LIMITS OF NATIONAL ECONOMIC POLICIES

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In the age of advancing globalisation, national economic policies of individual countries are increasingly constrained in the choice of applicable instruments - and even in the choice of attainable goals. Whereas the limitations implied by the globalisation of trade and foreign direct investment seem, on balance, beneficial, at least in the long run, the limitations implied by free movements of financial capital may in fact be harmful. There may be a need to design international arrangements reducing the negative effects of free capital movements.

International trade, which has been the backbone of globalisation, pervades everyday economic activities throughout the globe. Smaller countries have already become totally dependent on their exports and imports. Even the largest economies cannot rely solely on internal markets for their prosperity. Certainly, there is still a temptation to resort, under emergencies, to traditional instruments of the national trade policy: tariff and non-tariff barriers, export-promoting or import-substituting measures. But the trade policies adversely affecting trading partners inevitably provoke countermeasures (as was demonstrated by the US-Japan trade dispute.) Clearly, it is not in the interest of small countries to wage trade wars with much stronger partners. The large countries have much more room for more active trade policy. That is one of the reasons why it makes economic sense to form Economic Unions. But, in such a Union, individual members effectively lose the possibility of having an independent national trade policy. A member of the Union may retain a say over trade policy vis-à-vis the rest of the world, but can no longer substantially manipulate their trade with other member states.

Restrictions on the freedom of independent trade policy have obvious consequences for domestic economies. Competition on the increasingly free world market for goods forces adjustment on domestic producers everywhere. International standards emerging out of this process discipline the national agents. They have to compete with their technologies, management practices, prices and wages globally. The trade-induced adjustments are reinforced by the tendency for **deregulation** of domestic monopolies (e.g. telecommunication), growing **foreign direct investment** world-wide, and consolidation of **transnational corporations**. All these factors further limit the scope and effectiveness of **specific** (e.g. industrial) national economic policies.

Whether or not trade-induced globalisation and the ensuing limitations on national economic policies further, on balance, the wellbeing of mankind and of nations is of course hard to judge. Arguably, the process is inevitable and at least potentially beneficial to all nations, be it in the long-run only. That, at least, is what the neo-classical economics tells us. Hence, in principle, one should not deplore the fact that freer trade and foreign direct investment have limited the scope of specific national economic policies.

The ongoing globalisation process goes beyond the expansion of freedom of trade and foreign direct investment. Since the early 1970s there has been a growing liberalisation of cross-country **financial capital** flows. The process started with the dissolution of the Bretton Woods Accords which provided for adjustable (but not freely floating) exchange rates and restricted movements of financial capital. Free flows of financial capital and flexible exchange rates restricted the scope of national economic policies of individual countries even further, especially the smaller ones. Under the Bretton Woods Accords, expansion of trade and foreign direct investment did not preclude a national macro-economic policy aiming at **full employment and fast growth**. Keynesian fine-tuning, involving free manipulation of national fiscal and monetary policies was possible in any otherwise open market economy, no matter how small.

With international capital moving freely to exploit cross-country differences in interest rates, or in search of quick exchange rate gains, national monetary and fiscal policies have been losing their former effectiveness, even for the large countries. (That was the lesson of the French Socialists' failed experiment at the beginning of the 1980s.) Nowadays the monetary and fiscal policies of individual countries have been restricted by the need to keep up with the monetary and fiscal policies of other countries. Otherwise, the discrepancies between these policies are exploited by international currency speculators. In this way, the national policies of all countries collectively have become highly dependent on the whims of these speculators. No wonder these policies cannot pay attention to domestic unemployment and growth. The rising importance of global financial flows is illustrated in Table 1 below:[1]

Table 1 - Global Exports, Trade and Reserves; 1977, 1986 and 1995. (US$trn)

	1977	1986	1995
Annual world exports	1.31	1.99	4.80
Annual global forex trade, excluding derivatives	4.60	67.50	307.50
Global official forex reserves	0.27	0.46	1.20

As can be seen, there has been a tremendous expansion in the size of largely speculative capital flows circulating around the globe. The volume of world trade in goods and services has been **dwarfed** by the volume of forex transactions alone. Unimaginable resources have been put into activities whose contribution to the actual prosperity of mankind seems dubious. What is perhaps important is that the combined official forex reserves of the world are now no match for these resources. In 1977, these reserves were equivalent to 14.5 days' worth of global forex trading. In 1995 they were equivalent to only one day. This has implications: the ability of the Worlds' central banks (even if they decided to perfectly co-ordinate their actions) to withstand sudden attacks against any currency may now be strictly limited.

Are the limitations on national economic policies imposed by the post-Bretton Woods arrangements necessarily a good thing? Much of the available evidence does not seem to support such a claim. To focus attention, Table 2 below lists selected indicators of **real** economic performance in OECD countries under the last 12 years of the Bretton Woods Accords (1959-70) and the two subsequent 12 year periods (1971-82, 1983-94):

Table 2 - Post-War OECD Economic Performance
(annual average % change)

	1959-70	1971-82	1983-94
Real GDP growth	4.8	2.9	2.8
Real growth of exports	8.7	6.4	5.9
Real growth of gross fixed investment	6.1	2.1	3.8
Growth rates of:			
- total factor productivity	3.3	0.8	0.8
- labour productivity	4.6	1.7	1.5
- capital productivity	0.1	-1.3	-0.8

As can be seen, economic performance in the post-Bretton Woods period has been less spectacular than in the 1960s. Growth of GDP, fixed investment and exports have slowed down. Moreover, growth has become much more unstable. Inflation and unemployment, typically quite low under the Bretton Woods Accords, have become issues of importance.

Regardless of whether or not the imposition of fiscal and monetary discipline on individual countries - implicit under a regime of floating exchange rates and unrestricted movements of financial capital - is *per se* a positive development, the overall cost of such discipline is very high. Moreover, through their sheer size and speed of circulation, capital movements have acquired the ability to wreck, and very quickly too, even those economies that do **not** sin against the principles of conservative fiscal and monetary policies. The economic *El Nino* can strike any time, any place. This is a particularly unpleasant feature of the present global arrangements. It may well be in the interest of the global economy to limit the scope of this phenomenon by means, for example, of the **tax proposed by James Tobin**, or through international accords akin to Bretton Woods.

Note

1. All numbers quoted in this text come from D.Felix, *On drawing general policy lessons from recent currency crises*, Journal of Post Keynesian Economics, No.2, 1997-98, pp.223-235.