# The Role of Globalization in the Financial Crisis and Recovery

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*The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.*

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Thank you, President [R. Gerald] Turner.

It is common for a speaker at SMU to say how honored he is to be introduced by Gerald Turner. In my case, it is especially true. My wife's—Nancy's—family has been involved in SMU almost from the time Dallas Hall was the sole building on "The Hill." Today, I am speaking in a building named for my father-in-law, the late, great Jim Collins, Class of '37, who turned his energy to serving Dallas in the U.S. Congress after building a business: Fidelity Union Life. That business, which was sold to Allianz of Germany in the late 1970s, was the source of the funding for every facility on this campus with the name Collins or Sharp or Altshuler attached to it. Countless Collinses and Sharps and even two Fishers have been educated here. I know SMU well, and I knew Jim Collins as well as you could know any man. He would be very proud of what you have done as president of SMU and would consider you one of the greats, Gerald. And I know he would be very pleased to see his son-in-law given such a nice introduction, speaking here in the Crum Auditorium, attached to the building the university so graciously named in his honor. Thank you, Mr. President.

Today, you are going to hear from people who know firsthand what it means to operate a business in a globalized economy—particularly a business located in this unique part of the country, the global business nexus we call Dallas. Tom [Falk] and Rich [Templeton] are no strangers to the challenges and opportunities that await American businesses in an interconnected world, and I am confident that you all will benefit from their special insight.

I'd like to speak more about the context in which global business is conducted, in order to set the stage for what I expect Tom and Rich will be saying.

We have all read the headlines and listened to the pundits' chatter about a looming threat of "deglobalization." A slew of armchair analysts, calling to our attention historic declines in world trade and a rise of protectionist instincts, have lamented what they believe to be an impending reversal of globalization.

This morning, I will argue that a decline in trade flows, at least to some degree, was to be expected during this tumultuous period, the most severe global financial and economic crisis in decades. I will then turn to protectionism, the bête noire of internationally minded business operators and policymakers. And then I will conclude with some comments on where we are likely to go from here, making the point that globalization is still very much alive and that, like the music of Wagner, all is not as bad as it sounds.

As usual, I will speak only for myself, not for any other member of the Federal Open Market Committee or the Federal Reserve System. Which is fitting, for I will draw not only on my perspective as a Federal Reserve policymaker, but also on the four years I spent negotiating trade agreements for our country.

Let's begin with what the pundits have right: Our recent economic crisis has led to some truly historic declines in world trade. According to the International Monetary Fund's most recent *World Economic Outlook*, global exports of goods and services, by volume, will decline over 11 percent this year, with exports of advanced economies projected to fare worse than those of their emerging and developing peers.[1] If you look to the history books, you will learn that, by some measures, the pace of international trade's decline in the first year of this crisis was even greater than what we experienced during the Great Depression.[2]

Evidence of the harsh nature of the contraction in trade we have recently experienced can be found in international shipping costs. For years, I have used the Baltic Dry Index, a price index that captures movements in the shipping market for dry bulk commodities, as one indicator of the relative health of international trade flows. In the span of less than seven months, this index took an incredible nosedive, plummeting over 94 percent by the early part of December 2008. The price data for leasing "Capesize" vessels—one of the best indicators of shipments of iron ore, a critical ingredient to the key building blocks of infrastructure worldwide—is even more volatile: They reached a peak of nearly $235,000 per day in the summer of 2008 and, since that time, have fallen over 80 percent.[3] Data for container ships, the carriers of many consumer durables, are similarly bleak, as are the data for the rails that carry goods from the ports to the distribution points of consumer outlets. And, if you'd read page C1 from today's edition of the *second*-best newspaper in the world, the *Fort Worth Star-Telegram,* you would have seen that Alliance and DFW airports—in addition to others, like San Francisco, LAX and JFK—experienced sizable cargo business declines last year (although, for DFW, relatively less than its peers).[4] While the numbers were not broken out, it is likely that at least some of that downturn could be attributed to a decline in goods shipped between international destinations. In the blink of an eye, we went from shortage-driven inflation in transportation costs to dramatic overcapacity and slack. A little over a year and a half ago, daily lease prices of railcars in the United States were escalating rapidly; as of Oct. 1 of this year, roughly 178,000 railroad-owned freight cars, which placed end to end would total some 2,900 miles, have been laid up in storage for at least five months, according to what Matt Rose, the CEO of BNSF, recently told me. This is something of an improvement from a comparable car count for the previous month of 185,000, but it nonetheless provides a graphic indication of the enormous amount of slack in idle rail assets and the compression that had occurred in final demand for finished goods produced both domestically and abroad.

