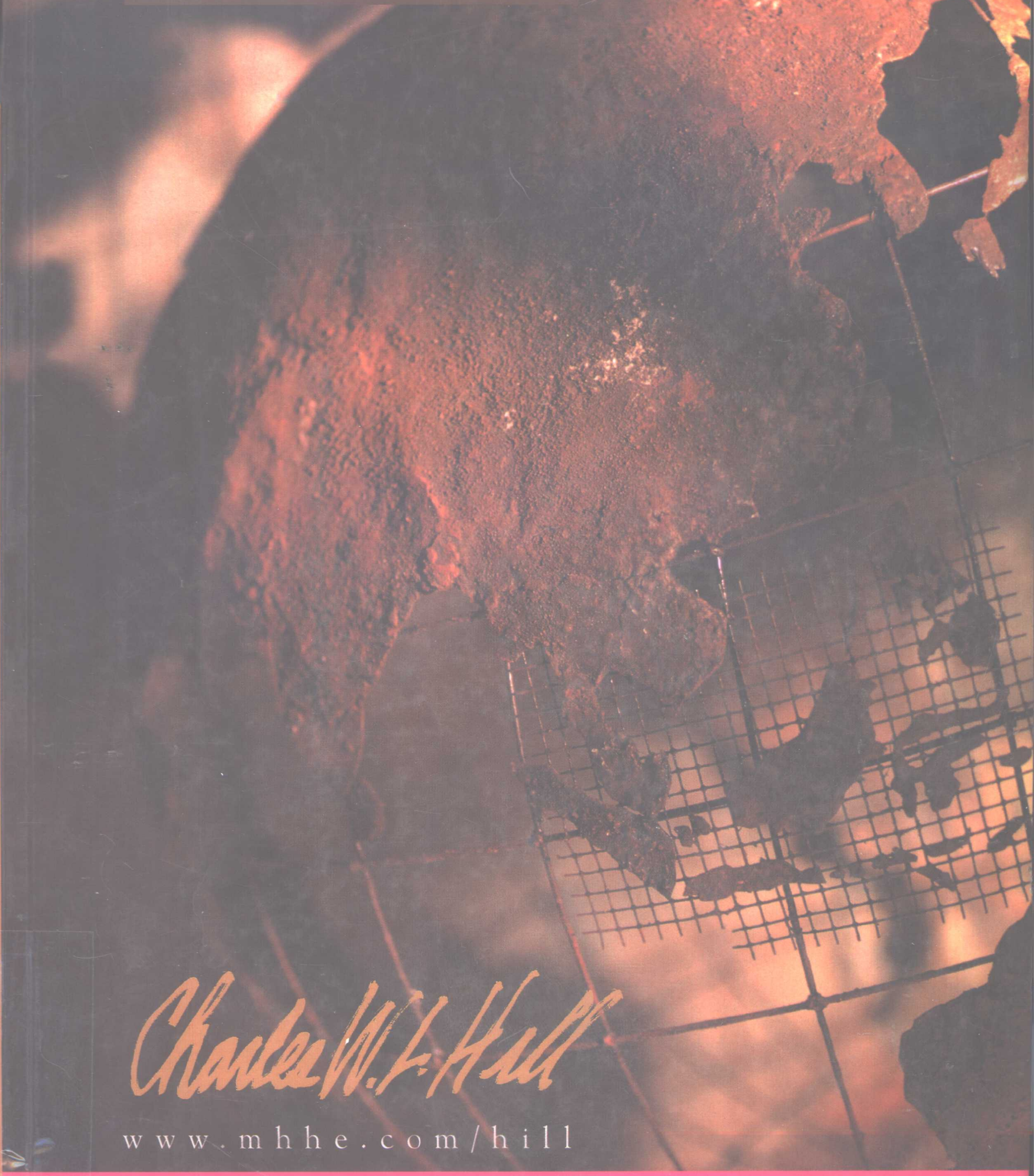
Postscript 2002



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INTERNATIONAL EDITION

INTERNATIONAL BUSINESS

Competing in the Global Marketplace: Postscript 2002

Third Edition

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Introduction

One key task of any author of an international business text is to keep the content as current as possible. This is a difficult job given that the world around us is constantly changing, often in ways that are important for the global economy and international business. In this postscript, we review some important developments that have occurred since the manuscript for this edition of the book was sent to the publisher, and we discuss the implications of these developments for international business. One development has been the continuing globalization of the world economy. A second development, which represents a countertrend to the first development, was the breakdown of the World Trade Organization meetings in Seattle in December 1999 in the face of protests from various groups opposed to globalization. A third development was the decision to allow China to enter the World Trade Organization. A fourth development was the January 1999 birth of the euro, the currency unit now used by 11 of the 15 nations of the European Union. Since January 1999, the euro has failed to live up to expectations. This postscript examines why. To mark the first year of a new millennium, the postscript closes with a review of the economic and political achievements of the 20th century and a discussion of the outlook for the early years of the 21st century.

