Globalization and the Social Contract

- Leader: **David A. Moss**, *John G. McLean Professor of Business Administration*

Overview

Globalization is not inevitable; it has come and gone before. Conventional wisdom holds that globalization is achieved when government gets out of the way, with lower taxes and regulation, allowing markets to operate unfettered. This view gets the role of government wrong. Globalization flourishes when governments are actively involved, creating rules and agreements that allow global trade to take place.

And in a climate where the greatest threat to globalization is a protectionist backlash, the role of government needs to be even greater. After the Great Depression, FDR offered a social contract where the United States would pursue free trade while also providing social protections to those who lost out. To address the rising wave of protectionism, the answer is not just freer markets, but a new social contract.

Context

Professor Moss presented an economic historian's perspective on the thinking that gets economies into trouble and offered suggestions for moving forward.

Key Takeaways

- **Defying common sense gets economies into trouble; our approach to globalization defies common sense.**

  One key lesson from the current financial crisis: defiance of common sense spells trouble. At three points leading up to the financial crisis, common sense was ignored:

  — *Bad loans.* Mortgages were offered to people who couldn't afford them, at interest rates higher than the norm. If home prices strained budgets, how could overextended buyers pay even higher rates to boot?

  — *"Risk-free" securities.* From these highly risky loans were created supposedly "risk-free" securities, as if by alchemy. Something doesn't make sense when securities with risky underlying assets have AAA ratings.

  — *High yields.* The yields on these AAA-rated securities were higher than usual. Usually low risk brings lower yields and higher risk brings higher yields, yet these supposedly low-risk securities also paid high returns.

  If any of the players had listened to common sense, they would have asked, "Do these mortgages make sense? By creating securities, can we really remove risk from risky assets? Should these securities really yield more?" Answering "No" at any point would have averted the overleveraging that occurred and the subsequent crisis.

  Many economists saw a financial crisis coming (but not its severity), knowing that the laws of economics don't allow common sense to be defied indefinitely. In two other economic matters, common sense is being ignored—suggesting more shoes yet to drop:

  1. *Current account deficit.* The United States spends 6% more than it produces, which cannot continue indefinitely. This may eventually result in a currency crisis, which could be disastrous, especially if it occurs on top of the current financial crisis. The solution: Americans must increase their personal savings rate, now near 0%. However, amid the current financial crisis, now isn't the right time for this message.
  2. *Globalization.* A protectionist backlash threatens globalization and its economic rewards.

- **Globalization is not inevitable. It requires sustained government efforts to support it.**

"Globalization" refers to flows of all sorts across national borders—goods, services, people, technology, capital, etc. Globalization is economically desirable because (as Adam Smith observed) productivity is driven by the division of labor. The more extensive a market, the greater labor specialization it can offer. Expanded markets also bring more competition, spurring innovation. But globalization also can increase job insecurity for some.

Conventional wisdom holds that globalization: 1) is inevitable; and 2) requires governments to get out of the way and let markets operate. Professor Moss asserts that both of these aspects of conventional wisdom are wrong:

— *Globalization is not inevitable.* It has come and gone before. In the early 20th century, the level of global trade that existed was comparable to today, and was seen by the leading thinkers of the time as a permanent fact of life. But due to protectionism, globalization collapsed.

> *"Globalization requires governments to open borders, which they don't have to do. So globalization can absolutely collapse; there's no indication it is inevitable."*
> — David A. Moss

— *Globalization requires conscious government action.* The idea that globalization occurs when governments get out of the way and let the markets operate is not accurate. In fact, the opposite is true. Globalization is a manmade creation brought about by the conscious efforts of governments to work together: to negotiate trade agreements (such as GATT), reduce tariffs, and create structures that enable global trade to occur.

Because globalization is manmade, sustaining it requires conscious effort and action. It can be reversed and destroyed if governments choose not to support it.

> *"Globalization . . . is a function of the deliberate actions of governments to bring down barriers and increase flows."*
> — David A. Moss

- **Globalization faces serious threats, the most serious of which is a protectionist backlash.**

  There are many low-probability events that could threaten global trade. A nuclear bomb in a shipping container, the spread of a major disease, and even the current financial crisis could have a major impact on international trade. But the most significant long-term threat, and that with the highest likelihood, is a protectionist backlash. It could start anywhere, including the United States, and spread rapidly.

  The reasons for growing protectionist sentiments include:

  — *Rising income inequality.* Free trade should increase average income. Overall GDP has grown but the gains from trade are concentrated among a very few winners. The result: In the United States the gap between the top and bottom income levels is arguably the highest in history.

  — *Falling mobility*. The concept of the American dream is the ability to move from the lowest to the highest class. But the reality is that social mobility has fallen sharply. It is now lower in the United States than in Europe.

