The book cover features a background with a diagonal brushstroke. The top-left portion is a warm, reddish-orange color, while the bottom-right portion is a dark, charcoal grey. The brushstroke itself is a mix of these colors, creating a textured, painterly effect that runs from the top right towards the bottom left.

THE LEXUS  
AND THE  
OLIVE TREE

THOMAS L.  
FRIEDMAN

UNDERSTANDING GLOBALIZATION

As the Foreign Affairs columnist for *The New York Times*, Thomas L. Friedman has traveled to the four corners of the globe, interviewing people from all walks of contemporary life—Brazilian peasants in the Amazon rain forest, new entrepreneurs in Indonesia, Islamic students in Teheran, and the financial wizards on Wall Street and in Silicon Valley.

Now Friedman has drawn on his years on the road to produce an engrossing and original look at the new international system that, more than anything else, is shaping world affairs today: globalization.

His argument can be summarized quite simply. Globalization is not just a phenomenon and not just a passing trend. It is the international system that replaced the Cold War system. Globalization is the integration of capital, technology, and information across national borders, in a way that is creating a single global market and, to some degree, a global village.

You cannot understand the morning news or know where to invest your money or think about where the world is going unless you understand this new system, which is influencing the domestic policies and international relations of virtually every country in the world today. And once you do understand the world as Friedman explains it, you'll never look at it quite the same way again.

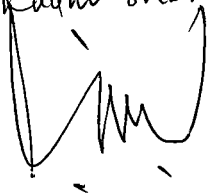
With vivid stories and a set of original terms and concepts, Friedman shows us how to see this new system. He dramatizes the conflict of "the Lexus and the olive tree"—the tension between the globalization system and ancient forces of culture, geography, tradition, and community. He also details the powerful backlash that globalization produces among those who feel brutalized by it, and he spells out what we all need to do to keep this system in balance.

Finding the proper balance between the Lexus and the olive tree is the great drama of the globalization era, and the ultimate theme of Friedman's challenging, provocative book—essential reading for all who care about how the world really works.

Kepada,

Datuk Seri Dr Mahathir  
Mohamad yang di-kaseli.

Dari pada,  
Kadun Shah Sulaiman







*Also by Thomas L. Friedman*  
From Beirut to Jerusalem (1989)



# *The Lexus and the Olive Tree*



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YAYASAN  
KEPIMPINAN  
PERDANA



THE  
LEXUS  
AND THE  
OLIVE  
TREE

*Thomas L. Friedman*

FARRAR STRAUS GIROUX

*New York*

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*For Ann*



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## Opening Scene: *The World Is Ten Years Old*

It's aggravating—we have nothing to do with Russia or Asia. We're just a little domestic business trying to grow, but we're being prevented because of the way those governments run their countries.

—Douglas Hanson, CEO of Rocky Mountain Internet, Inc.,  
speaking to The Wall Street Journal after the 1998 market  
meltdown forced him to postpone a \$175 million junk bond issue

On the morning of December 8, 1997, the government of Thailand announced that it was closing 56 of the country's 58 top finance houses. Almost overnight, these private banks had been bankrupted by the crash of the Thai currency, the baht. The finance houses had borrowed heavily in U.S. dollars and lent those dollars out to Thai businesses for the building of hotels, office blocks, luxury apartments and factories. The finance houses all thought they were safe because the Thai government was committed to keeping the Thai baht at a fixed rate against the dollar. But when the government failed to do so, in the wake of massive global speculation against the baht—triggered by a dawning awareness that the Thai economy was not as strong as previously believed—the Thai currency plummeted by 30 percent. This meant that businesses that had borrowed dollars had to come up with 30 percent more Thai baht to pay back each \$1 of loans. Many businesses couldn't pay the finance houses back, many finance houses couldn't repay their foreign lenders and the whole system went into gridlock, putting 20,000 white-collar employees out of work. The next day, I happened to be driving to an appointment in Bangkok down Asoke Street, Thailand's equivalent of Wall Street, where most of the bankrupt finance houses were located. As we slowly passed each one of

these fallen firms, my cabdriver pointed them out, pronouncing at each one: "Dead! . . . dead! . . . dead! . . . dead! . . . dead!"

I did not know it at the time—no one did—but these Thai investment houses were the first dominoes in what would prove to be the first global financial crisis of the new era of globalization—the era that followed the Cold War. The Thai crisis triggered a general flight of capital out of virtually all the Southeast Asian emerging markets, driving down the value of currencies in South Korea, Malaysia and Indonesia. Both global and local investors started scrutinizing these economies more closely, found them wanting, and either moved their cash out to safer havens or demanded higher interest rates to compensate for the higher risk. It wasn't long before one of the most popular sweatshirts around Bangkok was emblazoned with the words "Former Rich."