Globalization of the World Economy

As discussed in Chapter 1, for half a century global trade has expanded much faster than global output. Between 1950 and 1999 the volume of world trade increased twentyfold, while the inflation-adjusted value of world gross domestic product (GDP) increased a little over 6.3 times. The late 1990s and the first part of 2000 were no exception to this long-term trend. In 1998 and 1999, the volume of global trade in merchandised products expanded at 5 percent a year compounded, while world GDP grew at 2 percent in 1998 and 2.5 percent in 1999.[1]

For the first nine months of 2000, the volume of world trade surged to a near record 12 percent annual growth rate. While a slowdown in the last quarter of 2000 was expected to bring the total growth in the volume of world trade to about 10 percent for all of 2000, this is still well above historic norms and far in excess of the 4.5 percent expansion estimated for 2000. There are three reasons for this particularly strong growth. First, robust economic growth in the world's largest economy, the United States, resulted in high demand in the United States for imports, which grew at an annual rate of 20 percent during the first nine months of 2000. By comparison, US exports grew at an annual rate of 14 percent over the same period. As a result, in mid-2000, the US trade deficit hit a record $400 billion, amounting to about 4.5 percent of US GDP. Second, the continuing recovery of Asian countries from the 1997–98 financial crisis fueled growth in world trade. The value of Asia's imports and exports rose at a 27 percent annual rate in the first nine months of 2000 (these figures exclude China and Japan). Third, spurred by continued rapid economic growth, the value of China's trade expanded by more than one-third in the first nine months of 2000. Japan also registered a large expansion in international trade, which increased by 23 percent over the same period.[2]

The strong continuation of the long-term growth in the volume of international trade signals that the global economy is continuing to become ever more tightly integrated. As global trade grows faster than global GDP, national economies are becoming increasingly intertwined, depending on each other for an ever-larger percentage of goods and services. As this development unfolds, globalization is accelerating; global markets and global production systems are replacing national markets and national production systems. The economic theories reviewed in Chapter 4 suggest that this development is beneficial, with greater trade translating into an increase in the efficiency of the world economy, income gains in countries involved in the global trading system, and greater global economic growth.

A similar trend toward globalization can be seen in the data on foreign direct investment (FDI) flows. According to the most recent figures from the United Nations, foreign direct investment outflows hit record levels in 1999.[3] Enterprises resident in one country invested some $860 billion in productive assets in another country. This was up from $732 billion in 1998. Provisional data suggest foreign direct investment outflows will exceed $1 trillion in 2000. In comparison, the value of foreign direct investment in 1980 was just $60 billion, and in 1990 it was $210 billion.[4]

The rapid expansion of FDI suggests two things. First, individual enterprises are increasingly building global production systems, dispersing activities to those locations in the world where they can be produced most efficiently. Second, the data imply that enterprises are entering each other's markets in an attempt to create and exploit emerging global markets for the goods and services they produce. The most recent data also suggest a sharp rise in the volume and value of cross-border mergers and acquisitions. Mergers and acquisitions, rather than building operations from the ground up, are becoming the favored mode for entering foreign markets. In 1999, for example, the value of completed cross-border mergers and acquisitions rose to $720 billion and involved about 6,000 transactions, up from $100 billion in 1987.[5]

As a result of foreign direct investment activity, there are now some 63,000 multinational companies in the world with about 700,000 foreign affiliates. Their growing importance in the world economy can be measured by their share of foreign direct investment stock in world GDP, which increased from 2 percent in 1980 to 14 percent at the start of 2000.[6]

Despite this rapid growth, recent data show that foreign direct investment remains highly concentrated, with most of the flows taking place between a limited group of nations. In 1999, 10 developed countries received 70 percent of all FDI inflows, and 10 developing nations accounted for 80 percent of all the inflows into developing nations. The usual suspects figured prominently among this select group including the United States (the largest recipient of FDI and the second largest source), the United Kingdom (the largest source), France, Germany, the Netherlands, China, and Mexico. A similar though less dramatic pattern can be seen in the trade data, where 10 countries accounted for 58 percent of the value of world trade in 1999.

In sum, both the trade and foreign direct investment data suggest that we are witnessing not so much the globalization of the world economy, but the rapid integration of the economies of a select club of developed and developing nations. The poorer nations of the world continue to be left on the sidelines in the headlong rush toward global economic integration. Africa, for example, accounted for a little over 1 percent of all FDI in 1999 and about 2 percent of all international trade flows. In a recent report, the World Bank focused on this issue, noting that one-sixth of the world's people produce 78 percent of the world's goods and services and receive 78 percent of the world's income, an average of $70 a day. In contrast, three-fifths of the world's people in the 61 poorest countries receive 6 percent of the world's income, or less than $2 a day.[7]

This continuing disparity suggests that one of the biggest challenges facing global economic institutions such as the World Trade Organization, the World Bank, the International Monetary Fund, and the United Nations is to bring the poorer nations of the world into the global economic system of the 21st century. The exclusion of the majority of the world's population from the global economic system represents an enormous waste of resources, to say nothing of the suffering implied by the continued existence of extreme poverty. If the condition of the poor does not improve, the growing division between the rich and poor nations of the world could lead to geopolitical conflicts that impinge on the economic prosperity of the developed world.

The critical question is how to engage the world's poorer nations in the global economic system. The material contained in Chapters 2, 4, 6, and 10 suggests introducing democratic political institutions, reducing corruption, protecting property rights, deregulating markets, privatizing state-owned enterprises, and liberalizing regulations governing foreign trade and foreign direct investment will all help the poorer nations of the world to raise their economic growth rates and promote engagement in the world economy. However, many in the developed and developing world disagree with this assessment. Those who hold this contrary view made their presence felt in November 1999, when they helped to derail talks sponsored by the World Trade Organization that were aimed at initiating a new round of negotiations to reduce barriers to international trade and foreign direct investment.

The World Trade Organization: Recent Developments

The World Trade Organization (WTO) is the multinational institution that polices the global trading system, resolving trade disputes between member nations (see Chapter 5 for details). The WTO also coordinates efforts to further reduce barriers to cross-border trade and investment. With 140 countries in its membership roster as of November 30, 2000, and another 29—including China, the Russian Federation, and Saudi Arabia—negotiating their membership, the WTO is at the forefront of efforts to promote global free trade. Established in 1995, the WTO replaced the General Agreement on Tariffs and Trade (GATT), which had been overseeing world trade since 1947. The experience of the past few years suggests that the policing and enforcement mechanisms of the WTO are working well. Between 1995 and late 2000, 213 trade disputes between member countries were brought to the WTO.[8] This record compares with a total of 196 cases that were handled by the GATT over almost half a century. Of the cases brought to the WTO, three-quarters had been resolved by late 2000 following informal consultations between the countries in dispute. Resolving the remainder has involved more formal dispute resolution procedures, but these have been largely successful. In general, the countries involved have adopted the WTO's recommendations. Only a handful of cases so far have yet to be resolved by the WTO.

