Recent events have rattled the global economic order. Were they temporary setbacks, or something worse?

"LEADERSHIP in fragile times" is the theme of this year's World Economic Forum, the annual conference for the great and the good of the global economy that opened in New York this week. The assembled businessmen and politicians rarely notice the official agenda at this event: their real purpose is to see and be seen with each other. But for once that theme is apt. America has declared war on terrorism, Argentina's financial system has collapsed, and the world economy is enduring the worst slowdown in a generation. Does all this, as some argue, pose a threat to the liberal international order—that is, to globalisation?

For the first time in the modern era of global integration, the world's biggest economies (and many emerging ones with them) have stalled at the same time. As a result, the principal measures of economic integration, cross-border flows of goods and capital, showed no advance last year. After growing by 12% in 2000 and by an average of 7% a year throughout the 1990s, the volume of global trade was virtually stagnant in 2001. Foreign direct investment flows also slumped, from more than $1.3 trillion in 2000 to barely half that in 2001, according to UNCTAD, a United Nations agency.

If the business cycle had the biggest immediate effect on trade and investment, the other shocks of 2001—September 11th and the collapse of Argentina—raise more fundamental questions. The horror at the World Trade Centre exposed the dark side of global interconnections: the ease with which the West's enemies and their resources can move around the world. As for Argentina, it has long been an exemplar of global integration: during the 1990s it abolished trade barriers, opened its capital markets to international money and sold everything, from banks to ports, to foreign investors. Yet in December 2001 Argentina defaulted on $155 billion of debt and collapsed ignominiously into political and economic chaos.

Pessimists were quick to suggest that globalisation cannot survive these shocks. Within days of the World Trade Centre attacks, John Gray, a British political scientist and well-known globo-critic, wrote: "The era of globalisation is over. The entire view of the world that supported the markets' faith in globalisation has melted down." Stephen Roach, chief economist at Morgan Stanley, suggested the attacks and their aftermath "may bring about the demise [of globalisation]". Dani Rodrik, an economist at Harvard University and a prominent analyst of globalisation, wrote that Argentina's demise "offers a humbling lesson on the limits of economic globalisation in an age of political sovereignty". Eduardo Duhalde, Argentina's current president, calls the old system "broken".
Such warnings should not be dismissed out of hand. The lesson of the early 20th century, easily forgotten during the boom years of the late 1990s, is that globalisation is reversible. It was derailed by war (in 1914) and by economic policy during recession (in the early 1930s). This time, global integration might stall if the risk and of doing business abroad rises (perhaps as a consequence of heightened fears about security), or if governments once more turn their backs on open trade and capital flows. Either of these threats could prove decisive. The question is, will they?

**Better than it looks**

The war on terrorism could conceivably clog the arteries of the global economy: higher insurance premiums, longer delays at borders and higher transport costs are all possible sources of a “security tax” that would make global integration more costly. So far, however, the evidence that this has happened is patchy. Certainly, insurance costs for firms are rising. Indeed, Morgan Stanley analysts estimate that commercial insurance premiums for American firms will rise from $148 billion in 2000 to between $210 billion and $240 billion in 2002. Air travel has become more vexatious as security checks grow more frequent and rigorous. Air freight is more expensive. The World Bank estimates that air-freight costs have risen by around 15% since September 11th. Much of that may prove permanent.

But most of the goods that are traded internationally are sent by sea, and have been little affected. Vulnerable regions, such as South Asia, have seen transport costs rise, but there is little evidence that big ports or popular shipping lines have been substantially set back. Premiums for insurance against terrorist attacks have risen, but they are still a small fraction of shipping costs. A recent study by Craig VanGrasstek, a Washington-based trade expert, finds no discernible increase in shipping costs for American imports since September 11th. This could change, particularly if new security procedures are introduced. America's authorities, in particular, are debating extensive new measures to improve shipping security, such as introducing electronic seals on all containers, as part of increased "homeland defence". So far, though, the war on terrorism seems to have had a relatively small impact.

Similarly, terrorism does not seem to be causing firms to abandon global investment. The collapse in foreign direct investment in 2001 was due primarily to a halt in mergers and acquisitions of companies in rich countries. These deals became less attractive as share prices fell. But flows of foreign direct investment to developing countries held up fairly well, falling only from $240 billion to $225 billion, according to UNCTAD.

True, some firms have made high-profile decisions to reduce foreign investments. Several financial institutions, including Merrill Lynch, Morgan Stanley and Charles Schwab, have scaled back their operations in Japan. Gateway Computers pulled out of Ireland and announced it was abandoning its global ambitions. Home Depot, an American retailer, has moved out of Argentina and Chile. But there is no broader evidence that many businesses are changing their investment plans. A recent survey by the United Nations showed that 70% of respondents expected investment and employment in their foreign operations to rise over the next three years. Another survey of executives in American multinational firms by PricewaterhouseCoopers, an accountancy firm, showed that 27% planned international expansion in the next year, up from 17% before the terrorist attacks.