Within a few months, the Southeast Asian recession began to have an effect on commodity prices around the world. Asia had been an important engine for worldwide economic growth—an engine that consumed huge amounts of raw materials. When that engine started to sputter, the prices of gold, copper, aluminum and, most important, crude oil all started to fall. This fall in worldwide commodity prices turned out to be the mechanism for transmitting the Southeast Asian crisis to Russia. Russia at the time was minding its own business, trying, with the help of the IMF, to climb out of its own self-made economic morass onto a stable growth track. The problem with Russia, though, was that too many of its factories couldn't make anything of value. In fact, much of what they made was considered "negative value added." That is, a tractor made by a Russian factory was so bad it was actually worth more as scrap metal, or just raw iron ore, than it was as a finished, Russian-made tractor. On top of it all, those Russian factories that were making products that could be sold abroad were paying few, if any, taxes to the government, so the Kremlin was chronically short of cash.

Without much of an economy to rely on for revenues, the Russian government had become heavily dependent on taxes from crude oil and other commodity exports to fund its operating budget. It had also become dependent on foreign borrowers, whose money Russia lured by offering ridiculous rates of interest on various Russian government-issued bonds.

As Russia's economy continued to slide in early 1998, the Russians had to raise the interest rate on their ruble bonds from 20 to 50 to 70 percent to keep attracting the foreigners. The hedge funds and foreign banks kept buying them, figuring that even if the Russian government couldn't

pay them back, the IMF would step in, bail out Russia and the foreigners would get their money back. Some hedge funds and foreign banks not only continued to put their own money into Russia, but they went out and borrowed even more money, at 5 percent, and then bought Russian T-bills with it that paid 20 or 30 percent. As Grandma would say, "Such a deal!" But as Grandma would also say, "If it sounds too good to be true, it usually is!"

And it was. The Asian-triggered slump in oil prices made it harder and harder for the Russian government to pay the interest and principal on its T-bills. And with the IMF under pressure to make loans to rescue Thailand, Korea and Indonesia, it resisted any proposals for putting more cash into Russia—unless the Russians first fulfilled their promises to reform their economy, starting with getting their biggest businesses and banks to pay some taxes. On August 17 the Russian economic house of cards came tumbling down, dealing the markets a double whammy: Russia both devalued and unilaterally defaulted on its government bonds, without giving any warning to its creditors or arranging any workout agreement. The hedge funds, banks and investment banks that were invested in Russia began piling up massive losses, and those that had borrowed money to magnify their bets in the Kremlin casino were threatened with bankruptcy.

On the face of it, the collapse of the Russian economy should not have had much impact on the global system. Russia's economy was smaller than that of the Netherlands. But the system was now more global than ever, and just as crude oil prices were the transmission mechanism from Southeast Asia to Russia, the hedge funds—the huge unregulated pools of private capital that scour the globe for the best investments—were the transmission mechanism from Russia to all the other emerging markets in the world, particularly Brazil. The hedge funds and other trading firms, having racked up huge losses in Russia, some of which were magnified fifty times by using borrowed money, suddenly had to raise cash to pay back their bankers. They had to sell anything that was liquid. So they started selling assets in financially sound countries to compensate for their losses in bad ones. Brazil, for instance, which had been doing a lot of the right things in the eyes of the global markets and the IMF, suddenly saw all its stocks and bonds being sold by panicky investors. Brazil had to raise its interest rates as high as 40 percent to try to hold capital inside the country. Variations on this scenario were played out throughout the world's emerging markets, as investors fled for safety. They cashed in their Brazilian, Korean, Egyptian, Israeli and

Mexican bonds and stocks, and put the money either under their mattresses or into the safest U.S. bonds they could find. So the declines in Brazil and the other emerging markets became the transmission mechanism that triggered a herdlike stampede into U.S. Treasury bonds. This, in turn, sharply drove up the value of U.S. T-bonds, drove down the interest that the U.S. government had to offer on them to attract investors and increased the spread between U.S. T-bonds and other corporate and emerging market bonds.