The fact that countries are using the WTO represents an important vote of confidence in the organization's procedures. Reflecting this success, in its 1999 annual report the WTO noted:

> The state of the world trading system is generally sound . . . there were no major trade policy reversals in 1998 and 1999 and . . . there is no evidence of a return to protectionist measures. On the contrary, a number of countries have undertaken concrete measures to further liberalize their economic and trade regimes.[9]

However, the tone of this report, released in November 1999, was to sound overly optimistic given events that occurred in Seattle just a few days latter.

The World Trade Organization in Seattle

At the end of November 1999, representatives from the WTO's member states met in Seattle. The goal of the meeting was to launch a new round of talks—dubbed "the millennium round"—aimed at further reducing barriers to cross-border trade and investment. This round of talks was to be the ninth since 1947, when the forerunner of the WTO, the General Agreement on Tariffs and Trade (GATT), was established (see Chapter 5 for details). Since 1947, the GATT and then the WTO have substantially lowered barriers to cross-border trade. Under the auspices of the GATT and WTO, the average tariff rate on manufactured products imported into developed nations has fallen from over 20 percent of value in 1950 to 3.4 percent today. As barriers tumbled, the volume of international trade expanded dramatically, increasing twentyfold between 1950 and 1999. Many economists argued that this surge in trade was one of the engines of world economic growth in the second half of the 20th century. As explained in Chapter 4, free trade allows countries to specialize in the production of goods and services that they can produce most efficiently, while importing these goods and services that they produce less efficiently. By increasing the efficiency of resource utilization, economic theory predicts that free trade will boost economic growth and real incomes in all countries that participate in a free trade agreement. The experience of the last 50 years seems to bear this theory out.

Given this background, when the WTO convened in Seattle, expectations were high that after the normal amount of haggling, posturing, and last-minute brinkmanship, the talks would yield agreement on major goals for the next round of talks, which were scheduled to begin shortly thereafter. Prominent on the agenda was an attempt to get the assembled countries to agree to work toward the reduction of barriers to trade in agricultural products and trade and investment in services. These expectations were dashed on the rocks of a hard and unexpected reality. On December 3, 1999, the talks ended without any agreement being reached. Inside the meeting rooms, the problem was an inability to reach consensus on the primary goals for the next round of talks. A major stumbling block was friction between the United States and the European Union over whether to endorse the aim of ultimately eliminating subsidies to farm exporters. The United States wanted the elimination of such subsidies to be a priority. The EU, with its politically powerful farm lobby and long history of farm subsidies, was unwilling to take this step. Another stumbling block was related to efforts by the United States to write "basic labor rights" into the law of the world trading system. The United States wanted the WTO to allow governments to impose tariffs on goods imported from countries that did not abide by what the United States saw as fair labor practices. Representatives from developing nations reacted angrily to this proposal, suggesting that it was simply an attempt by the United States to find a legal way of restricting imports from poorer nations.

However, while the disputes inside the meeting rooms were acrimonious, it was events outside that captured the attention of the world press. Originally, the choice of Seattle as the host city for the WTO meetings seemed auspicious. The Seattle region was one of the export powerhouses of the United States and was home to two of the largest multinationals in the country: Boeing and Microsoft. Surely there were few cities in the world that would be more open to the idea of free trade.

The calculation went spectacularly amiss. The WTO talks proved to be a lightning rod for a diverse collection of organizations from environmentalists and human rights groups to labor unions. For various reasons, these groups are opposed to free trade. All these organizations argue that the WTO is an undemocratic institution that was usurping the national sovereignty of member states and making important decisions behind closed doors. They took advantage of the Seattle meetings to voice their opposition, which the world press duly recorded. Environmentalists express concern about the impact that free trade in agricultural products might have on the rate of global deforestation. They argue that lower tariffs on imports of lumber from developing nations will stimulate demand and accelerate the rate at which virgin forests are logged, particularly in nations such as Malaysia and Indonesia. They also point to the adverse impact that some WTO rulings have had on environmental policies. For example, the WTO recently blocked a US rule that ordered fisherman to equip shrimp nets with a device that allows endangered sea turtles to escape. The WTO found the rule discriminated against foreign importers who lacked such nets.[10] Environmentalists argued that the rule was necessary to protect the turtles from extinction.

Human rights activists see WTO rules as outlawing the ability of nations to stop imports from countries where child labor is used or working conditions are hazardous. Similarly, labor unions oppose trade laws that allow imports from low-wage countries and result in a loss of jobs in high-wage countries. They buttress their position by arguing that American workers are losing their jobs to imports from developing nations that do not have adequate labor standards.

Supporters of the WTO and free trade are quick to dismiss these concerns. They have repeatedly pointed out that the WTO exists to serve the interests of its member states, not subvert them. The WTO lacks the ability to force any member nation to take an action that it is opposed to. The WTO can allow member nations to impose retaliatory tariffs on countries that do not abide by WTO rules, but that is the limit of its power. Furthermore, the supporters argue, it is rich countries that pass strict environmental laws and laws governing labor standards, not poor ones. In their view, free trade, by raising living standards in developing nations, will be followed by the passage of such laws in these nations. Using trade regulations to try to impose such practices on developing nations, they believe, will produce a self-defeating backlash.

