

Global Political Economy and the Wealth of Nations

Performance, institutions, problems
and policies

Edited by Phillip Anthony O'Hara

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Global Political Economy and the Wealth of Nations

The recent era of globalization and neoliberalism has left some predicting the end of traditional concepts such as the nation state and localized economies.

This volume undertakes a comparative empirical analysis of the state of the world in the light of neoliberal globalization. Special reference is given to the pattern and nature of GDP, productivity, innovation, quality of life, human development, social capital and environmental performance, as well as trends and prognoses in Asia, Eastern Europe, Africa, America, and Oceania. The book also examines international institutions such as the WTO, the IMF, transnational corporations and the gender division of labour, and modern problems such as pollution, financial crises, ethnic tension, terrorism and war.

It is a comprehensive analysis of global capitalism and a reassessment of policy trends. Readers with an interest in international political economy, development economics, international politics and economics generally will find this to be a timely and informative volume for their book collection.

Phillip Anthony O'Hara is Director of the Global Political Economy Research Unit and Associate Professor at Curtin University, Australia. He has written and edited several other books, including the *Encyclopedia of Political Economy*, also published by Routledge.

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Foreword

The world has experienced many changes over the past three decades. The interaction between countries and people has increased remarkably, and the word “globalization” is used extensively to describe these trends. Policy changes have relatedly pushed almost all countries in a neoliberal direction of deregulation and more flexible organization. Globalization and liberalization are euphorically applauded by most mainstream economists and policy makers all over the world. These policies and trends are supposed to make the world economy grow sustainably, and even to close the gap between rich and poor.

Powerful interests support globalization and liberalization: ideological ones favoring free markets; intellectual ones from neoclassical economics; cultural ones with a Western bias; and the vested interests of corporations, global finance, and officials in international institutions and governments. The process of globalization itself propagates these views through the media and other channels.

There are, of course, dissenters among economists, other social scientists, activists, and policy makers, and protestors at meetings of international organizations espousing these policies. The current book is part of a recent trend to a “post-Washington consensus”, where the financial crises, corporate excesses and conflicts of the past decade or so have created a new vision of the how the world works. This vision says that even if globalization and neoliberalism bring benefits to many, it may also promote uneven development, financial instability, corporate greed, environmental destruction, and ethnic tension. This requires institutions and policies to promote social, public and innovative capitals or wealth to more fully embed society within economy.

The contributors to this volume follow a political economy tradition that provides an institutional and evolutionary perspective of the global system. As its title suggests, and as Phil O’Hara points out in his introduction, the book draws on the analytical method of the classical political economy of Adam Smith and his followers, but also on the work of Marx, Veblen, Keynes, Schumpeter, and their modern counterparts. It stresses both efficiency and equity, turning the spotlight on income distributional and social justice issues, including gender, poverty, and inequality across nations.

Like the classical political economists, the contributors take a broad view of the global economy. Although they explore economic issues such as growth and technological change, international trade, transnational corporations, and international finance carefully, they go far beyond the boundaries of economics narrowly defined. They thus also scrutinize environmental and health issues, the role of nation states, consumerism, ethnic tension, terrorism, and their connections to economic trends.

The contributors come from different backgrounds and from different parts of the world, and this book is thus a product of globalization itself. However, this fact also allows them to escape from certain intellectual fashions and biases. The unity of the volume lies in questioning the euphoria about globalization; recognizing the complexity of global-national-regional interactions; and surveying the institutional trends, processes and problems of the contemporary world. It presents a governance framework designed for the early decades of the twenty-first century for developed and developing regions.

This current book is also an improvement on many studies in international political economy that have sought an overly abstract critical analysis. It succeeds in being more pragmatic, empirical and realistic in its analysis of uneven development, institutions, problems and policies. It seeks to analyze the world on the basis of salient facts and dynamic processes.

It is also path-breaking in that it widens the scope of vision and provides a more holistic view of global, national, and regional problems and policies. It goes beyond a narrow economic and political analysis of contemporary issues by adopting an open-systems approach that includes social, environmental, and cultural factors. In doing so it presents a truly interdisciplinary analysis of political economy.

Overall, this book makes a substantial contribution to understanding contemporary processes and problems in the world economy. It makes fascinating reading, and should be required reading for courses on global political economy, development studies, and governance. It seeks to provide an analysis that improves the standard of living, quality of life, and environmental sustainability of planet Earth – that is currently in a state of considerable conflict and instability – and here lies its main contribution to knowledge and scholarship.

Amitava Krishna Dutt
University of Notre Dame

Preface

Many thanks to the writers of articles in this book for engaging in highly productive labor through innovative and leading-edge research. The articles were written during 2002 and rewritten during the last half of 2002 and early 2003. Hassan Bougrine, Amitava Krishna Dutt, and Reynold Nesiba generously undertook refereeing. All the papers are original works especially written for this volume, having been refereed by at least two persons, and been through one or more rewrite.

The book grew out of a collective recognition during the late 1990s and early 2000s of contradictory conditions emerging in the global, regional and national political economies. The boom of the 1990s and/or the greater level of globalization and deregulation, created certain conflicts and instabilities that contributed to financial and currency crises, speculative crashes, fraudulent accounting and financial practices, conflict and war, declining trust and cooperation, demonstrations against globalization and neoliberalism, and institutional disarray. The former “communist” regimes of Eastern Europe and Russia mostly had not recovered the output levels of 1990 in their quest for market reforms. Many countries of Europe, the US and other nations underwent major recessions and crises. Emerging nations of Asia griped through crises, recession and after recovery further recession. The process of uneven development led to Africa and parts of Latin America standing still or going backwards. The technological and corporate splurge of the 1990s led in the 2000s to major speculative crashes and corporate fraud. Typically during long wave downswing the short-cycle booms contribute endogenously to the emergence of major instabilities and crises every decade or so.

In response to this boom and crisis tendency, the spread of globalization and neoliberalism, as well as challenges to the Washington Consensus, I set up the Global Political Economy Research Unit (GPERU) in late 2000, and this book is the first project of GPERU. One week in late September 2000 I became especially concerned about trends in the world, and within a day a project outline was drawn up, with some tentative chapter titles to start the ball rolling to critically analyze the interface between global, regional and national political-economic processes. The study seemed to range widely, leaving few stones unturned. I wanted writers to examine the *contradictions*,

but also to undertake a thorough *survey* of the current state and evolution of the world, including its performance and dominant institutions, as well as providing progressive *governance guidelines* for the future and analyzing *likely future trends* (where possible). Within a week of the drafting of this preliminary outline, authors were showing excited interest. It was a pleasure meeting up with Rob Langham from Routledge in several places over the past few years; he helped a great deal, and sent off the outline to three reviewers, whose reports were very positive and instructive. Terry Claque helped a lot with the publishing agreement and other matters. In Miami, Gunder Frank and Alison Candela shared their wisdom of encouragement and advice. By the time I got back to Perth in early 2001 everything was organized, with an international caste of researchers and the chapters promised.

From there I went on study leave to be with Jim Devine at Loyola Marymount University in the first half of 2002, and use the wonderful resources of the University of California, Los Angeles, Young Research Library for my work on wealth distribution, terrorism and policy issues. Santa Monica was a great base from which to consider the first drafts, work on my own chapters, and communicate with writers. Presentations and interaction with writers at the ASSA meetings in Atlanta, the Eastern Economics Association in Boston and at LMU provided much sustenance. Howard Sherman stimulated, encouraged and provided resources that helped a great deal. For the intellectual space provided by study leave and long service leave, I thank my colleagues in the Curtin Business School who made this possible, including Harry Bloch and Ian Kerr for their generous support.

The camaraderie and resources offered by members of the Union for Radical Political Economics, Association for Evolutionary Economics, European Association for Evolutionary Political Economy, International Association for Feminist Economics, Association for Social Economics, International Confederation of Associations for Pluralism in Economics and Society for Heterodox Economics enabled this collective project to progress. Without these associations and their wonderful members there would be no *political economy* worth mentioning. Rhoda O'Hara gave her usual solid support. The trips I made to Prague, Tokyo, Budapest, Kerala, Malaysia, China, Portugal, Spain, France, Italy, Mexico, Greece, England, Ireland, US, New Zealand, Amsterdam and elsewhere over the years helped to stimulate a breadth of vision required for situating and analyzing the problems. Thanks to the many people I met on these trips for expanding my horizons and sharpening my insights.

Many of the issues raised in this volume are explored in more detail, or in a different context, in a series of articles, and a companion volume of mine entitled *Growth and Development in the Global Political Economy: Social Structures of Accumulation and Modes of Regulation* (London and New York: Routledge, 2004).

This book emanates from the things that stir our minds and passions. Prime factors are the need for human freedom, well-being, ecological suste-

nance and the instrumental functioning of institutions. The writers of this volume share a similar concern for humanity and the future of planet Earth. May your reading of this volume be as enjoyable, enlightening – and in places disturbing – as was my reading and analysis of the articles and issues. Communicating and exploring the state and evolutionary transformation of the world with my colleagues and friends writing for this volume was a great pleasure. They are to be praised for their efforts in understanding the world, including its problems, possibilities and likely trends, and sharing this with others on a global scale.

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Introduction

Phillip Anthony O'Hara

Recent changes to global capitalism

Much has been made of the recent trend to globalization in the world political economy. It has been argued that international trade, foreign direct investment, foreign exchange, information and transportation have all expanded relative to GDP (gross domestic product) in the past two or three decades. This has raised the question of whether we are undergoing a qualitative change in capitalism, and whether it has a profound impact on the way the world operates and our place in it.