  For a majority of Americans, income has stagnated or declined (in real terms) as GDP has grown. This is not just a trend in the United States but is occurring around the world.

> *"It is said that a rising tide lifts all ships. That's not been true. GDP has been growing, so there has been a rising tide, and yet incomes after inflation have not risen for those in the bottom half. . . . It's like you have small- and medium-sized ships anchored to the ocean floor, and the water is rising. They're borrowing to maintain living standards and stay above water. . . . That's not sustainable.*
> — David A. Moss

  Whether globalization is the cause for these economic issues is not clear. What is clear is that many Americans blame globalization. This is fueling increasing protectionist views. History shows that a protectionist backlash can sweep in quickly and it routinely begins with a backlash against immigration, as is being seen in America today.

> *"Immigration has been the lifeblood of the American economy and that [rebellion against it] is a potential warning about further protectionism coming."*
> — David A. Moss

- **Navigating globalization requires fundamentally changing society's social contract.**

  The argument to "just let markets function" assumes political stability and social peace. But a system where the gains are concentrated among a few winners won't remain stable; it will fuel protectionist attitudes. At the same time, history has shown that isolating oneself from the world, as many protectionists advocate, is also not a viable strategy.

  In the face of these challenges, what can the United States and other countries do?

  Looking at how the United States exited the Great Depression under Franklin Roosevelt offers a lesson. FDR was a champion of free trade, a fact that both modern Democrats and Republicans choose to ignore. He saw trade as a route to both prosperity and peace, as trading partners are unlikely to wage war against each other.

  But advocating for freer global trade was always coupled with social protections for the general population—a minimum wage, unemployment insurance, unions, and more. A bargain was struck with society: Open the country up to the vagaries of the global marketplace and in return, society will receive social protections in case they lose out as a result of global trade.

  This lesson shows that markets don't exist in isolation of a broader social system. Just advocating for markets to operate with no protections for those who lose out is certain to further a protectionist backlash. What is necessary is for the country's political leaders to strike a new bargain with society—a new social contract.

> *"We'll need to strike another bargain—not necessarily FDR's but another one. Somehow, people have to have a sense that they're protected [from the downside of globalization]."*
> — David A. Moss

- **For globalization to expand, international measures must be taken.**

  How does the world build a global market in the absence of a global government? It won't be easy, but international bodies like the World Trade Organization can often be effective even without enforcement powers. In addition, some attempt will be necessary to create greater harmonization of tax, regulatory, monetary, and trade policies.

Other Important Points

- **Getting started.** History has shown that as countries are in the process of developing economically, some forms of protection for certain industries for a certain period can be valuable. The developed countries need to recognize this fact and allow for different rules for developed versus developing countries.
- **Parallel challenge.** Former HBS Dean Edwin Gay founded the Massachusetts Association for Labor Legislation, which promoted social insurance (minimum wages, workers' compensation) for workers. Capitalism is enormously productive, Gay believed, but also brutal. He therefore felt it necessary to ensure social protections for the working populace so they bought into capitalism and had protections from its brutalities.
- **The education/mobility link.** The commitment to education in the United States has declined. No longer are U.S. children more likely to achieve higher educational levels than their parents. Evidence suggests that this decline is behind the decrease in social mobility.

Speaker Biography

David A. Moss (Leader)
John G. McLean Professor of Business Administration

David Moss is the John G. McLean Professor of Business Administration at HBS, teaching in the Business, Government, and the International Economy area. Moss graduated from Cornell University (BA, 1986) and went on to earn an MA in economics (1988) and a Ph.D. in history (1992) from Yale University. In 1992 and 1993, he served as a senior economist at Abt Associates, a public policy consulting firm based in Cambridge, Massachusetts. He joined the HBS faculty in July 1993.

Moss has published three books. *Socializing Security: Progressive-Era Economists and the Origins of American Social Policy* (1996) traces the intellectual and institutional origins of the American welfare state. *When All Else Fails: Government as the Ultimate Risk Manager* (2002) explores the government's pivotal role as a risk manager in policies ranging from limited liability and bankruptcy law to social insurance and federal disaster relief. The third book is *A Concise Guide to Macroeconomics: What Managers, Executives, and Students Need to Know* (2007). He has also published numerous articles, book chapters, and case studies, mainly in the fields of institutional and policy history, political economy, and comparative social policy.

Moss is a member of the National Academy of Social Insurance. Recent honors include the Robert F. Greenhill Award, the Editors' Prize from the *American Bankruptcy Law Journal*, the Student Association Faculty Award for outstanding teaching at HBS, and the American Risk and Insurance Association's Kulp-Wright Book Award.