Racing to the Top: How Global Competition Disciplines Public Policy

Remarks to the Dallas Friday Group

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The thought of speaking to such an august assembly in April was difficult enough. Then you invited me to address the Friday Group on … a Tuesday. You know, this could get downright confusing. I am happy to see so many of you managed to show up on the right day. One of the great pleasures of speaking in Dallas is seeing so many familiar and friendly faces.

I was a member of this group when it was less august and when we always met on Fridays. I remember one particular session some 20-odd years ago, when Ted Strauss introduced his brother Bob. They were vintage performances by both Strausses: Ted gave an intro that was longer than Bob's speech and, being an erudite fellow, was all over the map. In fact, Ted's introduction was so long that Ambassador Strauss said, "I hadn't realized Ted was going to provide a (expletive deleted) travelogue, so in the few seconds remaining, I better just get to the point and tell you what I came here to say."

Gray Mayes has provided a nice introduction, yet kindly kept it short. But I still think I'll keep to Bob Strauss' form and just get down to what I came here to say. I will speak, as always, only for myself and not for any other senior official at the Fed or for my colleagues on the Federal Open Market Committee.

We cannot fully understand the U.S. economy without appreciating how it interacts with the rest of the world. We live in an era of globalization, and policymakers in both the political and monetary realms must come to grips with this if we are to fulfill our mandates and do what is expected of us.

Globalizing economies are increasingly open to movements of goods, services, capital, people and ideas across borders. Citizens and companies do not seek to do business in far-away places for the sheer adventure of it. They do it because it makes them better off. This is the natural process of capitalism, constrained by the cost of transport and information and accelerated by technologies that make it cheaper to move goods, services and ideas. Globalization will proceed apace unless or until the governmental authorities intervene to stop it.

A few numbers tell the story of the world's march toward globalization:

- Trade as a percentage of gross world product has risen from 15 percent in 1986 to nearly 27 percent today.
- In the past two decades, the stock of foreign direct investment assets has nearly quadrupled as a percentage of gross world product, and the stock of portfolio investment assets has increased by a multiple of eight.
- More people than ever are crossing national borders—for business and pleasure. On average around the globe, countries received just one foreign visitor for every 100 people in 1950. By the mid-1980s there were six, and since then that number has doubled to 12.

■ The world communicates much more and in whole new ways. Since 1991, international telephone traffic has more than tripled. The number of cell phone subscribers has grown from virtually zero to 1.8 billion—30 percent of the world population—and Internet users will soon hit 1 billion.

Globalization generates controversy. It unleashes competition and accelerates the forces of creative destruction, to borrow the term coined by economist Joseph Schumpeter. In this turbulent sea of change, there are challenges and opportunities. Business leaders confront them every day. The men and women who manage America's businesses—the busy fingers of Adam Smith's fabled invisible hand—work 24/7 to hone their companies' productivity and competitiveness. They get it: They understand that America's workers and businesses cannot prosper by shrinking from the demands of globalization or hiding behind protectionist barriers.

Many analysts highlight the benefits of globalization to the private sector—not only the strength that competition builds but also the gains from trade, specialization and productivity that come with expanding markets. This is so widely written about now that it is almost old hat. I did not come to speak to you today about this dimension of globalization. You already know it because you practice it. Instead, I thought I would speak to you today about globalization and the public sector.

Today, the Dallas Fed is issuing its 2005 annual report. It includes some data that will give you a good fix on some of what we do. In addition to supervising and regulating banks, we processed almost a billion checks worth $900 billion last year and paid out and received 5.4 billion in circulating notes worth $92 billion. Money is the economy's lifeblood. Federal Reserve Banks are critical to maintaining the payments system and keeping the capillaries, veins and arteries of the economy's cardiovascular system operating efficiently.

I want to draw your attention to a punchy essay in the annual report that analyzes the interplay of globalization and public policy. Its title gives away our conclusion: *Racing to the Top: How Global Competition Disciplines Public Policy*. In short, we found strong correlation between increasing globalization and measures that promote faster growth, lower inflation, higher incomes and greater economic freedom.

The economic logic is straightforward. Competition brings benefits to the public sector the same way it does the private sector. Because factors of production are increasingly mobile in an era of globalization, governments vie to gain and hold onto them. Mobile factors will flee economies that burden them with high taxes, excessive regulation and capricious administration. They gravitate toward countries that offer the best opportunities to increase profits or paychecks. The economic benefits of productive factors give nations strong incentives to maintain or adopt better economic policies.