This book surveys and analyses the current structure and functioning of the global economy, set within the framework of national, regional and continental linkages. In this we have tried to employ a broader vision than most, scrutinizing not just the state of growth and development, institutions and governance issues, but also environmental, ethnic, health and social processes. We utilize a political economy approach that is interdisciplinary, evolutionary and systemic in nature. Broadly we follow the scope and vision of the classical political economists and their more modern counterparts, such as Thorstein Veblen, Joseph Schumpeter, W.A. Lewis, Paul Baran, Gunnar Myrdal, Hyman Minsky, David Gordon and Amartya Sen.

We also explore the validity of the claims that globalization – and its twin, neoliberalism – are operating to the detriment to socioeconomic stability and those with less power: national governments, the environment, ethnic minorities, working classes and underdeveloped nations. In particular, we explore the hypotheses that this global trend is significantly increasing levels of instability in the world political economy; that national governments are less able to manage their domestic economies; that it operates to the advantage of the advanced nations instead of the underdeveloped ones; that it has heightened ethnic, class and regional conflict through greater fragmentation and disarray of social institutions; and that globalization and neoliberalism has enhanced the rule of transnational capital around the globe at the expense of the underclasses.

The eighteen essays in this book variously explore the theme of globalization relative to economic performance, institutional structure, critical problems and policy issues. The general conclusions of the book are mixed

and involve various caveats and qualifications. A general theme is that globalization and neoliberalism are subject to various contradictory forces. In political economy contradictions are positive and negative elements that emanate from the same processes and are inextricably fused. Living with them subjects agents and nature to these dual forces, which can manifest as mainly positive or at other times mainly negative impacts, depending on the interactions and trends involved.

What are these contradictions? On a positive note, the free play of global market forces and the rule of capital seek to cast aside fetters to its expansion, through the penetration of ever greater and better markets, technologies, wants and needs, fashions and trends. Capitalism is by its very nature expansive, destructive, creative and seeking to dissolve non-capitalist relations and forces. It actively seeks to promote new methods, forms of competition, and markets in the struggle for survival and expansion. It doing so it potentially enhances the material position of certain classes and groups in the community. Those with high expectations and skills, in particular, are capable of gaining positions of power, influence and remuneration. And those innovators who survive and flourish are capable of reaping enormous material rewards that can enhance their lifestyle. If the benefits are able to trickle down to the mass of the population – globally, regionally, nationally and locally – then the positives are often very strong indeed.

But as it succeeds in some of the positives so the system and its agents usually unwittingly create various path dependent tensions, conflicts and antagonisms. Some of the conflicts and tensions are due to such expansive forces being uneven, asymmetric and unequally effective in opening regions and cultures to the creative and destructive forces of change and transformation. This seems to be happening in the relations between core, periphery and semi-peripheral nations. Other antagonisms are due to the dislocative effects of such transformation, as existing institutions are dissolved while new ones take some time to emerge, or are having great difficulty appearing. This is manifesting itself in the so-called “transition” from communism to a market economy, especially in the former Soviet Union and parts of Eastern Europe, as well as through various structural adjustment processes, such as the relative demise of agriculture, changes in skills and workplaces, and adjustment to new norms and mores.

Still other contradictions are due to conflicts within and between classes and other groups. For instance, a critical one is between financial and industrial capitals, the one tending toward periodic speculative bubbles and crises and the other dependent upon productive investment and productivity. The periodic dominance of industry by finance can lead to financial crises and deep recession, such as happened during the Asian financial crisis, in Japan and during the early twenty-first century in the US, Argentina and in many other regions (for example, in parts of Europe). Hot capital flows, high debt and unsustainable expectations of the future have major consequences for socioeconomic performance.

Globalization and neoliberalism have also created a mode of regulation whereby capital is more powerful relative to labor in most nations. This has impacted on working conditions, real wages and the time that people engage in work. Governments have tried to moderate spending patterns and reduce budget deficits where possible. State enterprises have often been sold off to the private sector. This has impacted on the working poor, and those dependent upon social security, unemployment benefits and state-sector employment. Women and certain ethnic groups have especially suffered in this respect because they are more dependent upon social benefits and employment outside the market system.

Also, the emphasis on exports, global competition and outside markets by most governments of the world has created a problem of aggregate effective demand. Every nation cannot reduce its domestic demand, with the aim of reducing costs and promoting technical efficiency, without risking the problem of inadequate spending. The trend to neoliberalism and leaving demand to the private sector can be anomalous when systemic vitality conflicts with individual corporate objectives. For instance, in a Kaldorian world of circular and cumulative causation, aggregate demand helps to sustain productivity and market global position due to economies of scale/scope and learning by doing. And for those economies unable to benefit from economies of scale and innovation – such as many developing nations of Africa, Latin America and Asia – special assistance in terms of state spending and industry policy may be needed to enhance long-term performance. Either way, the system may require special incentives and assistance to help propel innovative and sustainable growth.

Still other problems emerge as capital searches for new areas to penetrate and new technologies to activate. Traditional cultures less used to rapid change may see their value systems being questioned and their lifestyles upset. This is especially prevalent when transnational capital is accompanied by Western-style advisors and military personnel. Many Islamic peoples, for instance, may react to this by seeking to protect their own values and traditions from “Western barbarians” who seem to be out for dominance and power. This is especially true when such cultures are already under some degree of pressure as people move to the cities, employment is limited and security under threat. This is the environment in which terrorism and ethnic conflict emerges.

A special problem that emerges is that some indicators of growth, welfare and development are stressed more than others. For instance, when the policy and cultural mindset is focused on GDP growth, the type of policies and practices that are activated seek to switch as much production as possible from non-market activities to the market. This can create problems as production may in total not change, yet it appears that growth and perhaps development is occurring. In the process household and small business productive activities may diminish, families may be subject to major lifestyle changes as their members seek work in other areas, and environmental

pollution may increase. Indeed, the switch from so-called non-market to market relations may have a devastating impact on levels of social communication, trust, association and habitat. Without sufficient social, cultural and natural capitals, economic performance may be subject to greater instability and long-term deterioration.

These conflicts and dislocations are often outside the mainstream academic and policy debate. This book is an attempt to bring them directly into the analysis. Indeed, the main objective of this international collaboration among scholars is to illustrate how to undertake an interdisciplinary and holistic analysis of global capitalism. We seek to expand boundaries and perspectives, to go beyond economic views and analyze global capitalism as a system. Social, political and economic factors are all critical to a political economy approach to growth and development in the world economy. In essence we explore the extent to which the global tendency is affecting the social, natural and material wealth of nations, regions and institutions.

Outline of the book

In relation to Part I, "Global Performance and the Wealth of Nations", the major themes are as follows. At the start it needs to be pointed out that globalization is not a new phenomenon, and that there have been at least two eras of globalization in recent history: during the age of imperialism (1880–1914) and during the current so-called "global age" (1980–present). But, more fundamentally, some authors argue that the global trend is really a more long-term process that began (at least) several hundred years ago with the rise of early modern world-systems. Seen in this light, one needs to examine the question in a long-term historical framework, so that structural change can be more adequately comprehended. Indeed, the current global system, as it is called, is not really all that global, since some global trends are dominant, but even these trends are uneven and partial, and in many instances the nation state is quite significant.

Wil Hout in Chapter 1, "A global economy, polycentric world or system of nation states?" explores the question of the degree of globalization in some detail, and concludes that "the current order should be seen as a partially global one". The most dominant form of globalization lies in the financial domain, particularly in relation to trade in derivatives, such as swaps, options and other so-called "off-balance sheet activities". But even here it is uneven, being dominated by North American transactions, followed by European and Asian. International trade and foreign direct investment are also highly global but uneven, being heavily biased toward the industrialized nations, since most developing countries produce similar products and are less attractive to transnational corporations. He also shows that states continue to be important, depending on the degree of strength and power of their national economies. Overall, he demonstrates the importance of the core/periphery/semi-periphery analysis, inasmuch as the core nations are generally subject

more to the global trend and more powerful, the peripheral nations are less global and less effective, while the semi-periphery tends to have a medium level of globalization and effectivity. Globalization thus exacerbates the existing division of labor and uneven development in the global political economy.

In Chapter 2, “Wealth and welfare of nations, continents and corporations”, Phil O’Hara explores historical and more recent trends in socioeconomic performance in the light of the past couple of decades of globalization and neoliberalism. In particular, he analyzes the patterns and trends of wealth and welfare throughout the world according to a myriad of indicators. Special attention is paid to indicators such as GDP, technology achievement, human development, quality of life, economic welfare, inequality and social capital. A number of conclusions are made. First, the most important recent change is that some of the East-Asian nations have joined the club of high achievers in relation to virtually all indicators. The reemergence of Asia may simply be the reestablishment of trends long since dominant through many millennia. Africa and in many cases Latin America have been left out of the club for internal and external reasons. Globally, the 1970s–2000s have been a period of long wave downswing when not only GDP growth but also many other indicators, such as sustainable welfare, equality and trust, have diminished significantly in many regions of the world. Globalization and neoliberalism have thus not reestablished socioeconomic performance to the levels of the 1950s and 1960s; in fact, things seem to be getting worse rather than better.

Amitava Krishna Dutt in Chapter 3, “Uneven development, convergence and North-South interaction”, explores the pattern of inequality and income growth throughout the world over the past 40 years. In particular, he seeks to examine theory and empirical evidence to explain why developing nations of (especially) Africa and Latin America have been unable to generate sufficient growth, investment and technological advance to improve their relative position in the world economy. The empirical evidence supports this divergence between north and south in an age of so-called globalization. The key factors to explain this evidence are manifold. For instance, there tend to be increasing returns to scale in industry in the North while the South tends to experience diminishing returns and lack of innovation. Also, Southern demand for Northern products is more income elastic than Northern demand for Southern goods. There is also a brain drain from the South to the North, which tends to exhaust the stock of knowledge-intensive labor in developing nations. The further the South falls behind the North technologically the harder it is for them to keep up with the North, despite the *potential* advantages of the “technology gap”. He thus concludes that there are very good explanations behind the trend to divergence in the world political economy.

