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The New Global Economy: Opportunities and Challenges for Small Open Economies

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ABSTRACT

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Kym Anderson

This paper examines the strengthening forces behind the latest wave of globalization and draws out its consequences for the policy strategies of small open economies such as Singapore. The digital revolution's contributions to globalization have been substantial, but so too have the policy reforms by national governments over the past two decades, both unilateral and regional. In addition, the GATT/WTO has been important in encouraging economies to open up more and to commit to staying open to international trade and investment during the past half century for rich countries and especially over the past decade for developing countries. Greater openness of and interdependence between national economies provides wonderful opportunities for small open economies, but it is not without its challenges. Globalization is raising the rewards to economies choosing good economic governance, *but is also raising the cost to economies with poor economic governance.* Crucial to good economic governance is a permanent commitment to a liberal international trade and payments regime, for services as well as goods, in addition to sound macroeconomic, sectoral and factor market policies.

Keywords: globalization, trade and investment liberalization, small open economies

JEL codes: F13, F15, K33, O33

The acceleration of globalization over the past two decades has had both upsides and downsides. In East Asia the financial crisis of the late 1990s caused many people to question the virtues of market openness. But it is important to distinguish adverse short-term effects from long-term trends, and to ensure measures to curb the former do not dampen the growth prospects that can flow from the latter.

This paper focuses just on the latter, leaving later papers in the conference to deal with short-term financial and macro stability issues. It first places the causes of the acceleration of globalization in historical context, and then examines the consequences for small developing countries that are exposed to the forces of globalization. The consequences of concern to many communities and hence to politicians are not just growth-increasing efficiency but also distributional equity and environmental sustainability. Can the technological and policy-induced causes of global economic integration deliver win-win-win outcomes for efficiency, equity and the environment? What can be done in terms of national policy strategies to increase the likelihood of such a desirable combination of outcomes for a small open economy?

The paper is organized as follows. It first defines globalization and briefly describes indicators of its growth. It then summarizes technological aspects of globalization of relevance to small open countries, before noting changes in national economic policies that have contributed to globalization. The General Agreement on Tariffs and Trade (GATT) and now the WTO have added significantly to those governmental contributions to globalization. The implications of these developments for policies of small countries such as Singapore are then explored. The paper concludes by addressing the question of whether the anti-globalization protestors are a sufficient force to bring about a political backlash that reverses globalization, as happened during the first half of the twentieth century.

What is new about the current wave of globalization?[1]

Economists tend to adopt rather narrow definitions of globalization. For present purposes it can be defined simply as a decline in costs of doing business across space. When that space includes national borders, a key effect of such cost declines is to enhance the international integration of markets for goods, services, technology, ideas, financial and other capital, and labour. Indicators of its progress include convergence in prices for those products and factors within and between countries. That and related effects of globalization are being felt by all countries of the world.

Both technological and governmental barriers contribute to the costs of interacting internationally. Falls in transport costs, the huge decline in communication and information costs, cuts in tariff and non-tariff governmental barriers to trade in goods and services, and domestic economic policy reforms have combined in the late 20th century to accelerate globalization to an unprecedented speed that shows no sign of abating.

While the extent of the acceleration in globalization cannot be captured in a single statistic, several provide partial indications of what is involved. A standard indicator is the comparison between trade and GDP growth. While merchandise trade

[1] What follows draws on an earlier paper on a related topic (Anderson, 2001).

for centuries has grown faster than output for all periods except between the two world wars, the gap has been larger in the 1990s than in any earlier period since the mid-nineteenth century (Anderson 2001, Table 1). According to Maddison (2001, p. 363) merchandise exports as a share of global GDP was only 1 per cent in 1820 and less than 5 per cent in 1870; but it was above 10 per cent by 1973 and 17 per cent in 1998. When merchandise exports are expressed as a share of just merchandise value added, the increase has been even more dramatic over the past four decades: from 10 to 47 per cent for the United States, from 34 to 64 per cent for the United Kingdom, from 17 to 65 per cent for France, and from 25 to 64 per cent for Germany, for example (Bourguignon et al. 2002, p. 23).

As well, annual outflows of foreign direct investment grew more than six-fold between 1983 and 1990, and continued to grow more than twice as fast as goods trade in the 1990s. Intra-firm trade among multinational corporations (MNCs) is estimated to account for one-third of world trade, and another one-third is MNC trade with non-affiliates.

During the 1990s foreign portfolio investment grew even faster than foreign direct investment. Between 1991 and 1999, the annual value of cross-border mergers and acquisitions grew from $100 billion to more than $700 billion, or from 0.5 to 2.5 per cent of global GDP (UNCTAD 2000, p. 10). The stock of foreign assets rose to the equivalent to 18 per cent of global GDP by the early 1900s (double that of 1870). It took until 1980 to reach that level again, but since then that indicator has risen to 60 per cent of global GDP.

As a result of growth in both foreign investment flows and cross-border short-term bank lending, daily foreign exchange transactions now exceed global currency reserves, with international capital flows more than 50 times the value of international trade flows.

