

## Globalization and the Perspective for Small Industrial Countries

Address by Stanley Fischer<sup>1</sup>

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at the Zukunftsforum of the Federal Chancellery  
Chaired by Mr. Victor Klima, Federal Chancellor  
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### Introduction

Your Excellency, distinguished guests, ladies and gentlemen. It is a pleasure to be in this great city to speak with you this evening about globalization. This is an issue that is central to the work of a global institution like the International Monetary Fund and we have been examining it closely in recent months. In my presentation, I will draw heavily on work by the staff of the Fund, which will be available shortly in the May issue of the Fund's **World Economic Outlook**.

By globalization, we mean the growing interdependence of economies worldwide, through the increasing volume and variety of cross-border transactions--in goods and services, in international capital flows, and in knowledge. For many, globalization is a frightening prospect; for more, it is the gateway to growth and prosperity.

On a broad level, the benefits of globalization are those of specialization and the widening of markets through trade. By making possible an improved international division of labor and a more efficient allocation of global savings, globalization potentially raises productivity and living standards. At the same time, enhanced access to imported products provides consumers with a wider range of choices at lower cost. These are things that humans have always known as they have sought out opportunities for trade and commerce; economists have known them formally since the time of Adam Smith and David Ricardo.

International commerce and globalization are basic sources of economic growth and structural change. There can be little doubt that the remarkable, historically unprecedented growth of the world economy over the past half century owes much to the re-opening of trade and financial linkages that had been destroyed in the disasters of the Great Depression and World War II. And at an even broader level, beyond economics, globalization of commerce across economies forges cooperative links among countries and peoples that can help to foster global peace and harmony.

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<sup>1</sup> The views expressed are those of the author, not necessarily the International Monetary Fund. I am grateful to Owen Evans, Hans Flickenschild and Claire Adams for assistance in the preparation of this paper.

These observations should come as no surprise to an Austrian audience, against the background of the immense benefits that have accrued to your country from its participation in the international division of labor in Europe, and from your special geographical situation, between the advanced economies of western Europe and the transition economies of middle and eastern Europe and the former Soviet Union.

Capitalist market economies are dynamic systems engaged in a continuous process of structural change. It was the Austrian economist Joseph Schumpeter who described growth and development in the market economy as a process of creative destruction. The speed of these waves of creative destruction seems to vary substantially. In some periods, these forces move slowly, implying less rapid gains but also perhaps an easier process of structural change. In other periods, the forces of change gather speed and economic structures evolve quickly, bringing rapid gains but also more difficult adjustments.

We seem to be living in a period of such rapid change at present. Economic progress is in large measure a result of successful adaptation and adjustment to such changes. The process involves not only the expansion of total production but also a continuous rebalancing of sectors of production and the structure of employment, along with related changes in income distribution. The economy as a whole benefits from this process of development. But while some groups or sectors may benefit to a large extent, others may experience only small gains, and some may lose, as the comparative advantage of areas where they previously had a well-established productive niche may be undermined. A key concern about globalization is whether it may at times adversely affect large segments of society, perhaps even whole economies, particularly small ones.

These concerns about globalization are not new, for they are the same as the reactions to trade liberalization and to greater competition that have been expressed over the centuries. The concerns are there, they are valid, they must be dealt with, but we are fortunate that they have generally not been allowed to stop the progress of competition and of new methods of production. And when the attempt was made, in the centrally planned economies, it ended in spectacular failure. Indeed, one of the critical aspects of globalization, as it affects Austria, is the aftermath of central planning and the integration of the transition economies, some of whom are your neighbors, into the international market economy.

So much for the broad themes. Let me turn now to discuss first the challenges of globalization for the world economy, with particular reference to the situation of the advanced economies of North America and Europe. Then I will discuss issues of globalization in an Austrian context.

## The Challenges of Globalization for the World Economy

Economic integration among nations is of course not new. In many ways, the increasing integration of the world economy in recent decades represents the resumption of earlier trends that were interrupted by the World Wars and the Great Depression. In the late nineteenth century, barriers to economic exchange among countries were few and the flows of goods and capital were large, as were migration flows.

However, a larger part of the world and a larger number of countries is involved in late twentieth century globalization than a century ago. The former centrally planned economies are experiencing a historic transformation and joining the global market economy. Advances in technology have cut transportation, telecommunication and computation costs and at the same time they have permitted a decline in the bulkiness of production--put more dramatically, the weight of GDP has declined. Thus, for example, transportation of software across borders is simpler and cheaper than transportation of iron and steel. Economic distances have shrunk and coordination problems have diminished to such an extent that firms can now efficiently locate different phases of production in different parts of the world. The structure of trade has become increasingly intra-industry and intra-firm and foreign direct investment is serving as an important vehicle of globalization.

These advances in technology shape the modern world but they are also shaped by it, by the opportunities offered in the world economy that was the goal of the architects of the post-World War II economy--those who set up the IMF, the World Bank, the GATT (now the World Trade Organization), and later the European Community. In that framework, countries have lowered barriers to trade, removed restrictions on current account transactions and have increasingly moved toward capital account liberalization as well. The progress toward open economic systems is illustrated by the rising number of countries that have accepted the obligations of convertibility for current account transactions under Article VIII of the Fund's Articles of Agreement--from 35 countries in 1970 to 138 in early 1997, which is more than three quarters of the membership of the Fund, most remarkably including many of the transition countries.

How globalized have markets become? The extent of product market integration can be measured by the ratio of trade to output which has doubled since the 1950s and has continued to rise sharply over the last 10 years. Nevertheless, the extent of international integration of goods markets remains much lower than within domestic goods markets. Capital markets have also become more integrated, especially in the recent past. The growth of cross-border financial flows and the progress toward integration of financial markets has been even more remarkable and continues at a rapid rate as emerging market and transition economies enter the global system. Nevertheless, financial globalization still has a long way to go, and overall investment performance continues to be largely determined by domestic saving rates.

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One area where the degree of integration of markets remains low is that of labor markets in most countries. Although there is much concern about immigration in many countries, not least in Europe and the United States, the proportion of residents born abroad remains below 5 percent in most countries.

In the advanced economies, globalization has been accompanied since the 1970s by a decline in employment in manufacturing. This is the process of deindustrialization, which is often seen as a consequence of globalization. However, the facts do not support this conclusion. Indeed, deindustrialization appears to be a normal feature of progress and development in advanced economies. For industrial countries as a whole, manufacturing employment declined from 28 percent of the total in 1970 to 18 percent in 1994 (panel 1 of Chart 1). The counterpart of this decline in manufacturing employment was a sharp rise in employment in services (panel 2 of Chart 1).

Deindustrialization should not be seen as a symptom of failure of a country's manufacturing sector or its economy as a whole. Rather, it is a natural feature of the process of economic development in advanced economies and is generally associated with rising living standards. It reflects the rapidly rising productivity in manufacturing, compared with slower--or perhaps more difficult to measure--productivity growth in services (Table 1). Nevertheless, it can at times be associated with adjustment difficulties. For example, the service sector may not be able to absorb the labor released from manufacturing for a time, because overall growth is not fast enough, because of labor market rigidities or regulatory constraints or because investment in the service sector takes time. These adjustment difficulties can be exacerbated by increased competition from low-cost producers or foreign competitors who have been able to adjust more quickly or efficiently. All of these considerations point to the importance of labor and product market flexibility.

In this connection, the well-known contrast between the United States and much of Europe is instructive. Despite the sharp fall in the manufacturing share of total employment in the United States in recent decades, the absolute level of manufacturing employment in the United States has remained roughly constant, while employment in other sectors has expanded rapidly (Chart 3). As a result, the US economy has been able to employ its growing labor force and the unemployment rate has not experienced a secular increase. However, earnings have been relatively flat and income inequality appears to have risen.

In the industrial countries of western Europe, by contrast, the falling share of manufacturing employment has been associated with a steep drop in the absolute numbers employed in manufacturing and there has been little overall increase in employment since 1970. Consequently, unemployment rates have risen significantly above 10 percent in countries such as France and Germany (Chart 11). Hence the process of deindustrialization has been associated with negative features in both Europe and the United States--stagnant earnings and increasing income inequalities in one case (Chart 4) and high unemployment in the other.

There has been a great deal of research trying to account for growing wage inequality in most advanced economies. This analysis suggests that these important developments--increases in inequality in some countries and rises in unemployment in others--have not reflected globalization so much as the impact of rapid technological change (see Slaughter and Swagel). As technology has advanced, there appears to have been a rapid increase in the demand for high-skilled labor, reflected both in a shift in the structure of production from lower-skilled to higher-skilled branches of industry, and also a more important shift in relative skill demands within industries toward skilled workers. This move has contributed to an increase in the relative wages of skilled workers and a decline in the market-clearing relative wages of unskilled workers. The latter has manifested itself in a decline in the relative wages of unskilled workers, with high employment maintained, in countries where labor market practices are flexible such as the United States. It has been associated with increases in unemployment in cases where labor market institutions have prevented the decline in relative wages of unskilled workers needed to clear the labor market and keep unemployment low.

