

Macalester International

Volume 7 *Globalization and Economic Space*

Article 21

Spring 5-31-1999

Response to Popov

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Recommended Citation

Swaniker, Frederick (1999) "Response to Popov," *Macalester International*: Vol. 7, Article 21.
Available at: <http://digitalcommons.macalester.edu/macintl/vol7/iss1/21>

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Response

Frederick Swaniker

The impact of globalization on the world's financial markets became brutally obvious in mid-August, when Russia abruptly decided to let the value of the ruble fall and to default on its debt payments to foreign investors. This ignited a financial panic in markets as widespread as Malaysia, Germany, Brazil, South Africa, and the United States. In its wake, the devaluation left billions of dollars in losses for Wall Street investment banks and hedge funds, as well as financial institutions and corporations in almost every corner of the globe. This is but the latest in a series of economic events, such as the Mexican peso crisis in 1994 and the Southeast Asian financial crisis in 1997, that have occurred in one corner of the globe, only to produce disturbing repercussions across the world.

Fueled in large part by advancements in information technology and changes in economic policy, financial markets have become increasingly correlated with each other. Economies that were once separated by high transport costs and barriers to trade and finance are now enmeshed in an ever-tightening web of economic interactions. As a result of this globalization of markets, economies separated by vast amounts of physical space are interacting in a much smaller "economic space." One consequence of this tighter economic space is that events that occur in one country cause ripple effects in a multitude of others.

Given that the current turmoil in global financial markets was fueled in large part by events in Russia, the subject of Dr. Vladimir Popov's essay—the impact of what he terms "internationalization" on the Russian economy—is especially timely. Dr. Popov describes how the freeing of foreign trade and the introduction of the convertibility of the ruble resulted in a sharp decline in exports and contributed to the reduction in economic output in Russia. And he argues that the Russian government mishandled the internationalization process in three major ways: first, by sustaining an overvalued exchange rate of the ruble; second, by failing to stimulate export-oriented growth; and third, by not doing enough to attract foreign direct investment.

I begin my comments on Dr. Popov's essay with what I think are the major contributions of his paper to this intellectual discourse. Then I will offer my thoughts on some shortcomings of the paper. I will conclude by presenting my own perspective on the subject.

The first and most insightful part of Dr. Popov's arguments is his recognition of the overvaluation of the Russian currency, the ruble. By maintaining a fixed exchange rate to the dollar, while natural resource exports grew rapidly, the ruble became overvalued; this, in turn, hurt non-natural resource exports and stifled domestic commerce. It was only a matter of time before foreign-exchange traders recognized that the ruble was overvalued, resulting in the massive devaluation and global chaos that we are witnessing today. In retrospect, it is quite clear that the ruble was overvalued (which is why it came crashing down two months ago). However, given that Dr. Popov wrote his paper in early summer of 1998—that is, before the ruble crashed—his observations are rather clairvoyant. In fact, several Wall Street currency traders would still be employed today had they read Dr. Popov's essay, taken his words to heart, and avoided the ruble!

The second of Dr. Popov's contributions is his examination of the idea that "speed does not matter" in determining economic performance during transition from central planning to free-market, open economies. This issue has been a major sticking point in academic debates on transition; there is, as he mentions, a great divide between "gradualists" and "shock therapists." By showing that speed of transition is not a relevant and appropriate variable, he resolves this contentious debate.

Third and finally, Dr. Popov demonstrates, through econometric analysis, that initial conditions are indeed significant in explaining the economic performance of Russia compared with more successful economies in Eastern Europe. The term *initial conditions* refers to the state of the economies in Eastern Europe before they began their transition to free markets and integration into the world economy. Most scholars of this topic ignore these starting points and claim, for example, that Poland and Hungary's economies performed much better than did Russia's after 1989 because they were quicker to adopt Western "free-market reforms," were quicker to open up foreign trade, and became integrated more quickly into global capital markets. But these claims ignore the fact that Poland and Hungary had already begun to participate in the global economy long before Russia did in 1989, and, as a result, were better positioned to compete globally than was Russia.

My first concern about Dr. Popov's essay is my disappointment that he barely discussed events that have most recently occurred in Russia. Instead, he focuses primarily on events that occurred there between 1989 and 1996. Since Russia only recently opened itself to the outside world and the effects of globalization are only now being seen there, this is a particularly opportune time to discuss such effects. For example, I would have liked Dr. Popov to touch upon the impact of globalization on business in Russia — how American firms such as Vogue, McDonald's, Merrill Lynch, Ben & Jerry's Ice Cream, and Microsoft are aggressively vying for shares of the Russian market; how foreign investors have flocked (at least until recently) to Moscow's stock market; how Russian banks, businesses, and the government came to borrow heavily from international investors; and so on.