Many representatives from developing nations, who make up about 105 of the WTO's 140 members, also reject the position taken by environmentalists and advocates of human and labor rights. Poor countries, which depend on exports to boost their economic growth rates and climb their way out of poverty, fear that rich countries will use environmental concerns, human rights, and labor-related issues to erect barriers to the products of the developing world. They believe that attempts to incorporate language about the environment or labor standards in future trade agreements will amount to little more than trade barriers by another name.[11] If this were to occur, they argue that the effect would be to trap developing nations in a grinding cycle of poverty and debt.

However, such pro-trade arguments fell on deaf ears. As the WTO representatives gathered in Seattle, environmentalists, human rights activists, and labor unions marched in the streets. Some of the more radical elements in these organizations, together with anarchists who were philosophically opposed to "global capitalism" and "the rape of the world by multinationals," succeeded not only in shutting down the opening ceremonies of the WTO but also in sparking violence in the normally peaceful streets of Seattle. Against the wishes of the vast majority of protesters, a number of demonstrators engaged in property damage and looting. The police responded with tear gas, rubber bullets, pepper spray, and baton charges. When it was over, 600 demonstrators had been arrested, millions of dollars in property damage had been done to downtown Seattle, and the global news media had their headline: WTO talks collapse amid violent demonstrations.

The question that now must be asked is whether the events in Seattle portray an end to half a century of trade liberalization or whether they represent nothing more than a bump in the road. On the one hand, history suggests that the WTO will ultimately get the next round of talks under way. After all, the last round of global trade talks—the Uruguay Round—also took several years to initiate.

On the other hand, there is a sense that Seattle may have been a watershed. Previous trade talks had been pursued in relative obscurity with only interested economists, politicians, and businesspeople paying much attention. Seattle demonstrated, however, that the issues surrounding the global trend toward free trade have suddenly moved to center stage in the popular consciousness. The debate on the merits of free trade and globalization has become mainstream. Whether further liberalization occurs, therefore, may depend on the importance that popular opinion in countries such as the United States attaches to issues such as human rights and labor standards, job security, environmental policies, and national sovereignty.

It will also depend on the ability of free trade advocates to articulate the argument that, in the long run, free trade is the best way of promoting adequate labor standards, of providing more jobs, and of protecting the environment. Much of the media coverage surrounding the Seattle conference made it clear that the merits of free trade are not well understood, while the perceived drawbacks are easy to identify and make for good press copy. Exactly how this debate will play out remains to be seen, but given recent trends it would not be surprising if labor rights and environmental considerations played a much larger role than hitherto in the next round of global trade talks when they finally get started.

China and the World Trade Organization

China has been trying to join the WTO, and the GATT before it, for 14 years. Within China, membership in the WTO is seen as a necessary component of the country's long march toward a fully functioning market economy. Over the past 20 years the value of China's exports to the rest of the world has climbed by 15 percent per year on average, while imports have grown at an annual rate of 13 percent.[12] The growth in international trade has helped China to expand its economy at 8 percent annually for the past decade. China is now the world's seventh largest economy and with the addition of Hong Kong, its fourth largest exporter.

China's leaders believe that further gains from trade will require membership in the WTO. They understand that this will not be a painless process. Joining the WTO will require China to dismantle many trade barriers that currently protect local industry from foreign competition. They calculate that such short-term pain will be quickly outweighed by long-term gains as foreign competition forces China's producers to become more efficient and as trade with other nations expands.

Historically, one of the biggest roadblocks standing in the way of China's accession to the WTO has been the United States. The United States is China's largest trading partner, accounting for $70 billion of exports in 1999. With its large population and rapid economic growth, China also holds the promise of being a very important market for US producers. For years, however, influential political forces in the United States have opposed China's entry into the WTO on the grounds that the country has scant respect for human rights, labor standards, and intellectual property rights (China is one of the largest consumers of pirated computer software).

Despite domestic opposition, in general the Clinton administration in the United States was a supporter of greater economic engagement with China. This administration repeatedly argued that greater economic freedom in China would be followed by greater political freedom and greater respect for human rights. Accordingly, in November 1999, after a difficult series of negotiations, the Clinton administration and China signed a bilateral trade agreement. The agreement resolved a series of outstanding trade issues between the two countries and set down schedules for phasing out tariff and nontariff barriers. In return for Chinese cooperation, the United States agreed to support China's application to join the WTO. China's bid to enter the WTO was further strengthened in mid-2000, when the European Union negotiated a bilateral trade agreement with China, effectively removing EU objections to China's entry into the WTO. A further signal of US support was given in September 2000, when the US Senate voted to normalize trade relations with China. By doing so, the United States signaled its intention to stop linking trade deals with China to human rights issues. This vote, coming as it did almost a year after the protests in Seattle, seems to indicate that political consensus in the United States is still in favor of pursuing a pro-trade agenda.

With these endorsements in hand, as of late 2000 China was in the final stages of negotiating entry into the WTO. Ironically, the process is now being held up not by forces outside of China, but by forces inside the country. There is unease in China about the impact WTO membership will have on farmers and workers in inefficient enterprises, particularly those based in state-supported industries. Entry into the WTO will hurt producers in inefficient sectors, although it will be a tremendous boon to producers in more efficient sectors. Although the objections from internal forces are not trivial, it still seems likely that China will join the World Trade Organization sometime in 2001.

The Birth of the Euro

The euro, born January 1, 1999, is the common currency unit now used by 11 of the 15 nations of the European Union (EU). The 11 states are members of what is often referred to as the euro zone. For now four EU countries, Britain, Denmark, Greece, and Sweden, are still sitting on the sidelines, although there are indications that Britain and Sweden may join before 2002.