Harry Bloch and Sam Tang in Chapter 4, “Recent performance of the developing East Asian economies”, explore recent trends in the performance of East Asian nations, and then discuss the significance of the evidence for global growth and development. They present evidence that East Asian

nations such as China, Singapore, South Korea, Malaysia, Indonesia and Thailand experienced high growth during the 1970s–1990s, although during the Asian crisis years and the early years of the new millennium growth rates have subsided. For most of these nations, government direction of foreign investment and trade has been critical to their expanding wealth. They find that most of the nations have expanded on the basis of factor accumulation rather than innovation, and that this form of growth tends to heighten the instability and precariousness of their growth performance. Also, much of the more recent growth was the result of premature financial liberalization that was unsustainable as capital inflows subsided (and became unstable). This does not bring relief for the problems of the world capitalist economy since long-term growth requires more co-dependent industrial and financial innovation, which currently appears to be lacking.

In Chapter 5, “Transformation to a market economy in Eastern Europe, the former Soviet Union and Asia”, John Marangos presents the last paper in the “performance and wealth” part of the book. He examines the performance of the current and former “communist” nations in transformation to a market economy, and the significance of this transformation for the future of the world capitalist system. He starts off by recognizing that most of the former “communist” nations underwent some form of “shock therapy” to the market economy, and that most of them have not even reestablished the GDP levels of 1990. This raises the question of what factors caused this often substantial decline in wealth. He presents some evidence that it is in part due to the dislocation process itself: that the process of institutional change was too rapid, leaving many nations without suitable institutions on which to plan enterprising business and social pursuits. A major factor is said to be the fledgling system of democracy itself which, because of vested interests and other problems, failed to support long-term growth. The Chinese experiment in market socialism was seen as the most successful since it was relatively gradual and did not dislocate the institutions in the process. It is likely, however, to take a considerable amount of time before these nations in transformation will contribute – on balance – to long-term growth in the world capitalist system.

Part II (Chapters 6–10) examines in some detail the institutions underlying much of the “global trend”. Special reference is given to transnational corporations (TNCs), international financial institutions (IFI), the World Trade Organization (WTO), the global gender division of labor, and the system of fashion and style in the global economy. In general, this part of the book reveals contradictions in the institutions that simultaneously propel growth and accumulation together with a distorted form of reproduction that is uneven and to some degree unproductive.

John Davis’ Chapter 6, “Transnational corporations: dynamic structures, strategies and processes”, examines the recent trends and dynamics associated with the 65,000 TNCs operating throughout the world. Taking advantage of the major theories of TNCs, he shows that the transnational trend is motivated by the search for profitability, including market power, internaliza-

tion of activities to reduce transaction costs and, especially, the search for technological innovation and learning. In terms of the impact and significance of TNCs in the world economy, some major processes are scrutinized. It is argued that recent TNC globalization is consistent with the neoliberal project of promoting flexibility in labor and product markets so as to develop a deeper level of capitalist transformation worldwide. This process tends to bring a few developing nations into the orbit of advancement, while the majority in Africa and parts of Latin America are unable to attract suitable investment and technological innovation to sustain long-term development. In the process, a global rentier class is being created that has no real affinity to any nation or area, except perhaps those already in positions of power and hegemony. Democratic politics will continue to grow along the lines of the major power blocs, with the power of the TNCs potentially being able to exert their influence at the national level.

Maureen Burton and Reynold Nesiba in Chapter 7, “Transnational financial institutions, global financial flows and the International Monetary Fund”, examine the dominant patterns of finance in the global political economy. They find that the dominant players in the global banking sector emanate (at least nominally) from advanced nations – especially Japan, Germany, the US and the UK – although Chinese banks are starting to penetrate the global economy quite successfully. The circuit of global finance is contradictory, however, since deregulated global finance has led to both uneven development as well as financial instability and crises. Foreign direct investment (FDI) is not going to the major areas of poverty in the world – understandably enough – while debt flows of hot money are able to move in and out of areas, thereby upsetting their productive systems. Some degree of regulation of such hot flows are necessary; the IMF has to some degree recognized this problem, but history will tell whether their recent reforms will reduce the levels of financial instability in the developing world.

In Chapter 8, “The World Trade Organization, free trade areas and the distribution of wealth”, Hassan Bougrine explores the operation of the WTO and its influence on global wealth production and distribution. A major theme is that the WTO is a club that tries to look after the interests of the dominant players, which are mainly the highly industrialized nations and a few rising stars. This organization is said to have little regard for nations that are structurally stuck with problematic terms of trade, low barriers to entry and few potential economic rents to call upon such as innovations, royalties and patents. Many nations of sub-Saharan Africa and Latin America, and a few from Asia, are unable to join the exclusive club of powerful players, partly due to the rules of trade being against them. These structural problems are said to heighten inequalities due to class, ethnicity, nation and gender, which are reproduced through successive generations of differential access to global, regional and national networks, knowledge and technology.

Hella Hoppe and Wilfred Dolfsma in Chapter 9, “The global gender division of labor”, examine the institutional forces that are reproducing the

differential roles that men and women are playing in the global economy. They argue that women are subject to lower wages and worse conditions because they are often expected to provide household labor that reduces the time available for them to work in the official labor market. Women also have a higher propensity to be in the informal rather than formal economy, which reinforces the tendency for them to have more marginalized conditions and rewards. Even when they join the formal workforce, however, they are often in lowly service sectors or they may work part time, both of which provide lower wages than the male-oriented industrial sector. Since they are often expected to opt out of the labor force periodically to look after children and others, their ability to get promoted and increase their remuneration is limited even further. Often they miss out on access to the knowledge and other leading sectors due to established institutions and habits. Many of these institutions are ceremonial rather than instrumental, and need to (further) change so that women can participate and benefit more equally in the world of work. Proactive micro-credits and other measures can help to integrate women into mainstream and innovative lines of work.

The last chapter in Part II, Chapter 10 by Doug Brown, "Conspicuous consumption, fashion and style in the global marketplace", examines the contradictory role played by institutions such as fashion and style in the global society and marketplace. People are seeking new ways to establish meaning and association in their lives as neighborhoods and families decline. Neoliberalism and globalization provides a solution to this problem by providing goods and services that embellish certain symbols and meanings to which people can relate. Young people, for instance, can purchase clothing and records imbued with a style that is "hip". They can travel to places that enhance their required image. Older people can choose a suburban way of living – including house, car, spouse and garden – giving them a certain ambience that may enhance their self-worth. In the global marketplace, people can generally choose the styles of commodities that fit their budget and mode of life. By trying to achieve "all that is possible" and "be all they can be" they are able to feel that life is worthwhile. But this form of "integration" is unproductive since it promotes conspicuous consumption, waste and greater inequality. It draws people away from their authentic selves to a false self. The developing world tries to emulate this mode of living, leading to an expanding level of overconsumption and wastage. The environment also suffers since this form of living is ecologically unsustainable at the global level.

Part III of the book deals with specific global and regional problems, such as financial crises, pollution, poverty and hunger, ethnic and religious tension and the war on terrorism. A general theme linking these papers is that global capitalism and neoliberalism employ a mode of economy that makes society more disembedded. The relations of community and personal linkage tend to break down as footloose finance rules the world, habitat and village are disrupted, and the developing world is not suitably included in the rules and institutions of the system.

Chapter 11 by Brenda Spotton Visano, “Financial crises, crashes and speculative bubbles”, examines the causes of the numerous financial problems of the 1990s and beyond that engulfed Mexico, Asia, Brazil, Russia, Argentina, as well as the United States and other nations. The chief problem is that deregulated finance and other “innovations” tend to enhance speculative bubbles and unsustainable levels of debt as economic agents get caught in the euphoria of the boom. The endogenous workings of capitalism tend to create such conditions, and finance needs to be regulated by a series of prudential and activist policies ensuring finance serves the long-term interests of industry rather than just business. Deregulation in national economies is one problem, but deregulating the global economy compounds the difficulties as footloose finance can quickly move from one area to another. Contagion magnifies the problem. The financial crises of the 1990s and 2000s have enhanced these problems, but memory of such problems fades. Hence the need for well established and flexible policies to control such rampant financial flows. Some of the containment policies examined may be of assistance in promoting more stability.

In Chapter 12, “Environmental problems of the world”, Andrew Brennan details some of the ecological problems that beset the world political economy. This paper starts by analyzing the Circuit of Life. This includes the circuit of social capital of production, distribution and exchange; the social relations of family, workplace and state; plus the circuits of nature that provide the economy with energy, materials and habitat. The ecological problems of the world are to some high degree endogenously created by an economic system that exploits the resources of the natural world in the interests of maximum profit and accumulation. The capitalist economy persistently creates entropy, and helps to reproduce global warming and the destruction of biodiversity. The policies of globalization and neoliberalism teach us that population always needs to expand in the interests of demand, that the penetration of more markets is essential, and that neither corporations nor governments are likely to be made to adhere to any global protocols that reduce global warming and increase biodiversity. He concludes that we need to transcend or radically modify such policies and practices if we are to save the very species and habitats upon which we depend for long-term survival on planet Earth.

Chapter 13 by Ed O’Boyle, “World poverty, hunger and disease”, explores the critical question of to what extent people of various continents are subject to poverty, hunger and disease. This paper goes to the root of the concerns of humanity: how is the global society dealing with people who are poor, malnourished and dying of illnesses? What are the causes of such misery? He presents some good news and some bad news. The good news is that the percentage of people in poverty throughout the world has dropped significantly over the past decade or so, as has the infant mortality rate and the proportion of people who are malnourished. People are also living considerably longer. The bad news is that poverty, infant mortality and malnourishment has increased or remained fairly steady in many parts of sub-Saharan

Africa, Latin America and the Caribbean. People are also badly off in the former Soviet Union and Eastern Europe. The situation is especially grim in East and Southern Africa, where a combination of drought, famine, war and diseases such as AIDS, malaria, hepatitis and diarrhea are sapping the energy of the people. Every year in the world around 2–3 million people die from pneumonia, AIDS, diarrhea or tuberculosis.

