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GLOBALIZATION AND ECONOMIC CONVERGENCE: AN ASSESSMENT

Robert Rowthorn [*] ***and Richard Kozul Wright*** [**]

This paper offers a critical survey of a strong globalization thesis that predicts a direct link from more open trade and investment regimes to faster economic growth in developing countries and income convergence across the global economy. Its examination of recent experience suggests that while in a more open and integrated world economy both the quantity and the quality of investment are influenced by external factors the forces driving capital accumulation retain strong domestic roots and remain open to the influence of various types of policy initiative.

INTRODUCTION

Since the late 1970s there has been a fundamental change in economic policy, beginning in the industrial economies, then in developing countries and finally - and most dramaticall - in the former socialist economies. Emphasis has been placed on a minimal role for the state, greater reliance on market forces, and increased openness and integration into the world economy. Technological advances have on some accounts already eroded longstanding geographical, ideological and political obstacles to cross-border transactions, and transnational firms have been identified as the new engines of growth and development. These same forces are expected to generate faster economic growth, particularly for poorer countries, leading to convergence of incomes worldwide. From this perspective, policies still matter, but only to the extent that *dirigiste* economic regimes resist implementing rapid and comprehensive trade and financial liberalization along with the deregulation of domestic activity needed to take full advantage of the new growth opportunities.

Among the most ardent supporters of this strong globalization thesis have been practitioners of the dismal science. Indeed, while a good deal of the globalization debate has been characterized by loose and speculative discourse, conventional economists have been able to establish an authoritative voice by introducing a tighter analytical framework and a mass of empirical evidence. Their analysis of globalization has centred on the greater mobility of capital and has done much to revive the flagging intellectual fortunes of neo-classical growth and trade theory.

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This paper offers a critical survey of some of the analytical and empirical arguments linking globalization and convergence, and takes issue with the claim that capitalist economic development has entered a new phase in which the domestic determinants of growth have become subordinate to international economic forces. In the absence of a spontaneous link from greater openness to faster economic growth, the notion of a policy agenda centred simply on the elimination of the state from economic affairs is rejected.

I. GLOBALIZATION

Over the past two decades growing cross-border linkages have exerted powerful influences on the shape and direction of the world economy (table 1). From 1973 to 1994, the volume of world exports grew at an average annual rate of around 4.5 per cent, compared with 3.1 per cent for world GDP, but with a marked acceleration after 1985 to 6.7 per cent. As a consequence, world exports of goods and services in relation to world output rose from 12.1 per cent to 16.7 per cent over this period.

Table 1

The growth of international economic activity, 1964-1994

	Export volume	*World FDI flows*	*International bank loans*	*World real GDP*
1964-1973	9.2	--	34.0	4.6
1973-1980	4.6	14.8	26.7	3.6
l980-1985	2.4	4.9	12.0	2.6
1985-1994	6.7	14.3	12.0	3.2

Source: *IMF* (various years); *BIS* (various years).

Notwithstanding, international trade has not been the main catalyst for accelerating global economic integration. That role has been played by international capital. Cross-border financial flows have risen spectacularly over the past two decades, and the scope and depth of financial integration has far outpaced that in goods markets. The abandonment of fixed exchange rates in the early 1970s, along with a gradual loosening of capital controls opened the flood gates to short-term capital flows; average daily trade in the global foreign exchange market rose from $15 billion in 1973 to $880 billion in 1992 and over $1,300 billion in 1995. From 1980 to 1993, cross-border sales and purchases of financial assets rose from less than 10 per cent of GDP in the United States, Germany and Japan to 135, 170 and 80 per cent, respectively. International banking has also, over this period, grown considerably faster than world trade or output.

Direct investment flows have also made a significant contribution to global economic integration in the sphere of production, and at a pace considerably faster than trade in goods and services. During the 1970s, annual flows of foreign direct investment (FDI) averaged $27.5 billion, rising to $50 billion in the first half of the 1980s and to $166 billion in the second half. Following a dip in the early 1990s, they reached $318 billion in 1995.

While there is evidence that some of these flows have accelerated since the mid-1970s, it is unlikely that by themselves they constitute a structural break in the evolution of the world economy. Indeed, as may be seen from table 1, international economic integration was just as rapid in the 1960s and early 1970s. Consequently, observers have pointed to more qualitative changes in the nature of international trade and capital flows than was previously associated with the process of economic integration. These include: the rise in manufactured exports from low-wage to high-wage economies and the growth of intra-firm trade accompanying a finer geographical separation of production activities;[1] a shift in the composition of private capital flows from bank-lending to equity and portfolio investments, particularly in respect of capital flows to developing countries, along with a tremendous pace of financial innovation designed to reduce investors' exposure to credit, liquidity and exchange risk; a steady shift towards FDI in services, which now accounts for well over half of the total stock of FDI and an increase in the flow to developing countries (accounting for over one third of total inflows in 1993-1996), much of it linked to export-oriented manufacturing.[2]

These more qualitative changes in the pattern of economic flows have been associated with institutional changes at the microeconomic and macroeconomic levels that are said to be contributing to a much wider and deeper process of economic integration. The triumph of the market over the state - exemplified by the collapse of communism in Eastern Europe - has, from this perspective, not only widened the geographical scope of the international economy but has, by expanding the entry and exit options of capital, fundamentally altered the interplay of political and economic forces, thus greatly diminishing the independence and influence of purely domestic actors. Secondly, capital has become a much more complex factor of production. A more elaborate system of intra-firm flows of goods and

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[1] Paul Rayment has reminded us, however, that intra-firm trade was probably already high in the 1960s in the context of North-North intra-industry trade, although statistical limits make it difficult to give a precise figure.

[2] On the changing nature of international trade, see Krugman (1996); on trends in financial flows see Felix (1996), Kregel (1994) and Akyüz (1995); FDI trends are fully documented in UNCTAD's *World Investment Reports*.

services, as well as inter-firm alliances of various kinds, has emerged, giving rise to a more complex pattern of specialization linked to a new system of international production. Moreover, the importance of human capital is seen to be of growing importance in this system. Finally, the triumph of market forces has been accompanied by an emerging liberal international regulatory framework, which has further restrained the influence of domestic policy actions (e.g. Mankiw, 1995; Lawrence, 1993; Cable, 1995).

Strictly speaking, these pressures should culminate in a truly *global economy*, where all firms and financial institutions operate transnationally - i.e. beyond the confines of national boundaries. In such a world goods, factors of production and financial assets would be almost perfect substitutes everywhere, and it would no longer be possible to consider nation states as distinct economic identities with autonomous decision-making power in the pursuit of national objectives. Those public goods that are needed to maintain an open-market system, such as secure property rights and a stable monetary system, would become a global responsibility. Overall economic performance would depend upon the response of firms to global market incentives and the effectiveness of global regulations.

The political, social and moral dimensions of such a global economy are beginning to provoke considerable debate and controversy.[3] Economists have reacted to descriptions of conflictual global market forces with a mix of disdain and indifference and, while such responses have not always been unwarranted, they have done little to help generate a more constructive dialogue (Rodrik, 1997). In fact, the world economy is still a very long way from this situation. A more apt description of the current situation is global economic interdependence, where cross-border linkages between markets and among production and financial activities are now so strong that economic developments in any one country are influenced to a significant degree by policies and developments outside its boundaries. However, the extent and nature of that influence continue to depend upon a country’s resource endowments, institutional arrangements and domestic policy choices.

The prospects of this interdependent world economy over the medium to longer term will hinge