The establishment of the euro was an amazing political feat. There are few historic precedents for what the Europeans are doing. Establishing the euro required the participating national governments not only to give up their own currencies, but also to give up control over monetary policy. Governments do not routinely give up control over important economic policy instruments—sacrifice national sovereignty for the greater good—so this demonstrates the importance the Europeans attach to the euro. By adopting the euro, the EU has created the second largest currency zone in the world after that of the US dollar.

Euro notes and coins will not actually be issued until January 1, 2002. In the interim, national currencies will continue to circulate in each of the 11 countries. However, in each participating state the national currency will stand for a defined amount of euros. Notes that now look like French francs or German deutsche marks or Italian lira are mere denominations of the euro. In each participating state, banks and businesses now keep two sets of accounts, one in the local currency and one in euros. Many prices are now posted in both euros and the local currency. Increasingly, many business transactions will be conducted in euros.

After January 1, 2002, euro notes and coins will be issued and the national currencies will start to be taken out of circulation. After about six months, only euros will be in circulation, and all prices and routine economic transactions within the euro zone will be in euros. In effect, after January 1, 2002, the euro will move from being a virtual currency to a real currency.

Benefits of the Euro

There are several reasons the Europeans decided to establish a single currency in the EU. First, they believe that businesses and individuals will realize significant savings from having to handle one currency, rather than many. The savings come from lower foreign exchange costs and lower hedging costs. For example, an individual going from Germany to France will no longer have to pay a commission to a bank to change deutsche marks into francs. Instead, travelers will be able to use euros. According to the European Commission, such savings could amount to 0.5 percent of the European Union's GDP, or about $40 billion per year.

Second, and perhaps more importantly, the adoption of a common currency will make it easier to compare prices across Europe. This should increase competition because it will be much easier for consumers to shop around. The resulting increase in competitive pressures should lead to lower prices within the euro zone, resulting in substantial gains for European consumers. Third, faced with increased competition and lower prices, European producers will be forced to look for ways to reduce their production costs to maintain their profit margins. To the extent that this occurs, the introduction of a common currency, by increasing competition, should ultimately produce long-run gains in the economic efficiency of European companies.

Fourth, the introduction of a common currency should give a strong boost to the development of a highly liquid pan-European capital market. The development of such a capital market should lower the cost of capital and lead to an increase in both the level of investment and the efficiency with which investment funds are allocated. This could be especially helpful to smaller companies that have historically had difficulty borrowing money from domestic banks.

Finally, the development of a pan-European, euro-denominated capital market will increase the range of investment options open to both individuals and institutions. For example, it will now be much easier for individuals and institutions based in, let's say Holland, to invest in Italian or French companies. This will enable European investors to better diversify their risk, which again lowers the cost of capital and should also increase the efficiency with which capital resources are allocated.[13]

Drawbacks of the Euro

The main drawback of a single currency is that national authorities within the euro zone have lost control over monetary policy. The European Central Bank (ECB) now manages monetary policy within the euro zone. Its prime objective is to ensure price stability. The major tool at its disposal is its ability to set interest rates for the euro. The implied loss of national sovereignty to the ECB underlay the decision by Britain, Denmark, and Sweden to stay out of the euro zone, at least initially. In these countries, many people are highly suspicious of the ECB's ability to remain free from political pressure and to keep price inflation under tight control.

In theory, the design of the ECB should ensure that it remains free of political pressure. The ECB is modeled on the German Bundesbank, which historically has been the most independent and successful central bank in Europe. The language contained in the Maastricht treaty prohibits the ECB from taking orders from politicians. The executive board of the bank, which consists of a president, vice president, and four other members, carries out policy by issuing instructions to national central banks. The policy itself is determined by the governing council, which consists of the executive board plus the central bank governors from the 11 euro zone countries. The governing council votes on interest rate changes. Members of the executive board are appointed for eight-year nonrenewable terms, insulating them from political pressures to get reappointed. Nevertheless, the jury is still out on the issue of the ECB's independence, and it will take some time for the bank to establish its inflation-fighting credentials.

According to critics, another drawback of the euro is that the EU is not what economists would call an optimal currency area. An optimal currency area is a region where similarities in the underlying structure of economic activity make it feasible to adopt a single currency and use one exchange rate as an instrument of macroeconomic policy. Many of the European economies in the euro zone, however, are very dissimilar. For example, Finland and Portugal have very different economies. They have different wage rates and tax regimes and different business cycles, and they may react very differently to external economic shocks. A change in the euro exchange rate that helps Finland may hurt Portugal. These differences complicate macroeconomic policy. For example, when euro economies are not growing in unison, a common monetary policy may mean that interest rates are too high in depressed regions and too low in booming regions. It will be interesting to see how the EU copes with the strains caused by such divergent economic performance.

One way of dealing with such divergent effects within the euro zone might be for the EU to engage in fiscal transfers, taking money from prosperous regions and pumping it into depressed regions. Such a move, however, would open a political can of worms. It is difficult, for example, to imagine the citizens of Germany forgoing their "fair share" of EU funds to create jobs for underemployed Portuguese workers.

Reflecting on these issues, several critics believe that the euro puts the economic cart before the political horse. In their view, a single currency should follow, not precede, political union. They argue that the euro will unleash enormous pressures for tax harmonization and fiscal transfers from the center, both policies that cannot be pursued without the appropriate political structure. The most apocalyptic vision that flows from these negative views is that far from stimulating economic growth, as its advocates claim, the euro will lead to lower economic growth and higher inflation within Europe.