The steep drop in the yield on U.S. Treasury bonds was then the transmission mechanism which crippled more hedge funds and investment banks. Take for instance Long-Term Capital Management, based in Greenwich, Connecticut. LTCM was the Mother of All Hedge Funds. Because so many hedge funds were attracted to the marketplace in the late 1980s, the field became fiercely competitive. Everyone pounced on the same opportunities. In order to make money in such a fiercely competitive world, the hedge funds had to seek ever more exotic bets with ever larger pools of cash. To guide them in placing the right bets, LTCM drew on the work of two Nobel Prize-winning business economists, whose research argued that the basic volatility of stocks and bonds could be estimated from how they reacted in the past. Using computer models, and borrowing heavily from different banks, LTCM put \$120 billion at risk betting on the direction that certain key bonds would take in the summer of 1998. It implicitly bet that the value of U.S. T-bonds would go down, and that the value of junk bonds and emerging market bonds would go up. LTCM's computer model, however, never anticipated something like the global contagion that would be set off in August by Russia's collapse, and, as a result, its bets turned out to be exactly wrong. When the whole investment world panicked at once and decided to rush into U.S. T-bonds, their value soared instead of fell, and the value of junk bonds and emerging market bonds collapsed instead of soared. LTCM was like a wishbone that got pulled apart from both ends. It had to be bailed out by its bankers to prevent it from engaging in a fire sale of all its stocks and bonds that could have triggered a worldwide market meltdown.

Now we get to my street. In early August 1998, I happened to invest in my friend's new Internet bank. The shares opened at \$14.50 a share and soared to \$27. I felt like a genius. But then Russia defaulted and set all these dominoes in motion, and my friend's stock went to \$8. Why? Because his bank held a lot of home mortgages, and with the fall of interest rates in America, triggered by the rush to buy T-bills, the markets feared that a lot of people would suddenly pay off their home mortgages early. If a lot of peo-

ple paid off their home mortgages early, my friend's bank might not have the income stream that it was counting on to pay depositors. The markets were actually wrong about my friend's bank, and its stock bounced back nicely. Indeed, by early 1999 I was feeling like a genius again, as the Amazon.com Internet craze set in and drove my friend's Internet bank stock sky high, as well as other technology shares we owned. But, once again, it wasn't long before the rest of the world crashed the party. Only this time, instead of Russia breaking down the front door, it was Brazil's turn to upset U.S. markets and even dampen (temporarily) the Internet stock boom.

As I watched all this play out, all I could think of was that it took nine months for the events on Asoke Street to affect my street, and it took one week for events on the Brazilian Amazon (Amazon.country) to affect Amazon.com. *USA Today* aptly summed up the global marketplace at the end of 1998: "The trouble spread to one continent after another like a virus," the paper noted. "U.S. markets reacted instantaneously . . . People in barbershops actually talked about the Thai baht."

If nothing else, the cycle from Asoke Street to my street and from Amazon.country to Amazon.com served to educate me and many others about the state of the world today. The slow, stable, chopped-up Cold War system that had dominated international affairs since 1945 had been firmly replaced by a new, very greased, interconnected system called globalization. We are all one river. If we didn't fully understand that in 1989, when the Berlin Wall came down, we sure understood it a decade later. Indeed, on October 11, 1998, at the height of the global economic crisis, Merrill Lynch ran full-page ads in major newspapers throughout America to drive this point home. The ads read:

#### The World Is 10 Years Old

It was born when the Wall fell in 1989. It's no surprise that the world's youngest economy—the global economy—is still finding its bearings. The intricate checks and balances that stabilize economies are only incorporated with time. Many world markets are only recently freed, governed for the first time by the emotions of the people rather than the fists of the state. From where we sit, none of this diminishes the promise offered a decade ago by the demise of the walled-off world . . . The spread of free markets and democracy around the world is permitting more people

everywhere to turn their aspirations into achievements. And technology, properly harnessed and liberally distributed, has the power to erase not just geographical borders but also human ones. It seems to us that, for a 10-year-old, the world continues to hold great promise. In the meantime, no one ever said growing up was easy.

Actually, the Merrill Lynch ad would have been a little more correct to say that *this* era of globalization is ten years old. Because from the mid-1800s to the late 1920s the world experienced a similar era of globalization. If you compared the volumes of trade and capital flows across borders, relative to GNPs, and the flow of labor across borders, relative to populations, the period of globalization preceding World War I was quite similar to the one we are living through today. Great Britain, which was then the dominant global power, was a huge investor in emerging markets, and fat cats in England, Europe and America were often buffeted by financial crises, triggered by something that happened in Argentine railroad bonds, Latvian government bonds or German government bonds. There were no currency controls, so no sooner was the transatlantic cable connected in 1866 than banking and financial crises in New York were quickly being transmitted to London or Paris. I was on a panel once with John Monks, the head of the British Trades Union Congress, the AFL-CIO of Britain, who remarked that the agenda for the TUC's first Congress in Manchester, England, in 1868, listed among the items that needed to be discussed: "The need to deal with competition from the Asian colonies" and "The need to match the educational and training standards of the United States and Germany." In those days, people also migrated more than we remember, and, other than in wartime, countries did not require passports for travel before 1914. All those immigrants who flooded America's shores came without visas. When you put all of these factors together, along with the inventions of the steamship, telegraph, railroad and eventually telephone, it is safe to say that this first era of globalization before World War I shrank the world from a size "large" to a size "medium."

