

Michael C. Webb

I Introduction

The globalization of financial markets, begun with the emergence of the Euromarkets in the 1960s, accelerated during the 1980s and 1990s. Short-term financial capital now moves with great speed across national borders among the advanced capitalist countries (ACCs) and increasing numbers of so-called emerging market economies (EMEs). These flows generate international economic instability and pose serious problems for traditional tools of national economic policy, as well as for the achievement of broader political goals such as democratic accountability and government legitimacy. As cross-border economic links have grown, international cooperation has been widely seen as a mechanism for responding to these problems. This chapter examines the response of the Group of Seven (G7) to the macroeconomic policy problems associated with financial globalization, assessing the character and effectiveness of G7 policy coordination and the implications of G7 action for the broader political goals of liberal and social democracy.

Broadly speaking, political action is essential both for promoting the growth of international markets and for coping with negative consequences of that growth, especially regarding social equity and stability. Paradoxically, the state is both a primary agent encouraging international market growth and the key institution that citizens look to for protection from the problems created by unfettered market growth. This analysis draws inspiration from Karl Polanyi's idea of the double movement governing the dynamics of modern society — the combination of a tendency towards the expansion of self-regulating markets and a countertendency towards greater intervention in markets for the self-protection of society.¹ With the emergence of active international financial markets, the dual functions of market governance at the domestic level are increasingly being supplemented (some would argue supplanted) by governance arrangements at the international level. In particular, coping with the negative consequences of international market growth without reversing international economic liberalization almost inevitably involves some element of international policy coordination.

This trend has been apparent for many decades, though pressures for stronger international governance have intensified with recent trends towards economic globalization, particularly in the area of finance. Postwar international trade and monetary regimes were designed to promote a kind of international liberalization that was embedded in a prior concern for domestic economic and social stability — what John Ruggie called “embedded liberalism”.² The Bretton Woods system sought to promote markets internationally (markets for trade and investment, though not financial capital) while preserving governmental capacity for the self-protection of societies at the national level. It did so by matching trade liberalization with measures to shelter national macroeconomic stabilization policies from international market pressures. These measures included capital controls,³ balance of payments lending through the

IMF, and coordinated intervention in foreign exchange markets to maintain fixed exchange rates in the face of differences in macroeconomic policies in different countries.⁴

The growth of international capital mobility undermined the Bretton Woods compromise. International capital markets now react very quickly to differences in macroeconomic policies between countries, and especially to monetary policies. For example, a loosening of monetary policy in one country would cause an immediate capital outflow, as investors search for higher interest rates and lower inflation abroad. This would trigger an immediate depreciation of the national currency, a problem that is exacerbated by the tendency of foreign exchange markets to “overshoot” appropriate levels. Open financial markets also can impart a deflationary bias to all countries’ macroeconomic policies. If each central bank sets interest rates independently, those that set interest rates at relatively low levels will experience capital flight and currency depreciation. These may force them to raise interest rates to defend the currency, regardless of whether higher interest rates are appropriate in light of domestic conditions. The result can be to force interest rates in all countries up to the level of the country most determined to fight inflation, slowing growth and raising unemployment for all. The risk of capital flight can also force governments to pursue restrictive fiscal policies even in the face of weak domestic demand and high unemployment. Finally, international capital mobility can create or exacerbate international financial crises, as investors’ herd instincts drive excessive capital flows both into and out of particular countries or regions.

The G7 has responded to the problems created by international capital mobility primarily by supporting the expansion and efficient functioning of international financial markets. Ideological convergence around orthodox norms for macroeconomic policy has been matched by convergence in economic performance around low inflation rates and shrinking budget deficits. The annual rate of consumer price inflation in the G7 countries has fallen from 5.5 percent in the 1980s to 2.7 percent in the 1990s. Fiscal deficits also shrank, from an average of 2.9 percent of GDP in 1981-91 and 3.4 percent in 1992-95, to only 1.4 percent in 1997-98.⁵ This indicates a sharp tightening of fiscal policy in the face of lingering recession and high unemployment in most G7 countries.

