits, etc.) in an effort to foster long-term motivation and productivity.

Thus the manager will be the important link between the employee and the organization. Such specific and tailor-made employee rewards and development objectives must be integrated with corporate goals and objectives. The manager will most often be the only individual with the knowledge to mesh these two needs together. The importance of employee development is magnified in an industry of changing business strategy. For example, managers of AT&T who will be responsible for a foreign market are deployed to that market to acclimate them to local traditions, customs, and business practices.

Conclusion

The international trade statistics over the past decade reveal a concerning, if not alarming, development regarding the competitiveness of U.S. industry. Can America compete? A popular view is that we cannot, and we must respond through protectionist legislation. This, I believe, is nothing more than misguided patriotism. Indeed, through trade, we as people gain through technology, investments, and innovations, whether they occur abroad or in Cincinnati. We also have to adjust to those changes whether they are initiated at home or abroad. We need to adjust and adapt better.

The United States and the world have and will continue to reap large rewards from freely moving resources. A free flow of products, services, labor, capital, and knowledge promises enormous gains from specialization, competition, and economies of scale. While some progress has been made with the removal of explicit trade barriers, much work remains. Furthermore, deregulation of the financial industry will play a large role in international expansion. Perhaps most important, is the acceptance of domestic monetary policies of zero inflation. Simplification of the economic decisionmaking process would boost productivity and growth through better resource allocation. But as long as the world has a collection of sovereign states --

with the right to print money and different tastes for inflation, with different abilities in the workplace, with different preferences for saving, etc. -- exchange rates should be allowed to adjust and reflect the changing relative scarcities of currencies.

In such a world, the phrase "business as usual" will be obsolete. Business practices and strategies will have to be constantly reassessed and updated. Technology will thrive in such an environment, serving to expand the edge of production frontiers, and making our business world even more dynamic. Corporations, probably more than at any time in our history, will have to be forward-looking in their vision.

The responsibility will fall directly on the manager's shoulders. He or she must be much more of an entrepreneur, able to perceive opportunities and assess the impact of changes -- organizational and environmental. He or she must also be a top communicator, able to convey messages from the market to the organization and within the organization. In a more market-driven world, the manager will be the key component to a more flexible, successful organization.