The 1990s also saw an explosion in the world's capacity for electronic commerce: a doubling in the number of telephone lines, a 25-fold increase in the number of cellular phones, a quadrupling in the number of personal computers, and an expectation that by now more than two-thirds of those PCs have internet access (WTO 1998b, p. 8).

The only dimension of globalization that is smaller now than in the 19th century is people movement. Then more than 5 per cent of the population of numerous European countries emigrated to the New World every decade, compared with very little today (Baldwin and Martin 1999).

Technological contributions to globalization

There have been three technological revolutions in transport and communication costs in modern times that have contributed substantially to globalization.[2] The cost of transporting goods was lowered enormously in the 19th

[2] There is much debate among historians as to how important earlier waves of globalization were. O'Rourke and Williamson (2002) believe Adam Smith's view, that the discovery of the Americas by Columbus in 1492 and the success of Vasco da Gama in reaching South Asia via Southern Africa in 1498 were the two most important events in recorded history, is no longer correct. They support their argument by showing that relative product prices and relative factor prices were closely tied to relative factor endowments prior to the 19th century, but were more independent thereafter. Heckscher-Ohlin trade theory (in which factor prices tend to move with product prices in the absence of complete specialization) would suggest that means international economic integration was greater in the latter

century be the advent of the steam engine, which led to the railway and steamship. Steel hulls for ships and refrigeration further lowered the real cost of ocean transport late last century, particularly for perishable goods. The telegraph helped too (O'Rouke and Williamson 1999).

The second technological revolution lowered hugely also the cost of moving people. It was dominated, in the middle half of the 20th century, by the falling cost of transport by car and aeroplane thanks to mass production of such goods and associated services. Ocean freight rates (helped by containerization) and telephone charges also fell massively over this period.[3]

The third and current revolution in transport and communications technology, beginning near the end of the 20th century, is digital. Aided by deregulation of telecom markets in many countries, it is lowering enormously long-distance communication costs and especially the cost of rapidly accessing and processing knowledge, information and ideas from anywhere in the world. Science has been among the beneficiaries of the digital revolution, spawning yet another revolution, namely in biotechnology.

A side-effect of the Internet's expansion is the growth in the use of the English language. It has been claimed that there are now more people using English as a second language than there are people for whom it is a first language (Cairncross 2001). This too is lowering costs of communicating between countries.

Governmental contributions to globalization

The above developments have been reinforced by government decisions to liberalize goods and services trade and currency and investment regimes, to better assign and enforce property rights, and to free up domestic markets.

Following the protectionist inter-war period, market liberalization began with the lowering of import tariffs on trade in manufactures between industrial economies. Within Western Europe that trade was especially liberal following the Treaty of Rome and the formation of the European Free Trade Area. In the 1980s trade reform was followed by extensive liberalizations of foreign exchange markets and of restrictions on financial capital flows, leading (with the help of new digital technologies) to the development of new varieties of internationally tradable financial security instruments. At the same time many non-OECD countries – including China, the Soviet bloc and Indo-China -- began moving away from inward-looking to outward-oriented trade and investment policies. The 1980s also saw the deregulation of domestic markets in a growing number of countries, which reinforced the effects of deregulating transactions at national borders. The pace of reform has continued unabated into the new century (Lawrence 2001).

These reforms benefit most the countries making them, but they also tend to benefit their trading partners.[4] Hence the more countries open up and reform, the greater is the gain to other countries from doing likewise. In particular, they expand the opportunities for developing and transition economies to access goods and

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period.

[3] Hufbauer (1991). Transport costs can be crudely captured by the extent to which the c.i.f. import price exceeds the f.o.b. export price for a product. For United States merchandise trade, that mark-up has fallen from 9.5 per cent in the 1950s to 6 per cent in the 1990s (Frankel 1997).

[4] Even those that might lose in the short term from an adverse terms of trade change are in the long term likely to benefit from the faster economic growth and greater openness of the reforming countries.

services markets, investment funds, and technologies, thereby raising the pay-off to those economies from joining the band-wagon of liberalization. Those that have already done so have grown much faster than the rest, and have seen their incomes converge toward OECD income levels.[5] The reasons for faster growth of more open economies have to do with the dynamics of trade liberalization, something which is not just an abstract idea from new trade and growth theory (Grossman and Helpman 1991; Taylor 1999) but one that is well supported empirically (USITC 1997).

Yet greater openness can carry some risks, especially if appropriate domestic policies and institutions are not in place. Past examples of inadequate policies include prudential regulations of the financial sector, distortions to domestic factor markets, insufficient environmental measures and social safety nets, and poorly defined property rights. There is also a risk that the market-opening reforms of the post-war period and especially the past fifteen years could be reversed by governments as domestic political circumstances change. As explained in the next section, during the past 50 years that risk has been contained by the GATT and, since 1995, its successor the WTO. But, as shown by the events in Seattle in late 1999 and in subsequent summits of the world's economic leaders, that risk is certainly not eliminated.