These are extremely important results. Note that the result is that most--about 80 percent--of what we are seeing and deploring in advanced country labor markets appears to be the result of changes in technology. Some--about 20 percent--is the result of international competition. These are interesting results, but the policy implications would be the same even if the proportions were reversed--for either way, the need is to improve the quality of labor in the advanced economies.

In some advanced economies, increased inflows of low-skilled workers from abroad have taken place, raising concern about possible effects of immigration on wages and job prospects of home country low-skilled workers. The available empirical research indicates only small effects of low-skilled immigration on wages and employment in the advanced economies, with the nature of the impact reflecting differences in labor market flexibility, as just discussed (see the papers by Zimmerman and Friedberg and Hunt).

The difference in the behavior of unemployment in Europe and the United States has been much studied and commented upon. What has happened in the United States establishes that globalization does not have to cause high unemployment. What has happened in Europe suggests that labor market institutions and the scale of unemployment benefits are critical to the behavior of employment.

These results emphasize the challenges for labor market institutions posed by globalization. It is always tempting to forego some of the gains in order to shelter producers in certain sectors of production or workers in some segments of the labor market. But that way lies stagnation. A preferable policy response is to deal with the rigidities that make it difficult for goods, labor and financial markets to adjust, and to find ways of helping those adversely affected to adjust. For example, education and training provide ways for workers in advanced economies to upgrade their skills to meet the demands of a changing global economy.

In the same vein, the shift in labor demand in the more advanced economies toward more highly skilled workers can pose important challenges for labor market institutions. Some countries (such as Australia and Sweden, for example) have centralized wage bargaining institutions that may permit a high degree of macro wage flexibility in response to shocks but that also curtail microeconomic wage flexibility, across occupations, skill levels and industries. Centralized wage arrangements are not well-suited to the microeconomic shifts in labor demand that accompany deindustrialization and globalization. Given the diversity of skills, productivity levels and value added associated with jobs in the service sector, the structural shift toward service sector employment may carry with it a need for more flexible and decentralized labor market arrangements.

Let me turn next to other features of globalization. First, globalization also has important implications for country authorities' approach to tax policy, especially in smaller countries. The location of production facilities is increasingly a choice variable and the tax regime of the host country is an important factor in such decisions. This development constrains the extent to which countries can implement higher rates of corporate taxation than their neighbors. In a similar vein, mobile factors of production--such as financial capital and some highly trained segments of the labor force--are in a position to move from high-tax to low-tax locations, a fact which constrains the extent to which the taxation of mobile factors of production can differ across countries. Consequently, countries may find it necessary to rely more heavily than before on taxation of immobile factors of production, particularly labor. To offset this bias, the international community is beginning to consider ways of harmonizing tax rates and tax systems.

Second, the interdependence of national financial markets has altered the environment for monetary and fiscal policy. A central implication of a high degree of capital mobility is that inappropriate levels of exchange rates have become more difficult to sustain. Given the massive flows in foreign exchange markets, the ability of country authorities to resist sustained pressure against the exchange rate has been sharply reduced. The vulnerability of pegged-but-adjustable regimes was underscored by the ERM crises of 1992 and 1993 and the Mexican financial crisis of 1994 and 1995. These developments reinforce the need for firm and prudent financial policies, combined with a willingness to tighten these policies quickly in response to adverse shifts in market sentiment.

Large and rapid movements of capital across borders expose banking systems to new risks and challenges. Many countries have experienced banking sector problems and crises in recent years as domestic institutions of bank regulation and supervision have not been revised and updated with the speed necessary. Moreover, banking sector problems increasingly take on a cross-border dimension and may require an explicitly multilateral response. Some observers have called for the establishment of an international banking standard (Goldstein). The Basle committee has prepared a paper outlining its approach to best practice in the area of bank supervision. We at the Fund are cooperating closely in this work. We are also working to strengthen our surveillance to deal with the macroeconomic implications of banking sector problems and are collaborating closely with other international organizations and groups, such as the Basle Committee and the World Bank, in this effort.

## Globalization in the Austrian Context

Austrian economic performance over the last several decades has been highly favorable. Output and living standards have risen substantially, inflation has remained firmly under control and financial imbalances have been largely absent and have been redressed quickly when they have emerged. Policy makers clearly have understood the requirements of a currency peg for a small open economy and have acted accordingly. Thus, the credit for this record of strong economic performance belongs to an approach to economic management that has been firm and clear-sighted, aimed at ensuring that Austria reaps the benefits of the phenomenon that we call globalization--for Austria has clearly understood, long before globalization became a fashionable term, that as a small economy it can only prosper in the context of regional and international growth and development.

Globalization is not just desirable for small countries, it is more than that. Far more than in the case of large economies, it is essential to their economic stability and growth. However, in the recent past fresh challenges have arisen, many of them stemming from the recent acceleration of globalization, discussed in a more general way in the previous section. While output growth has continued--albeit at a more modest pace--and inflation has been well under control, employment stagnated in the 1990s (Charts 5, 6 and 7). Moreover, the fiscal imbalance became worryingly large in 1993-95 although there has been a substantial improvement since then, reflecting the strong program of fiscal consolidation implemented over the last two years.

The globalization of capital flows and financial markets has made the link between the Austrian schilling and the deutschemark even tighter. Chart 8 shows interest rate movements in Austria and Germany and it is evident that interest differentials, which were already small in 1993 and 1994, have become even smaller in the recent past. The peg to the deutschemark has served to anchor Austria to its stability-oriented partner and has also enabled your country to benefit from participation in a wider European market.

Of course, this approach implies that there is no room for independent financial policies. The envisaged move to participate in economic and monetary union in Europe is only a logical continuation of your approach and, by removing any remaining exchange rate risk, should serve your country well.

Globalization of financial markets also implies a need to re-examine and renovate the approach to financial supervision and regulation in Austria to ensure that domestic banks and financial markets are able to meet the challenges associated with potentially volatile movements in international capital. The efforts that are underway in these areas need to be carried forward with all due speed.

The process of economic globalization has a number of different aspects for the Austrian economy. There are the vital processes of achieving integration into the European Union and early participation in EMU. There are the massive structural changes underway in the neighboring transition economies. It is easy to see these changes as a threat--as leading to a possible loss of jobs which would otherwise stay at home. But these changes should also

be seen as the creation of a potentially major new market which Austria is well placed to serve and from which large benefits may accrue.

The challenge for Austria is to ensure that it continues to be internationally competitive. In no area is the challenge greater than in labor markets. Labor market trends in Austria are illustrated in charts 9 and 10. Real wages in manufacturing have risen faster in Austria in the 1990s than in European partners and industrial employment has declined sharply over the same period. Nevertheless, the unemployment rate, at about 4 percent of the labor force, has remained substantially lower than in virtually all European partner countries, in part because of a generous retirement system which has encouraged early retirement and kept labor force participation relatively low. In order for Austria to capitalize fully on the benefits of globalization and to avoid a ratcheting up of unemployment, such as has been experienced in some other countries, improved flexibility of labor and product markets is essential. The goal should be not to protect sectors of the economy or the labor force from change but rather to enhance the forces of economic dynamism so that the full benefits of globalization can be reaped. There is no more important task facing your country and the other advanced economies.

### **Concluding Thoughts**

Does globalization make it more difficult for small open economies to achieve the goals of their economic policies? You will not be surprised to hear a representative of the IMF answer this question in the negative. But if you look at the goods you buy, and the investments you make, at the economic opportunities you have compared with those of your parents and grandparents, you will surely find it easy to agree.

Globalization offers immense benefits by providing domestic producers with improved access to global markets and domestic consumers with increased access to products from the international marketplace. Domestic savers have a wider array of assets from which to choose and investment needs can be met if necessary from the global capital market.

At the same time, globalization intensifies market discipline over macroeconomic policies by limiting even further the scope for countries to follow policies that are incompatible with medium-term financial stability. The discipline exerted by globalization extends beyond the realm of policy to the private sector by strengthening of competitive pressures in product and labor markets. For the benefits of globalization to be fully reaped, institutional structures need to be re-examined to ensure that they are sufficiently flexible to cope with the competitive pressures of the global market and that they meet international best practice. Such a re-examination of institutional structures may be critical for the financial system and also for product and labor markets.

Globalization in the late twentieth century is unleashing some of the most powerful economic forces ever observed. Globalization cannot be ignored. Nor should it be treated with suspicion. Rather, if properly responded to, it presents opportunities for continuing economic progress all over the world--not least in small countries.



