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The Myth of Economic Interdependence

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"[T]he world [is] becoming more globalized and the international society [is] becoming more closely intertwined." Prime Minister Junichiro Koizumi1

“I have witnessed and participated in the globalization of finance as major economies around the world have become increasingly interdependent.” Henry Paulson, U.S. Secretary of the Treasury2

“As sovereign nations in our modern world, we are not merely independent but also interdependent.” Canadian Prime Minister Stephen Harper3

“What some call globalization is in fact the triumph of human liberty across national borders.” President George Bush4

We often hear that the world is becoming more economically interdependent. This observation is so universally shared as to go virtually unquestioned. Economists, legal scholars, government officials, journalists, and business leaders frequently assert that, whether states want to integrate economically or not, increasing economic interdependence is happening, and countries simply must accommodate that reality, or they risk becoming economic relics. The global financial crisis of 2008 is a vivid example, if one were needed, of the extent to which our economies have grown interdependent with good and bad consequences. The theory that international capital markets has become “de-linked” from one another has been disproved as financial panic spreads across the globe. The worldwide fall in aggregate demand, the contraction of global markets, and the crash of stock exchanges from India to Russia, all appear to corroborate the assertion of global economic interdependence. Yet, the appearance of economic interdependence may be illusory. In this paper I will challenge the conventional view that economic interdependence is increasing and unavoidable.

For purposes of this paper, I will use the term “economic interdependence” to refer to the reliance of national economies on foreign sources of goods, services, and capital, and the reliance on exporting to foreign markets to maintain full employment. In other words, economic interdependence refers to the extent to which our total consumption and/or our total production depend upon foreign markets. A country that imports a large portion of its energy and raw

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materials, or a country that exports a large portion of its manufactured goods could be considered highly interdependent. Some countries, like Japan, for example, may be interdependent in both senses. Economic interdependence is one crucial component of "globalization," although globalization refers to a more generalized process of economic, cultural, social, and political integration. The rhetoric of globalization and economic integration are often inseparable.

One of the leading writers in the United States on globalization, The New York Times columnist Thomas Friedman, has written, that

> globalization involves the inexorable integration of markets, nation-states and technologies to a degree never witnessed before.

> The driving idea behind globalization is free-market capitalism – the more you let market forces rule and the more you open your economy to free trade and competition, the more efficient and flourishing your economy will be.5

The implications of growing interdependence are that states are powerless to resist the overwhelming transformative force of the market. Arguments for protecting domestic industries are anachronistic. National goals and policies must yield to the market leviathan. As Professor Akira Kojima from Keio University Graduate School of Business and Commerce has argued, "The system of interdependence and globalism is a system that demands a partial relinquishment of sovereignty."6

Whether we think that interdependence is good or bad, the rhetoric used to describe economic interdependence often implies that this process of integration is natural, inexorable, unprecedented, and increasing at an ever more rapid pace as technology improves and trade barriers fall. Progress towards greater economic integration is presumed to be irreversible. It appears that states have little choice but to get on board the train or be left behind. These assumptions about the character of economic interdependence are significant because they define and limit the terms in which free trade is discussed and debated. The central idea that economic interdependence is natural masks the underlying policy choices that governments make concerning their commitment to free trade. However, if we take a closer look at the evidence of economic interdependence, we must conclude that the assumptions about interdependence are unfounded.

Interdependence is seen as natural in the sense that it does not result from the specific policy choices of any single government, but rather, it has emerged as a natural feature in the global landscape – a product of improved technology, education, and living standards.7 Economic interdependence is sometimes described as if it were a kind of innate gravitational force pulling nations toward convergence. Robert Zoellick, the President of the World Bank, has

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7 According to Professor Kojima, "[s]ince globalization is a natural phenomenon, it is important to be able to benefit from it while minimizing friction." GLOBALIZATION, supra note 6, at § 5.3. "With the advances in information and communications technologies and the diversification of demand, the trend toward greater globalization with minimal national barriers will almost certainly move forward." Taichi Sakaiya, Minister of State, Economic Planning Agency, Speech on the Present and Future of the Japanese Economy (Sep. 1, 1999), available at http://www5.cao.go.jp/99/b/19990903b-daijinkouen-e.html.
stated bluntly that "[G]lobalization is akin to a force of nature."8