Ed O'Boyle argues that the principal causes of these problems are economic globalization, the inability of the technological, biological and political revolutions to permeate many underdeveloped nations, and the sexually promiscuous tendencies of many cultures. For instance, AIDS and the recent SARS virus were able to spread so quickly because of the globalizing trends in transportation and human mobility. Africa, in particular, has not adequately benefited from the revolution in medicine and sanitation, the revolution in science and technology, nor the political revolution in democracy and representation. The high rate of poverty, disease and mortality in certain areas is partly due to the legacy of colonialism, the inadequacies of domestic institutions, and external influences. In this light, the gluttonous lifestyles that are characteristic of people in the advanced capitalist nations appear immoral. The inability of governments, corporations and people in the advanced world to collectively demonstrate enough humanity and respect for the peoples of Africa and Latin America is a sad reflection of the state of the world. The last 20 years has seen a heightened level of individualism, greed and lack of trust throughout the world that has in a sense created the environmental conditions for these schisms and uneven developments.

Chapter 14 by Asoka Bandarage, "Ethnic and religious tension in the world: a political-economic perspective", examines the underlying cultural and institutional relationships and processes creating tension among ethnic and religious groups. This is of special interest in the current environment where certain Islamic fundamentalists are engaged in a Jihad against US hegemony (and Western "barbarism") on a global scale, and numerous ethnic and religious groups are involved in conflict. Rather than explaining these conflicts by a "clash of civilizations" or "primordial ties and identities", as some have, she rightly emphasizes the political economy factors at play. Examples include militant Islam, recent conflict in former Yugoslavia and Rwanda, evangelical orders (and associated right-wing violence) in advanced nations, unrest in the West Bank and the Gaza strip, as well as Hindu-Christian and Tamil violence in South Asia. The main factors involved in these numerous conflicts are said to be the "post-colonial predicament" of these peoples, as well as the devastating influence of globalization and poverty on their lifestyles.

The colonial and post-colonial experience imparted institutions on the people that were inherently conflicting; especially relating to the divisions and power-plays of politics, national and regional borders, and ideological divisions. Globalization and neoliberalism have created the conditions of insecurity, separation, alienation and cultural disintegration. The imperatives of

global competition and profitability have led to a fragmentation of local culture. Uneven development has led to more relative poverty in a world where material conditions have come to dominate spiritual concerns. Such poverty, disarray and lack of trust is a breeding ground for ethnic tension in search of victims and enemies – usually the “cultural other”, including opposing religions, ethnic minorities, migrants and outside forces. Messianic and fundamentalist beliefs and actions tend to emerge out of this economic and spiritual vacuum. The more proactive sects emerging from the conflicts tend to provide material and personal support structures that people are often lacking in their lives. Asoka Bandarage believes that what is urgently needed are universal ethical movements and approaches, based on an inclusive and integrative philosophy, that can satisfy human economic, social and emotional needs.

In Chapter 15, “The war on terrorism, political-economic contradictions, and policy issues,” Phil O’Hara examines the political economy foundations of terrorism and the so-called war on terrorism. Since the 11 September 2001 attacks on New York and Washington, D.C., the US and its allies have come to see “terrorism” and a certain “axis of evil” as principal threats to its security. In response to these attacks, the US has led the war in Afghanistan and the war against the regime of Saddam Hussein in Iraq, as well as a concerted campaign against al Qaida, bin Laden and their sympathizers. A new global war is in process between the US and its allies and certain Islamic fundamentalist groupings, “rogue states” and their supporters. The US is not popular in parts of the East and, especially, the Middle East. Many resources are now being spent on homeland security, customs and travel security, and related ways of reducing the threat of terrorism and from those supposedly with weapons of mass destruction.

This chapter examines the contradictory processes involved in the generation of “terrorism”, and the policy options that follow from such contradictions. The first contradiction of terrorism is that it is utilized because it has a low fatality risk to the individual citizen but is considered a major threat by citizens. In other words, it is a relatively low-cost option to the terrorists while having a high impact on society. The second contradiction is that a high-technology society promotes high-technology solutions by terrorists, which to some degree limits the technology. The third contradiction is that the US strategic support for the *Mujahideen* in Afghanistan to defeat Soviet “communism” – and indirectly the Taliban and al Qaida – itself led to a vacuum that promoted the terrorist threat. And the fourth contradiction is that the spread of globalization and neoliberalism indirectly helped the growth of terrorism as a generation or two in the Middle East saw their society being affected by outside military forces, an ethically questionable “Western” culture, and a demoralized and internal culture with few opportunities for its peoples. Many reacted by fighting “the other”, in the form of materialistic cultures of the Soviets and the United States, that were appearing to “dominate” their region. The chapter then posits a number of

policy measures that follow from such contradictions. These include making friendly cultural overtures to Islam, helping solve the problems in Palestine and the Middle East through a reduction in Western dominance, instigating a form of regulation of international finance and transportation, as well as upgrading information-communications security, homeland security and consequence management on the ground.

Up to this point the book has examined the socioeconomic performance and wealth of nations and regions, the institutional fabric of global capitalism, and critical problems that beset the world. All through these discussions policy implications have been analyzed to varying degrees. Part IV of the book seeks to deepen the analysis of policy issues. Chapter 16 by Phil O'Hara, "The viability of government policies in a globalized economy", explores the national policy significance of the trend to globalization. The chapter begins by recognizing that the trend to globalization is only partial, and that certain regional and local customs and cultural traits still do exist that link people to national and regional processes. This leads national and state governance structures to ways of influencing political economy processes. Global linkages are also possible through more coordinated measures to moderate the instabilities of capital flows and embark on proactive measures of social and cultural innovation and protection. To the extent that globalization is happening, it is necessary both to protect citizens from the ravages of seemingly impersonal forces and provide them with resources to engage meaningfully in the increasingly global communications and knowledge economy. Furthermore, monetary policy must seek not to stimulate speculative bubbles in the equity and foreign exchange markets. Lastly, recent research strongly supports the use of fiscal policy for enhancing the educational, health, communications and infrastructural requirements of nations and regions. In short, there is much scope for national policy, despite some of the obvious potential problems that impact on national government from the globalization trend.

In Chapter 17, "Viable policies, programs and institutions for the future", Hassan Bougrine outlines a shamelessly heterodox program of action at the level of governance. First, he defines the goals of such a program as eradicating poverty, democratizing wealth, and promoting a clean and healthy environment. Then he elaborates on the means to attaining these goals, including a full-employment strategy, a public debt system and a policy of protecting biodiversity. Critical is the development of coordinated global governance in the light of interdependencies and instabilities in the world economy. Hassan Bougrine outlines the basics of a Chartalist theory upon which this framework is based. Taxes drive the money supply through providing the demand for government money that the system as a whole requires. Monetization of debt is the norm since government spending is financed by the drawing of checks and the like through the Treasury. Public deficits are required during normal times in order to stimulate private spending. Balanced or surplus budgets would be uncommon, but certainly necessary when inflationary demand is impinging on the system. Full employment

would thus be possible – where all those who are willing to work could get a job – if the public sector instigated a system of employment of last resort. Jobs would be available to those out of work in order to instill in them the skills of a modern economy and enhance their self-worth. This program is based on alternative notions of public finance and governance that deserve to be seriously investigated and developed.

Lastly, Baidya Ghosh in Chapter 18, “Development policies for the twenty-first century”, examines some policy options and directions in order to reduce uneven development. He first critically evaluates development policies since the 1950s, then examines the changing development concepts through the decades and lastly centers on prospects for development in an age of neoliberalism and so-called globalization. He argues that recently a new conception of development has emerged that provides some optimism. Questions of human development, strong sustainability and social capital have begun to take center stage. The emphasis is being placed on human capability, resource availability and bounded freedom. It is important to distribute resources to those negatively impacted by restraints of class, gender, ethnicity, region and caste. Human development is taking a broader direction than GDP to encompass literacy, health, trust and sociality. In an age of neoliberalism the emphasis is given to reducing corruption, money laundering and vested interests while expanding productive government spending on health, education, infrastructure and communications that spurs private spending. And in the global age it is critical to moderate the hot capital flows and financial instabilities by concentrating on the fundamentals of innovation, skill-development and network formation. The challenges of implementing such policies are great, but the rewards from successfully developing them can be widespread.

Future prospects for global capitalism

The major themes discussed and explored in this book point to various possible futures for global capitalism. Of course, the future is in some large measure indeterminate and uncertain. But patterns and tendencies are discernible, which can guide us in making prognoses for the future. Scenario one will apply with no discernible changes in the tendencies and processes. This is the situation where the current contradictions are in motion, and the positive and negative aspects discussed in this book are in force. The current positive forces are the continuing tendency for the expansion of markets, providing good jobs for those with the skills and tacit knowledge to contribute to innovative business networks, and the creative destruction of inefficient firms and institutions.

The negative forces of the existing system include the relative dominance of finance over industry, leading to the emergence of periodic financial crashes and crises; the destruction of institutions and firms that leads to major structural adjustments and dislocations; the promotion of inequality and

greed that breed problematic corporate governance and unproductive activities; the demise of non-capitalist relations that to some extent destroys community and trust; the forces of uneven development and center-periphery divergence that question the effectiveness of the global system; the lack of effective demand that negatively impacts on both productivity and innovation; and overconsumption that leads to environmental anomalies as well as conspicuous fashions and fads, reducing the cultural integrity of the system. Some of these negative elements have been recognized in the literature, but seldom do most of them get the attention they deserve. If the system operates with "business as usual", then these anomalies will continue to plague, especially, those who are struggling to survive in an uncertain world, but in one form or other we are all affected by this uncertainty and instability.

