Index overstock

THE SAFEST PATH to stock market success, investors have often been told, is to diversify—to invest in different stocks representing the whole market. But by so often choosing index funds, perhaps we are heeding that advice too well.

Unlike typical mutual funds, index funds invest in all the components of a stock index (the Dow Jones Industrials or the S&P 500, for example) and thereby closely duplicate the index’s returns. Because of their inherent diversification and low administrative costs, index funds have skyrocketed in popularity since their 1976 debut.

But a recent study by Randall Morck and Fan Yang finds that stocks included in market indexes may be overvalued relative to similar excluded stocks. Index membership increases the demand for stocks in the index as fund managers and diversity-seeking investors buy more shares. Since the number of shares issued is relatively fixed, the prices of stocks in the index go up.

Worse, Morck and Yang fear that the popularity of index funds caused an “indexing bubble” mirroring the “tech bubble” of the late 1990s. More than just an overvaluation, a bubble could occur if investors bought index-included stocks as much for their perceived propensity to continue increasing as for their underlying value. As the stock prices of firms included in the index increase, demand for those stocks rises, further increasing their price. The authors conclude that in 2001, the values of stocks included in the S&P 500 were as much as 90 percent above those for similarly sized companies not included in the index—a premium far in excess of what would be considered merely “overvalued.”

Normally, investors sell overvalued stocks and buy their undervalued peers, eventually bringing prices back into line. But the popularity of index funds has made this almost impossible. Index funds are still attracting investors even as stock market investment overall has declined in the last three years. As a result, the premium on index funds, though diminished, has persisted. Morck and Yang point out, however, that if investors found alternative ways of diversifying and indexing became less popular, then the prices of a number of prominent stocks could fall sharply. Until then, the prices of indexed stocks will likely continue to command a premium. —Matt Rutledge

ACCORDING TO CONVENTIONAL WISDOM, globalization is about breaking down national borders. Indeed, it is often argued that growing economic integration and interdependence lead to more open borders and more harmonious cross-border relations. President Vicente Fox of Mexico, a leading proponent of this view, took office in December 2000 promoting a bold vision of an open U.S.-Mexico border, including the free movement of labor and the creation of a North American community. Such a proposal would further advance the process of continental integration. With the U.S.-Canada and U.S.-Mexico borders already the two busiest land crossings in the world, U.S.-Mexico trade has more than tripled and U.S.-Canada trade has nearly

Border security in the age of globalization: How can we protect ourselves without losing the benefits of openness? By Peter Andreas
Photographs by Nubar Alexanian
doubled since the start of the North American Free Trade Agreement (NAFTA) in 1994.

Fox’s border-free vision of North America was one of the first casualties of the devastating terrorist attacks on the Twin Towers and the Pentagon on September 11, 2001. In both political debates and policy practice, the events of that day raised fears and put borders very much back in style, as the United States began a dramatic tightening of border inspections as part of its new and expanding war on terrorism. Traditional border issues, such as trade and migration, would now be inescapably evaluated through a security lens.

But the cross-border transportation and communications networks used by terrorists are also the arteries of a highly integrated and interdependent economy. Currently, about one-quarter of all U.S. production for export (2.5 percent of U.S. gross domestic product) goes to Canada and 15 percent is destined for Mexico. Constricting the arteries that facilitate this trade increases the cost of the cross-border flow of people and goods, with significant economic repercussions for ourselves and our trading partners. Similarly, the way in which border controls are implemented and managed could reduce the benefits of open borders and significantly affect the future of North American economic integration. Notes Stephen Flynn, a senior fellow at the Council on Foreign Relations, “U.S. prosperity—and much of its power—relies on its ready access to North America and global networks of transport, energy, information, finance, and labor. It [would be] self-defeating for the United States to embrace security measures that isolate it from these networks.”

**BORDER CONTROLS BEFORE AND AFTER 9-11**

Before the attacks on 9-11, U.S. border enforcement overwhelmingly focused on inhibiting the flow of illegal drugs and immigrants. The enforcement apparatus of the Immigration and Naturalization Service (INS) was designed to handle millions of migrant workers entering the country in search of employment rather than to detect a few individuals who arrive to commit terrorist acts. Counterterrorism had traditionally been a low priority. Similarly, the U.S. Customs Service focused its energy on controlling the entry of illegal drugs into the country, and

Border security is back in style. But a sustained crackdown risks inhibiting legitimate trade and travel.
the Coast Guard concentrated on interdicting illegal drugs and immigrants. If the efficacy of these efforts was and continues to be controversial, perhaps one reason is that border enforcement efforts have sought to project the image of heightened security while not substantially slowing legitimate cross-border flows of people and goods.

Also, prior to 9-11 most enforcement activity centered on the U.S.-Mexico border, while the U.S.-Canada border was barely policed—only 334 agents were assigned to the 5,525-mile northern border compared with over 9,000 agents stationed at the 2,662-mile southern edge. Even during the 1990s, when the INS budget tripled and the size of the U.S. Border Patrol doubled, attention remained almost exclusively directed at the U.S.-Mexico border. On September 11, 2001, there were as many Border Patrol agents in Brownsville, Texas, as along the entire U.S.-Canada border.