The Early Experience

In the first 20 months of its existence, the euro did not live up to expectations of all its supporters. In January 1999, the euro was trading at 1 euro = \$1.17. By late November of that year, the value of the euro had slumped to 1 euro = \$1. Although it recovered slightly in December, by the end of the year the euro had still lost 15 percent of its value against the US dollar and was also down significantly against the Japanese yen. The slide continued in 2000, and by fall 2000 the euro was trading at 0.88 = \$1, representing a decline against the dollar of more than 20 percent.

Critics were quick to claim that the fall in the euro demonstrated the lack of confidence the foreign exchange market has in the ability of the ECB to effectively manage monetary policy. However, there are no signs that the ECB is mismanaging monetary policy in the euro zone.[14] Inflationary pressures seem to be under control, the ECB seems to have managed interest rates with some skill, and there is no sign that the ECB is bowing to political pressure. Rather, the decline in the value of the euro can be attributed to two other factors: the growth differential and the interest rate differential between the United States and the European Union.[15]

With regard to the growth differential, while the US economy has continued to expand at a robust rate since January 1999, the EU economy showed more moderate growth. In 1999, the US economy grew at a 4.2 percent annual rate, while the EU economy grew at a slower 2.4 percent rate. A big drag on the EU economy in 1999 was Germany, the largest national economy in the euro zone, accounting for one-third of all output in the zone. Germany grew by 1.6 percent in 1999. The weakness in Germany can be partly attributed to inflexible labor markets, which have kept labor costs high and hindered the international competitiveness of German enterprises. In addition, Germany was more exposed than other EU nations to Eastern European economies. When Eastern Europe was hard hit in 1997–98, German industry suffered more than most. Although 2000 looks to have been better for Europe, with the EU nations expected to have grown by 3.5 percent over the full year, the US economy grew by an even stronger 5.2 percent. Yet again, Germany was the drag on the EU economy. Although Germany is coming to grips with its internal problems, and a recovery in Eastern Europe has helped, at 2.9 percent Germany still registered the lowest growth rate among all major EU economies in 2000.

With relatively slow growth in Europe, much of it attributable to problems in Germany, investors have been hesitant to hold euro-denominated assets, particularly when the returns to holding dollar-denominated assets, such as US stocks, have been so much greater. The healthy US economy and the long boom in the US stock market drew investment money away from Europe and into the United States. Also, the strong US economy led to a surge in foreign direct investment into the United States. Both of these factors have helped to bid up the price of the dollar relative to the euro.

The interest rate differential between the United States and the euro zone countries has exacerbated this trend. In a world where capital is internationally mobile, interest rate differentials can play a large role in explaining short-term exchange rate movements. In the United States, the Federal Reserve Board raised interest rates in 1999 and early 2000 in an attempt to slow down the rapidly expanding US economy, which was beginning to show signs of inflationary pressures. As a consequence, the differential between the long-term interest rates on dollar- and euro-denominated government bonds widened from 0.5 percent in January 1999 to 1.6 percent in August 2000. Not surprisingly, capital flowed to the United States and away from the euro zone to gain the benefits of higher US interest rates. As that occurred, the euro continued to depreciate against the dollar.

While this situation has created the impression that the euro has not been the success that was hoped for, there are some silver linings to these clouds. For one thing, the depreciation in the value of the euro against the dollar, and to a lesser extent the Japanese yen, has helped to make EU enterprises more competitive in the global marketplace. This has been translated into expanding exports and a growing surplus on the current account of the balance of payments in the euro zone (i.e., a trade surplus). According to the IMF, the current account surplus in the euro zone will amount to 0.9 percent of GDP in 2000 and is forecasted to reach 1.3 percent of GDP in 2001. In contrast, the United States has been running a current account deficit (a trade deficit) amounting to 4.2 percent of GDP in 2000 and is expected to run the same again in 2001.

There are now signs that the US economy is slowing, and the Federal Reserve Board has lowered interest rates in the United States. This reduced the interest rate differential between the United States and euro zone and should slow or reverse the flow of money from Europe to the United States. Furthermore, if the slowdown in the United States is steep enough, investors may start taking money out of US stocks, and foreign businesses may slow their rate of investment in the United States. If these trends occur, the euro may recover much of the ground that it has lost against the dollar. In sum, the recent weakness of the euro seems to owe more to short-term capital flows than it does to long-term problems in the euro zone or to any mismanagement by the ECB. It is certainly too early to write off the euro. It would not be surprising if the euro strengthened against the dollar in 2001.

International Business in the New Millennium

With the dawn of a new millennium, it seems worthwhile to reflect on how far the world has come over the last hundred years and what the next few years might hold for the global economy and for international business.

A Hundred Years of Progress

The last hundred years have in many ways seen remarkable progress. A person born at the beginning of the 1900s in the United States, then the world's richest country, entered a world in which few had access to running water, electricity, or the telephone. The automobile had only recently been invented and was still the plaything of the rich. Aircraft, radio, penicillin, television, computers, and the Internet all lay in the future. Average life expectancy was 47.3 years. Many people were infirm by the age of 40. There were 75 million people in the country and 1.65 billion people on the planet, up from 980 million in 1800. Income per capita was under $400. The United States was a continental economy in which international business and international trade played a limited role, but that role was starting to expand.