However, if policy is directed to moderating some of these problematic tendencies then there is some hope that social, political and economic progress may emerge through global, national and regional networks and relationships. The first critical policy option is for the global society and its nations to create an innovative and compassionate system that instills trust and sociality in its peoples. This requires a creative vision of innovation, which includes not only the usual forms, such as new processes and products, markets, raw materials and organizations, but also cultural, social and political improvements. These are required not simply to promote efficiency (narrowly formulated), but also to provide institutional and lifestyle support for sustainable development, ethnic diversity and compassion, and culturally embedding capability enhancement.

In an uncertain and constantly changing system, governments and corporations need to recognize the need for resources for people to enhance their skills, adjust their lifestyle, and have access to funds, in order to prevent personal dislocation and anomie from getting worse. A move away from the free market philosophy is required, to recognize the importance of capability expansion, resource availability, and trust. More attention needs to be given to the social fabric in neighborhoods, communities and social-business networks. Trust is at historically low levels. Social support resources are generally poor. A cultural transformation needs to be engendered through the proactive force of political and corporate leaders, non-government organizations and international institutions.

There is a need for more empathy with the various religious and ethnic groups in the world. Some degree of coming together is needed of the great visions of Islam, Christianity, Hinduism and Buddhism, as well as Western and Eastern philosophies of society and governance. The inability of various nations to grow and develop places pressure on their inhabitants, and stimulates the development of fundamentalist beliefs that promote global conflict. Hegemonic dominance and colonial and post-colonial practices have, in many cases, worsened this situation. In short, the Western cultural heritage needs to reduce its superiority complex and seek to share and understand

other beliefs. This is critical since ideas and ideologies help to pattern practices and material outcomes.

Second, recent research has supported the need for a switch from transfer payments to more productive government spending to prevent higher rates of unemployment and underemployment from emerging. There is thus a need to enhance government investment on education, health, infrastructure and communications, which tend to have crowding-in effects on private spending. Such policies are necessary both in advanced and developing nations. This is unlikely to be a major burden on government finances for two reasons: such activities enhance national income, and central government spending generally follows the Chartalist theory. This is the situation where taxes drive money and governments enhance the liquidity of the system through innovative spending schemes.

The third governance issue is to moderate unstable financial flows in order to promote long-term innovation, industry and social stability. The conflict between finance and industry is a critical one that requires policies to restore confidence in the pursuit of productive activities of an industrial, service and social nature. The experience of the financial and economic crises of the 1990s–2000s in the developing and also advanced world teaches us (if we didn't already know) about the problems of corporate greed and insufficient attention being given to business ethics and trust. The dominance of finance capital is a problem not only when the money and capital markets are being deregulated, but also after the deregulation and reconstruction process when the banking sector may be seen as strong and the macroeconomy as resilient. Hence the need for some combination of more effective corporate governance, changes to accounting and auditing practices, Tobin taxes, capital controls and, eventually, a real global central bank.

Fourth, from an environmental perspective, it appears that major initiatives are required to temper global warming and species extinction. The Kyoto Protocol was a minimalist approach, but even here the strongest nation in the world refuses to cooperate. We need leaders who can instill and promote a vision of strong sustainability, and an educational process that enables citizens to comprehend and act on the scientific evidence. Technologies and consumptive patterns need to be molded so as to reduce energy consumption and entropy. It is likely that we need a major international organization to administer these policies, alongside international and regional agreements that stimulate reform.

It may be difficult to promote such changes in the global and regional political economy, since the contradictions demonstrate that the positive and negative influences are endogenously connected. But through moderation of the extremes of global capitalism and neoliberalism, the contradictions can be lessened to some degree. While this may inhibit some of the great successes – or, more likely, reorient priorities – it should also reduce some of the uncertainties and instabilities. This needs to be done in a way that balances system and individual requirements. A strengthening of local and

international democracy and a greater level of citizen participation in social and economic life should help to facilitate the embedded system of livelihood required for a healthy community. In this way it is possible to have a more just and humane existence while enabling social, political and economic innovations to be effectively instigated.

Part I

**Global performance
and the wealth of
nations**

1 A global economy, polycentric world or system of nation-states?

Wil Hout

Introduction

The purported “global” dimension of social phenomena and processes has, over the past few decades, increasingly come to dominate discussions in policy circles as well as among scholars. In particular, with respect to the contemporary political-economic order, the discourse has focused on seemingly global issues. For instance, in the early 1990s, supporters of the East Asian model of development heralded the outward orientation of the Asian economies and argued that the policy of trade openness pursued by these countries would be a good example for other developing countries (World Bank 1993: 23–5; Ohmae 1996: 120–1). Likewise, after the Asian financial crisis of 1997–1998, critics pointed at global developments – in particular, global capital flows – in their explanations of the vulnerability of the South East Asian economies (e.g. Bello *et al.* 2000: 12–16). Recently, so-called anti-globalists have rallied against what they consider to be the bulwarks of globalization, such as the World Trade Organization (WTO), the International Monetary Fund (IMF) and World Bank, the Group of 8 (the main industrialized countries plus Russia), the European Council and the Davos-based World Economic Forum.

Many analysts and critics of the current political-economic order seem to assume that the move to “globalness” is as inescapable as it is historically unprecedented. In this chapter I scrutinize this and similar claims. In particular, I analyze the structure of the global political economy that has developed over the last few decades. The second section presents a brief overview of some political-economic interpretations of the nature of the global order, which helps to provide a theoretical understanding of the empirical findings presented in the next three sections. In the third section, I assess to what extent the international economic order has become truly “global”. Section four analyzes the asymmetry or unevenness of contemporary globalization. In the fifth section, I try to establish to what extent the nation-state is still the most important building block of the global political economy. The final section contains some conclusions.

Interpretations of the global order

The recent literature on the global political economy is replete with discussions of the essence of the “global”, “transnational”, “international” or “supraterritorial” order. Because the definition of a subject matter colors one’s understanding of it, it is of more than mere academic interest to chart which central assumptions on and explanations of the global order follow from different perspectives. In what is one of the best-known recent books on the issue of globalization, Hirst and Thompson (1999: 10) have made the following distinction between the globalized and the international economic order:

A globalized economy is a distinct ideal type from that of the inter-national economy and can be developed by contrast with it. In such a global system distinct national economies are subsumed and rearticulated into the system by international processes and transactions. The inter-national economy, on the contrary, is one in which processes that are determined at the level of national economies still dominate and international phenomena are outcomes that emerge from the distinct and differential performance of the national economies. The inter-national economy is an aggregate of nationally located functions.

Hirst and Thompson’s distinction between a globalized and an international economy indicates that a judgment about the balance between global and international forces is dependent on the importance of national (or domestic) transactions relative to cross-border transactions. An *international* economy will be characterized by the fact that transactions are still predominantly oriented toward the domestic level; cross-border transactions follow from the domestic ones, for instance, because producers in one country have acquired a competitive edge over producers in other countries, or because producers buy abroad raw materials or parts they need in their manufacturing process. The *globalized* economy, on the contrary, would be dominated by economic activities that can no longer be identified with a single national economic domain. In such a situation, “global” or “transnational” firms – also referred to as “footloose capital” – would be the supreme economic actors. Partly because of their definition of globalization, which would require quite an extreme shift of economic activity to the global level, Hirst and Thompson conclude that the present-day international order should be seen as an inter-national rather than a globalized economy.

In a recent introduction, Jan Aart Scholte has defined globalization as the rise of “supraterritoriality” (2000: 42). Supraterritoriality is understood as “an end to what could be called ‘territorialism’, that is, a situation where social geography is entirely territorial” (2000: 46). In Scholte’s (1997: 430) view, internationalization means “increased movements between countries of goods, investments, people, money, messages and ideas”. Globalization, on the other hand, should be seen as

a trend whereby social relations become less tied to territorial frameworks. From this perspective borders are not so much crossed or opened as transcended. Here “global” phenomena are those which extend across widely dispersed locations simultaneously and can move between places anywhere on the earth pretty much instantaneously. Territorial distance and territorial borders hold limited significance in these circumstances: the globe becomes a single “place” in its own right.

(Scholte 2000: 431)

Scholte’s empirical judgment about the present political-economic order differs considerably from the one put forward by Hirst and Thompson. According to Scholte (2000: 18), the current order should be seen as a partially globalized one, in that some sectors (such as money and finance) are more globalized than others, and some countries and regions (for instance, the United States and Western Europe) have generally experienced more globalization than others (such as sub-Saharan Africa).

Authors from the so-called world-systems tradition have applied a “holistic” perspective to the existing global order and have argued that the world-system is the appropriate unit of analysis, instead of separate national economies or societies. It is argued that the modern world-system, which came into being in sixteenth-century Europe, has expanded ever since and now spans the globe. The world-system is assumed to operate on the basis of capitalist production for a world market, with economic actors who aim to accumulate capital. Chase-Dunn *et al.* (2000: 78) have defined structural globalization as “changes in the density of international and global interactions relative to local or national networks”. World-systems analysts reject the idea that international integration, or globalization, is a recent phenomenon; instead they see it as

a long-term trend with already significant amounts of international investment, trade, and political-military competition having occurred in earlier centuries. World-systems analysts also know that economic integration has been a cyclical feature of the larger system, with some periods of local and national autarky followed by other periods of greater international integration.

(Chase-Dunn 1998: xi)

A global economy?

Different approaches have been proposed to study the extent to which economic relations have taken on a truly global character. Most empirical studies include data on international trade and financial flows. For reasons of data availability and comparability with other analyses, in this chapter I will limit the discussion to these two aspects of the global political economy.