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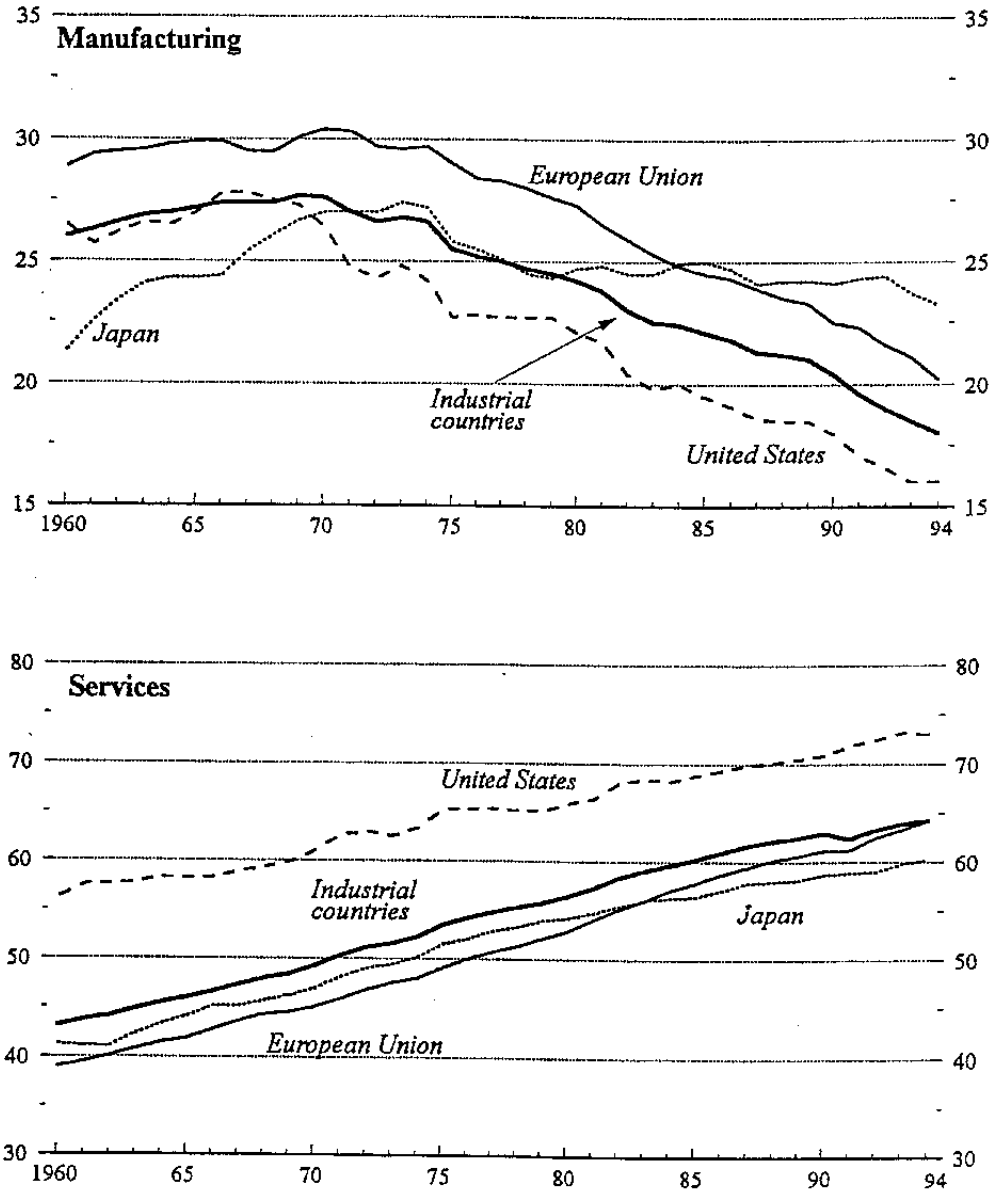
**Table 1. Industrial Countries: Growth of Output and Employment**

	1960-70	1971-94	1960-94
<b>Output</b>			
Manufacturing	6.3	2.5	3.6
Services	5.3	3.3	3.8
<b>Output per person employed</b>			
Manufacturing	4.6	3.1	3.6
Services	3.0	1.1	1.6
<b>Employment</b>			
Manufacturing	1.7	-0.6	0.0
Services	2.4	2.2	2.2

### Chart 1. Selected Advanced Economies: Employment by Sector as a Share of Total Civilian Employment

(In percent)

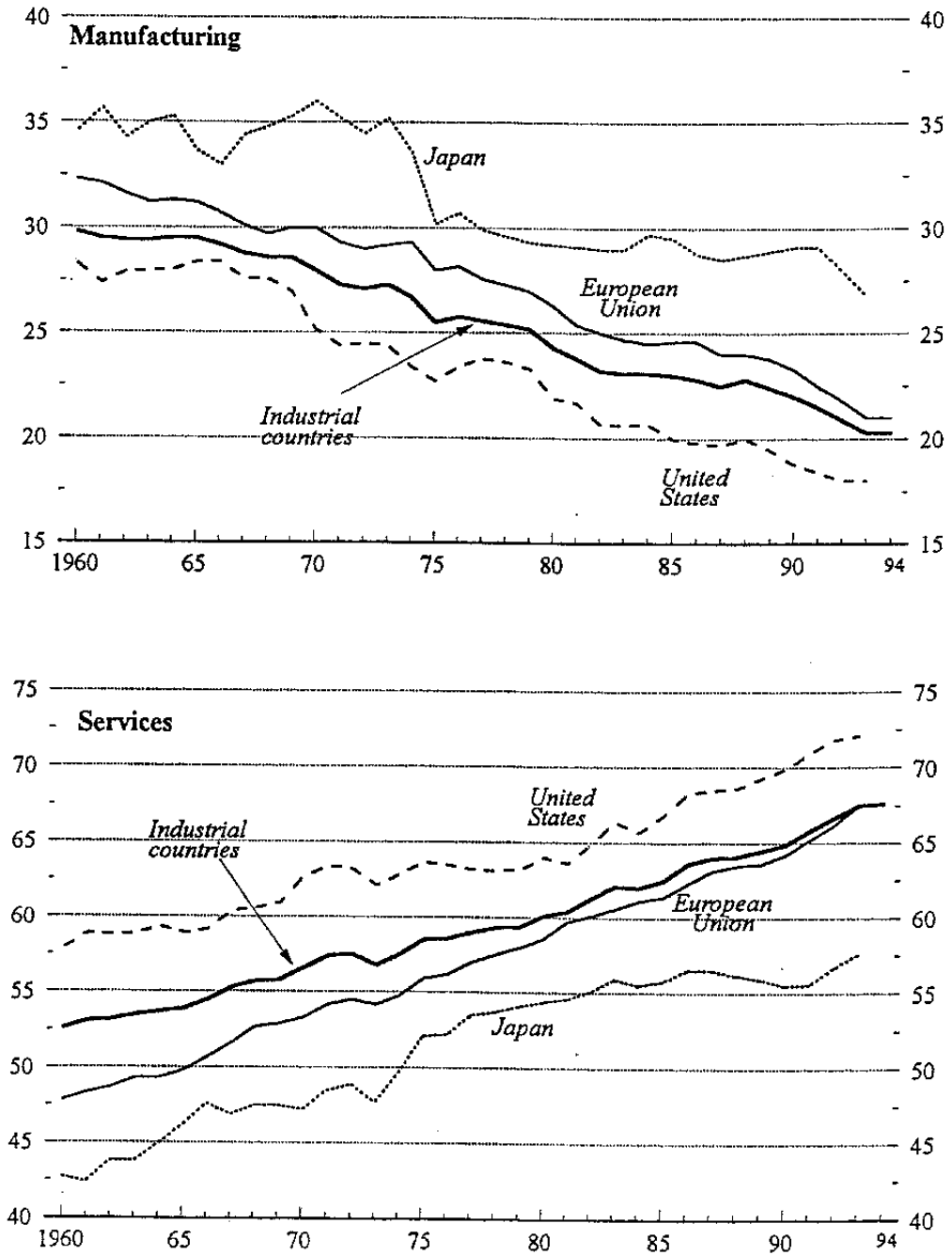
The share of manufacturing employment has fallen in all industrial countries, while the share of services employment has risen.