The attacks on the World Trade Center and Pentagon complicated business as usual along both U.S. borders. The immediate U.S. response included increasing spending on border security and a dramatic tightening of inspections. The 2003 federal budget provided for a more than $2 billion increase in border security funds, including a 29 percent increase for the INS, a 36 percent increase in the inspections budget of the Customs Service, and the largest budget increase in the Coast Guard’s history. Moreover, these agencies have now been brought together and folded into the new Department of Homeland Security—representing the largest reorganization of the federal government since the end of World War II.

One major change was an increased enforcement effort at the U.S.-Canada border. Under the Patriot Act, the number of agents deployed at the Canadian border was tripled; the Coast Guard now stops all boats crossing the Great Lakes and escorts gas and oil tankers. For its part, Canada also ordered a high state of alert at border crossings immediately after the attacks. Since then, it has enhanced the levels of security at airports, added new funding for detection technologies and personnel, initiated legislation to combat the financing of terrorism, and frozen the assets of known terrorist groups. It also introduced a fraud-resistant resident card for new immigrants, increased detention capacity and deportation activity, instituted greater security screening for refugee claimants, and tightened its visa regime—including adding a requirement that Saudi and Malaysian visitors obtain visas.

To a significant degree, these new U.S. border security measures have consisted of taking the old drug and immigration enforcement infrastructure and adapting it to counterterrorism efforts. Yet the counterterrorism mission is far more difficult than stopping the flow of illegal drugs and immigrants, and the expectation of success is much higher—indeed, the American public expects a success rate of 100 percent. And the indicators of success used for traditional border enforcement work, such as arrests and seizures, are visible and relatively easy to
use, whereas even counterterrorism “successes” can be infrequent and difficult to observe (for example, the attack that does not take place). In short, border enforcers have been given a harder job, face higher expectations, and have to rely on more difficult measures of progress.

**A NEW KIND OF TRADE BARRIER?**

As understandable as these border security measures may be, a sustained crackdown at U.S. land ports of entry risks a considerable impact on legitimate travel and trade. The United States and Canada conduct $1.3 billion worth of two-way trade a day, most of which is moved by truck. According to one estimate, a truck crosses this border every 2.5 seconds—amounting to 45,000 trucks and 40,000 commercial shipments every day. Immediately following 9-11 and the ensuing clampdown, the result was a dramatic slowing of cross-border traffic. Delays for trucks hauling cargo across the U.S.-Canadian border increased from 1–2 minutes to 10–15 hours, stranding shipments of parts and perishable goods. Automobile companies, many of which manufacture parts in Ontario and ship them to U.S. assembly plants on a cost-efficient, just-in-time basis, were particularly vulnerable. Ford closed an engine plant in Windsor and a vehicle plant in Michigan due to part shortages. Massive traffic jams and long delays also characterized the U.S.-Mexico border, where an estimated 300 million people, 90 million cars, and 4.3 million trucks cross the border annually.

While border delays are now not as long as immediately following the attacks, heightened security concerns can have a chilling effect on cross-border exchange. Put differently, security can become a new kind of trade barrier. Indeed, the United States’ response immediately after 9-11 was the equivalent of imposing a trade embargo on itself, observes Stephen Flynn. While the long-term process of North American integration has not been reversed, it has certainly been complicated by the squeeze on the cross-border transportation arteries that provide its lifeblood.

**FUTURE BORDER TRAJECTORIES**

There are at least three potential future border trajectories in North America. At one extreme, one can imagine a substantial hardening of U.S. border defenses with security trumping all other considerations—the equivalent of a high tariff on the economies of both the United States and its neighbors. At the other are multilateral policy harmonization and a “pooling” of sovereignty similar to that which exists among European Union members—where common visa and asylum policies, a shared information system, and standardized border procedures essentially provide a common security perimeter. The most likely scenario for North America lies somewhere in between: a series of initiatives involving a mixture of enhanced cross-bor-
der security collaborations and partial policy convergence.

As the task of border control becomes more difficult, looking for answers beyond physical borderlines may be one way to enhance security while encouraging economic integration. For example, there are a number of innovative new cargo-tracking systems, inspection technologies, and traffic management strategies that are being promoted to extend policing beyond the ports of entry.

These “smart border” measures are designed to both ease border congestion and enhance security at the same time. For example, manufacturers and transport companies can beef up internal security measures to seal their cargo and can use new information and tracking technologies to assure the accountability of drivers and shipments. Regular business travelers can be prescreened and provided with an identification card with biometric information (such as handprint or retina information), and their vehicles can be equipped with electronic transponders. To facilitate border inspections and ease congestion, passenger information can be transmitted to border agents in advance. And for cargo, the entire inspection process could even be pushed away from the physical border into a trilateral continental inspection facility.

Balancing the twin policy objectives of border facilitation and enforcement has always been an awkward and cumbersome task. Since 9-11, the balancing act has become even more difficult as we seek ways to advance market integration while also managing our security and other public policy interests. Although it will likely be impossible to fully reconcile the twin imperatives of integration and security, how well we manage this formidable and inescapable challenge will profoundly shape the future of cross-border relations in North America.

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“Smart border” measures can simultaneously enhance security and encourage economic integration.