Together with the above-mentioned technological revolutions, these policy reforms have brought about a more-integrated global trading system, a much more-integrated global capital market, and more integrated firms as international transactions that formerly took place between independent entities are being internalized within single multinational firms or corporate alliances. The increasing mobility of the productive assets of firms enables them to minimize their corporate income tax exposure by strategically locating their headquarters and using transfer pricing in their intra-firm international trade. It also encourages governments to compete for the presence of firms, via regulatory reforms, lower tax rates, and other investment incentives (including, particularly in developing countries, restraints on the adoption or enforcement of higher environmental and labour standards). Some would say this could leave governments with less tax revenue to supply social policies at a time when the demand for such policies is rising with income growth and with disruptions in the market for low-skilled labour. If the regulatory reform is growth-enhancing and includes the privatization of state-owned enterprises, on the other hand, optimists would say government revenue could expand.

Not all growth-enhancing government policy changes have involved a reduction in government activity. Some of the most successful knowledge-based regional developments in OECD countries in the past quarter-century have benefited from local government support (Audretsch 2002). The support has come in the form of encouraging an entrepreneurial climate that promotes the production and commercialization of knowledge in the locale. Its justification is that knowledge spillovers are such that the productivity of an entrepreneurial firm is greater in the presence of similarly entrepreneurial firms nearby, yet individual firms cannot reap the benefits of creating a cluster. Hence the value of local government support for R&D, the provision of venture capital, and/or tax breaks for new firms starting up in that locale and thereby contributing to an entrepreneurial cluster.

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[5] See, for example, Dollar (1992), Edwards (1998), Sachs and Warner (1995) and, for a bibliography, WTO (1998a, pp. 62-63).

Implications for the location and composition of production

These technological and governmental revolutions have contributed increasingly to the drift towards urbanization. The first revolution helped launch the industrial revolution in Western Europe, but partly by lowering the cost of exploiting natural resources abroad which allowed primary sectors in less-densely populated and tropical countries to expand also. The second revolution accelerated industrialization in the West and its spread to the Far East including via what Vernon (1966) described as the product cycle. The third and current revolution is increasing the scope to subdivide the processes of production and distribution into parts that can be relocated anywhere in the world according to ever-increasing changes in comparative advantages over time (Jones and Kierzkowski 1997; Feenstra 1998; Arndt and Kierzkowski 2001). That can be via various means including sub-contracting, licencing, joint ventures, and direct foreign investment by multinational corporations (Markusen et al. 1996). The more foreign investment is the facilitator of this fragmentation of production phenomenon, the more important it will be to include investment liberalization in international trade negotiations aimed at mazimizing the gains from economic integration (Arndt 2002).

As well, methods of industrial production are altering dramatically. Specialized, single-purpose equipment for mass production is being supplemented or replaced by flexible machine tools and programmable multi-task production equipment. Because this type of machinery can be quickly and cheaply switched from one task to another, its use permits the firm to produce a variety of products efficiently in small batches (Milgrom and Roberts 1990).

The resulting productivity growth in industrial and service sectors is altering the key source of wealth of nations, which is moving ever-faster away from natural to human capital (that is, from raw materials and physical capital per worker to human skills and knowledge). In particular, wealth creation in the 21st century will depend especially on the ability to access and make productive use of the expanding stocks of knowledge and information, and to build on them through creative research and development to design highly flexible production methods (World Bank 1998). How well and how quickly people of different regions are able to do that will increasingly determine relative economic growth rates. But for all countries the extent and speed with which economic events abroad are transmitted to domestic markets will increase inexorably – and governments will have less and less capacity to isolate their economies from such trends, as financial derivatives and electronic commerce have made clear in the cases of international financial flows and a widening range of traded goods and services (WTO 1998b).

Geography also matters. An aspect stressed in new trade theory is the importance of agglomeration for lowering costs of production. For whatever historical reason, suppose an industry starts in a particular region. Then when another industry wishes to start, it looks for a location that among other things will economize on transport costs. Hence it locates where domestic demand is large, and that is where the first industry started because of the workers it attracted. If one industry is supplying inputs to another, that transport cost gain is especially obvious. Similarly skilled workers also may be needed in the two industries, so co-locating attracts a larger pool of such people to draw from. And there may be some learning that spills over from one to the other industry. These have been described as ‘centripetal forces’ that cause agglomeration of activities around a ‘core’. Industrial activity so congregated makes it

such a low-cost producing centre that the 'periphery' finds it difficult to compete except in primary products. Hence both within and between countries there is this tendency for concentration of industrial (and increasingly many service) activities in large urban centres.

That economic geography theory of optimal location of production grew naturally from Krugman's work on the importance of scale economies (Krugman 1991). The three sets of centripetal forces involved are market size effects (linkages), thick labour markets, and pure external economies. Hence it is not just low wages that are going to attract foreign (and domestic) investment. On the contrary, some skilled labour and the presence of other firms in the same business generating relevant know-how also can be important explanators of where firms locate, as can stable domestic politics. That is why such countries as Singapore are more attractive to investors than many lower-wage countries.