## Chart 2. Selected Advanced Economies: Value Added by Sector as a Share of GDP at Current Prices

(In percent)

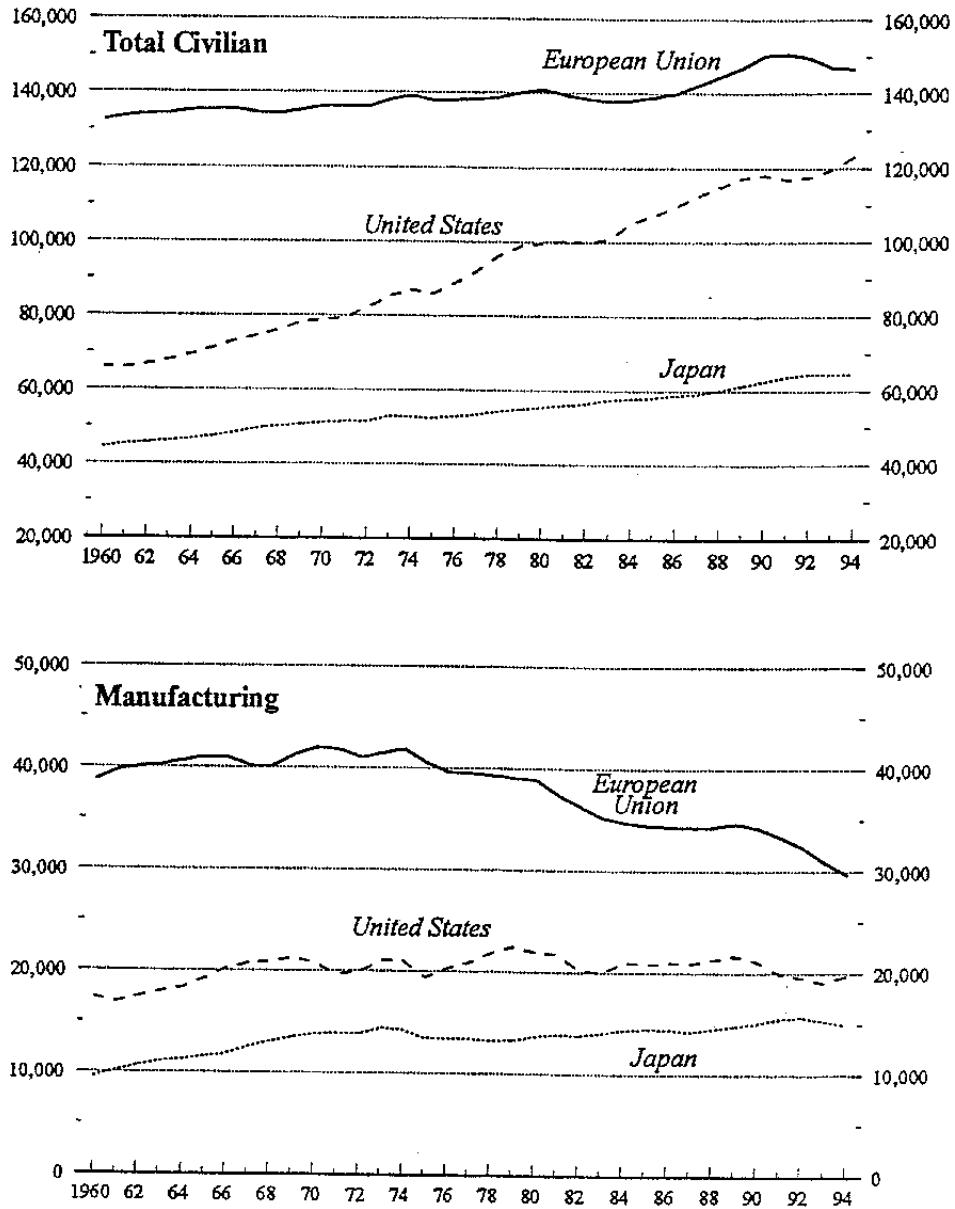
Value added in manufacturing as a share of GDP measured in current prices has fallen in all industrial countries, while the share of value added in services has risen.



### Chart 3. Selected Advanced Economies: Employment

(In thousands)

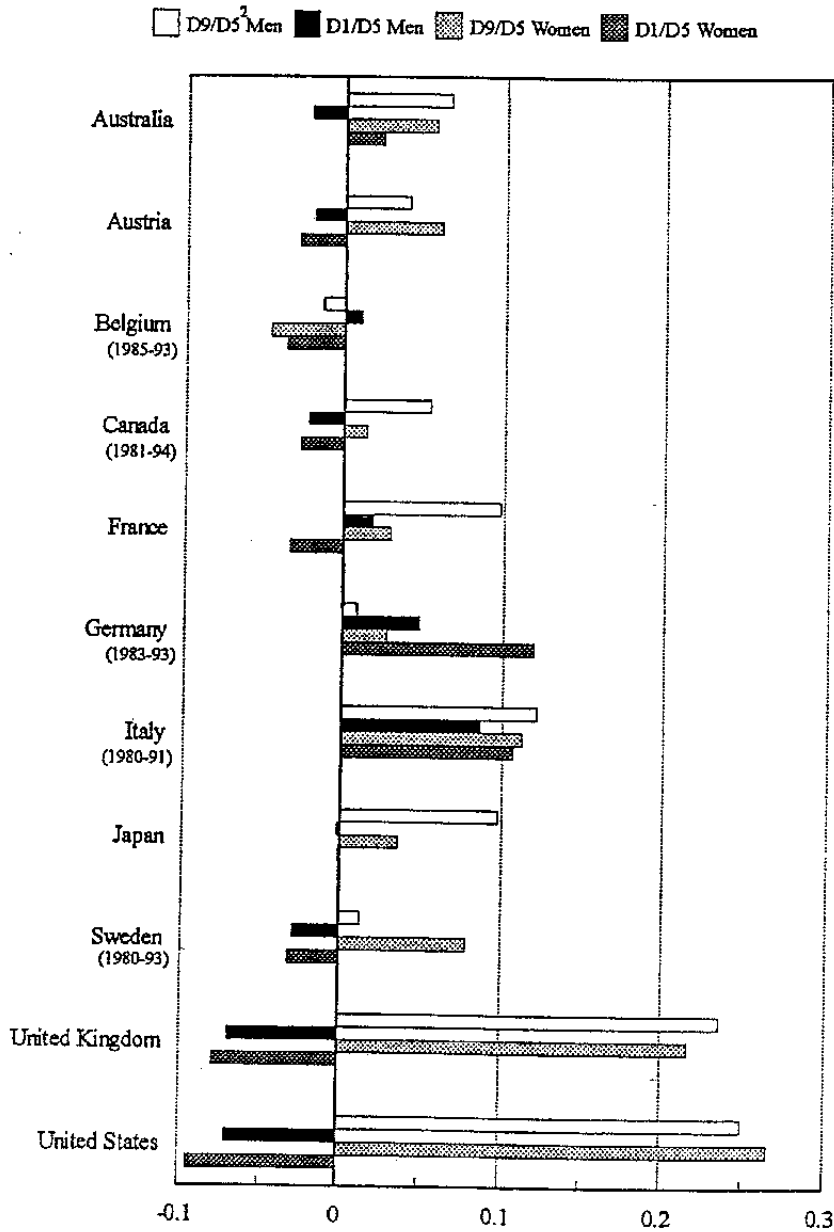
The number of persons employed in manufacturing has fallen in the European Union since the early 1980s but has not declined in the United States or Japan.



### Chart 4. Selected Advanced Economies: Changes in Ratios of Earnings Deciles <sup>1</sup>

(Difference between 1980 and 1994; unless otherwise indicated)