A person born at the beginning of 2000 in the United States entered a dramatically different world. Life expectancy had risen to 77 years, the consequence of a revolution in health care. Income per capita was $30,000. Automobiles, aircraft, antibiotics, computers, television, cell phones, and Internet connections were common. There were now over 6 billion people in the world and 270 million in the United States. There had been a dramatic expansion in both industrial output and in international trade. World trade had expanded twentyfold and world output sixfold since 1950.[16]

The world was a much more democratic place. In 1900, there were 55 sovereign nations, another 55 national entities that were governed by colonial and imperial systems, and 20 protectorates under the sway or protection of foreign powers. A mere 12.4 percent of the world's people lived under some form of democratic government, although suffrage was generally limited to males. By 2000, the great empires had disappeared and the world had 192 sovereign nations. Freedom House, an organization that tracks the spread of democratic freedoms, classified some 85 of these nations, or 44.3 percent, as "free." In 2000 55 percent of the world's population was living in democratic states, a greater proportion than at any other time in history.[17]

Market-based economic systems were also at a high-water mark around the globe. During the 20th century, rival philosophies of political economy, including fascism and communism, had fallen by the wayside. The "free world" had won a hot war against fascism (World War II) and a cold war against Communism. Liberal democracy with its emphasis on market-based economic systems was the ascendant ideology. Even the last great Communist state, China, had embraced market-based systems, making its claim to be a "Communist" country ring hollow. Clearly, this was a world in which international business could thrive, as indeed it has.

However, the 20th century was not one of smooth progress. There were two world wars and hundreds of minor ones that claimed some 37 million lives. Worse still, several Communist governments exhibited an appalling proclivity to murder their own people.

Some 62 million civilians were killed in the Soviet Union between 1917 and 1991, 35 million in China between 1949 and 1990, and 1.5 million in a spasm of brutality Cambodia. There was mass genocide in Turkey, Nazi Germany, Rwanda, and Bosnia. The Japanese killed some 6 million civilians in occupied territories during World War II. Overall, governments during the 20th century killed some 170 million civilians.[18] There was dropping of atomic bombs on Hiroshima and Nagasaki. There was the influenza pandemic of 1918, which left 20 million people dead around the world (in contrast, 8.5 million soldiers lost their lives during World War I). There was the still unfolding AIDS pandemic, which had claimed 16 million lives by 2000 and left 36 million infected with the HIV virus worldwide.[19] There was the great depression of the 1930s, during which the average American saw his income fall by more than half. For much of the 20th century most of the world lived under totalitarian dictatorships of one sort or another. Only in the last decade, since the 1989 collapse of Communism in Eastern Europe, has the balance of the world's population lived in democratic states. Moreover, for all of the progress of the 20th century, much of the world's population still lives in conditions that have more in common with the United States of 1900 than that of 2000. The GNP per capita of India with its 1 billion people, for example, is only about $400 per year. Despite dramatic economic growth, China's 1.2 billion people have a GNP per capita of under $900.

Reasons for Optimism

Looking forward, there are plenty of reasons for optimism, but the history of the 20th century also teaches us to expect reversals and uneven progress. Although predicting the future with certainty is impossible, one can argue that if current trends hold, living standards around the world will continue to improve. There are several reasons for expecting this. First, the prevailing economic ideology of the globe, with its emphasize on market-based systems, is likely to be supportive of the capitalist mode of production. In turn, as explained in Chapter 2, market-based systems beget innovations in products and processes, and innovations are the fuel of economic progress.

Second, the prevailing economic ideology is also supportive of removing barriers to cross-border trade and investment. Even without any further reductions in such barriers, the relatively low level of such barriers today seems likely to ensure that the trend toward the globalization of product and capital markets will continue. In turn, the efficiency gains that flow from global markets will constitute a rising tide that lifts all economic boats.

Third, as noted above, for the first time in history the majority of the world's population now lives in democratic states. The trend toward greater democracy seems to be firmly in place. Over the past 15 years, new democracies have sprung up throughout Latin America and Eastern Europe. There are signs that democracy may be gaining a foothold in parts of Africa, and several Asian countries, such as South Korea, have become far more democratic in recent decades. History teaches us that democracies rarely start wars, which bodes well for the future.

Fourth, current advances in computing and communications technology, if maintained for two more decades, promise to vastly improve the efficiency of global markets and global business. Communications technology has always been a major driver of economic progress. The Gutenberg press, postal services, the telegraph, the telephone, and the Internet have all lowered the costs of bringing together buyers and sellers—of making markets work—realizing substantial efficiency gains in the process. The Internet, because of its global reach, rapid growth, and potential for transmitting huge bundles of information at almost zero cost, will have a particularly dramatic impact in the near future.

Future Challenges

Having laid out the reasons for being optimistic about the near future, it would be naïve not to highlight some of the potential problems that might stall global economic growth in the coming decades, or at least present international businesses with some significant challenges. One possibility is that a combination of continued population growth, poverty in some less developed nations, and environmental degradation might lead to an ideological backlash against the global move toward free markets and the capitalist mode of production. One might argue that the protest against the World Trade Organization in Seattle might portend the leading edge of such a backlash.

Current estimates suggest that global population will continue to expand from 6 billion today to between 9 and 11 billion by 2100. Much of this growth is predicted to take place in the poorer nations of the world, many of which have yet to share in the economic benefits of global capitalism.[20] Environmentalists argue that population pressure puts stress on the environment, ranging from deforestation and soil erosion to air pollution and global warming.[21] As we saw at the recent World Trade Organization meetings, there will certainly be those who maintain that the adoption of free market economics and free trade are causes of such problems.

Naturally, one could counter that the relationship is not this simple. By creating wealth and incentives for enterprises to produce technological innovations, the free market system and free trade could make it easier for the world to cope with problems of pollution and population growth. While pollution levels are rising in the world's poorer countries, they have been falling in developed nations. In the United States, for example, the concentration of carbon monoxide and sulphur dioxide pollutants in the atmosphere decreased by 60 percent between 1978 and 1997, while lead concentrations decreased by 98 percent, and these reductions have occurred against a background of sustained economic expansion.[22] These figures are a testament to the ability of rich countries to take steps that limit the adverse environmental impact of economic development. However, this somewhat subtle argument is not an easy one for many to accept and often falls on deaf ears. The collapse of Communism has created something of an ideological vacuum into which political movement opposed to unfettered free markets might step; and a movement advocating greater regulation of markets and trade to protect the environment could fit the bill here.