More recently, Krugman (1999) has stressed that there are also some offsetting 'centifugal forces' that need to be taken into account. Three he stresses are land rents (e.g., space is more expensive to rent in London than Edinburgh), immobile factors (e.g., the right soils and climate for growing premium winegrapes cannot be re-located), and pure external diseconomies (e.g., pollution and congestion in large urban centres). The events of 11 September 2001 add to that list. Hence there will be some industries that can thrive in the so-called periphery because the 'centifugal forces' more than outweigh the 'centripetal forces'. Among them would be industries whose products are cheap to transport relative to their value. In so far as Singapore is 'peripheral' relative to the big markets near the shores of the North Atlantic, then its comparative advantage in producing such products may grow.

International flows of various forms of produced capital also alter an economy's comparative advantage (as can international migration of labour, but that is relatively much less important currently). A survey by Shatz and Venables (2000) provides a useful summary of evidence of its patterns. The authors point out that multinationals have become increasingly important to the world economy, with overseas production by U.S. affiliates now three times U.S. exports, for example. Much foreign direct investment is between high-income countries, but FDI in some developing and transition regions also grew rapidly in the 1990s. Adjusting for market size, much investment stays close to the home country, while adjusting for distance, much heads toward countries with the biggest markets. As a result, FDI is more geographically concentrated than exports. Thus U.S. affiliate production in Europe is 7 times U.S. exports to Europe; but that ratio drops to 4 for all industrial countries and to 1.6 for developing countries.

Shatz and Venables also point out that multinational activity in high-income countries is overwhelmingly "horizontal", involving production for sale to the host country market of products for which being close to the market matters a lot (e.g., beer and soft beverages that are relatively expensive to transport). In developing countries, a greater proportion of multinational activity is "vertical", involving manufacturing at intermediate stages of production. Thus only 4 per cent of U.S. affiliate production in the European Union is sold back to the United States, whereas for developing countries the figure is 18 per cent, rising to 40 per cent for Mexico. Similarly, less than 10 per cent of Japan's affiliate production in the EU is sold back to Japan, compared with more than 20 per cent in developing countries.

In models of horizontal activity, the decision to go multinational is a tradeoff between the additional fixed costs involved in setting up a new plant and the savings

in transport costs (infinite in the case of nontradable services) and taxes on trade. In models of vertical activity, direct investment is motivated by differences in factor costs – differences that are magnified by import tariffs and transport costs.

The major outward investors carry out much of their horizontal investment in large markets, where the fixed cost of establishing a new plant can be spread over a large volume of sales. For U.S. investors, this means Europe, especially the United Kingdom; for Japan and Europe, it means the United States. Most EU investments, however, stay within the EU. The major outward investors carry out much of their vertical investment closer to home: the United States, in Mexico; the EU, in Central and Eastern Europe; and Japan, in Asia. In the case of overseas Chinese, closeness in a cultural sense means much of their FDI is flowing to mainland China as the PRC becomes more receptive to such flows.[6]

Implications for concentration and competitiveness of production

The rash of domestic and cross-border mergers and acquisitions in recent years certainly has concentrated production in some industries, including high-profile ones such as software and biotechnology where R&D is an important cost and intellectual property an important asset. In the case of biotechnology firms, mergers/takeovers have been both horizontal (e.g., bringing together medical and agricultural applications) and vertical (e.g., bringing together seeds and complementary products such as herbicides). Also, rival innovative firms frequently seek to reduce risk by coordinating their innovative activity through means such as research joint ventures, innovation trading and licencing of proprietary technology (Baumol 2002, Chs. 6 and 7). Certainly there are economic risks associated with such concentration, as Harhoff, Regibeau and Rockett (2001) make clear in the case of genetically modified food. But there are also enormous opportunities that need not be confined to the largest economies. Singapore is actively seeking some of those in the case of biotechnology. Also, the share of global production held by the (say) four biggest firms within a sector varies enormously across sectors. Within beverages in the late 1990s, for example, that share for soft drinks was 78 per cent, compared with 42 per cent for spirits, 35 per cent for beer, and just 6 per cent for wine (Anderson, Norman and Wittwer 2001). And small countries feature in those lists (e.g., Holland in the case of beer and Australia in the case of premium wine).

Does it follow that greater concentration means less competition? Not necessarily. For a start, the growing importance of product differentiation means that as consumer demand for variety grows with per capita income, monopolistic competition will increase even in sectors where there are many firms. But more importantly, both theory and the EC single-market experience suggest that while the total number of firms in the world as a whole may decrease, and their size increase, the number supplying each country and the intensity of competition in each market tends to increase with greater international economic integration (Krugman 1980, Smith and Venables 1988). In any case, even if more monopolistic behaviour were to result, it is not *necessarily* a bad thing: the lower cost structure of a natural monopolist in a contestable market could deliver a lower consumer price even if the firm restricts

[6] The familiarity and transport and communication cost reasons for this ‘closeness to home’ investing magnifies the gains from the international fragmentation of production that occur following the reduction in tariffs in regional integration agreements.

supply so as to keep that price above marginal cost.