Our study uses the globalization index devised by A.T. Kearney and *Foreign Policy* magazine, which ranks roughly 60 countries from the most to least globalized. It includes cross-border trade and investment as well as measures for technologies that shrink the world, people-to-people connections and government participation in the global community. The United States is the fourth most globalized country in the world, behind Singapore, Switzerland and Ireland. Iran comes in last.

We looked at how the countries in the A.T. Kearney/Foreign Policy index fared on 18 measures of public policy, all from such well-respected sources as the World Bank, the Fraser Institute of Canada, the Heritage Foundation, Harvard University and Transparency International. The mashing of all these numbers yielded some interesting results that shed light on the debate about globalization.

Overall, we found a strong correlation between globalization and better policies. As nations become more globalized, they tend to be more open to international trade, maintaining lower tariffs and reducing other barriers. They are more open to foreign capital, allowing foreigners to participate in their economies as direct and portfolio investors. Increasing globalization is associated with fewer and better-administered regulations, a more favorable corporate tax environment and policies that stimulate innovation.

In countries with a higher degree of globalization, you also find policies supporting more accountability in the private and public sectors. These nations are more likely to maintain courts that recognize property rights and enforce the rule of law. Their governments are more effective and less corrupt. Policies in these more globalized countries tend to be more stable, an important consideration for the long-term planning needed for business.

As a central banker, I am particularly interested in our study's implications for monetary policy. Inflation is the central banker's nemesis—the Lex Luthor of the monetary realm. It robs money of its purchasing power. It cripples the poor and destroys the purchasing power of the elderly and others who live on fixed incomes. It erodes incentives to work and save. And it debases investment. Let inflation get out of control, and in no time, a dollar invested becomes a quarter earned.

Today, money is probably the most mobile factor of production. In a nanosecond, it can scurry to any part of the world with just a squeak of a computer mouse. Nations that fail to control inflation will find they cannot retain their own capital or attract money from other countries, except at high interest rates. They end up not only with high inflation but also with lower investment, higher interest rates and slower growth.

Most countries want to avoid these outcomes. They want to retain capital and attract it from other countries. Low inflation helps them do so. Over the past 30 years, there has been a marked decline in inflation across the world—particularly among the nations most integrated into the world economy. We found that inflation descended in stair-step fashion in the period from 2001 to 2003. It averaged 10 percent among the least globalized quarter of nations in our study, then fell to 6.2 percent for the next quartile of globalized nations, 3.1 percent for the third quartile and 2.3 percent among the most globalized quartile.

Not every government policy has improved with globalization. For example, our study found no evidence of increasing globalization and fiscal restraint. Governments tend to get bigger as nations become more interconnected to the world economy. Public transfers and subsidies increasingly pervade nations as they globalize, and personal income taxes become more burdensome as well. Why does fiscal policy respond little to globalization? We do not have a definite answer, but perhaps it is because these nations are richer and have the means to spread those riches through their societies.

Government labor policies also seem sticky, if not quite immune, when it comes to dealing with the forces of international competition. Except for the top quarter of globalized nations, labor market flexibility does not generally improve as economies open up to the rest of the world. As long as workers refuse to acknowledge they are competing in a global economy, they will petition wealthy governments to protect their jobs. Labor market rigidities slow job growth and raise unemployment, in turn creating a greater demand for expensive and expansive safety nets for idle workers.

The recent demonstrations in France show the political difficulty of enacting even relatively modest changes in regulations that hamstring hiring and firing, raise costs and increase unemployment. Yesterday, the French government yielded to those protests, withdrawing the proposed reforms. Perhaps it is an overly optimistic view, but I am encouraged that the French government recognized that restoring competitiveness requires loosening of the country's labor laws. And not all French youths were protesting the proposed new law. Some of them were in other countries—at jobs that are not available in France. Boris Mollereau, just 27 years old and a business school graduate, moved to London to find work, making him a mobile factor, if ever there was one. Listen to what he had to say in this morning's *Financial Times*: "Here, I might lose my job more easily, but I can find another job just as easily. French people don't realize that a robust job market is in itself a form of job protection."

Could it be said any better?

Other countries, including Germany, have also come to realize the importance of nimble labor markets in today's ever more connected world. They are beginning to enact reforms. You cannot stop firms from seeking the best workers for the money, wherever they may be found, especially as advances in telecommunications and transportation and inventory and supply chain management bring the world closer together. Labor's best option in a globalized world is to adapt, compete and get stronger.

With the important exceptions of fiscal and labor policies, our study concludes that globalization is associated with better policies. Of course, there is a chicken-and-egg problem in discerning whether globalization improves public policy or whether nations that improve their policies succeed in becoming more globalized. It is probably both. We should celebrate, not denigrate, globalization. In general, it is associated with better government policies, ones that lead to higher living standards and greater economic freedom.

Thank you.