Trade

Hirst and Thompson (1999: 27) have presented an historical comparison of the level of integration of the international system on the basis of trade figures of selected (core) countries. Their analysis reveals that these countries' openness to trade – operationalized as merchandise exports and imports as a percentage of gross domestic product – at the end of the twentieth century was on a par with the situation at the beginning of the twentieth century.

Chase-Dunn *et al.* (2000: 78) have argued, however, that (trade) globalization should be taken as a variable characteristic of the whole world-system. They recognize that there has been indeed an increase of global integration during the second half of the twentieth century, but hold that this growth does not represent an entirely different stage in the development of the world-system. Global integration, as measured with trade openness data, has reached an unprecedented high level, but this level does not, in their view, deviate significantly from the long-term trend of globalization, with lapses from 1880 to 1902 and 1925 to 1945, that is evident since the early nineteenth century (Chase-Dunn *et al.* 2000: 87–8).

Figure 1.1 presents the results of an analysis of global trade openness, using the approach suggested by Chase-Dunn *et al.* (2000). The two series that are pictured in this figure represent, respectively, the yearly global average trade openness, weighted by population, and the regression line of trade openness between 1960 and 1999. Global trade openness was measured as the weighted average value of all countries' exports of goods and services, expressed as a percentage of their gross domestic product. Because the measure is based on calculations in terms of each country's own currency, it is not dependent on a conversion into a different currency, such as the US dollar.¹ Figure 1.1 suggests that the average openness to trade has increased considerably over the final four decades of the twentieth century. On average, as expressed by the regression line in Figure 1.1, trade has grown by 0.44 of a percentage point per year between 1960 and 1999.

The analysis performed by Chase-Dunn *et al.* on trade openness between 1815 and 1995 has suggested that the data display the occurrence of three upward cycles of trade globalization (1815–1879, 1903–1924 and 1946–1995). My analysis, which covers the 1960–1999 period, indicates a substantially faster growth than the yearly increase of 0.28 of a percentage point that was reported by Chase-Dunn *et al.* (2000: 88) for the 1946–1995 period, and thus suggests a speeding up of the pace of trade globalization in the last several decades. On the basis of the present analysis, one might hypothesize that there was a “cycle within a cycle”, starting in 1960, or even a new, fourth cycle, starting in the 1990s. It is, however, too early to back up the latter surmise with sufficient empirical data.

Figure 1.2 adds some nuance to the possible conclusion of an increase of trade globalization since 1960. This figure compares the trade shares of seven major country groups, calculated on the basis of export data, over the period

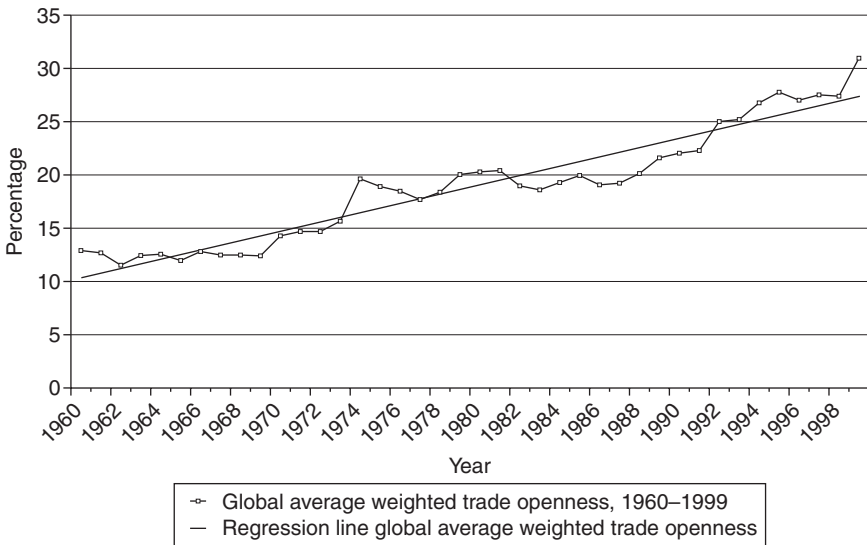


Figure 1.1 Global average weighted trade openness, 1960–1999

Source: Adapted from World Bank (2001).

between 1960 and 1999, as reported in World Bank (2001). The nine columns of Figure 1.2 indicate that trade in the 1960–1999 period remained heavily dominated by high-income OECD countries, although the percentage share of their exports in this period fell from 87 to 72 per cent of total world exports. The export share of countries in East Asia and the Pacific, which clearly was the most dynamic economic region in the past few decades, increased considerably, but did not get very much beyond 10 per cent of world exports.

Finance

The straightforward way in which data on trade can be used to measure the extent of trade globalization is not available in the same way for international finance. There is a wealth of different international financial markets, and there are many different types of transactions, such as currency trade, the issue of and trade in bonds, direct and portfolio investment, and trade in financial derivatives. Different indicators reflect the huge increase of transactions in international financial markets. For instance, trade in international debt securities more than doubled from 8.2 per cent of world gross domestic product (GDP) in 1993 to 17.4 per cent in 1999 (IMF 2000; World Bank 2001). The sum total of funds raised on international capital markets through international bonds and loans grew from 0.1 per cent of world GDP in 1963 to 2.7 per cent in 1995 (OECD 1996; World Bank 2001). Foreign bank

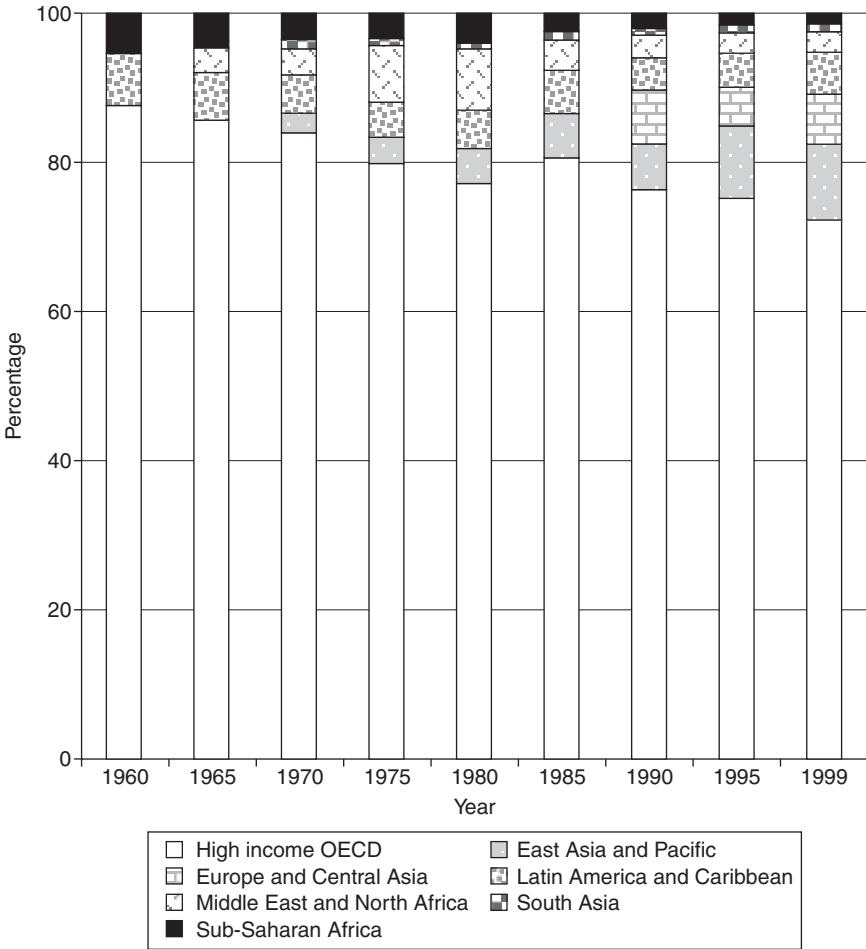


Figure 1.2 Trade shares of major country groups, 1960–1999

Source: Adapted from World Bank (2001).

loans, which were less than 2 per cent of domestic loans in the 1960s, increased to 13 per cent of domestic loans in the period from 1992 to 1998 (Johnson 2000: 15). Foreign direct investment (FDI) from all OECD countries increased from 0.6 per cent of these countries' total GDP in 1981 to little over 3 per cent in 1999 (OECD 1993, 2001; World Bank 2001).

Figure 1.3 shows the development of trade in so-called financial derivatives since the mid-1980s (IMF 2000, World Bank 2001). Derivatives are financial products such as futures and options involving the buying and selling of foreign exchange, equity and commodities. Derivatives were developed originally as “hedging” instruments, meant to protect traders from

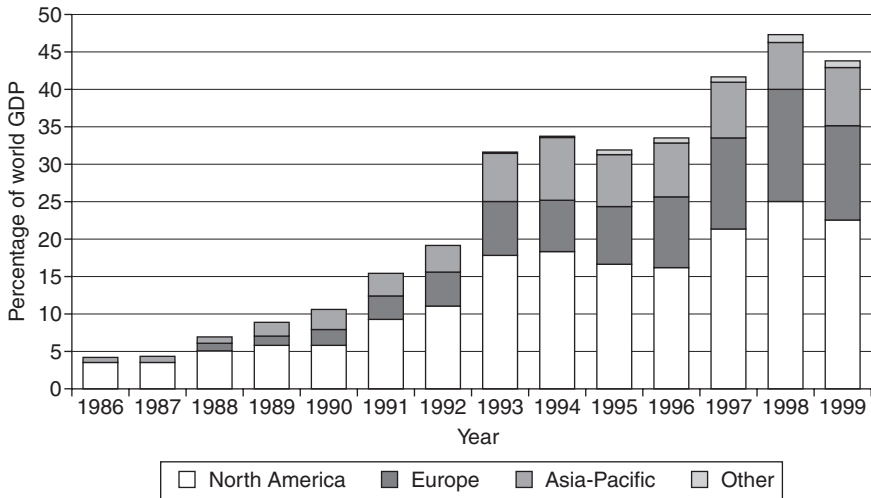


Figure 1.3 Exchange-traded derivatives, 1986–1999

Source: Adapted from IMF (2000), World Bank (2001).

exchange rate risks and increases of interest rates. Over the past few decades, derivatives have become investment objects in their own right (cf. Scholte 2000: 116).