This first era of globalization and global finance capitalism was broken apart by the successive hammer blows of World War I, the Russian Revolution and the Great Depression, which combined to fracture the world both physically and ideologically. The formally divided world that emerged after World War II was then frozen in place by the Cold War.

The Cold War was also an international system. It lasted roughly from 1945 to 1989, when, with the fall of the Berlin Wall, it was replaced by another system: the new era of globalization we are now in. Call it "Globalization Round II." It turns out that the roughly seventy-five-year period from the start of World War I to the end of the Cold War was just a long time-out between one era of globalization and another.

While there are a lot of similarities in kind between the previous era of globalization and the one we are now in, what is new today is the degree and intensity with which the world is being tied together into a single globalized marketplace. What is also new is the sheer number of people and countries able to partake of this process and be affected by it. The pre-1914 era of globalization may have been intense, but many developing countries in that era were left out of it. The pre-1914 era may have been large in scale relative to its time, but it was minuscule in absolute terms compared to today. Daily foreign exchange trading in 1900 was measured in the millions of dollars. In 1992, it was \$820 billion a day, according to the New York Federal Reserve, and by April 1998 it was up to \$1.5 trillion a day, and still rising. In the last decade alone total cross-border lending by banks around the world has doubled. Around 1900, private capital flows from developed countries to developing ones could be measured in the hundreds of millions of dollars and relatively few countries were involved. According to the IMF, in 1997 alone, private capital flows from the developed world to all emerging markets totaled \$215 billion. This new era of globalization, compared to the one before World War I, is turbocharged.

But today's era of globalization is not only different in degree; in some very important ways it is also different in kind. As *The Economist* once noted, the previous era of globalization was built around falling transportation costs. Thanks to the invention of the railroad, the steamship and the automobile, people could get to a lot more places faster and cheaper and they could trade with a lot more places faster and cheaper. Today's era of globalization is built around falling telecommunications costs—thanks to microchips, satellites, fiber optics and the Internet. These new technologies are able to weave the world together even tighter. These technologies mean that developing countries don't just have to trade their raw materials to the West and get finished products in return; they mean that developing countries can become big-time producers as well. These technologies also allow companies to locate different parts of their production, research and marketing in different

countries, but still tie them together through computers and teleconferencing as though they were in one place. Also, thanks to the combination of computers and cheap telecommunications, people can now offer and trade services globally—from medical advice to software writing to data processing—that could never really be traded before. And why not? According to *The Economist*, a three-minute call (in 1996 dollars) between New York and London cost \$300 in 1930. Today it is almost free through the Internet.

But what also makes this era of globalization unique is not just the fact that these technologies are making it possible for traditional nation-states and corporations to reach farther, faster, cheaper and deeper around the world than ever before. It is the fact that it is allowing individuals to do so. I was reminded of this point one day in the summer of 1998 when my then seventy-nine-year-old mother, Margaret Friedman, who lives in Minneapolis, called me sounding very upset. “What’s wrong, Mom?” I asked. “Well,” she said, “I’ve been playing bridge on the Internet with three Frenchmen and they keep speaking French to each other and I can’t understand them.” When I chuckled at the thought of my card-shark mom playing bridge with three Frenchmen on the Net, she took a little umbrage. “Don’t laugh,” she said, “I was playing bridge with someone in Siberia the other day.”

To all those who say that this era of globalization is no different from the previous one, I would simply ask: Was your great-grandmother playing bridge with Frenchmen on the Internet in 1900? I don’t think so. There are some things about this era of globalization that we’ve seen before, and some things that we’ve never seen before and some things that are so new we don’t even understand them yet. For all these reasons, I would sum up the differences between the two eras of globalization this way: If the first era of globalization shrank the world from a size “large” to a size “medium,” this era of globalization is shrinking the world from a size “medium” to a size “small.”