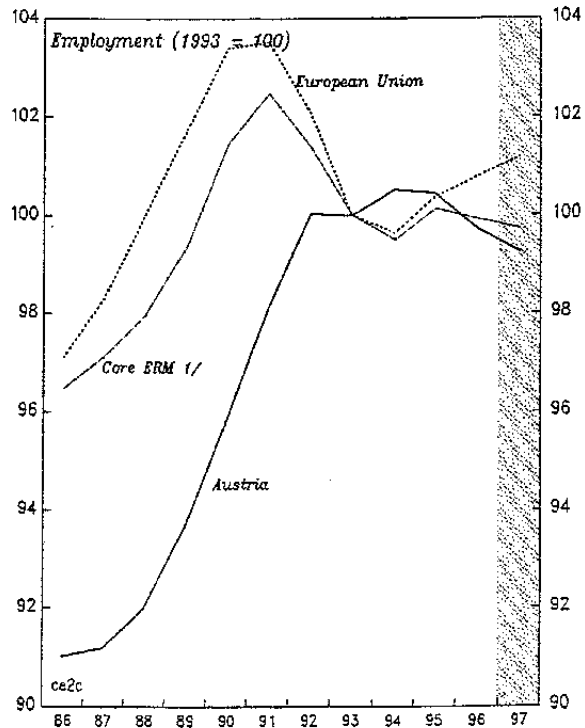
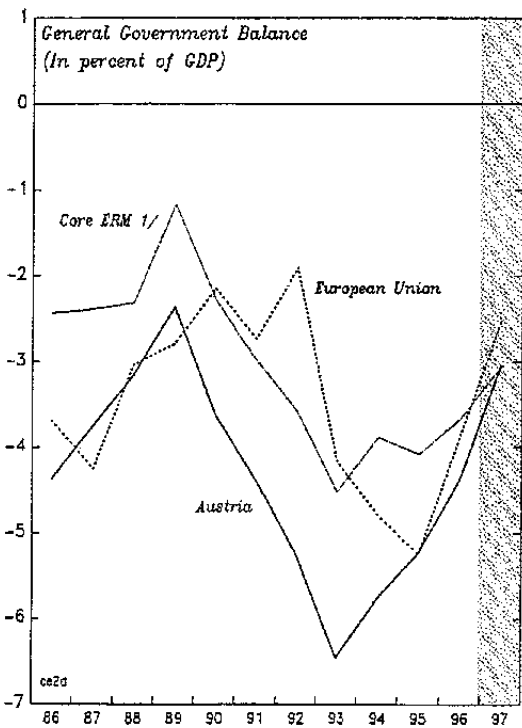
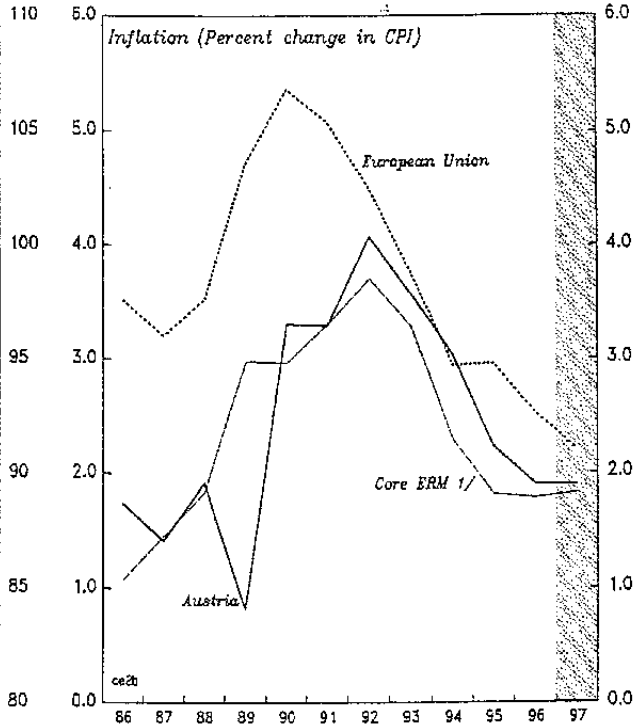
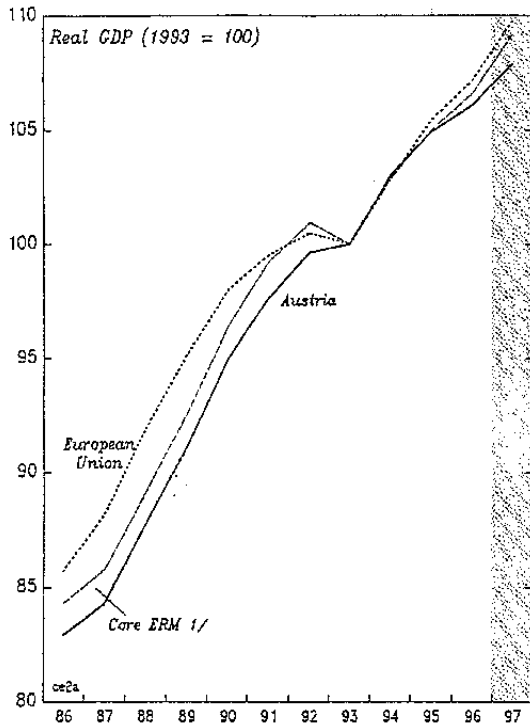
Wage inequality has risen significantly in some countries, especially the United Kingdom and the United States.



<sup>1</sup>Data are based on gross hourly earnings or gross earnings of full-time, full-year workers, except data from Austria, which include part-time workers.

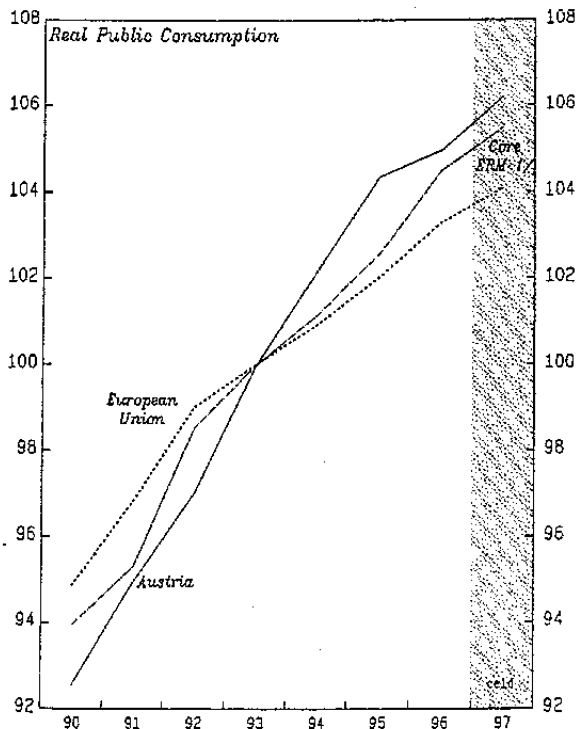
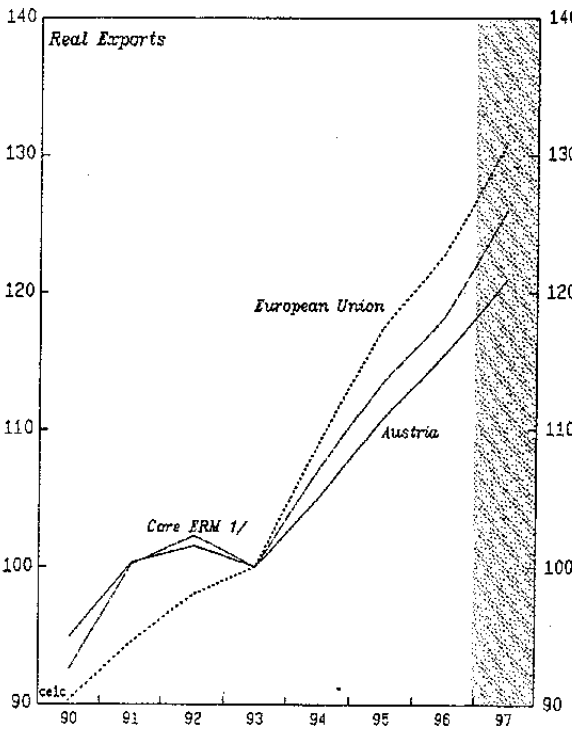
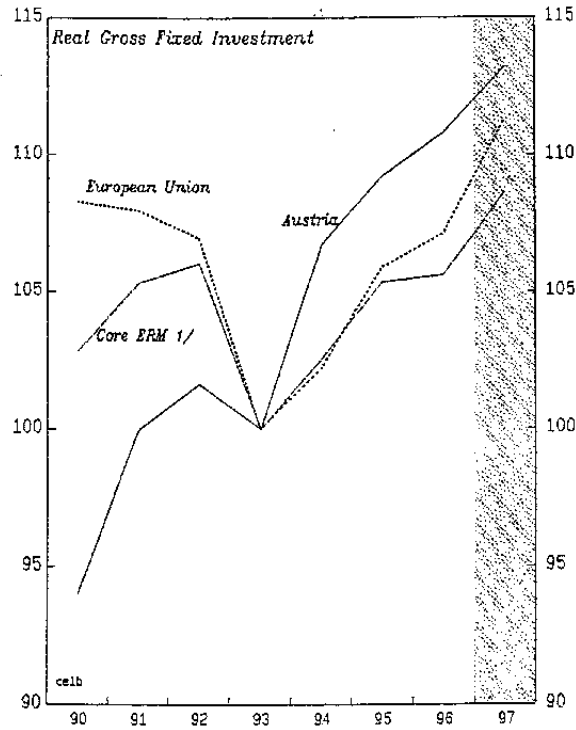
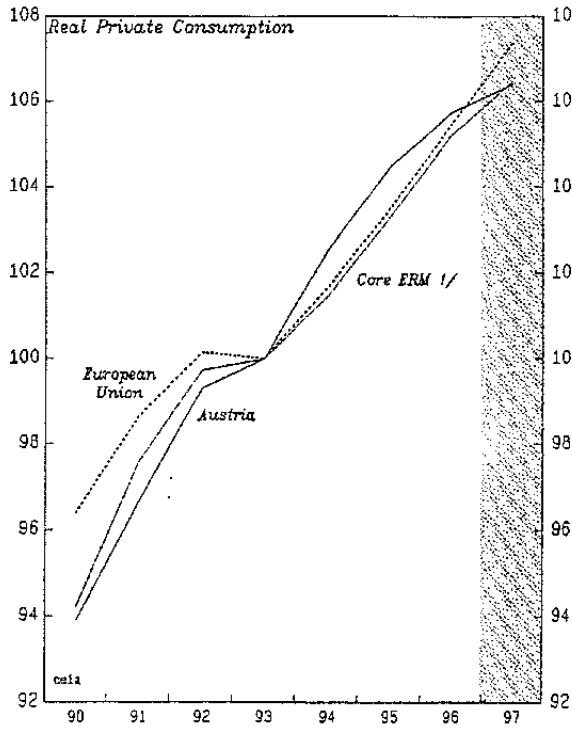
<sup>2</sup>D9, D5, and D1 refer to the upper limits of the ninth, fifth, and first deciles, respectively. D5 is thus equal to the median of the distribution.