In the 1986–1999 period, trade in derivatives has experienced an unprecedented increase, resulting in a volume of almost \$14,000 billion in 1998, or 47.3 per cent of world GDP. The trade in derivatives is probably the clearest sign of financial globalization in the current era. The data in Figure 1.3 reveal, however, that financial globalization, as trade globalization, is highly uneven. Of the total trade in derivatives in international financial markets at the end of the 1990s, more than 50 per cent took place in North America, almost one-third involved European countries, between 15 and 20 per cent occurred in countries in the Asia-Pacific, and less than 1 per cent related to countries in the rest of the world.

A different way to measure financial globalization, as suggested by Scholte (2000: 80), is by focusing on international payments as registered by, for instance, the Clearing House Interbank Payment System (CHIPS). Figure 1.4 pictures the development of international electronic interbank payments as a ratio of world GDP between 1971 and 1999. Figure 1.4 shows that international payments among banks have soared since the early 1980s. Despite the relative decrease of payments after 1998, this indicator points out that financial globalization has reached an evident peak in the late 1990s with a more than 10:1 ratio between international payments and world GDP.

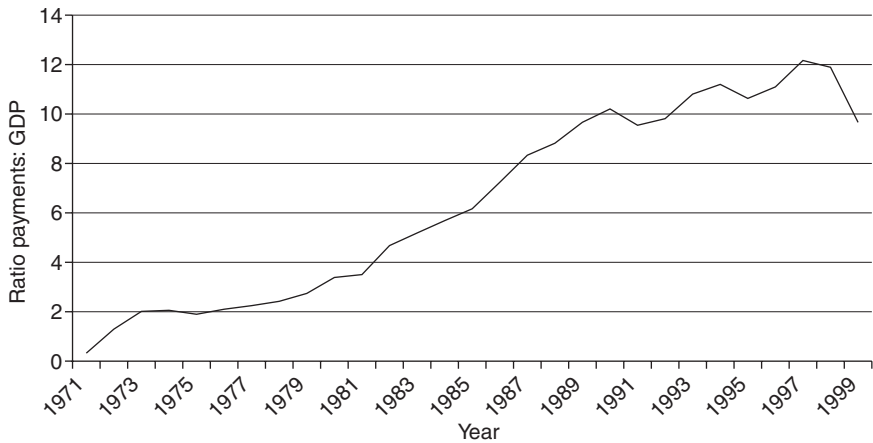


Figure 1.4 Global electronic payments as ratio to world GDP, 1971–1999

Source: Adapted from CHIPS (2002), World Bank (2001).

Conclusion

The analysis reported in this section indicates that the contemporary political-economic order is at least partially globalized. Important international financial flows, as witnessed by indicators on the international trade in financial derivatives and international electronic interbank payments, indicate that the international financial system, in particular, shows clear signs of globalization. Also, trade has increasingly become global and, at the end of the twentieth century appears to have reached an all-time high when expressed in terms of world GDP. At the same time, however, it appears that this late twentieth-century growth of trade is the continuation of a long-term process, which goes back at least to the beginning of that century.

A polycentric world?

Several authors have argued that it is not sufficient to focus on purely *global* trends in order to draw conclusions about the structure of the political-economic order. Drawing upon Holm and Sørensen's (1995) analysis, it can be argued that globalization is *asymmetrical* or *uneven*. For this reason, two foci are called for with respect to the purportedly global interactions. It is necessary to focus, first, on the main actors involved and, second, on the nature of the transactions that take place as part of globalization.

The actors

Economic transactions are by no means evenly spread across the world. Available data on the direction of trade indicate that trade takes place mainly

among industrialized countries (the core of the system), and that there are several blocs discernible within the industrialized world.

Table 1.1 presents a summary of the direction of trade by focusing on intra- and inter-regional shares of merchandise trade (WTO 1999). It appears from the data that three regions stand out in terms of their share of world exports, which is given in the final column: North America (17 per cent), Western Europe (44.6 per cent) and Asia (24.5 per cent). These three regions, the richer part of which formed the category of high-income OECD countries in Figure 1.2 above, are not only the main sources of world exports; they are also characterized by relatively high percentages of intra-regional trade. Of all exports originating in North America, 37.6 per cent remained in the region. The comparable figure for Asia was 44.5 per cent, while for Western Europe it was as high as 68.8 per cent. The low- and middle-income countries of Africa, Latin America and Central and Eastern Europe, including the Commonwealth of Independent States, appeared to be relatively outward-oriented: 53.3 per cent of African and 52.8 per cent of Central and Eastern European exports went to Western Europe, while 53.6 per cent of Latin American exports were directed toward North America.

The data in Table 1.2 indicate the limited significance of formal regional cooperation schemes in the developing world. With the possible exception of Mercosur (the Southern Common Market in Latin America) and ASEAN (the Association of South East Asian Nations), attempts to stimulate regional trade among developing countries appear to have had little effect. This means that the balance of world trade remains heavily biased toward the industrialized countries, as most of the developing countries' exports continue being oriented toward North America, Western Europe and Japan. The growth of world trade that took place toward the end of the twentieth century has not resulted in a noticeable increase of trade in the developing world. The lack of complementarity of developing countries' exports – or, in other words, the fact that most developing countries tend to produce (almost) identical goods – continues to stand in the way of attempts of these countries to diversify their export base away from the industrialized world (e.g. Trebilcock and Howse 1999: 367–94).

Recent data on cross-border investment show a pattern similar to international trade. Figure 1.5 indicates that foreign direct investment in the 1988–1999 period was primarily oriented toward the industrialized countries.² In 1999, Western Europe and North America attracted almost 70 per cent of all foreign direct investment, while these two developed regions were the source of more than 87 per cent of all outward investment (UNCTAD 2000: 289). The two most significant recipient regions of foreign direct investment in the developing world in the 1988–1999 period were East Asia and the Pacific and Latin America and the Caribbean. The share of the former region hovered around 12.5 per cent in the 1988–1999 period, while the share of the latter region grew from a 6.9 per cent annual average between 1988 and 1993 to 10.5 per cent in 1999. The other parts of the

Table 1.1 Intra- and inter-regional merchandise trade, 1998 (percentages)

Origin	Destination					Share of world exports	
	North America	Latin America	Western Europe	Central, Eastern Europe/ CIS	Africa	Middle East	Asia
North America	37.6	16.3	19.5	0.9	1.3	2.8	21.3
Latin America	53.6	20.7	14.9	1.1	1.1	1.1	6.5
Western Europe	8.9	2.6	68.8	5.7	2.7	2.6	7.4
Central and Eastern Europe and CIS	4.7	1.4	52.8	30.8	0.9	2.3	6.1
Africa	15.0	2.8	53.3	0.9	9.3	1.9	13.1
Middle East	13.9	1.5	22.6	0.7	3.6	9.5	43.8
Asia	26.1	2.9	19.3	1.1	1.6	3.1	44.5
Share of world imports	20.4	5.9	43.3	4.3	2.3	2.8	19.8
							100.0

Source: Adapted from WTO (1999).

Table 1.2 Intra-regional trade in selected regional organizations in the developing world, 1990–2000 (percentage of total exports)

	1990	1995	2000
Latin America			
Andean Group	4.1	12.0	9.0
Central American Common Market (CACM)	15.4	21.7	12.1
Caribbean Community (Caricom)	9.8	5.0	15.0
Latin American Integration Association (LAIA)	10.8	17.1	14.4
Southern Common Market (Mercosur)	8.9	20.3	20.8
Organization of Eastern Caribbean States	8.1	11.7	4.6
Africa			
Economic Community of the Great Lakes Countries	0.5	0.5	0.8
Common Market for Eastern and Southern Africa (Comesa)	6.6	7.8	6.6
Economic Community of Central African States	2.1	2.1	1.5
Economic Community of West African States (Ecowas)	7.8	9.8	10.2
Southern African Development Community (SADC)	3.1	10.6	8.8
Central African Customs Union and Economic Union	2.3	2.2	1.3
West African Economic and Monetary Union (CEAO)	12.0	9.8	13.2
Arab Maghreb Union	2.9	3.8	2.4
Asia			
Association of South East Asian Nations (ASEAN)	19.0	24.7	22.7
Gulf Cooperation Council	8.0	6.8	5.6
South Asian Association for Regional Cooperation (SAARC)	3.2	4.4	4.2

Source: Adapted from UNCTAD (2001).

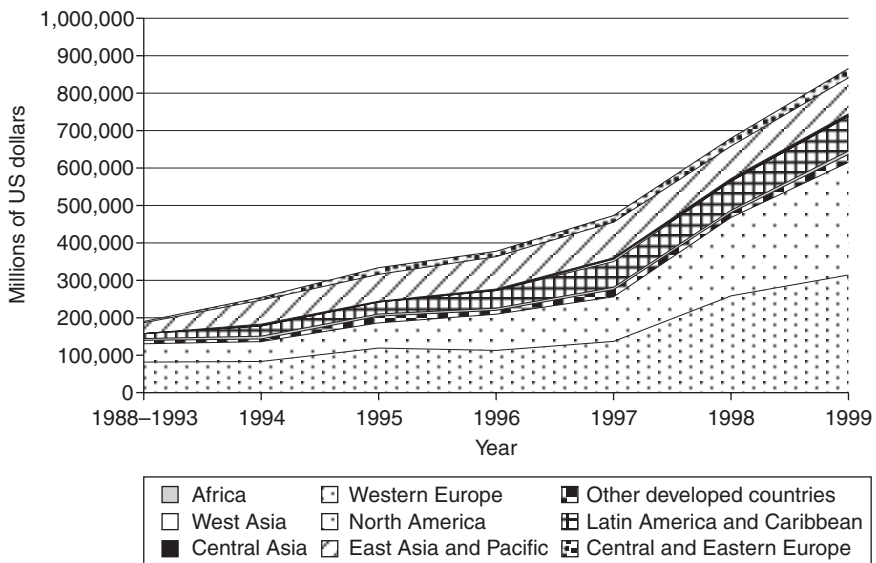


Figure 1.5 Foreign direct investment inflows, 1988–1999

Source: Adapted from UNCTAD (2000: 283–7).

developing world (most notably, Africa, West and Central Asia, and Central and Eastern Europe) did not manage to attract more than a few per cent of the total global flow of foreign investment.