The GATT/WTO's contribution to globalization

History shows that the risk of market-opening being reversed is much more likely in the absence than in the presence of international constraints on national trade policy actions. For example, the Cobden-Chevalier Treaty of 1860, between England and France, contained a most-favoured-nation (MFN) clause. This required that the agreed cut in the tariff on each item in their bilateral trade was to be applied also to their imports from other countries. It also meant that every European country that subsequently signed a trade treaty with either England or France (and most did by 1867) signed onto MFN. The effect was a network of treaties that lowered hugely the level of tariff protection in Europe (Kindleberger 1975), allowing world output and trade to boom for several decades until the First World War intervened.

Following that war, efforts to restore liberal trade centred on international conferences but did not lead to renewed trade treaties with binding commitments to openness based on MFN. Then when recession hit in the late 1920s, governments responded with beggar-my-neighbour protectionist trade policies that drove the world economy into depression. The volume of world trade shrunk by one-quarter between 1929 and 1932, and its value fell by 40 per cent. The first attempts to reverse that protection were discriminatory, as with the Ottawa Conference of 1932 that led to preferential tariffs on trade among members of the British Commonwealth.

Out of the inter-war experience came the conviction that liberal world trade required a set of rules and binding commitments based on non-discriminatory principles. While there was not enough agreement to create an international trade organization, at least a General Agreement on Tariffs and Trade was signed by 23 large trading countries in 1947. The GATT provided not only a set of multilateral rules and disciplines but also a forum to negotiate tariff reductions and rules changes, plus a mechanism to help settle trade disputes. Eight so-called rounds of negotiations took place in the subsequent 46 years, the last one (the Uruguay Round) culminating in the 'interim' GATT Secretariat being converted into the World Trade Organization in January 1995.

The GATT, and now even more so the WTO, contributes to globalization in several crucial ways. The WTO has four key objectives: to set and enforce rules for international trade, to provide a forum to negotiate and monitor trade liberalization, to improve policy transparency, and to resolve trade disputes. Apart from the transparency role, these were also the key objectives of its predecessor before the WTO came into being. However, the WTO is much more comprehensive than the GATT. For example, GATT's product coverage in practice was confined mainly to manufactures (effectively not including textiles and clothing), whereas the WTO encompasses all goods (including sensitive farm products), services, capital to some extent, and ideas (intellectual property). As well, following the conclusion of the Uruguay Round negotiations, the interim GATT Secretariat was converted to a permanent WTO Secretariat with greatly strengthened trade policy review and dispute settlement mechanisms. It has also taken on two new roles: cooperating with the IMF and World Bank with a view to achieving greater coherence in global economic policy making, and facilitating the integration of developing countries into the global trading system.

GATT/WTO rules to govern international trade serve at least three purposes. First, they protect the welfare of small and weak nations against discriminatory trade policy actions of large and powerful nations. GATT Articles I (most-favoured-nation) and III (national treatment) promise that all WTO members will be given the same conditions of access to a particular country's market as the most favoured member, and all foreign suppliers will be treated the same as domestic suppliers. These fairness rules are fundamental to instilling confidence in the world trading system. In particular, they lower the risks that are associated with a nation's producers and consumers becoming more interdependent with foreigners -- risks that otherwise could be used by a country as an excuse for not fully opening its borders.

Second, large economies have the potential to exploit their monopoly power by taxing their trade, but we know from trade theory that the rest of the world and the world as a whole are made worse off by such trade taxes. Thus while each large economy might be tempted to impose trade taxes, the effect of lots of them doing so simultaneously may well be to leave most if not all of them worse off -- not to mention the welfare reductions that would result in many smaller countries. Hence the value of agreeing not to raise trade barriers and instead to 'bind' them in a tariff schedule at specified ceiling levels. This rule is embodied in GATT Article II, whereby WTO members are expected to limit trade only with tariffs and are obligated to continue to provide market access never less favourable than that agreed to in their tariff schedules. Again, the greater certainty which this tariff-binding rule brings to the international trading system adds to the preparedness of countries to become more interdependent and of business people to invest more.

The third and perhaps most important contribution of multilateral rules disciplining trade policy is that they can help governments ward off domestic interest groups seeking special favours. This comes about partly via Article II, which outlaws the raising of bound tariffs, as well as via numerous other articles aimed at ensuring that non-tariff measures are not used as substitutes for tariffs. This benefit of the system is sometimes referred to as the 'Ullyses effect': it helps prevent governments from being tempted to 'sin', in this case to favour special interest group at the expense of the rest of their economy.[7]

While no-one would argue that the GATT rules have been applied without exception, the fact that they are there ensures the worst excesses are avoided. They therefore bring greater certainty and predictability to international markets, enhancing economic welfare in and reducing political tensions between nations. More than that, by promoting interdependence the GATT/WTO indirectly has raised the price and hence reduced the likelihood of going to war.