If such a movement does arise, it may create many difficult challenges for international businesses, including limits to cross-border trade and investment, government regulation of business activities, consumer revolts, and the imposition of "pollution taxes." For a foretaste of what might come, one only has to look at the recent unhappy experience of Monsanto. Using recombinant DNA technology, Monsanto has genetically engineered certain types of seed corn so that they produce proteins that function as natural insecticides or so they are resistant to Roundup, a popular herbicide sold by Monsanto. Seeds engineered in this manner reduce the need to use insecticides and herbicides, thereby lowering farmers' costs and boosting crop yields. Monsanto thought the world would welcome its innovations, which it believed were environmentally beneficial. Its genetically altered seeds, such as soybeans, have become extremely popular among farmers not only in the United States but also in many other countries including Brazil, India, and China.

In Europe, however, environmentalists mounted a vigorous and largely successful campaign against Monsanto's products, arguing that genetically altered crops might lead to "genetic pollution." According to environmentalists, one possibility is that insects might soon become resistant to the "natural insecticides" produced by Monsanto's genetically modified seed corn. Thus, in the long run, Monsanto's products might actually end up creating "superbugs" that damage crop yields, not improve them. There is also a vague fear that genetic engineering, because it "upsets the natural order of things," might lead to serious problems that have yet to be identified, such as cancer. While these arguments lack scientific support, consumers and politicians across Europe have been receptive to them. Responding to pressure from consumers, many European supermarkets will no longer stock genetically modified foods. Also, the European Union has banned the importation of some genetically modified crops, even though this probably violates World Trade Organization rules. This backlash has effectively reduced Monsanto's ability to sell its products in a market of more than 350 million people, costing the company significant revenues.[23]

Another challenge to globalization and international business might arise from the fear that rapid globalization will drive down the wage rates of workers in developed nations, who will see their jobs "exported" to low-wage locations in the developing world. This fear has long underlay the opposition of labor unions to free trade. Populist politicians on both the left and right frequently articulate this argument. These politicians call for "fair trade"—meaning tariff barriers on imports from low-wage countries to protect inefficient domestic producers—as opposed to "free trade." If the argument gains wider support, it could lead to a partial retreat from free market ideology and an increase in trade barriers. To buttress their case, those who make this argument point to the evidence on growing wage inequality in developed nations. For example, a Federal Reserve study found that in the seven years up until 1996, the earnings of the best-paid 10 percent of US workers rose in real terms by 0.6 percent annually while the earnings of the 10 percent at the bottom of the heap fell by 8 percent. In some areas the fall was much greater. In New York City, the real wages of the worst-paid 10 percent dropped by 27 percent over this time period.[24] However, it seems unlikely that this growing inequality is due to globalization. In the United States, for example, only 13 percent of GNP can be attributed to international trade, and only one-fifth of that, or some 2.6 percent, is trade with developing nations. Most of America's trade is with high-wage countries such as Japan, Canada, and the nations of Europe. Given this, it is difficult to argue that international trade is the cause of growing income inequality.

It should also be noted that recent research suggests the evidence of growing income inequality may be suspect. Robert Lerman of the Urban Institute has taken a close look at the data. He believes that the finding of inequality is based on inappropriate calculations of wage rates. Reviewing the data using a different methodology, Lerman has found that far from increasing income inequality, an index of wage rate inequality for all workers actually fell by 5.5 percent between 1987 and 1994.[25] If future research supports Lerman's finding, the argument that globalization leads to growing income inequality may lose much of its punch. During the last few years of the 1990s, the income of the worst-paid 10 percent of the population has actually risen twice as fast as that of the average worker, suggesting that the high employment levels of these years have triggered a rise in the income of the lowest paid.[26]

A final challenge to globalization and international business might arise if the economic gap between the wealthy nations of the world and the poorest nations continues to widen. Despite all the benefits associated with globalization, over the last hundred years or so the gap between the rich and poor nations of the world has gotten wider. In 1870 the average income per capita in the world's 17 richest nations was 2.4 times that of all other countries. In 1990, the same group was 4.5 times as rich as the rest.[27] While recent history has shown that some of the world's poorer nations are capable of rapid periods of economic growth—witness the transformation that has occurred in some Southeast Asian nations such as South Korea, Thailand, and Malaysia—there also appear to be strong forces for stagnation among the world's poorest nations. A quarter of the countries with a GDP per capita of less than $1,000 in 1960 had growth rates of less than zero in the 1960–95 period, and a third had growth rates of less than 0.05 percent.[28]

Although the reasons for economic stagnation vary, several factors stand out. Many of the world's poorest countries have suffered from totalitarian governments, economic policies that destroyed wealth rather than facilitated its creation, scant protection for property rights, and war. Such factors certainly help explain why countries such as Afghanistan, Cambodia, Cuba, Haiti, Iraq, Libya, Nigeria, Sudan, Vietnam, and Zaire have failed to improve the economic lot of their citizens during recent decades. A complicating factor is that many of these countries have rapidly expanding populations. Without a major change in government, population growth may exacerbate their problems.

It is an open question as to whether such states will prove to be a destabilizing influence in the economy of the 21st century. They may lash out at their neighbors, as Iraq did in the 1991 Gulf War; export their people to other nations, as Haiti and Vietnam have done; or sponsor extensive terrorist activities, as Libya has done. If such geopolitical events do come to pass, there may be significant fallout for the global economy and international businesses. The task for the world community is to find ways to bring these countries into the global trading system so that they can share in the prosperity that has been and will be created.

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