If economic interdependence is a natural progression, it follows that it is also beyond the control of any one state. States cannot reverse the progress towards interdependence. As the U.S. Trade Representative Susan Schwab told an audience of business leaders, "[g]lobalization is here to stays.9 Protests against the World Trade Organization ("WTO") are irrelevant; the competitive forces that are opening markets are irresistible. The new protectionism, one commentator observed, "is nothing more than a hopeless reaction to the rapid progress of globalization." Though individuals "are vainly trying to put up resistance. It is nothing more than a transitional phase, then, soon to end."10 If states try to resist economic integration, they will end up only hurting their own citizens. Prime Minister Hashimoto told the Diet that unless Japan continues to open its markets, "our society will lose its dynamism, and there will be no tomorrow for our nation."11 States cannot resist the pressure to integrate because of competition for capital or the demands of modern business.12 Instead, governments should accommodate interdependence by easing barriers to free movement of goods, services, and capital and learn to compete in a changing environment.13

Though interdependence is seen as a natural phenomenon, it is also seen as historically unprecedented. Economic interdependence is generally viewed as a late twentieth-century phenomenon made possible by rapid telecommunications, huge container ships, air travel, and the internet. Moreover, interdependence is seen accelerating over time so that if it were possible to measure interdependence, we would expect that the degree of interdependence was uniformly higher today than at any time in the past and that the rate of increase was accelerating with changes in technology and reductions in trade barriers. For example, Prime Minister Fukuda

10 Atsushi Sugita, Janus at Large: Neo-Liberalism and Statism in Contemporary Japan, in JAPANESE RESPONSES TO GLOBALIZATION: POLITICS, SECURITY, ECONOMICS AND BUSINESS 29 (Glenn D. Hook & Harukiyo Hasegawa, eds., 2006).
13 "Since the world is changing rapidly in the age of globalization, Japan has no other alternative for survival than to take seriously the globalism of 'Japan in the world' and 'Japan in Asia' if it wants to continue to enjoy being as safe and prosperous as it has been thus far." INITIATIVE TOWARD A JAPAN-ASEAN COMPREHENSIVE ECONOMIC PARTNERSHIP DISCUSSION GROUP, INTERIM REPORT 1-4 (2002), available at http://www.kantei.go.jp/foreign/policy/2002/021016asean_e.html.
remarked that "[g]rowing interdependence and globalization in the international community today are resulting in great benefits, enabling the movement of people, goods, money, and information at a speed never seen before." 14 The accelerating pace of globalization helps to explain why governments cannot resist or regulate it. Prime Minister Fukuda warned that economic integration "has progressed so rapidly that it now even threatens to shake the very framework of nation-states." 15 A report to the Japanese Prime Minister concluded that "[t]his trend will accelerate even further in the twenty-first century." 16

If you believe that economic interdependence is natural, inexorable, unprecedented, and increasing at an ever more rapid pace, then you are likely to conclude that government policy should favor open markets, deregulation, and privatization of industry. You probably believe that free trade areas and customs unions should be expanded, and national regulatory policies should defer to the requirements of the World Trade Organization. If you start with the assumption that economic interdependence is an objective exogenous fact like the weather, then you conclude that we can adjust our expectations to it, but we cannot change it. Protecting domestic industries or workers from import competition seems irrational if you think that import competition or sudden shifts in capital flows or employers moving overseas will continue unabated and you are only disadvantaging your own economy by distorting the natural order of things. In other words, if economic integration is unavoidable, then the question becomes how to accommodate it rather than whether to engage in free trade and how to balance the costs and benefits.

For this reason, a great deal depends on the question of whether economic interdependence is in fact a natural, inexorable, unprecedented, and accelerating phenomenon. To evaluate that question we would need a way of measuring the progress of economic interdependence over time.

There are several possible standards we could use to measure the degree of economic interdependence. One metric would be to look at the increasing flow of capital, goods, services, and labor across borders. No one would doubt that the volume of cross-border flows have increased over time. Those increases in volume are partly a result of the lowering of trade barriers over the last 60 years and the improvements in transportation and communication technologies that reduce the transactional costs of trade. For example, certainly as the size of container ships has grown the cost of shipping has fallen and the volume of goods shipped has increased. Or the availability of the internet has certainly widened the flow of services across borders. But the mere fact that the volume of trade has increased does not tell us anything about the relative dependence of one economy on another. If as a result of rising incomes and lower prices we are consuming more imported wine or shoes, it does not mean that we are necessarily more dependent on other economies. We need to measure the increased volume against something else to see if our dependence has increased.

