The United States in a Global Economy

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Abstract

During the uneven recovery from recession and the debate over NAFTA, many American seemed to be unhappy with the prospects for the foreign and domestic economy. The real, underlying, issue was the supposed inability of American firms to compete with foreign firms. Also, Americans wanted to delay or avoid the need to restructure some of the industries in the United States.

This article describes some of the problems of our foreign economy, the events that influenced the development of our foreign economic policy, and the interactions that disturb and weaken domestic economic policy.

It seems that we in the United States are unable, or unwilling to balance our international accounts, that the countercyclical policy of our government seems impotent, and that the dollar purchases fewer units of foreign currency than ever before. This article is concerned with the reasons for the presumed decline of our international position, the diminished efficacy of domestic stabilization policy, and the connection between these events with the globalization of our economy.

In the United States, most Americans react with chagrin and disappointment to the apparent decline in the ability of US corporations to compete internationally. As our manufacturing sector employment lessens and the prices of foreign products rise, we are uneasy about our economic future. Some of the younger generation in the United States expect a lower standard of living than their parents enjoyed. The economic malaise is reinforced daily by the media, repeating a litany of real and perceived problems. The list seems endless. A few of the most frequently heard, follow:

1. Our deficit in foreign payments is evidence of a consumption fixated economy spending more on high priced foreign products than it should, and therefore, saving and investing less.

2. From our Federal Government deficit, we may conclude that the members of our Congress, are also somewhat less than frugal, and that the deficit is growing so large that we must borrow from abroad to secure its financing.

3. We contend with low productivity of our human capital originating, at least in part, from individual’s decisions to devote less effort and commitment to their education.
4. Deficient American management reacts to declining profit and increasing foreign competition by selling assets to foreign firms, downsizing remaining American firms, and laying off labor.

5. Ultimately the cumulative result of these difficulties will be to substantially reduce our living standard.

There are several more, but these contain the major difficulties. Is the economic condition of the United States as bad as some believe? If so, how did it come to this?

**A Brief History of the Dollar as International Money**

The erosion of the international position of the United States in the 1980s begins with our role in the reconstruction of the world economy after the end of World War II. It fell to the United States to provide the majority of the leadership, the reserve currency for many of the central banks of the world, the transaction medium of international exchange, and most of the commodity supply for reconstruction. It was not all altruistic, for this assistance fully employed our economy during the change from a wartime to a peacetime economy. After the end of other wars, the United States economy had suffered a period of dislocation and unemployment.

At the end of World War II, international trade was promoted by both England and the United States, and by our former adversaries as a way to stimulate economic reconstruction and development. The gain from multilateral trade which was the objective of the General Agreement on Tariffs and Trade required a stable and acceptable medium of international exchange and the only currency available with those attributes was the United States dollar. If trade was to increase to the point where the gains from trade were to be useful in the world’s reconstruction, the supply of international currency must also increase. Americans cooperated with the strategy for reconstruction by purchasing large amounts of foreign products resulting in much growth of US dollar credits in the accounts of foreign producers and their central banks. On the other end of the transaction, foreigners, at first, were very happy to receive dollars for their products. However, when the supply of any economic commodity increases, its price declines, other things equal, and so it was with the increasing supply of dollars. The excess supply pressure on the pegged exchange rate of the United States dollar finally caused abandonment of fixed rates and replacement by a system of floating exchange rates determined by the supply and the demand for dollars.

In another development, the United States budget deficit, which began as the result of domestic welfare and national security spending, quickly became international, at least
with respect to its financing. In the 1970s, our federal debt began to be owned, more and more, by foreign entities. The sale of Treasury debt instruments, denominated in dollars, to foreign holders continued the supply pressure on the dollar.

In the 1980s, private debt created by leveraged mergers, in addition to government spending, was not confined to the United States. Substantial foreign reserve surpluses of the West German economy disappeared with the costs borne by the German government for the reunification with East Germany. Ros Lifton, a research economist for Nomura Securities in Frankfurt projects a doubling of German federal government debt to 1.9 trillion marks (1.3 trillion dollars) between the years 1989 to 1994 (Wessel and Roth 1992). Japanese government debt is estimated at about two-thirds of their GDP, similar to the proportions in the United States (OECD, Japan 1991). The increased international strength of the German Mark and the Japanese Yen takes some pressure off the dollar, but by this time, there are just too many dollars in world circulation. Also, the international perspectives of the German and Japanese governments are more realistic than the sometimes altruistic, and often uncoordinated international approach of the United States.