But why do countries need the WTO to negotiate freer trade? One of the clearest lessons from trade theory is that an economy unable to influence its international terms of trade cannot maximize its national income and economic growth without allowing free trade in all goods and services. Consumers lose directly from the higher domestic prices of importables, while exporters lose indirectly

[7] Petersmann (1991, p. 83) goes so far as to say that "the primary regulatory function of the GATT .... [is] the welfare-increasing resolution of *domestic* conflicts of interest *within* GATT member countries among individual producers, importers, exporters and consumers ." Similarly, Roessler (1985, p. 298) claims that "the principal function of the GATT as a system of rules is to resolve conflicts of interest within, not among, countries. The function of the GATT as a negotiating forum is to enable countries to defend the national interest not against the national interests of other countries but against sectional interests within their own and other countries."

because import barriers cause the nation's currency to appreciate (there is less demand for foreign currency from importers) and raise the price of labour and other mobile resources. More-open economies also grow faster. Why, then, do countries restrict their trade, and why do they need to get together to agree to liberalize those protectionist trade regimes multilaterally, when it is in their national economic interests to do so unilaterally?

Numerous reasons have been suggested as to why a country imposes trade barriers in the first place, but almost all of them are found wanting (Corden 1997). The most compelling explanation is a political economy one. It has to do with the national income re-distributive feature of trade policies: the gains are concentrated in the hands of a few who are prepared to support politicians who favour protection, while the losses are sufficiently small per consumer and export firm and are distributed sufficiently widely as to make it not worthwhile for those losers to get together to provide a counter-lobby, particularly given their greater free-rider problem in acting collectively (Hillman 1989, Grossman and Helpman 1994, Anderson 1995). Thus the observed pattern of protection in a country at a point in time may well be an equilibrium outcome in a national political market for policy intervention.

That political equilibrium in two or more countries might, however, be able to be altered for the better through an exchange of product market access. If country A allows more imports it may well harm its import-competing producers if there are no compensation mechanisms; but if this liberalization is done in return for country A's trading partners lowering their barriers to A's exports, the producers of those exports will enjoy this additional benefit. The latter extra benefit may be sufficiently greater than the loss to A's import-competing producers that A's liberalizing politicians too become net gainers in terms of electoral support. Likewise, politicians in the countries trading with A may well be able to gain from this trade in market access, for equal and opposite reasons. Thus a new opportunity for trade negotiations can stimulate trade liberalization by altering the incentives to lobby politicians and thereby the political equilibrium in trading nations.[8]

Such gains from trade negotiations involving exchange of market access will tend to be greater nationally and globally, the larger the number of countries involved and the broader the product and issues coverage of the negotiations. Hence the wisdom in negotiating multilaterally with more than 100 countries over a wide range of sectors and issues, as in the Uruguay Round, despite the process being cumbersome. Now that there is so much more product coverage under the WTO than under the GATT, and the number and extent of participation by developing country members keeps growing, the scope for exchange of market access has increased dramatically. That is especially true for exchanges between more- and less-developed economies, now that agriculture and textiles and clothing are back in the GATT mainstream and services and trade-related intellectual property have been added, making a wider range of intersectoral tradeoffs possible.

Implications for the policy choices of small countries

[8] Elaborations of this economists' perspective can be found in Grossman and Helpman (1995) and Hoekman and Kostecki (2001). Political scientists are beginning to take a similar view. See, for example, Goldstein (1998).

Greater openness of and interdependence between most national economies provides wonderful opportunities for small economies, even though it is not without its challenges. Globalization is raising the rewards to economies choosing good economic governance, *but is also raising the cost to economies with poor economic governance.* Just as financial capital can now flow into a well-managed economy more easily and quickly than ever before, so it can equally quickly be withdrawn if confidence in that economy's governance is shaken – as the recent East Asian financial crisis demonstrated all too clearly. Two aspects of good economic governance in the wake of globalization are especially worth stressing: commitment to a liberal international trade and payments regime, and growth-enhancing domestic policies that are not distorting domestic product or factor markets. Together they will enable producers to take maximum advantage of prospective trade opportunities following the next WTO round of trade negotiations.

Commitment to a liberal trade and payments regime

A key to practising good economic governance is to commit to a permanently open international trade and payments regime and to provide secure property rights (intellectual as well as physical). The stability of the commitment to openness is much more crucial now than even just 15 years ago, because otherwise capital inflows and investments will be only short-term in nature -- and will be susceptible to withdrawal should confidence waver. It is for this reason, and because of the comprehensiveness of WTO agreements, that liberal trade policy commitments under the WTO are so important. They are valued by would-be investors because WTO commitments involve both legal bindings and most-favoured-nation treatment by trading partners. The legal bindings mean a WTO member cannot return to a more protectionist regime by raising tariffs above the bound rates listed in the member's Schedules of commitments (at least not without paying compensation). Nor does that member risk facing higher than MFN bound tariffs in exporting to its trading partners if they are WTO members.