I am also curious to know how the integration of Russia into the world economy is affecting Russian politics, culture, values, norms, and beliefs. For instance, how is the ordinary person on the street in Russia coping with the impact of globalization? How does the Russian public perceive this force called globalization which has enabled citizens to buy thousands of once-unobtainable foreign products but has, at the same time, destroyed so much of their paper wealth in just a few days of hectic trading on Wall Street. It would also have been enlightening for Dr. Popov to discuss, for example, the role that Western advice from institutions (such as the International Monetary Fund) played in Russia's post-Soviet economic disaster. Other questions left unanswered include: What pressures are being exerted on Russian policy-makers as a result of the harsh blow that the global economy has dealt Russia? Are there pressures to slap controls on capital markets, create tariff barriers, and perhaps renationalize some strategic industries that have been hurt by global competition? Are there any positive aspects to the integration of Russia into the global economy — such as the influx of new ideas, the availability of higher-quality goods, and the introduction of Western methods of management?

The second criticism I have of Dr. Popov's essay is that it does not directly address the theme of this year's Roundtable; the bulk of it focuses on economic events that have occurred *inside* Russia. Many of the events Dr. Popov describes have little to do with globalization but are, instead, remnants from the era of central planning. He does not adequately address how these changes *inside* Russia have affected the world *outside* Russia. Judging by the effect of the present Russian economic crisis on global markets, Russia plays an increasingly important

role in world markets—due largely to its prominence as an exporter of oil, diamonds, and other natural resources and as a potentially lucrative and massive market for European, American, and Asian firms. Dr. Popov also fails to make any connection to the concept of economic space. As demonstrated, with the increasing linkages between Russia's economy and the economies of other countries, Russia's case is a wonderful example of the shrinking of economic space in the world today.

With the deregulation of financial markets worldwide, the sheer volume of money flowing across borders has exploded dramatically. As a result, a few thousand dollars saved by a person in Minnesota can be used to finance the government's deficit in Thailand. With so much money in search of investment opportunities, it is extremely tempting for companies and governments in the developing world to become addicted to this seemingly "free" money, and to take on more and more credit than is prudent. In my opinion, the most important lesson we can take away from the Russian and Asian crises is that *the less-developed countries in Africa and Latin America should be absolutely certain that their economies are ready both institutionally and politically* before jumping onto the global bandwagon and starting to collect as many foreign dollars as they can. Only credible, strong, and stable economic institutions and political regimes can prevent the inflow of foreign money from wreaking havoc in the local economy. Otherwise, volatile private capital—which flowed in so rapidly—can flow out even faster, causing entire financial systems to collapse. These less-developed countries also should avoid the mistake of becoming too dependent on "global dollars," as companies and governments in Asia and Russia did. Unless these steps are taken, countries such as Brazil and South Africa, which are viewed as the next frontier by global investors, will also be devastated by a Russian-style crisis.

I would also like to emphasize that, despite that caveat, I am not suggesting that developing countries should withdraw from the global economy. The mishaps that occurred in Asia in 1997 did so after more than twenty years of solid economic growth and massive increases in living standards financed in large part by foreign investment and augmented by very open, export-oriented economies. The benefits of participating in the global economy—gains from trade and the acquisition of knowledge and technology—are undeniable, and I firmly believe that these countries should, by all means, take part. But they should make sure that they have a solid financial system, a transparent legal

system, and a stable political system before trying to attract as much foreign investment as they can.

I also contend that there has to be greater economic cooperation between nations if this era of shrinking global economic space is to be a prosperous one. The system as it exists today simply will not be sustainable in the long run. Further, the powerful industrialized nations and the institutions they control — such as the World Bank and the International Monetary Fund — pressure developing and transition economies to free their exchange rates, engage in free trade, and participate fully in the global capital markets. Yet when disasters strike, as in Russia and Southeast Asia, these same industrialized nations and multilateral institutions are often slow to assist the stricken countries or are unable to do so. When the IMF requests funding to aid a country in crisis, the United States Congress may tie up the bill for months; by the time this funding is finally approved, it is too late to alleviate the crisis, so whatever money is thrown in to fight the crisis is wasted. Countries must work together in two ways. First, they must *prevent* such crises from occurring at all — for example, by regulating speculative investments and reckless lending to developing countries. And second, the developed nations should also be willing to act quickly to assist their less-fortunate brethren in times of crisis, to prevent these crises from afflicting the rest of the global economy. If the global economy is to succeed, a spirit of international cooperation needs to arise.

On the eve of a new millennium, global markets are rapidly converging into one big, complex amalgam. This promises great prosperity for some countries, as has been demonstrated by the dramatic increases in wealth of the Asian “Tigers” and by the benefits reaped by companies that have decided to compete globally. Yet this new proximity of markets brings with it the threat of increased instability and a dangerous interdependence among markets, as exemplified by the widespread effects of the recent Russian crisis. The ever-smaller economic space in which the world now operates presents enormous challenges to the multinational companies that seek to remain competitive in the global marketplace. Even more serious are the challenges that regulators and governments around the world face, as they wrestle with the powerful and potentially destructive forces of globalization. The looming question now is: Who will prevail? The multinational companies and savvy Wall Street currency traders? Or will governments and multilateral institutions, such as the United Nations, be able to maintain control? If an even balance between these forces can be

achieved, the result will be a new and better world. The present disaster in Russia, which threatens the world with prolonged instability and the possible rise of an increasingly isolated and hostile state with thousands of nuclear weapons, reveals how destructive the forces of globalization can be. Moving forward, the nations of this world need to cooperate and, thus, prevent the occurrence of other such crises.

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