In order to do this we need to ask the question what portion of a country’s gross domestic product ("GDP") – meaning, the total value of all goods and services produced in a year – is

16 THE FRONTIER WITHIN, supra note 12, § II(1).
represented by goods or services that it imports or exports? If over time a country relies on imports for a larger proportion of what it consumes, or it relies on exports for a larger proportion of what it earns, then the country’s dependence on foreign sources of supply or foreign markets would be increasing. Happily, the value of a country’s exports and imports is easy to determine. The current account, which is one of the elements of the balance of payments, is a ready measure for the total value of goods and services exported and imported.

One objection to relying on the current account might be that it does not appear to take into account increased foreign investment. For example, when Toyota opens a production facility in California it employs more Americans and arguably increases our “dependence” on Japanese capital. As an indication of our openness to international trade, this measurement can be misleading, however. When a multinational enterprise opens a new plant, it is often hard to say whether it represents a foreign or a domestic investment: Sony, General Electric, and Eurobus have shareholders and operations around the globe; if Sony purchases a U.S. communications company, does it cease to be a U.S. firm? Counting all of Sony’s assets in the United States as Japanese fails to take into consideration all of the Americans who work for Sony, manage Sony, and profit from Sony’s activities worldwide. Moreover, the presence of foreign firms in the domestic market may increase as a response to increased protectionism; one of the primary reasons that a foreign firm might establish a manufacturing plant in the domestic market may be to get behind the host country’s trade barriers. Indeed, part of the motivation for Japanese automobile manufacturers to open plants in the United States was in response to the protectionist pressures of the 1980’s.

If we wanted to measure the flow of foreign capital we could look at the capital account, which is another element of the balance of payments. The capital account measures the difference between how much capital is entering a country and how much capital is going abroad. The capital account is exactly equal and opposite to the current account. For example, the United States in 2007 had a current account deficit of more than $731 billion and a capital account surplus of the same amount. Thus, as a practical matter, whether we consider the current account or the capital account as a percentage of the GDP we arrive at the same result.

Looking at imports and exports of goods and services as a percentage of a country’s GDP is a good rough measure of a country’s dependence on foreign markets. Every country keeps count of its imports and exports of visible or tangible goods, and this measure is fairly easy to perform through the customs service. While it is harder to measure the balance of services, that is, the net amount of services imported and exported, is at least a very rough approximation of the extent to which a country may rely on foreign suppliers or foreign sources of income.

If we were to plot points on a graph over time we would naturally expect to find that as barriers to trade have declined and transportation and communication have become more efficient, that the trade in goods and services as a percentage of our GDP has also increased. Graph number 1 illustrates that for the world as a whole the degree of economic interdependence has markedly and steadily increased since 1960. The horizontal axis shows the years 1960-2005 and the vertical axis represents world trade in goods and services as a percentage of the world’s GDP. The upward slope over the last four decades is consistent with the conventional view that “the world is growing more economically interdependent.”
As you might expect what is true for the world’s economy taken as a whole is even more true of China. Graph number 2 tracks the import and export of goods and services in China as a proportion of China’s GDP. Graph number 2 illustrates the growing economic interdependence of the People’s Republic of China. Here we see the dramatic shift that has occurred in China since it ended its economic isolation in the 1970’s and became the world’s fastest growing exporter and importer of goods. The close similarity of the graph lines for China and for the world as a whole suggest the enormous influence that the opening of China has had on world trade.
Graph number 3 charts the current account in India as a proportion of India’s GDP. Although economic interdependence did not increase in India as early as it did in China, since the 1990’s we see a similarly rapid rise of interdependence. This graph captures the sense in which India was both more open than China at the start of the 1970’s, but was also slower to respond to the opportunities for increased trade in the 1980’s. Today we can see that Indian policy has changed markedly over the last three decades. Due to the size of the Indian and Chinese markets, the growth of their trade alone has had an enormous impact on the world’s increased interdependence represented in graph number 1.

Graph 3: India Trade as Percentage of GDP, 1962-2007

Should we conclude therefore that as expected the world’s growing economic interdependence is natural, inexorable, unprecedented, and accelerating? In fact, this trend is not universal, and it is difficult to find any other examples quite as dramatic as India and China. When we have historical data over longer periods of time than are available for China and India, we see that there are cyclical patterns of interdependence and not one long continuously rising slope.