The security of a stable trading environment instils a confidence in investors that is noticeably less in countries that are not WTO members. Thankfully more and more customs territories choosing to join WTO, including China and Taiwan in recent months and prospectively Russia and Vietnam before too many more years. The commitment to greater openness that WTO accession requires is increasing the prospects that acceding countries will gain more from globalization.

Growth-enhancing domestic policies that are not distorting product or factor markets

The extent to which liberalizing one's own trade and payments regime and securing greater market access opportunities for one's exports boosts a developing country's economic growth depends importantly also on the domestic policy environment. Essential are sound, predictable, and stable macroeconomic, taxation, pricing and other regulatory policies that are not sectorally biased, and policies and institutions that ensure the markets for factors are operating efficiently and are growth enhancing. Especially important are the incentives for investment in human capital: formal education to raise skill levels and other forms of social capital, a sound intellectual property regime, and R&D to boost the stock of knowledge and flow of new ideas.

For Singapore, perhaps the most important protectionist bias is towards the services sector. It is a net exporter of commercial services, with a ranking among Asian traders in 2001 of 5th for exports and 7th for imports of services. That ranking would be higher still if Singapore opened up more of its services markets (see Bhaskaran 2002, Table 5, and WTO 2000b). Trading partners currently negotiating bilateral trade agreements with Singapore (e.g., the United States and Australia) are seeking lower barriers to trade and investment in numerous services areas, including banking and telecoms. They are also seeking reforms to competition policy and to regulations concerning infrastructure. If Singapore meets those requests, the next logical step is to multilateralize those 'concessions' during the WTO's on-going Doha Development Round, to ensure any increased imports of services are from the lowest-cost source. Likewise, the challenge with regional integration agreements – such as the ASEAN Free Trade Agreement (AFTA) and the prospective China-ASEAN FTA – is to use such agreements as stepping stones rather than a stumbling blocks to freer multilateral trade and investment. Particularly for the new AFTA members whose applications to join WTO are still being negotiated (Cambodia, Laos and Vietnam), AFTA commitments provide an opportunity to liberalize with a subset of WTO trading partners. The choice of products to be liberalized and the strictness of the rules of origin will determine whether that leads to trade creation or trade diversion. Their economies, and the world as a whole, will be better off the more it is the former relative to the latter. Singapore would be a major gainer from both its own and its trading partners' liberalizations of services trade and investment, given that services already account for two-thirds of its GDP and one-quarter of its exports.

For poorer countries, Uruguay Round reforms abroad will make their agricultural and textile/clothing exports more profitable. Trade liberalization by developing countries themselves will tend to reinforce that, because many developing economies have traditionally protected heavy manufacturing industry at the expense of light manufacturing and primary production – a pro-urban, heavy-industry bias. Such economies would thereby become even more complementary with Singapore's as that bias is reduced.

What about equity and environmental sustainability?

Few would argue against the claim that world economic growth in aggregate would be strengthened by falls in transactions costs of doing business across national borders. A higher rate of growth normally translates into improved living standards and longer, healthier lives. Yet many are still skeptical about whether their small country, or their particular type of household within their country, will necessarily benefit from greater globalization.

As argued above, in terms of countries WTO rules-based trade liberalization in the past has favoured small economies more than large in proportional terms. But will that continue to be the case in the future if economies of scale combine with economies of agglomeration to give market power to mega urban centers? Chances are small economies such as Singapore will simply have to work harder to compensate for their smallness – although in Singapore's case its strategic location on major sea routes remains a major advantage as compared with, for example, the location of South Pacific island economies.

In terms of households, as and when new market opportunities in agriculture and textiles become available to developing countries under successive WTO rounds

of multilateral trade negotiations, so poorer households will tend to benefit more than richer ones. This would follow the pattern of the late nineteenth century when trade opening led to factor price convergence and hence to reduced income inequality between what are now the OECD countries (O'Rourke and Williamson 1999). The change in inequality *within* those countries diverged though: the change in the wage-rental ratio because of both merchandise trade and mass migration meant that inequality fell in Western Europe but rose in the 'New World' (Williamson 1997; Hatton and Williamson 1998).

