From the Editor

Christopher Ragan

Over the past few years, much has been said about globalization and how it has changed national economies. Massive reductions in transportation and computing costs have combined with instant electronic communications to radically change the way firms in all parts of the world operate. Firms can place their research and development centers in Germany, do their banking in Japan, and manufacture their products in Malaysia, all while keeping their head offices in New York. Globalization has also contributed to a considerable feeling of insecurity in the labor market. More than ever before, workers in rich countries—especially the relatively unskilled—now feel that they are in direct competition with workers in Taiwan, Indonesia, Chile or Hungary. The world truly has become a "global village".

But this is old news—the effects of globalization on firms and workers have been talked about for some time. What has been less talked about is how globalization has changed the way that national governments must behave. Does globalization place new constraints on the nation-state, or does it present new opportunities? Does globalization spell the end of the nation-state, or can we expect the nation-state to continue in its current form? If the nation-state is destined to die, what will take its place?

These issues are obviously of central importance. The effects of globalization on the nation-state will shape the way we think about reforming existing international institutions, such as the UN, the World Bank, and the IMF—after all, how can we think clearly about reforming such institutions unless we know what we expect these institutions to do, and what we *need* them to do. The effects of globalization will also influence the way that new institutions—like the WTO—develop in their formative years. Finally, globalization will play a large role in the future design of international institutions, such as ones which would establish rules governing social or environmental standards.

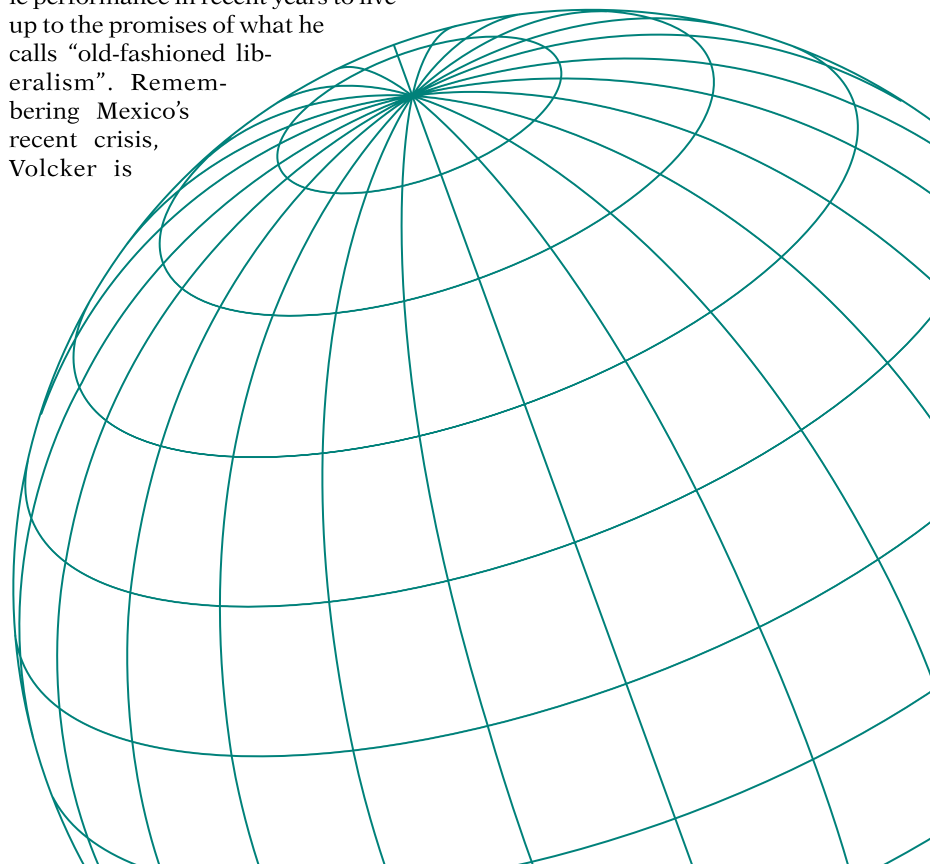
DOSSIER: GLOBALIZATION AND THE NATION-STATE

Given the importance of these issues, it is appropriate that the *Dossier* in this inaugural issue of *World Economic Affairs* be devoted to the theme "Globalization and the nation-state". To address this crucial topic, we have asked some leading international thinkers to present their views. Their judgments range from the need for capital controls in emerging economies to the need for new and more effective international institutions. Though there may be subtle disagreements among the various views, there is also a unifying message: Globalization is inexorably changing the form of the nation-state.

The *Dossier* opens with an article by Paul Volcker, former Chairman of the Board of Governors of the U.S. Federal Reserve System. Volcker is clearly concerned about the international monetary system, especially the failure of economic performance in recent years to live up to the promises of what he calls "old-fashioned liberalism". Remembering Mexico's recent crisis, Volcker is skeptical that greater surveillance can solve the problems associated with the mobility of short-term capital. He suggests that some form of capital controls may be appropriate for emerging economies.

Paul Kennedy, the Yale historian and author of *The Rise and Fall of the Great Powers* and *Preparing for the Twenty-First Century*, highlights a main tension created by globalization. One force is the widening sphere of economic activity; the other is the growing constraints upon the nation-state. He argues that exchange rate volatility, migration from poor to rich countries, and the continued search for world peace are all putting severe strains on the nation-state. These transnational problems, Kennedy argues, require transnational solutions—and probably the creation of new international institutions.