For example, Graph number 4 tracks the measure of U.S. interdependence from 1790 to the present. We find that interdependence increased at a slower rate since 1990 than it had from 1950 to 1980. Today, the U.S. trade in imports and exports is equal to about one-quarter of the U.S. GDP. This is a substantial proportion, but it is hardly unprecedented, and in fact, it is far less than it was early in U.S. history. Foreign trade as a proportion of GDP peaked in early 1800’s when the U.S. trade in goods and services amounted to more than 40 percent of GDP. Of course, this makes some sense. In that period, the United States was in the same position as many recently decolonized economies, largely dependent on the export of raw materials and the import
of virtually all of its manufactured goods. Since then trade as a proportion of the GDP has ebbed and flowed over time with changes in world economic conditions and U.S. trade policy changes. U.S. interdependence fell during the nineteenth century as the United States developed its own manufacturing base and adopted high tariffs. In the first two decades of the twentieth century the United States reduced tariffs and increased its economic interdependence, but it reversed course during the 1920’s with the adoption of the exceptionally high-tariff rates known as the “Smoot-Hawley Tariff.” During the 1930’s the United States approved a series of bilateral agreements to lower the Smoot-Hawley Tariff, and thus, we see a gradual increase in economic interdependence. The U.S. GDP began growing more rapidly during and immediately after World War II. During this time U.S. exports increased to our allies and later for the reconstruction of Europe. Sometimes the growth of GDP outpaced the increase in exports, and sometimes, the increase in exports outpaced the growth of GDP. As a result, trade as a percentage of GDP wobbled up and down from 1940-1958, but it remained relatively stable. Trade as a percentage of GDP really increased from the mid-1960’s until the mid-1980’s. During this period the United States significantly increased its economic interdependence. A large factor was the sudden increase in the price of imported oil and the increased U.S. demand for imported automobiles and steel. Since the 1980’s, U.S. economic interdependence has increased at a slower rate despite the creation of the World Trade Organization, the North American Free Trade Area, and more than a dozen other U.S. free trade agreements.

Graph number 5 represents the measure of economic interdependence in the United Kingdom since 1830. The UK has been a leader of world trade longer than any other country, yet we see here that the degree of economic interdependence rose and fell rapidly over the last 175 years, and there has been no consistent pattern over time. Just as we saw in the case of the United States, Britain’s economic interdependence rose and fell as a function of changes in trade policy,
worldwide economic and political conditions, and the growth of the domestic economy. A
detailed study of the ebb and flow of trade in Britain would reveal the important influence of
British colonial policy and later, of British policy towards the European Economic Communities.
Today, the UK is one of the most interdependent countries; British trade in goods and services in
2005 equaled more than 50 percent of GDP.

One other example of a major trading power is Japan. Graph number 6 shows that Japan’s
economic interdependence rose dramatically in the 19th century and not surprisingly fell
precipitously during the Second World War. Japan’s level of economic interdependence rose
very rapidly during the period of occupation and reconstruction following the war, but what is
most surprising is that it remained fairly constant from the 1950’s to the mid-1970’s when the oil
price shock hit. From 1975 to 2000, Japan’s economic interdependence has swung widely from a
high of 28 percent to a low of around 17 percent. The overall trend in the last two decades
appears to represent a reduction in economic interdependence. Again, the determining factor
appears to be Japanese policy and economic conditions rather than a natural evolution to higher
levels of economic integration driven by technology.
What lesson can we draw from this brief and admittedly incomplete survey? Clearly, the general increase in the world’s economic interdependence represented in Graph number 1 reflects the overwhelming influence of the growth of Indian and Chinese imports and exports. However, this general trend does not necessarily hold true for all or most other countries, even countries we would regard as open economies. The most we can say is there is nothing natural or inevitable about a long term rise in interdependence. Rather, interdependence is a historically contingent process that rises and falls, reflecting changes in world economic policies and the specific trading policies of individual countries.

Once we abandon the false premise that economic interdependence is natural, we can unmask the underlying political trade-offs. States can choose to pursue certain policies that will encourage or discourage economic integration. The choice that states make to pursue economic integration is one that can and should be weighed against competing policy choices, such as improving labor conditions, reducing poverty, and protecting the environment. So long as we continue to espouse the rhetoric that economic integration is natural, we will obscure the difficult policy choices we face.