CHART 5  
Austria  
Comparative Economic Developments I



Source: IMF, World Economic Outlook.  
1/ Belgium-Luxembourg, Denmark, France, Germany, and Netherlands.

CHART 6  
Austria  
Comparative Economic Developments II  
(1993 = 100)

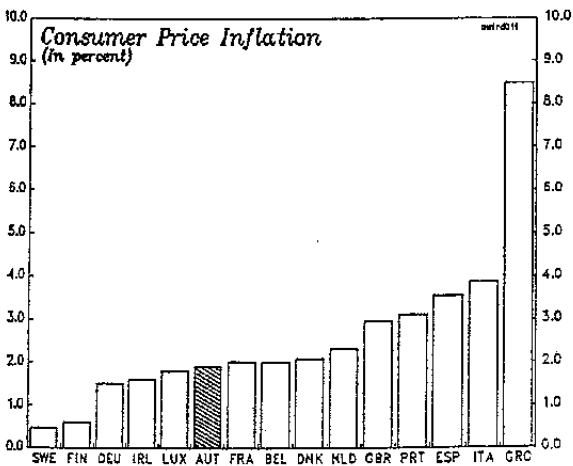
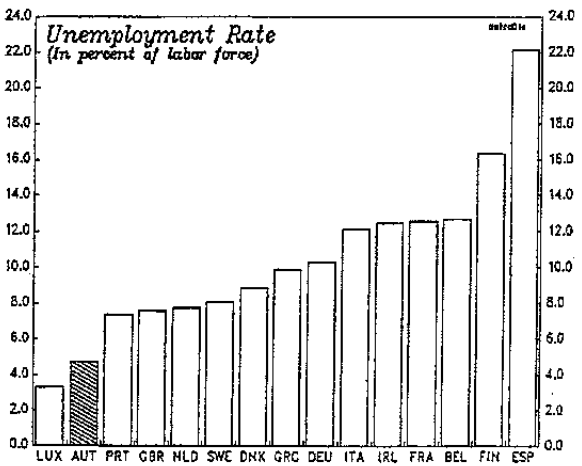
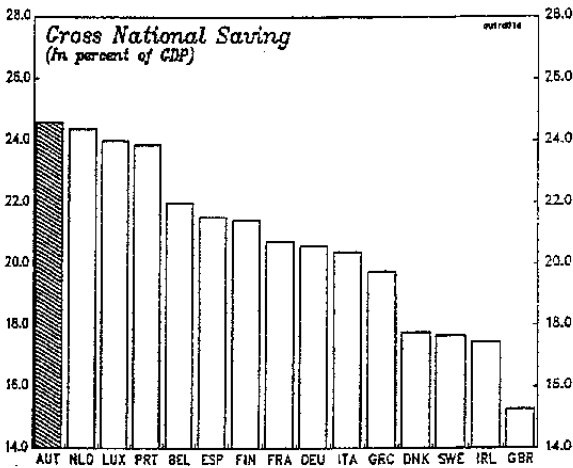
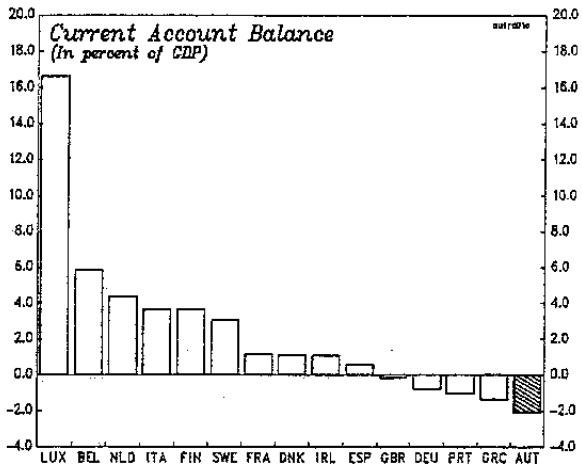
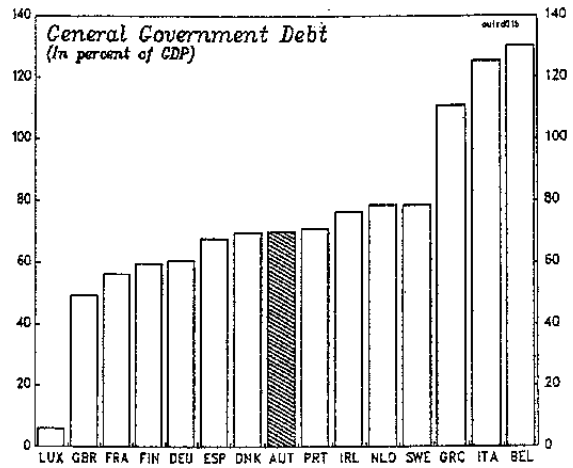
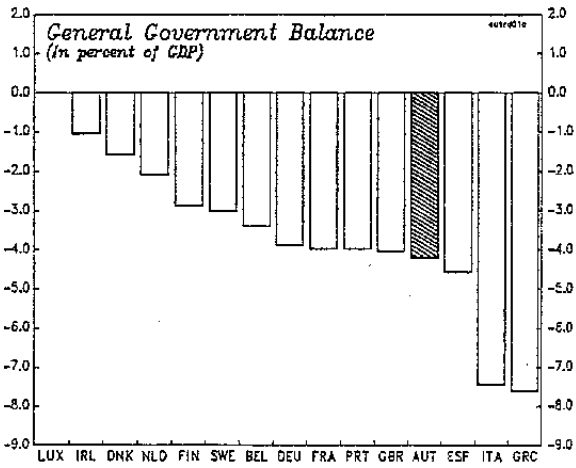


Source: IMF, World Economic Outlook.  
1/ Belgium-Luxembourg, Denmark, France, Germany, and Netherlands.



CHART 7  
AUSTRIA

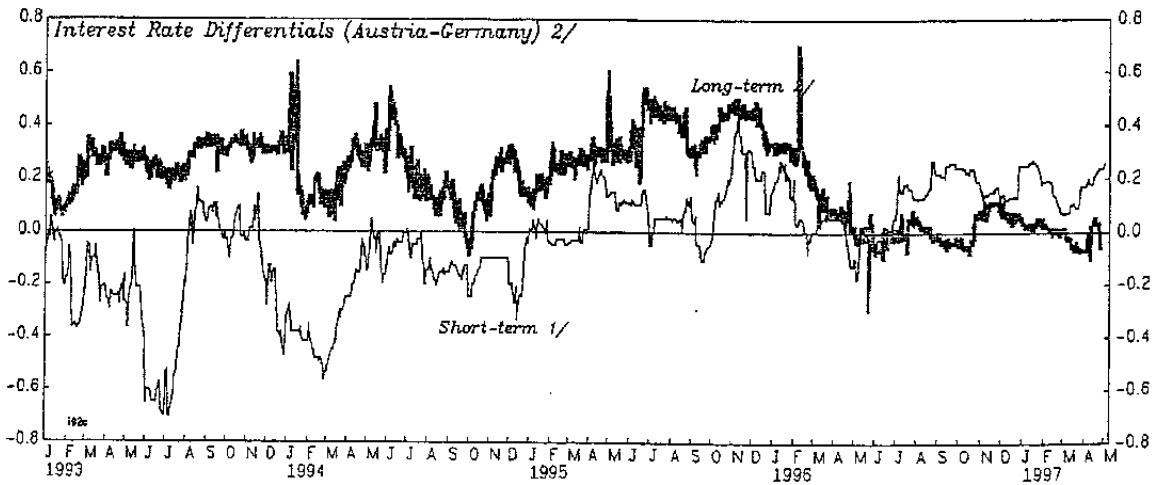
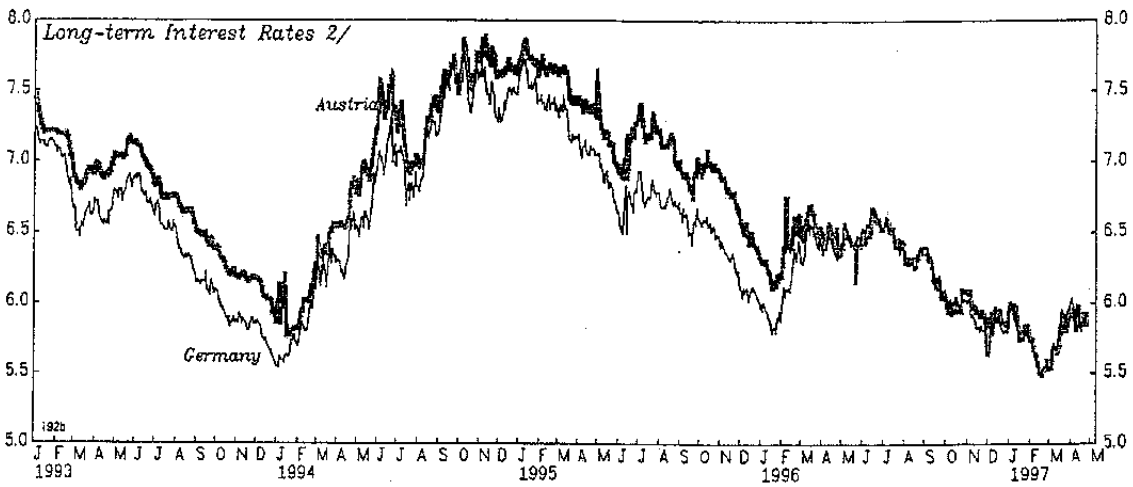
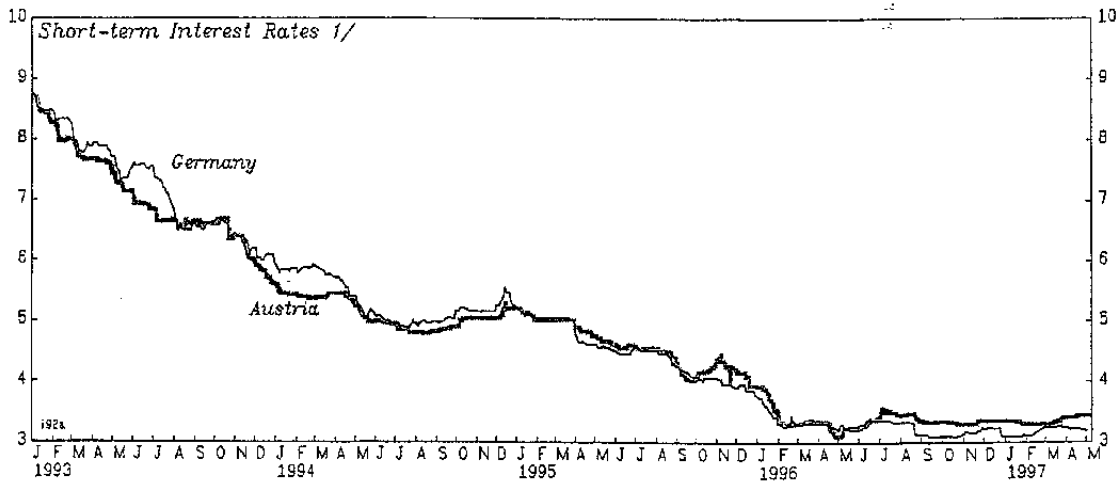
INTERNATIONAL COMPARISONS OF FUNDAMENTALS, 1996