Michael Hart, an expert on NAFTA from the Centre for Trade Policy and Law at Carleton University, takes a detailed look at the connection



between globalization and social policy. Hart argues that globalization has led to a shift in demand away from unskilled and toward skilled labor. This has increased income inequality and thus increased pressure on social programs. At the same time, however, the greater international capital mobility brought by globalization has reduced the ability of national governments to finance social programs. This tension leads Hart to conclude that a new set of international trading rules is necessary. The rich countries especially see the value of such rules, for without them some developing countries may choose to use low social standards as a means of attracting foreign investment—a potent competitive weapon.

Pierre Marc Johnson, a prominent Montreal lawyer and former Premier of Quebec, focuses on how globalization has changed the behavior of firms and how these changes affect the functions of the nation-state. Like Michael Hart, Johnson believes that the increasing mobility of capital across international borders acts to constrain the traditional nation-state. But Johnson also sees globalization as creating new roles for the nation-state. One is to provide assistance to firms for R&D in an effort to influence a country's pattern of comparative advantage. Another is in applying political pressure on other nation-states to help its own firms conquer foreign markets.

The *Dossier* is closed by Jeffrey Sachs, the Harvard economist and economic advisor to several national governments. Sachs begins with a fascinating history of the world economy since 1840, arguing that today's global economy has much in common with the one at the turn of the century. Then, looking back at the last 15 years, he argues that recent economic changes have created a fundamental tension for the traditional nation-state. The undisputed importance of international trade in the success of economies, together with the need to manage the world environment, suggests to Sachs that the traditional nation-state is too small to be the effective level of government. Like Paul Kennedy, Sachs is led to push for stronger and more effective international organizations. On the other hand, Sachs argues that the traditional nation-state is likely too big to deal effectively with education, culture, and other important social issues. This points to the devolution of power toward local governments. Sachs therefore sees the traditional nation-state in imminent danger of being pulled apart by the forces of globalization.

Taken together, the five papers in the *Dossier* present a wide-ranging discussion of the effects of globalization and its implications for the functioning of the nation-state. They do not provide answers to all the questions posed above; indeed, the articles probably raise more questions than they answer. But they nonetheless provide the necessary groundwork for thinking about these important issues.

FORUM: SHOULD WE WORRY ABOUT EXCHANGE RATE VOLATILITY?

Exchange rate volatility has been actively debated at least since the collapse of the gold-exchange standard in 1971. Proposals for reducing exchange rate volatility are almost as varied as the exchange rates themselves. At one extreme is the so-called "Tobin Tax"—a small tax on all currency conversions designed to reduce the mobility of short-term capital. At the other extreme is a common currency, such as that presently being groped toward in Europe. Between these two extremes lies the option of fixed exchange rates—sometimes called an adjustable peg—where the monetary authorities maintain a par value for the currency but retain the ability to adjust this par value if the need arises.

The choice of exchange rate regime is of crucial importance. By adopting flexible exchange rates (as most countries currently have), a country has the ability to pursue its own monetary policy objectives. Central to this monetary autonomy is the exchange rate acting as a shock absorber, partially insulating the economy from external shocks. The other side of this exchange rate flexibility, of course, is that the exchange rate adjusts daily to all kinds of news to which foreign exchange traders respond. Proponents of flexible exchange rates see this volatility as evidence that the exchange rate is doing its job; advocates of fixed exchange rates argue that this volatility generates uncertainty, reduces trade volumes and lowers overall living standards.

A system of fixed exchange rates, in contrast, eliminates this day-to-day variability in the exchange rate, but at a high cost. By pegging its exchange rate, a country sacrifices any monetary autonomy and thus must import its monetary policy from abroad. Furthermore, changes in the foreign exchange market, that under flexible exchange rates would lead to changes in the exchange rate, now lead to changes in the central bank's stock of foreign exchange reserves. And dramatic changes in these reserves have in the past led to attacks on the currencies—Britain in 1992 and Mexico in 1994 are the most recent examples. These crisis episodes are part of the cost of a system of fixed exchange rates.

The *Forum* presents two articles—a case for and a case against fixed exchange rates. Pierre Fortin, one of Canada's leading academic economists, argues that a system of fixed exchange rates would be an improvement over the status quo. William Robson, senior policy analyst at the C.D. Howe Institute, Canada's most widely known think tank, argues that fixed exchange rates create more problems than they solve.

Arguing that speculation is responsible for exchange rates moving "too much", Fortin's main proposal is an ERM-style system for Canada and the United States. He lists two pre-conditions for such a system: fiscal discipline, which is soon to come; and wage-price flexibility, which he believes would be generated by the creation of such a system.

Robson argues that a system of fixed exchange rates is worse than either a common currency or a system of flexible exchange rates. As Britain and Mexico discovered, fixed exchange rates open the door to speculative attacks. As long as the authorities have the ability to change the pegged value if the need arises, then the market will make sure that the need *does* arise. So a movement from flexible to fixed exchange rates may bring the benefits of day-to-day stability but only at the high cost of inducing occasional and severe crises.

The debate over the "right" exchange rate regime will probably last for many years. One important issue which is sidestepped by both Fortin and Robson is the relationship between exchange rate volatility and the volume of trade, and thus, by extension, the relationship between exchange rate volatility and overall living standards. Is there any compelling evidence that trade volumes are lower *as a result of* exchange rate volatility? Is there any evidence that forward markets are unsuccessful in providing the necessary hedging for exporters and importers? If the answer to both questions is "no", then the argument in support of fixed exchange rates is more difficult to make. These are clearly tough questions to answer, but until some answers are provided, the debate will not be settled. ◆