The broader, aggregate data speak to the implosion in trade that we have witnessed. As of June of this year, our quarterly imports, by volume, had fallen just over 20 percent after peaking in the third quarter of 2007. A similar measure of American exports, by volume, peaked later—as the

[1] *World Economic Outlook: Sustaining the Recovery*. International Monetary Fund, October 2009. Data provided by Haver Analytics.

[2] Further analysis in a pending piece by Mark Wynne at the Federal Reserve Bank of Dallas cites the work of two well-known economic historians—Barry Eichengreen and Kevin H. O'Rourke (their analysis can be found at http://www.voxeu.org/index.php?q=node/3421). Starting at the peak in industrial production that preceded each downturn, Eichengreen and O'Rourke show that the pace of decline in the first year of our current travails bests that of the first year of the Great Depression.

[3] Numbers from Bloomberg.

[4] "Alliance Cargo Traffic Off 19 Percent in 2008," by Sandra Baker, *Fort Worth Star-Telegram*, Oct. 16, 2009, p. C1.

crisis went global in the second quarter of 2008—but still managed to drop roughly 15 percent through this June.

These are just some of the doomsday figures that naysayers have highlighted to portend an onslaught of deglobalization. To be sure, these data are quite startling and, indeed, quite historic. But do they portend that deglobalization is taking root? I think not.

As most of you know, I am not a trained economist. I earned my bona fides like many of you in this room—in the world of private business, after earning an M.B.A. at Stanford: the SMU of California. That said, I have spent enough time around economists to learn two things:

1. Number one: Stanley Fischer, my much-revered but spelling-impaired namesake at the Bank of Israel (he insists on inserting a 'c' in Fisher), was right when he quipped that there are three kinds of economists: those who can count and those who cannot.
2. Number three: Simple questions rarely, if ever, have simple answers.

Before asserting that "deglobalization" is occurring, we must understand what has driven these global trade declines and look behind the simple headline figures and "instant analysis"—my favorite oxymoron—that accompanies the assertion of the Eeyores of punditry who claim that globalization is at risk.

Let's start by examining how the dramatic trade declines of the past year compare with what we otherwise might have expected in the midst of a global recession and whether a reversal of globalization, or maybe something else, is to blame. My colleagues at the Dallas Fed's Globalization and Monetary Policy Institute—specifically, its director, Mark Wynne, and one of its senior economists, Jian Wang—have been doing just that.[5] I want to share some of their preliminary findings with you.

First, a look to the dictionary: What exactly do we mean by globalization? Let me give you my CliffsNotes definition: Globalization is the process by which national borders become increasingly open to international transfers of goods, services, capital, people, ideas and a variety other economic inputs and outputs. To businessmen and women, globalization is about managing to greater efficiency by driving the costs of goods sold, expenses, inventory sourcing and management to optimization. It is also about maximizing market reach and expanding top line volume. For the business operator, globalization is a means to better profits so as to maximize returns to a company's stakeholders. You will no doubt hear much about this from Tom and Rich.

To macroeconomists, globalization is about the integration of national markets into one global market. Fluctuations in the flows of goods and services may certainly be necessary for, or symptomatic of, such integration, but the extent to which any economy can be said to be globalized—the extent to which a domestic economy is integrated with economies elsewhere—is *best* judged on the basis of how close its domestic prices for various goods and services are to those on world markets.

[5] Their efforts will be published as part of the Dallas Fed's *Economic Letter* series.

In the presence of transportation costs, barriers to trade and so on, we can reasonably expect that there will be a difference between the domestic price of a good and the price that prevails globally. The size of this difference or distortion determines just how much of the good we will import and consume. With the removal of these barriers, that distortion will decline, domestic prices will fall and trade will increase.

It is possible for trade volumes to increase without an integration of markets. While trade growth is necessary for globalization, it is by no means sufficient. A domestic boom, for example, could leave us clamoring for all kinds of goods and services, in all price ranges, without driving down those domestic price distortions. The same could happen in reverse: A global recession that reduces import demand would likely lead to a decline in trade but might not have any effect on the wedge between domestic and international prices.

That, arguably, is largely what took place from last fall through the first half of this year. As the crisis spread from North America to the rest of the globe, the dramatic deterioration in economic prospects and the contagious seizure that afflicted financial markets in the advanced economies following the failure of Lehman Brothers last September caused the markets for emerging-market exports to dry up, engulfing them in the global downturn.

As policymakers, we would prefer to study price differentials when looking for evidence of globalization. Trade growth, again, is necessary but insufficient. And alternatively, evidence of trade decline is likely necessary, but insufficient, as evidence of that alleged multisyllable phenomenon, deglobalization.