Source: IMF, World Economic Outlook.

Countries are: AUT=Austria, BEL=Belgium, DNK=Denmark, FIN=Finland, FRA=France, DEU=Germany, GRC=Greece, IRL=Ireland, ITA=Italy, LUX=Luxembourg, NLD=Netherlands, PRT=Portugal, ESP=Spain, SWE=Sweden, GBR=United Kingdom.

CHART 8  
Austria  
Interest Rate Developments

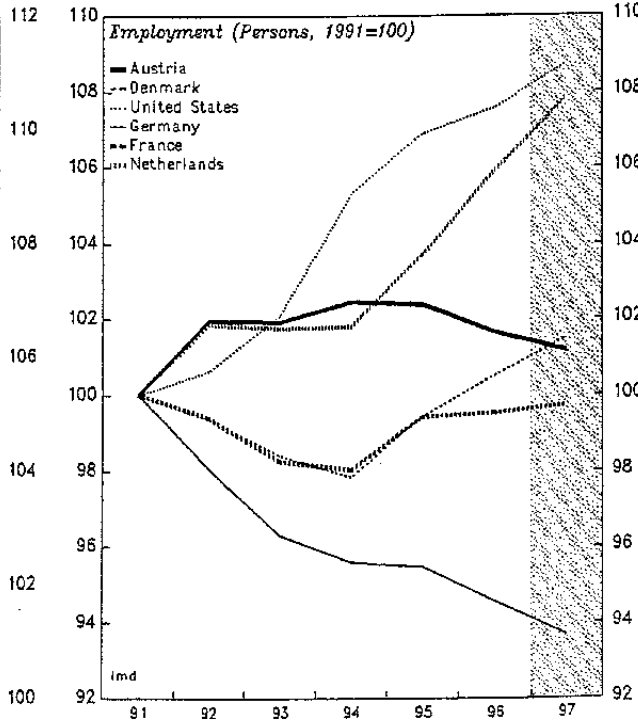
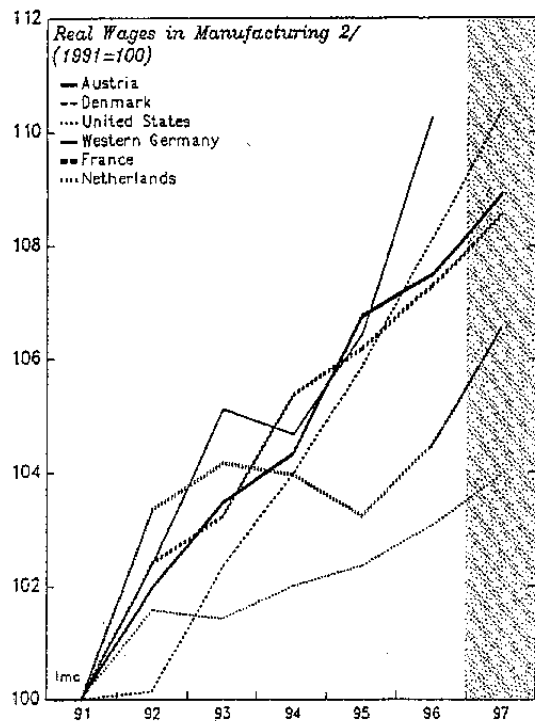
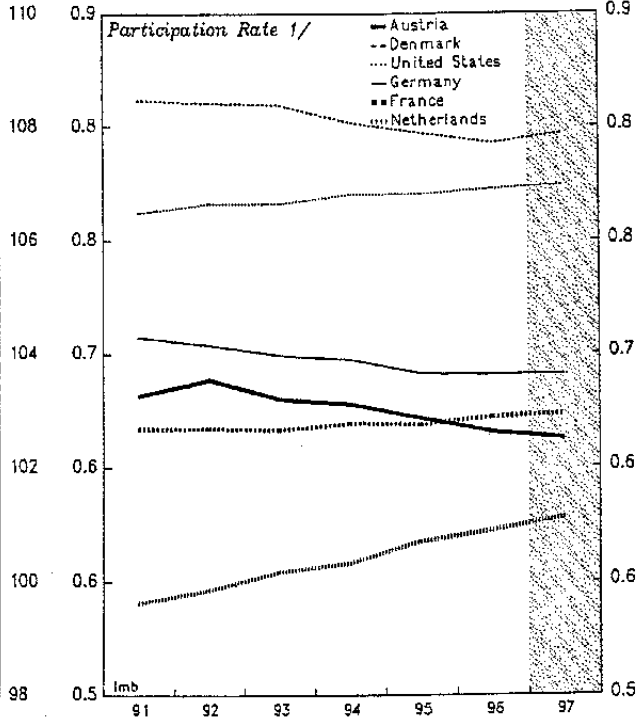
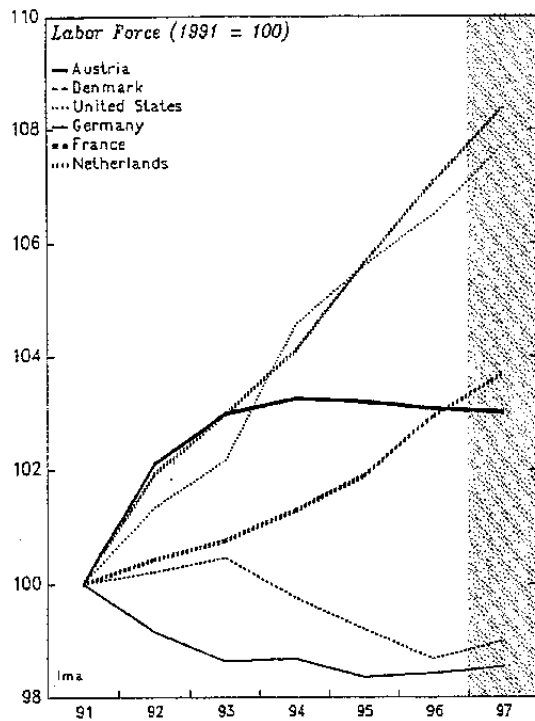


Source: IMF, International Financial Statistics.

1/ Three-month deposit rates.