This book is an effort to explain how this new era of globalization became the dominant international system at the end of the twentieth century—replacing the Cold War system—and to examine how it now shapes virtually everyone’s domestic politics and international relations. In that sense, it is meant as a contribution to the body of literature that has been attempting to define the post-Cold War world. Among the most widely read of this genre are four books: Paul M. Kennedy’s *The Rise and Fall of the Great Powers: Economic Change and Military Conflict from*

1500 to 2000, Francis Fukuyama's *The End of History and the Last Man*, the various essays and books of Robert D. Kaplan and Samuel P. Huntington's *The Clash of Civilizations and the Remaking of World Order*.

While all of these works contained important truths, I think none of them really captured the post-Cold War world in any holistic way. Kaplan's reporting was vivid and honest, but he took the grimmest corners of the globe and overgeneralized from them to the fate of the rest of the world. Huntington saw cultural conflicts around the world and wildly expanded that into an enduring, sharply defined clash of civilizations, even proclaiming that the next world war, if there is one, "will be a war between civilizations." I believe both Kaplan and Huntington vastly underestimated how the power of states, the lure of global markets, the diffusion of technology, the rise of networks and the spread of global norms could trump their black-and-white (mostly black) projections.

Both Kennedy and Huntington tried to divine the future too much from the past and the past alone. Kennedy traced (quite brilliantly) the decline of the Spanish, French and British empires, but he concluded by suggesting that the American empire would be the next to fall because of its own imperial overreaching. His implicit message was that end of the Cold War not only meant the end of the Soviet Union but would also herald the decline of the United States. I believe Kennedy did not appreciate enough that the relative decline of the United States in the 1980s, when he was writing, was part of America's preparing itself for and adjusting to the new globalization system—a process that much of the rest of the world is going through only now. Kennedy did not anticipate that under the pressure of globalization America would slash its defense budget, shrink its government, and shift more and more powers to the free market in ways that would prolong its status as a Great Power, not diminish it.

Huntington's view was that, with the Cold War over, we won't have the Soviets to kick around any more, so we will naturally go back to kicking the Hindus and Muslims around and them kicking us around. He implicitly ruled out the rise of some new international system that could shape events differently. For Huntington, only tribalism could follow the Cold War, not anything new.

Fukuyama's pathbreaking book contained the most accurate insight about what was new—the triumph of liberalism and free-market capitalism as the most effective way to organize a society—but his title (more

than the book itself) implied a finality to this triumph that does not jibe with the world as I find it.

In a way, each of these works became prominent because they tried to capture in a single catchy thought “The One Big Thing,” the central moving part, the underlying motor, that would drive international affairs in the post-Cold War world—either the clash of civilizations, chaos, the decline of empires or the triumph of liberalism.

This book is very different. I believe that if you want to understand the post-Cold War world you have to start by understanding that a new international system has succeeded it—globalization. That is “The One Big Thing” people should focus on. Globalization is not the only thing influencing events in the world today, but to the extent that there is a North Star and a worldwide shaping force, it is this system. What is new is the system; what is old is power politics, chaos, clashing civilizations and liberalism. And what is the drama of the post-Cold War world is the interaction between this new system and these old passions. It is a complex drama, with the final act still not written. That is why under the globalization system you will find both clashes of civilization and the homogenization of civilizations, both environmental disasters and amazing environmental rescues, both the triumph of liberal, free-market capitalism and a backlash against it, both the durability of nation-states and the rise of enormously powerful nonstate actors. What I have tried to write is a guidebook for how to follow that drama and how to think about managing it.

Just one last word before we start. The publisher and editor of this book, Jonathan Galassi, called me one day and said, “I was telling some friends of mine that you’re writing a book about globalization and they said, ‘Oh, Friedman, he loves globalization.’ What would you say to that?” I answered Jonathan that I feel about globalization a lot like I feel about the dawn. Generally speaking, I think it’s a good thing that the sun comes up every morning. It does more good than harm. But even if I didn’t much care for the dawn there isn’t much I could do about it. I didn’t start globalization, I can’t stop it—except at a huge cost to human development—and I’m not going to waste time trying. All I want to think about is how I can get the best out of this new system, and cushion the worst, for the most people. That is the spirit that motivated this book.

The first part of the book explains how to look at today’s globalization system and how the system works. The second part explains how nation-states, communities, individuals, and the environment interact with this

system. The third part explains the backlash against globalization. And the fourth explains the unique role the United States plays, and needs to keep playing, in stabilizing this new system.

Thomas L. Friedman  
Washington, D.C.  
February 1, 1999