A current significant characteristic of the economies of most of the industrialized countries of the world, including the German and Japanese, is the reliance on debt financing, private and public. Economic development is part of the reason for capital market growth but, public and private leveraging of largely inadequate capital bases must be a large part of the capital market growth, and some of the reason for the need for innovation, efficiency, and globalization of capital markets. In 1993, in the global bond market, the United States dollar continues to be the currency denomination of preference by a sizable margin (Orr 1992).

The Mobility of Capital

The fact of a truly global market for capital resulted from three events. Joan Spero writes that these events were 1) the removal of regulation of capital flows by many governments, 2) establishment of rapid data transfer networks in the world's financial houses, and 3) new varieties of securities used to hedge the risks created by expanding capital markets (Spero 1988). Governments might impede the short-run flow of goods and services with tariffs and quotas, but money was too slippery. There were too many new and different types of instruments for the regulators. And practically, these money flows were economically much too beneficial and important to debt ridden governments to be restricted, as money capital transfers traveled in digital streams between continents at the speed of light.
In the decade just passed, the increase in size of these cross border capital flows is staggering:

* In 1980, the amount of cross border lending was $324 billion, by 1991 the figure was $7.5 trillion.

* Transaction turnover of foreign exchange is currently $900 billion each business day.

* In 1980, annual worldwide cross border equity transactions was $120 billion, by 1990, the figure was $1.4 trillion (Crook 1992).

Bill Orr writes that 250 trillion dollars flows through the international bank payments system each year, and to give perspective, that figure is 10 times the value of world GDP, and 50 times the total trade in world trade (Orr 1992). Some of these money flow increases are evidence of domestic public deficit financing, along with international economic and business development. Whatever the source or use of the funds, the result of global, innovative, capital markets is an increase in the rate of turnover or velocity, and therefore a very large, probably inflationary, increase in the world’s money supply.

One other financial statistic that is, at first a bit puzzling, is information to the effect that in 1991 outflow of international funds from all the world’s countries was $130 billion more than inflow of funds to all the world’s countries. That is to say, the world ran a $130 billion deficit with itself, a highly improbable situation (Root 1994). The inequality between the world’s exports and imports has been explained by failure to record transportation costs. Another explanation may be that no country wants to own up the fact that they are enjoying a surplus in the balance of foreign payments, so the accounts, collectively, show a bit of a bias toward the deficit side.

**Innovation in Capital Markets**

Eurodollar markets, an early capital innovation, anticipated the diminished restriction of banking. At that time, Eurodollars were devices for the purpose of eluding regulation and control. Eurodollars were United States dollar credits, deposited in English or foreign banks to avoid United States Regulation Q interest rate restrictions. Another explanation of the Eurodollar market holds that Soviet government agencies with dollar denominated checking accounts, possibly for the purchase of US wheat in the 1970s, were placed in English banks to protect the accounts from sequester by the United States which could have resulted from some Cold War incident. Whatever the reason for the advent of the Eurodollar accounts, the innovation expanded the supply of capital funds. All of these
Eurodollar accounts and Eurodollar loans were immune to regulation by the Federal Reserve System, and represented the increased use of United States dollars as an international medium of exchange.

In the United States, the Congress passed The Federal Reserve Deregulation and Monetary Control Act of 1980, which narrowed the differences between the banks and other financial intermediaries. The legislation encouraged competition which was expected to increase investment in the business sector and durables consumption in the household sector by reducing the costs of borrowing. The real effect of the Banking Act of 1980, along with the various bank holding company acts, was to signal the beginning of a considerable liberalization of the financial system in the United States.

Similar changes, reducing the degree of regulation of the financial systems in the United Kingdom, in Europe, and to a lesser degree in Japan, occurred at about the same time. In Japan, access by foreign financial institutions to the Japanese market was improved, but not as much, and not as early as in other countries. In Japan, futures and options markets were established, and competition between banks and securities firms was increased. Peter Rose finds 31 “key steps” in the deregulation of the Japanese banking and financial system (Rose 1991).