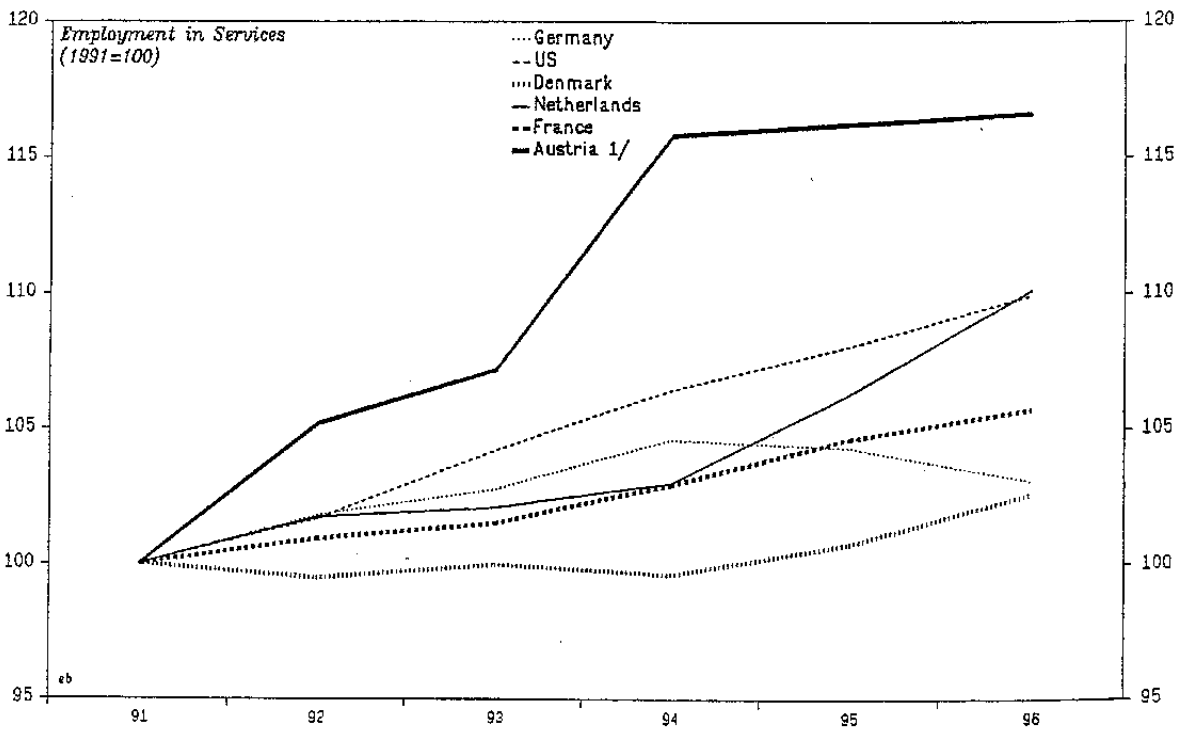
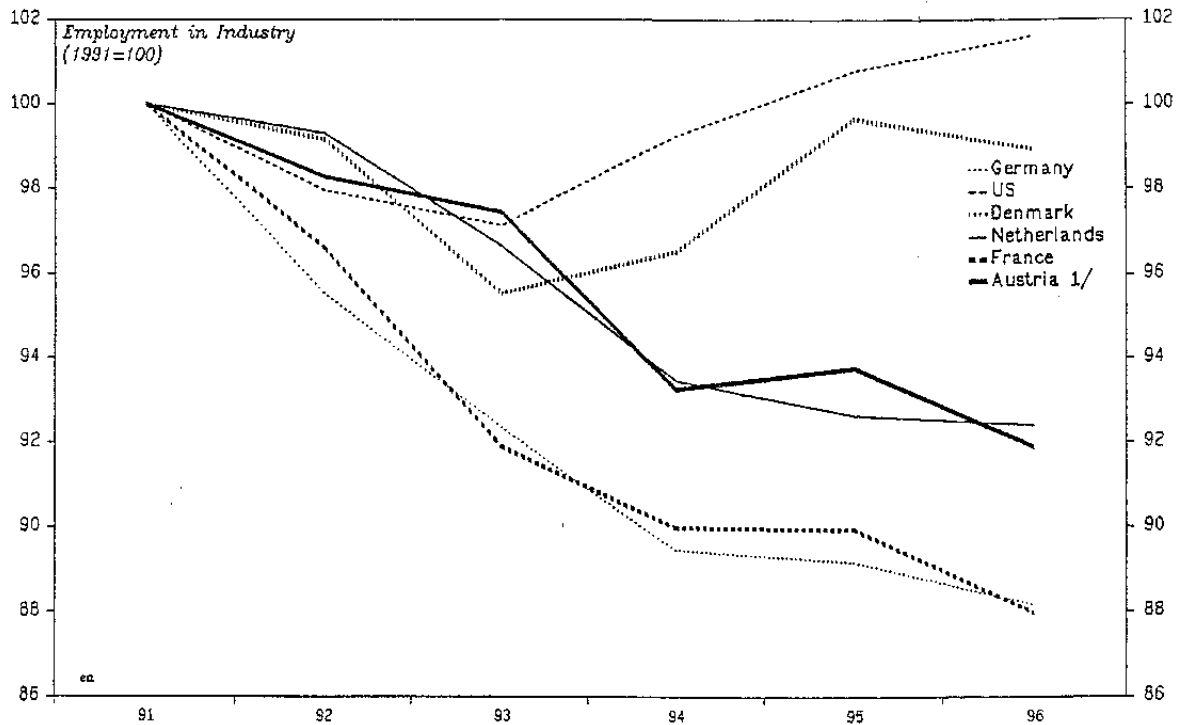
2/ Ten-year government bond yields.

CHART 9  
Austria  
Labor Market - International Comparison



Sources: IMF, World Economic Outlook. Working age population used in calculating participation rates are from OECD Economic Outlook.  
1/ Labor force as a share of working age population.  
2/ Hourly wages deflated with the GDP deflator.

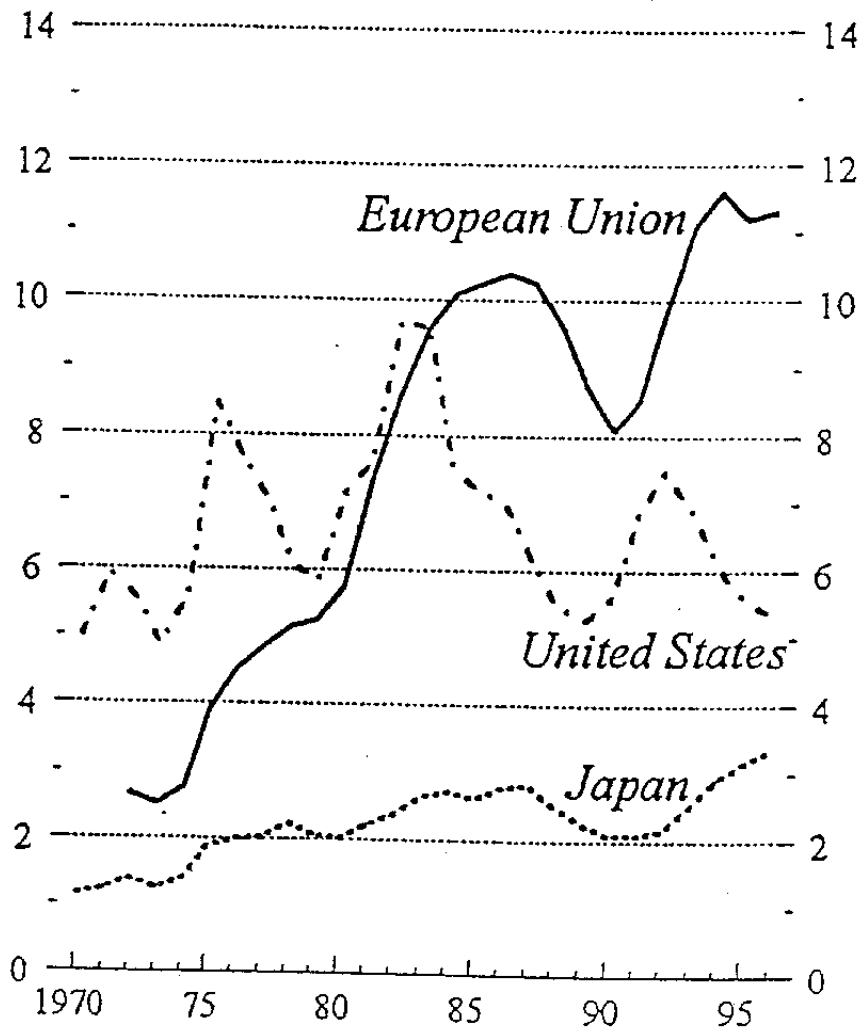
CHART 10  
Austria  
Employment



Sources: OECD, Quarterly Labor Force Statistics; Statistisches Bundesamt Wiesbaden; Danmarks Statistik; and Nationale Rekeningen.

1/ Provisional Fund staff estimates for 1996.

Chart 11 Unemployment Rates  
(In percent)



**Chart 12 Value Added in Manufacturing,  
Constant Prices**  
*(In percent of real GDP; PPP weights)*