With respect to poverty alleviation, the proportion of the world's population living in poverty certainly has fallen a lot in the past half-century (from more than half to just under a quarter living on less than US$1 a day in 1990 dollar terms), even if the absolute number of poor people is still disturbingly high at around 1.3 billion and the number on less than $2 a day is growing.[9] And the inequality in life expectancy has shrunk substantially over the past half-century. That these indicators should decline with economic growth is no surprise, since nation states are not prevented by globalization from using income redistribution policy measures.[10]

A policy reform that would have really major impacts in reducing the remaining intra- and inter-national income inequality, and in raising overall global income, is the freeing up international migration. In recent decades the flow of migrants has been only a small fraction of what it was in the nineteenth century (Hatton and Williamson 1998; Zlotnik 1999), and most rich countries are reluctant to expand their intake substantially. Yet recent empirical research by Walmsley and Winters (2002) reinforces earlier findings by Hamilton and Whalley (1984) in suggesting that fewer restrictions on international labour movements could provide huge welfare gains, particularly for unskilled workers. That is also consistent with the findings of Lindert and Williamson (2001) who conclude that international migration in the 19th century accounted for all of the wage convergence and two-thirds of the convergence in GDP per worker during that century. These empirical findings shed light on the questions posed at the end of the seminal paper by Mundell (1957), in which product trade is shown to be a perfect substitute for factor trade under certain conditions. In particular, they suggest that the remaining restrictions on product trade are still a major limitation on factor price convergence across countries. Those new results will encourage poorer developing countries to keep pressing at the Doha and subsequent WTO negotiating rounds for liberalizing at least the temporary movement of natural persons (to use the GATS terminology).

Whether environmental sustainability will improve as globalization proceeds is an empirical question that has to be answered on a case-by-case basis. But one would expect the lowering of transactions costs of doing business to be resource-saving, and similarly with trade policy reform since it allows more products to be produced in their lowest-cost locations. Recent studies of large developing countries such as India (Nugent and Sarma 2002) and Indonesia (Strutt and Anderson 2000) suggest that their own price and trade policy reforms are likely to be environmentally friendly. For small service-dominated economies such as Singapore's, the

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[9] The proportion of the world trying to survive on the equivalent of less than $1 per day was 75 per cent in 1870 and 83 per cent in 1820, while the proportion with less than $2 per day was above 90 per cent (Bourguignon et al. 2002, p. 57).

[10] Although pressure from footloose multinationals on national governments to keep corporate tax rates down may be growing with globalization, and that could reduce the capacity of those governments to redistribute income to the poor.

environmental consequences of further opening up, whether positive or negative, are likely to be minor.

Conclusion: will globalization reverse, as it did during 1914 to 1945?

The trek back to globalization since World War II is by no means complete, especially in the case of the movement of labour internationally. Nonetheless, the world has moved a long way from the reversal back to begger-thy-neighbour policies of the inter-war period. During the past few years there has emerged a new wave of anti-globalization forces, however, that begs the question: could globalization be reversed again? The nineteenth century reversal has been attributed to three key factors: cheaper grain from the New World in Europe which threatened to lower land rents, European mass migration to the New World which threatened to lower wages, and competition from European manufacturers which threatened the New World's fledgling industrial firms (Bourguignon et al. 2002, p. 31). Clearly, distributional effects of globalization can be the seeds of its own undermining.

While it is not possible to be definitive, the likelihood of the current globalization wave reversing seems remote for several reasons:

- While anti-globalization forces have increasing potential to be disruptive at economic leaders meetings (ironically *because* of globalization elements such as the internet, email, and the falling price of travel services), they are far from unified in their causes and they have few viable alternative policy proposals;
- The floating of exchange rates has reduced the risk of widespread financial instability of the sort experienced in the 1930s (as evidenced by the relatively minor ripple effects of recent financial crises such as in Mexico, East Asia and Argentina, and contrary to the claims of anti-globalization groups);
- The deepening of international markets for goods and services as the share of GDP traded rises globally is gradually reducing fluctuations in those products' prices;
- The rise of multinational corporations (MNCs) has increased the political pressure for liberal trade policies (the exception being sectors in which MNCs are minor players, such as agriculture and apparel);
- So too has the growth in importance of international institutions such as the IMF, World Bank and WTO; and
- There are no remaining insular blocs such as COMECON to absorb nations seeking refuge from globalization forces.

Having said that, at least three major challenges remain. First, reducing intra-national and global inequality and poverty is paramount for achieving and maintaining the peace and security on which economic growth and openness thrive. That requires better domestic policies, including adequate local and national social safety nets (e.g., education and training subsidies) to assist those bearing disproportionately high shares of the costs of adjustment to globalization forces.

Second, better stewardship of the world's natural resources and environment is required for that growth to be sustainable in the long run. Given the growing importance of international environmental externalities, this may well require the

development of a World Environment Organization of the sort proposed by Whalley and Zissimos (2002). Progress on this and the inequality/poverty fronts not only would be of value in their own right but also would appease many of the more reasonable anti-globalization protestors, leaving only those without a viable alternative policy agenda on the streets.

Finally, governments still have to convince many of their constituents that openness and domestic market reforms are desirable. A recent survey of 24 OECD and Eastern European countries (O'Rourke and Sinnott 2001) found that in every country in the sample respondents on average favoured lowering the inflow of migrants, while in every country except two (Netherlands and Japan) respondents on average favoured limiting imports "to protect the national economy". Until that skepticism about the benefits of globalization is reduced through awareness campaigns and the like, popular opinion will remain an obstacle to reducing the remaining barriers to international economic integration and reaping the rewards from openness which in turn require well-functioning domestic markets and institutions.

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