Belhomme, et al, in their research on European capital markets identifies more than 20 separate innovations in instruments, or in financial practices that occurred in the decade of the 1980s (Belhomme, et al 1992). Representative of the innovations in instruments are variable interest rate or indexed debt, zero-coupon bonds, high yield-high risk (junk) bonds, hybrid debt-equity instruments, Euro-equities, and risk covering derivatives to mention only a few. Changes in the practices of the firms, increasing efficiency and reducing costs, include; the removal of fixed commissions, increased access to markets by new firms, reorganization of government securities markets, increased local small-cap unlisted markets, and possibly the most important, securitization. Securitization is the repackaging of groups of assets for the purpose of spreading risk, with the resulting instrument taken directly to the market without the benefit of a financial intermediary. On October 27, 1986, liberalization of regulation in the city of London made that major financial market the “freest in the world” (Burnstein 1988).

As money flows become increasingly international, national governments continued to be national. The result is that globalization of finance brings with it complexities and some risks for the global economy, because the rules of economic stabilization policy have changed. The same technology that enabled the rapid movement of funds also brings instant information. A global market for capital is more vulnerable, especially
during this period of transition. Erratic, volatile, prices and market shocks in newer foreign markets are transmitted to the world market with force and speed not encountered before. In the October 1987 incident, quick innovative action by several agencies saved the system. We were fortunate that time.

The Transition from Regional to Global Capital Markets

The benefits of a global capital market are better known than the possible costs. With the globalization of capital we get the microeconomic benefit of competition, efficiency in the cost of capital, and efficiency in the allocation of the other factors of production. During the period of change from regional to global markets, governments who relinquish regulation of capital markets, risk loss of potency of the effect of macroeconomic policy. With an open economy, and capital free to go where the reward is highest, economic policy makers find that they have little control over interest rates. For countries with freely floating exchange rates, with increasing proportions of GDP coming from foreign trade and finance, and with the need to service extravagant internal deficits, these features make policy complex and conflicting. National governments discover that macroeconomic policy aimed at domestic targets becomes weaker because the international effects. As an example: Domestic monetary policy to reduce interest rates and stimulate the economy may reduce the return on new foreign investment and result in depressing the economy. Policy makers advocating rules only, macroeconomic policy, may find that they are not be able to define the rule in a way that is operable because of the interaction between domestic monetary policy and its interaction with the global economy.

Fiscal policy, causing change in aggregate demand, affects price level and interest rates, and attracts or repels international short-term speculative money flows. The recent conflict between the German Central Bank and most of the other European Community members is an illustration of the direct link between interest rates and exchange rates. Open economies with the complexity of all the different options for policy, and the interaction of those policies, are mixed blessings for policy makers.

Another cost of the globalization of capital is the possibility of financial crisis. If crises are more probable during the period of transition to globalization, then the ultimate cost of the globalization of capital is the danger of an old fashioned financial panic.

Financial instability might begin in any number of ways. In one way or another, my bet is that any crash of the financial system comes from the conflict of a global capital market and ill-advised national financial policy. According to Heilbroner, politics is the
logic of applied morality, and economics is the logic of applied efficiency (Heilbroner 1987). In time of stress, the logic of applied, and usually localized morality, has the higher expediency coefficient.

Seamless, worldwide, capital markets make possible rapid mobility of money capital and these markets are precursors of less perfect mobility of the other factors of production. Political maneuvers and mindsets that belong to another era only temporarily impede an inexorable economic transformation of every open economy.

The Transformation of the United States Economy

The globalization of capital is the result of technology, accommodated by the policies of governments that allowed access to their national regions. At the same time, we are adjusting to globalization of our economic system which will be much more difficult, and is beyond the control of national governments.

At mid-century roughly sixty percent of US national output was manufactured commodities, and those activities employed, directly or indirectly, a majority of the labor force. Relatively little of this output was sold outside of the US national economy and little was imported into the national economy. The firms that turned out this product were American firms, they employed mostly American citizens, and the wages and profits that American firms generated were distributed in the United States. Growth of output, employment, and national income attracted foreign competitors who brought new, interesting, successful products to the US market.