At first sight, financial flows to emerging markets—bank loans, bonds and cross-border investment in shares—seem to have been worst affected. In its latest analysis, published this week, the Institute for International Finance (IIF), a group that represents financial institutions, reckons that the 29 biggest emerging economies a net outflow of more than $30 billion in financial flows last year. Much of this was money fleeing Argentina and Turkey, which also had a financial crisis. But it adds to a broader trend. Cumulatively, over the past four years, emerging economies have received a mere $19 billion in these kinds of financial flows, as they were buffeted first by the Asian crisis of 1997 and then by the Russian debacle of 1998. Compare this paltry figure with the $655 billion the same emerging markets received between 1994 and 1997, as banks fell over themselves to lend and investors lapped up emerging-market bonds.

Now, the emerging-market bubble has clearly deflated, and with it has gone the breathless talk of a truly global capital market. Some analysts even fear that things could get worse. Bill Cline, chief economist at the IIF, reckons that a messy debt-restructuring in Argentina could jeopardise the entire asset class of emerging-market bonds.

Such pessimism may prove excessive. In many ways, global capital markets were remarkably resilient in 2001. Financial markets recovered quickly after September 11th. And, when it finally happened in December 2001,
Argentina's default on $155 billion of debt (the largest in history) had no wider repercussions.

During the past couple of months, share prices and currencies in many emerging markets have been rising and bond yield spreads have fallen, bolstered by lower short-term interest rates in the United States. Though the spread between the yield of American treasuries and emerging-market bonds rose after September 11th, it has fallen since mid-October. If you exclude Argentina, spreads between J.P. Morgan's benchmark index for emerging-market bonds and American treasuries have narrowed by more than two percentage points since the end of September and are at their lowest level since early 1998. Since Argentina defaulted in December 2001, several emerging markets, including Brazil and Turkey, have issued new bonds.

In short, the contagion that worsened previous emerging-market crises, particularly after Russia's default in 1998, has not reappeared. That is partly because Argentina's debt default (unlike Russia's) was widely expected. In a “slow-motion” collapse, investors have plenty of time to anticipate bad news, and run. In addition, perhaps, the market for emerging-market bonds has matured: hit by a series of crises, investors have become reluctant to pour their money into any old emerging economy, and are getting better at distinguishing between good and bad risks. The result is a smaller market, which is far from “global”: only a handful of countries now have access to international financial flows. But it is also a safer one. No longer, for instance, do Brazilian and Argentine bonds move in tandem simply because the two countries happen to be next to each other on the map.

Good news for some

In short, most aspects of globalisation have survived the shocks of 2001 remarkably well. But at the same time these events have worsened a long-standing problem. Global integration is a selective phenomenon. Many countries benefit; many do not.

Measured either in terms of trade or direct investment, integration has been highly uneven. A few developing countries have managed to increase their trade a lot. They are the same countries that have attracted the lion’s share of foreign direct investment. And they have also seen the benefits of openness. A recent study by the World Bank showed that 24 countries, home to 3 billion people, and including China, Argentina, Brazil, India and the Philippines, have substantially increased their trade-to-GDP ratios over the past 20 years. These are the low-income “globalisers”. On average, their growth rates have improved as well. GDP per head in these economies grew by an average of 5% a year during the 1990s (compared with 2% in rich countries) and their poverty rates declined.

However, another 2 billion people live in countries that have become less rather than more globalised. In these countries—including Pakistan and much of Africa—trade has diminished in relation to national income, economic growth has been stagnant, and poverty has risen. According to the World Bank, income per head in these “non-globalising” countries fell, on average, by 1% a year during the 1990s.

In short, globalisation is not, and never was, global. Much of the world, home to one-third of its people and including large tracts of Africa and many Muslim countries, has simply failed to participate. The shocks of 2001 now risk worsening this long-standing marginalisation. The global recession hit the prices of commodities from oil to cocoa—and it is commodities that still dominate the non-globalising countries’ exports. Many of these countries also rely heavily on tourism—an industry hit especially hard since September 11th. Moreover, any rise in transport costs may harm such countries most.

September 11th also offered powerful evidence of the danger to others when countries fall further behind. Failed states and impoverished economies can be havens for terrorists. After the attacks on New York and Washington, no country—least of all the United States—can believe it is immune from the effects of poverty and political collapse halfway around the globe. Fortunately, both rich and poor countries seemed to draw the right lessons from this. The goal must be to spread the benefits of globalisation more widely.
A silver lining?

For rich countries that has meant concentrating on trade and, to a lesser extent, on aid. The rich world's leaders were determined to launch a new round of global trade talks in November 2001. And the launch that resulted promised talks focused especially on the needs of the poor world. Gordon Brown, Britain's finance minister, called on rich countries to double their aid from $50 billion a year to $100 billion. He enjoys the support of many other rich-country governments. Colin Powell, America's secretary of state, has also spoken out in favour of more aid.