Unfortunately, we lack the reliable global price data needed to perform a more thorough analysis on that front. As such, we must move forward—cautiously—with our discussion of trade flows. If we posit that deglobalization is not the likely culprit behind the recent historic declines we have witnessed in global trade, we have to ask ourselves what other factors might be at play.

With regard to fluctuations in international trade relative to movements in the business cycle, two facts are worth mentioning. First, exports and imports are, in economists' lingo, "procyclical." In other words, they move in tandem with GDP. Second, swings in exports and imports are far more volatile than those of the business cycle. The average volatility, or standard deviation, of GDP is about 1.7 percent. For exports, that number is over three times greater, at 5.6 percent, and for imports, 5.2 percent.

In short, international trade flows move in the same direction as—and are a lot more volatile than—the overall economy.

Why is this the case? Despite innovations that now allow market participants to pass what we once defined as "nontradable" assets across national borders, the composition of international trade is still heavily skewed toward goods. Goods, by value, make up close to 70 and 84 percent of our exports and imports, respectively. More important, most of those goods fall into the category of "durables." In 2008, for example, more than 60 percent of American traded-goods trade, excluding energy, was classified as durable.

A durable good can be loosely thought of as anything with a relatively longer lifespan. Consumers and producers make use of these products for an extended period. As an economist might say, they provide utility over time. For a firm, this might include large manufacturing equipment. For a household, it might include a car or a refrigerator. Or, in the case of my friend and neighbor, Jerry Jones, it might include an 11,500-square-foot, flat-screen television that footballs can reach. Demand for these goods—except for in the case of Jerry, who is a unique risk taker!—is quite volatile. When the economy hits a wall, as it did last year, households postpone these larger purchases, and firms rein in previously scheduled capital expenditures.

That is what we've seen this year: In the final three months of 2008 and beginning of 2009—again, as the crisis went global—worldwide demand for durable goods fell substantially, registering annualized quarter-over-quarter declines in some developing nations that are well into the double digits. Given the contribution that these goods make to international trade, it should come as less of a surprise that global exports and imports dried up in the midst of the most severe global recession since World War II.

There is another reason we might expect a relatively sharper decline in trade flows during a global economic downturn—one that is tied to globalization itself. Economists call it "vertical specialization" or "internationalized production." The other gentlemen you will hear from today might know it simply as doing business in a global world.

Many goods today are manufactured in more than one place. Firms are no longer beholden to the labor and capital available within their own national borders. They can source various stages of production from anywhere in the world, using each host nation's comparative advantage to drive down costs and expand profit margins. Whereas in previous periods, trade was composed solely of finished products, the story is now much more complex. Firms export materials to countries around the world and receive finished—or perhaps near-finished—goods that they can then sell at home or abroad or ship away for further finishing.

When global demand takes a hit, we don't just see a drop-off in the international exchange of finished goods. Intermediate products that multinational firms trade in this globalized production process fall by the wayside as well. Trade losses are compounded, relative to what they might have been before globalization began.

Again, it should come as no surprise, then, that as the global economy declines, trade flows decline even more.

What *has* come as a surprise, however, is that the *magnitude* of this decline has been over and above what we might have expected based on our understanding of fundamentals.

In the past, econometric models with only two variables—American income and dollar strength—have done reasonably well explaining quarterly fluctuations in our imports. Also, and not surprisingly, models that contain *foreign* income and dollar strength have typically done well explaining quarterly fluctuations in American exports.

Until last fall.

I am given to reminding the economists at the Dallas Fed that my undergraduate professor, John Kenneth Galbraith, used to say that economic modeling and forecasting was invented to "make astrology look respectable." So I have asked them to dig deeper into what might have caused this breakdown. As you may recall, there was no shortage of stories in the financial media last fall about the drying up of trade finance and credit and its detrimental effect on trade flows. Given the nature of the crisis and the abundance of this anecdotal evidence, it is reasonable to assume that a severe reduction of trade finance may well have been the culprit.

Trade finance is, broadly, every kind of loan, insurance policy or guarantee tied to an international good or service transaction. It includes a range of tools: from direct credit extended by an exporter to government-backed guarantees to letters of credit issued by commercial and multilateral banks and private insurers. Trade finance instruments can even act as pure risk hedges, insuring against the myriad potential problems (commercial, political and the like) that can arise in international transactions.