Traditional American corporations were organized with rigid, top down, management and their new foreign subsidiaries had little autonomy. In the 1960s, American firms confronted competition from manufacturing firms in European and Asian countries with efficient capital and labor that turned out products of equal or better quality than many of our domestic products. In the beginning the foreign firms sold their output at lower prices than the prices of American products. American managers were not derelict, for they reacted to foreign competition by the formation of multinational firms and moved their manufacturing operations to the sources of cheaper inputs so that the firm could maintain its profitability. The burden of these changes fell on labor as manufacturing was shifted out of the United States and domestic manufacturing employment declined.

As the competition mounted, a foreign payments deficit placed US dollar credits in the accounts of foreign nationals, they used the money to purchase assets in the United States. In Congress and on Main Street, many Americans felt that the country had been invaded by an alien and hostile force, out to destroy our economy. Except in business
circles, few US citizens realized that most of "American" corporations also had operating subsidiaries outside the United States, in every lucrative market in the world.

Consider these two situations: An American firm establishes a manufacturing unit in a foreign country to take advantage of lower input prices or a better product market. The subsidiary hires local labor and buys local inputs and those funds remain in the foreign country. As local labor becomes efficient with the technology, and may develop technological advancements of its own, the knowledge and the expertise required to produce value remains with the local work force.

In a second case, a Japanese firm comes to the United States and the wage and input revenue effects, above, are reversed. The most important effect is the access to new and probably more efficient technology. The new value-creating knowledge will remain with our work force and be available for our own development. Which is the better of the two scenarios?

In mature and developed economies, the traditional, centrally controlled corporations have given way to new and more agile forms of organization. Multinational firms have given their foreign managers much more autonomy. In large firms with numerous divisions, managers use "internal markets," where intermediate products and their inputs can be sourced either inside the divisions of the firm, or from more advantageous markets, outside the firm.

In a global economy, if Americans suffer a decline in their standards of living, it will be because some Americans do not have skills that are highly valued in the new and transformed world economy. From the relative performance of American students on the various tests of academic accomplishment, it may well be that some part of our student population is falling below world standards and will not be compensated as highly as those who attain value producing skills. Many participants in the US economy do possess highly valued skills which means that the distribution of income will be distorted to a degree that will cause more social problems than we have at present. Effective competition by the United States in the global economy requires increased investment in our human capital.

**Conclusion**

In specific response to the five points at the beginning of the article:

1. For a majority of our citizens, the measure and definition of personal saving may not reflect the true stock of saving available for investment. We purchase foreign goods rationally, because we derive more utility from them than from the alternatives available to us.
2. A considerable amount of the deficit represents expenditure on investment for infrastructure. Much of the remainder was used in successful conclusion of the Cold War. In the future we should see slower growth in the debt than the growth of GDP, which is our best estimate of our ability to "pay off," or at least cope with the debt.

3. Item 3 may be the single valid concern. We must motivate students, support and improve education, and devote as much of our resources as we can to investment in human capital. Maintenance of our human capital is the primary source of effective competition in the global economy.

4. American managers in some firms have made bad decisions, as we all have at one time or another, hopefully not as bad as in the case of GM and IBM. On the whole, the managers of most US firms have performed well, after a late start.

5. United States citizens will experience reduced living standard only when they neglect their own education and skill attainment. Massive expenditure on investment in human capital will be ineffective if an individual's motivation and ambition is not present.

At an earlier time, trade in goods and services determined exchange rates, and control of foreign payments required free and flexible exchange rates. Now and in the future, with the globalization of capital, capital flows and the determinants of capital flows will set exchange rates, which will require changes in the conduct of domestic economic stabilization policy. It is well known that domestic monetary policy can’t change short-term interest rates without affecting exchange rates.

The decline of the international value of the dollar began with of the necessity of the use of the United States dollar as an international medium of exchange, and continued because we saved so little and bought so much of other country's product. As the Mark and Yen currencies gain value, the international reliance on the dollar should diminish.

International competition has produced American manufactured products with higher quality and competitive prices, but we share our market with the world. We will effectively compete in that world only if we maintain, and increase, our knowledge and technical base.

Comparative advantage and the gains from trade will always be valid principles, which will continue to expand our foreign sector. Accendancy of other manufacturing economies insures that United States currency will never return to its past preeminence as the sole international medium of exchange, nor should we want it to. As the United States dollar is required to do less, internationally, and if our citizens can maintain their expertise, the United States will continue as a productive and viable international participant.
References