Poor countries, for their part, continue to try to promote trade and direct investment, while taking more care than before (more care than they were hitherto advised to take) about opening their capital markets. Surprisingly, perhaps, Argentina's Mr Duhalde is not representative. When he says he regards his country's plight as evidence of a broken international system, his is a lonely voice. Even he has tempered his complaints recently.

Most developing-country governments view Argentina's collapse as an indictment not of economic liberalisation, but of specific macroeconomic failures—namely, keeping a fixed exchange rate for too long and relying on foreign borrowing to fund profligate government spending. Floating exchange rates are now the norm throughout emerging economies. And caution is the watchword in foreign borrowing. Countries such as India and China have expanded their trade but have gone more slowly on opening their capital accounts. Meanwhile, poor-country governments are keen on further trade liberalisation—which is why they signed up to the new round of global trade talks in Doha last year.

The Doha round will bring particular benefits for the developing countries. Liberalisation of farm trade is high on the agenda. The current rules hurt the poorest countries especially. (Subsidies for farmers in rich countries are worth around $1 billion a day—more than six times as much as the rich countries' entire foreign-aid budget.) The round also promises greater access to rich-country markets in textiles and other labour-intensive manufactured goods. Since more than 70% of the exports of the poorest countries are farm goods and textiles, the potential benefits are big.

Moreover, as a global trade negotiation, the Doha round will prompt poor countries to lower barriers against each other's goods. Average tariffs for manufactured goods are four times higher for trade between poor countries than for exports to rich countries. The Doha agenda also offers specific technical and financial help for poor countries with the mechanics of integrating into the global trade system. Overall, the World Bank calculates that broad progress toward freer trade, in which the Doha round will be decisive, could increase poor countries'GDP by an extra $1.5 trillion by 2015 and lift an extra 320m people out of poverty.

Unfortunately, there are already plenty of reasons to worry about the fate of the Doha trade talks. Some poor countries already seem to be back-peddalling. In Geneva, the start of negotiations has been marred by bickering over who will take the chair and how the talks will be structured. And the close co-operation between the United States and the European Union is being tested by several bilateral tiffs, particularly over America's imminent decision to impose tariffs on steel imports and its tax treatment of the foreign subsidiaries of American firms. Europe charges, and the World Trade Organisation agrees, that these constitute an export subsidy. While both sides are trying hard to solve these problems amicably, they undoubtedly muddy the agenda.

Worse, there are few signs that either Europe or the United States is willing to defeat the vested interests that demand trade restrictions in textiles and farming. America's Congress is about to pass a farm bill that substantially increases subsidies to farmers. Before it agreed to the trade-promotion authority ("fast track") that the administration needs when it conducts trade negotiations, America's House of Representatives insisted on a number of side agreements that will make freer trade in textiles and agriculture harder. Even Pakistan, one of America's most important and most vulnerable allies in the war against terrorism, has as yet received no increases in market access for textiles, by far its main export.

America's hopes for regional trade integration have faded too. The Free Trade Area of the Americas was initially
high among George Bush's trade priorities. Argentina's collapse has set back these hopes. Mr Bush said recently that he now wanted to create a free-trade area with Central America—a much less ambitious aim than that of creating free trade throughout the hemisphere by 2005.

If the outlook for trade liberalisation is mixed, the prospect for more generous aid is worse. Rich countries have proclaimed ambitious development goals: cutting poverty in half, reducing infant mortality by two-thirds and providing universal primary education by 2015. The United Nations is holding a grand meeting on aid in Mexico in March. It hopes to build on the momentum of Doha.

Yet, despite the call for an extra $50 billion in aid, there seems little chance of action, largely because of American stinginess. The Bush administration has vetoed any reference to doubling aid flows at the Mexican conference. Paul O'Neill, America's treasury secretary, says he “would like to see evidence of what works before making new commitments”. America contributes only 0.1% of its GDP in foreign aid, by far the lowest share of any industrialised country. If America does not take the lead, there is little chance of a more generous provision of aid.

Nor is there much hope for the third potential source of help for the world's poor. International migration could do even more than trade to help the poorest countries. One estimate, by Harvard's Mr Rodrik, suggests that an increase in temporary migrants from poor countries equivalent to 3% of the rich-country workforce would boost developing countries' incomes by $200 billion a year, more than the new trade round. However, the impact of September 11th has, if anything, made the prospect of freer movement of people even more elusive. Talks between America and Mexico on immigration reform and amnesties for illegal immigrants are being allowed to drift.

Over the next 20 years, the rich world's population will fall slightly, while the developing world will acquire 2 billion extra people, many of them in countries that are currently political and economic failures. Unless, with help from the rich countries and from each other, they can find ways to integrate into the international economy, much of the potential gains from globalisation will be lost. The rich countries too will pay a price for that failure. Despite the seeming resilience to the shocks of 2001, these are fragile times.