While hard data on trade-specific finance are difficult to obtain, there are a few quantifiable measures we can point to as evidence of a drying up of this important trade tool. Since the summer of 2007, private capital coming into and out of the U.S. has plunged. In the span of one year, these flows fell from 15 percent of our GDP to zero. Declines in trade credit were similarly dramatic. The contraction in trade credit available, for example, to Korean firms in the fourth quarter of last year was the most severe since the Asian crisis of the late 1990s. And for Brazilian firms, the contraction was more severe than during the *real* devaluation crisis in the early part of this decade.

When a global flight to quality takes hold—something we've witnessed to a startling degree during this financial crisis—we might expect that investors, banks and firms would limit their exposure to relatively risky nations. Surprisingly, though, emerging markets were not the only victims. Firms in the U.S., Japan and Germany, for instance, also saw record drops—literally unprecedented at the end of last year—in trade credit liabilities.

The subject of trade finance is very much on the front burner in the debate on the need for a new regulatory regime governing financial institutions. Had you read page 4 of yesterday's *Financial Times*, you would have seen an intriguing article discussing the accounting treatment of trade credit and an assertion that the "shortage of trade finance [during the financial crisis] was responsible for more than 10–15 per cent of the fall [in global trade]." It went on to say that "… bankers warn that a diminished capacity for trade-related lending could create bottlenecks that will slow or stop the recovery."[6]

Here is the point: The dramatic turndown in trade we have witnessed was the result not of some invidious plan to undo globalization. It resulted from a turndown in the domestic gearing of the world's larger economies, which spread to the emerging economies that feed into demand from those larger economies, and it was exacerbated by the financial crisis, including a clampdown in trade credit.

This does not mean globalization is being undone. It does not mean that "deglobalization" has begun.

[6] "Regulators Urged to Loosen Credit Restrictions on Banks," by Alan Beattie, *Financial Times*, Oct. 15, 2009, p. A4.

That said, we must remain ever vigilant to forces that we know can undo the good that has come from globalization. The biggest threat of all is the political instinct when times are tough to embrace protectionism.

Today, protectionism is more subtle than in the past. Governments no longer have to resort to explicit tariffs and quotas to stave off the inflow of foreign goods and services. They can be more creative. At the Dallas Fed, we commonly watch indicators released by the World Trade Organization such as antidumping investigations. While these numbers are still well within the experience of the past decade, their increase throughout 2008 and in the first half of 2009 is not something we can simply ignore.

One cannot be too blunt about the dangers of protectionism. It is, quite frankly, the crack cocaine of economics: It may provide politicians with a temporary high, yet it is instantly addictive and inevitably proves debilitating and fatal for an economy. We must keep a watchful eye on quick fixes—like the imposition of tariffs on affordable Chinese tires—to make sure this dangerous instinct does not get out of hand. We cannot forget that what made the Great Depression "great" or the even worse 23-year "Long Depression" that closed out the 19th century "long," was the onslaught of protectionist measures enacted by a host of countries around the world. We would be well-served to remember that lesson.

Having said all that, I must tell you, as a former trade representative, I am encouraged by recent developments on the trade front. For example, we hear little these days from Sen. Schumer and Sen. Graham (or even the Secretary of the Treasury) about the need to take punitive actions in retribution for what they consider insufficient flexibility in the exchange rate of the Chinese currency. While I disagree, from a free-trader's perspective, on the Section 421 action taken on Chinese tires—an action that only hurts lower-income groups in the U.S. who buy those cheaper tires—I assume, without any more knowledge than what I learned about the way things operated when I was a trade representative during the second term of the Clinton administration, that the current administration undertook that action as an inexpensive way to placate an important constituency and that there might have been far more expensive alternatives on the table. And I take heart that while Congress has not seen fit to act on the U.S.–Korea Free Trade Agreement—an agreement I have long championed—it has at least been agreed to between negotiating parties and has occasioned an agreement between Korea and the European Union that was initialed yesterday (and modeled in-fact on the Korea–U.S. agreement).

While I doubt the practicability of letting the G-20 or the IMF become global regulatory forums or rule-making bodies that trump sovereign authorities of their member nations, I also take heart that at least these forums are being used proactively to discuss common problems and keep the momentum for positive financial reform and continued trade liberalization moving forward. That momentum could have easily gone into reverse under the difficult global financial and economic conditions that have obtained.

This does not mean that those who believe, as I do, that a more fully interconnected, globalized economy leads to the most efficient allocation of resources (which in turn leads to a more productive, efficient and prosperous environment for American businesses) should let down their guard. It does mean that we have cause for optimism. Globalization is proceeding. That's the good news. And nobody is in better position to exploit it and make it work to the benefit of their stakeholders than Dallas-based businesses.

Thank you. And now, in the best tradition of central banking, I would be happy to avoid answering any questions you might have.