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The Gulliver Effect

John Donne wrote, "No man is an island, entire of itself." True enough, and true of countries, too, although Americans find the concept annoying. In physical terms, Americans view the U.S., like some classical physics experiment, as immune to outside influence. But the truth is that the economy is an open system and always has been. As with the shift from closed to open models in physics, this realization makes for big changes in the dismal science.

Arthur R. Burns, pipe-smoking chairman of the Federal Reserve Board from 1970 to 1978, exemplified the old isolationist economics. He spoke and acted as though the U.S. was free to set its monetary policy in Washington, D.C., regardless of the rest of the world. Indeed, to admit that the U.S. was part of Planet Earth was long considered an affront to national dignity.

In 1973 Burns and George Shultz, who was then secretary of the Treasury, faced a news conference in Paris after one of the many crises during the collapse of the Bretton Woods system of fixed exchange rates—which had been in place since the end of World War II. A reporter asked Shultz what the floating dollar meant for American monetary policy. As Paul Volcker, Burns's cigar-chomping successor, recounts the tale, Burns, always conscious of the prerogatives of an independent Federal Reserve chairman, reached over and took the microphone from Shultz and pronounced in his most authoritarian tone, "American monetary policy is not made in Paris; it is made in Washington."

Those living in small countries with close ties to their bigger neighbors, in contrast, have long known that their economies rise and fall with global tides. Earlier this century a string of Swedish economists and historians announced that they had found international price correlations; no Swede living beside the great bear of the German Empire in 1910 could doubt that the price of lumber and iron ore was set in world markets, rather than in Sundsvall.

In the 1940s the American economist Paul A. Samuelson remade the Swedish insight into "factor price equalization," but few of his compatriots paid serious attention. When U.S. economists look at the world, they see no obvious international influences on the domestic economy. Trade with any one nation amounts to only a tiny fraction of the American gross domestic product.

These isolationists should take a lesson from Jonathan Swift and realize that economics without the rest of the world is scientifically bankrupt. When Gulliver awoke from his nap in Lilliput, the little folk had tied him down with tiny threads. "I attempted to rise, but was not able to stir: for as I happened to lie on my back, I found my arms and legs were strongly fastened on each

TIED DOWN by tiny global threads, the U.S. economy resembles Gulliver.

side to the ground; and my hair, which was long and thick, tied down in the same manner. I likewise felt several slender ligatures across my body, from my arm-pits to my thighs. I could only look upwards."

The slender ligatures of the world economy are the commerce in luxury automobiles between Japan and the U.S., in corporate bonds between London and New York or in financial managers between Zurich and Chicago. Each link is trivial, but there are thousands of them. The giant Gulliver, also known as Uncle Sam, can only look upward.

Thanks to the Gulliver effect, the monetary policy of the U.S. is "made" in the markets of the world. Floating the value of the dollar with respect to other currencies gains Washington some freedom, but as long as global investors choose between Treasury bills and their counterparts from the Bundesbank or the Japanese Central Bank, the Federal Reserve cannot ignore the rest of the world. Furthermore, whether the dollar is fixed or floating, the structure of prices—including wages and interest rates—is set by the tug of thousands of international threads.

The Gulliver effect constrains not only economic policy but also how much American economists can ignore other countries when they make their theories. Large-scale models of the economy, fashionable as science back in the 1960s and nowadays still used for brute-force prediction, generally ignore the ties connecting U.S. prices to those elsewhere; introductory economics classes do not even cover such interconnectedness. Most American theorizing about economic growth ignores imports and exports. When U.S. economists think about monopoly, they think in one-nation terms, as though Volkswagen and Toyota had never happened to the automobile industry. It is as though an energy model of the earth ignored input from the sun or radiation into space.

Since the 1970s, a growing but still small group of U.S. economists has worked to think of American prices and wages as set not by supply and demand at home but by factors elsewhere. The Harvard economist Jeffrey Williamson, for example, has been exploring the effects of the global economy on American wages over the century past—it is hard otherwise to make sense of recent experience.

In doing so, these economists are returning to the roots of their discipline, laid down in Swift's era, when a single superpower did not yet dominate world trade. As late as 1817 the Isaac Newton of economics, David Ricardo, assumed in his economic *Principia* that international trade determined prices and wages, just as planetary orbits are determined by the sun. In the 19th century, when nationalism intervened, economists started believing that each planet could instead choose its own path. But now the facts are beginning to remind them. Just as physicists learned the limits of a mechanics based on idealized assumptions about perfectly elastic, frictionless bodies, economists are learning to look beyond their own borders.

DONALD N. McCLOSKEY is professor of economics and history at the University of Iowa.