But these orthodox indicators of economic health were accompanied by serious economic instability and poor performance in terms of economic growth, living standards and economic equality. The freeing of international markets has been accompanied by dramatic exchange rate movements, including the exchange rate crises in the EU in 1992-93 and the ongoing gyrations of the dollar-yen and dollar-mark relationships (for example, the yen rose to 84 to the dollar in 1995, only to fall to 147 to the dollar in 1998, a decline of 43 percent in the dollar purchasing power of the yen).⁶ The average annual GDP growth rate among the G7 countries fell from 2.7 percent in the 1980s to 2.1 percent in the 1990s, and from 2.1 percent to only 1.4 percent when measured on a per capita basis. Unemployment remained high through both decades (6.9 percent in the 1980s and 6.8 percent in the 1990s).⁷ The rapid growth of international markets has also been associated with widening economic disparities across and within countries. The share of the world’s income accruing to the wealthiest 20 percent of its population rose from 70 percent in

1960, to 76 percent in 1980, and to 86 percent in 1994, while the share accruing to the poorest 20 percent fell over the same years from 2.3 percent, to 1.7 percent, to only 1.1 percent.⁸ There is growing evidence within the ACCs of a widening gap between skilled workers who benefit from globalization and less-skilled workers who face long-term unemployment and declining real wages.

Various possibilities for G7 cooperation to ensure that the benefits of international trade and investment flow are distributed more widely have been proposed and considered. All involve some reassertion of political authority over markets. Macroeconomic policy coordination could reduce international payments imbalances and international economic instability, and in more ambitious forms could tackle slow growth and high unemployment through a coordinated pro-growth strategy — sometimes called global Keynesianism. Alternatively, the G7 could cooperate to restore national macroeconomic policy-making autonomy, either by creating a more stable exchange rate system or by reestablishing government controls over destabilizing foreign exchange speculation. As we shall see, the G7 has generally rejected these forms of political management in favour of further market liberalization, macroeconomic orthodoxy, and reforms to enhance international financial transparency. Ideology, the sheer technical difficulty of effective action in the face of open international capital markets, and traditional political differences have all contributed to this unbalanced approach to political management of the global economy.

But international policy coordination is not just a technical exercise for promoting international adjustment; it is also central to the resolution of broader political questions. The development of a more globally-integrated economy has undermined the ways the problems of governmental legitimacy and democratic accountability were addressed domestically by individual ACCs, and has posed them as international problems that need to be addressed at a level above that of the sovereign state. Liberal democratic theory assumed a territorial state in which there was a direct correspondence between the citizens affected by a government's decisions and the citizens who exercised democratic control over that government by virtue of the vote. Economic globalization undermines that correspondence. Governments must now be responsive to non-citizens (eg, foreign currency traders), which makes them less able to respond to the democratically-expressed preferences of their own citizens.⁹

The legitimacy of democratic capitalist governments has also rested in part on their economic performance. A key role of the capitalist state since the Great Depression has been to redistribute some of the fruits of economic development to those who do not share in the benefits distributed by the market, through such means as progressive taxation, social welfare programs, and full employment policies. Financial globalization makes it difficult for most governments to promote economic growth and reduce inequality with conventional Keynesian tools. But as Louis Pauly points out, “citizens in democratic societies continue to hold the government of their own state — alone — responsible for widening economic prosperity”.¹⁰ The inability of governments to meet these expectations undermines governmental legitimacy and contributes to the anti-government malaise affecting many ACCs in the 1990s.

I return to these arguments about democratic accountability and governmental legitimacy in the conclusions. The next two sections of this chapter examine the G7's performance in managing the global economy in the 1990s in two key areas; monetary and fiscal policy coordination, and managing exchange rates and short-term capital flows.