The nature of transactions

Not only is there a differentiation among different groups of actors in the global political economy, but also the nature of transactions differs according to the world-system position of countries (core, semiperiphery, periphery). Chase-Dunn (1998: 207–214) has indicated that the core-periphery hierarchy is best captured by making a differentiation on the basis of the relative capital intensity of production. Thus, in the core of the world-system (the industrialized countries) the production of capital intensive commodities tends to be prevalent. Likewise, the periphery (the bulk of the developing countries) leans toward labor intensive production. The semiperiphery is characterized by either a mix of labor and capital intensive production or by “a predominance of activities which are at intermediate levels with regard to the current world-system distribution of capital intensive/labor intensive production” (Chase-Dunn 1998: 212).

Table 1.3 shows that, on the basis of export data of 1999, a clear distinction can be made between the industrialized countries and groups of developing countries as to the composition of their exports.³ The share of primary commodities in the 1999 exports of developing countries was approximately 13 percentage points higher than the corresponding share of the developed countries. The differences among the developing countries, however, appear to be more significant. They tend to reflect the distinction among the core, semiperiphery and periphery that was alluded to above. The developing countries of Africa, West and Central Asia and Oceania, the majority of which belong to the periphery (see Van Rossem 1996: 515), show a clear bias toward the production of primary commodities (raw materials and agricultural produce): over 80 per cent of all African exports are still primary

Table 1.3 Exports of primary commodities and manufactured goods, 1999 (percentage of total exports)

	<i>Primary commodities</i>	<i>Manufactured goods</i>
Developed countries	15.4	80.8
Developing countries, of which in:	28.5	69.0
America	40.6	56.8
Africa	80.9	18.2
West Asia	70.3	29.4
Central Asia	74.2	14.6
Other Asia	14.0	83.1
Oceania	60.0	28.2

Source: Adapted from UNCTAD (2001).

product, while the comparable figures for Central Asia (over 74 per cent), West Asia (around 70 per cent) and Oceania (60 per cent) show a slightly less pronounced but nevertheless significant primary orientation. The two predominantly semiperipheral groups of developing countries (those in East Asia and Latin America) display two different patterns of export orientation. The East Asian countries, many of which followed a strategy of export-led growth since the 1970s, display an export pattern similar to that of the developed countries. These are the semiperipheral countries with a predominance at the intermediate level of capital and labor intensive production. The Latin American developing countries, where there appears to be a mix of core and peripheral activities, show the greatest diversification of their exports, as primary commodities constitute about 40 per cent of their exports and manufactured goods account for almost 57 per cent of total exports.

Conclusion

The analysis presented in this section indicates that the contemporary global political-economic order continues to be dominated almost completely by the industrialized core. To the extent that it is useful to characterize the current political-economic order as polycentric, it is clear that this order remains organized along the lines of a core-periphery-semiperiphery hierarchy.

The data presented in this section on trade and investment flows show that most parts of the developing world are marginal to the current world economy. To an important extent, trade remains concentrated within the triad of Western Europe, North America and Japan and East Asia. Most formalized regional trading schemes in the developing world continue to have limited or no significance, with the possible exception of Mercosur and ASEAN. Foreign direct investment flows tend to remain focused on Western Europe and North America, although East Asia and Latin America and the Caribbean each succeed in attracting approximately 10 per cent of worldwide investment flows. The weakness of much of the developing world in terms of trade flows is further illustrated by the fact that most developing countries tend to retain their focus and dependence on primary products. The exceptions in this case, as in the other categories, appear to be East Asia and, to a lesser extent, Latin America.

A system of nation-states?

The role of the state in the global political economy has been a major issue of contention among analysts. In particular, the relatively recent attention for the supposed tendency toward globalization has resulted in what Linda Weiss (1998: 2, 3) has called a “new era of ‘state denial’”, which amounts to assumptions of “the diminution or displacement of states as power actors in the domestic and international arenas”.

Table 1.4 Government revenue, 1975–1997 (percentage of gross domestic product)

	1975	1980	1985	1990	1995	1997
Low income	14.8	16.2	15.5	15.5	15.1	15.0
Middle income	n.a.	n.a.	22.2	17.4	17.8	19.1
High income	20.2	22.4	23.2	23.9	27.9	28.7

Source: Adapted from World Bank (2001).

Note

n.a. not available.

Scholars who have adopted a world-systems perspective, such as Christopher Chase-Dunn (1998: 109–30) and Giovanni Arrighi (1994: 27–36), have consistently emphasized that the capitalist system and the state – and, for that matter, the capitalist world-system and the inter-state system – should not be seen as separate entities, but that the interrelationship between these should be studied. In this context, it is argued that the strength of the state and the role of countries in the world-system are related. Various indicators have been suggested to illustrate this point. One common measurement is the ratio of government revenues (taxes and other receipts) to gross domestic product. The ratios for three groups of countries (high-, middle- and low-income), roughly representing core, semiperiphery and periphery, is given in Table 1.4.⁴

Table 1.4 illustrates that state strength varies with the place that countries occupy in the world-system. In core countries – those countries with high income – the extractive capacity of the state appears to be considerably higher than in the countries of the periphery (low income) and the semiperiphery (middle income). The difference between the core and semiperiphery seems to be especially clear since 1990.

The findings on state strength and its relation to world-system position support Chase-Dunn's (1998: 111) expectation that core countries will have more means at their disposal to manifest themselves economically or militarily in the international arena than countries from the semiperiphery and periphery. The results also lend support to Chase-Dunn's (1998: 121) view that the greater extractive capacity of states in the core, and to a lesser extent also in the semiperiphery, provides these states internally with more room for maneuver because they have relatively good access to resources.

In addition to state strength, it is also possible to focus on the differences in government effectiveness among countries at the three tiers of the world-system. In Table 1.5, data on government effectiveness are presented. These data are derived from a dataset on the quality of governance across the world in 1997–1998, which was recently compiled by a team of researchers from the World Bank Institute. Kaufmann *et al.* (1999: 8) have defined government effectiveness as “the quality of public service provision, the quality of

Table 1.5 Government effectiveness, 1997–1998

	<i>Mean government effectiveness</i>
Low income	−0.64
Middle income	−0.17
High income	1.28

Source: Adapted from World Bank (2000).

the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures and the credibility of the government's commitment to policies". The variable is a combination of many indicators, and its values range from +2.5 to −2.5.

The results in Table 1.5, which represent the average scores of low-, middle- and high-income countries, show that the level of government effectiveness depends on the place of countries in the world-system. Core (high-income) countries tend to have, on the whole, much more effective governments than semiperipheral (middle-income) countries, while the latter possess significantly more effective governments than the low-income countries of the periphery. This finding also supports Chase-Dunn's (1998: 121) suggestion that governments of core countries have better opportunities than governments in other countries to introduce and implement successful policies.

In addition to the relationship between state strength, government effectiveness and position in the world-system, several analysts have pointed at the connection that appears to exist between the openness of countries to the international economy and the importance of the government (e.g. Cameron 1978; Rodrik 1997). Table 1.6 lists the bivariate correlations between the trade openness of countries – measured as exports of goods and services as a percentage of gross domestic product – and various indicators of the importance of governments in the economy at four different moments in recent

Table 1.6 Correlations of export openness and indicators of the role of government in the economy, 1970–1996

	1970	1980	1990	1996
Total government expenditure	0.42	0.36	0.35	0.32
General government consumption	–	0.52	0.44	0.53
Tax revenue	0.38	0.36	0.33	0.33
Current government revenue	0.33	0.44	0.39	0.37

Source: Adapted from World Bank (2001).

Note

The correlation between export openness and general government consumption for 1970 is not reported because of the large number of missing cases.

history. The correlations are based on a varying number of countries for which data are available.⁵

The correlations that are reported in Table 1.6 indicate that the findings of Cameron and Rodrik on trade openness and government activity are corroborated for a large sample of countries, irrespective of the position that these countries have in the world-system. It is even more significant that the correlations do not appear to weaken over time, as this is a finding which runs counter to the “state denial” hypothesis that is central to part of the globalization literature.

The analysis of the connection between trade openness and various indicators of the economic role of the state provides support for the “governance approach” to globalization (cf. Hout 1997), which emphasizes the possibilities that governments (and supra-national organizations) still possess to regulate the globalizing international economy. This approach provides a counterweight to what Hirst and Thompson (1999: 262) have called “the new political rhetoric” of globalization, which is inspired by “an anti-political liberalism” stressing that “[f]ree trade, transnational companies and world capital markets have liberated business from the constraints of politics, enabling it to provide the world’s consumers with the cheapest and most efficient products”. The governance approach emphasizes that political institutions remain indispensable, because they buttress social groups in the light of their increasing vulnerability to global economic developments, as evidenced by growing trade openness in recent times.

Conclusion

As much as the contemporary global political economy appears to be subject to the forces of globalization – with respect to trade and, in particular, international finance – it also proves to be a system where states continue to take in an important role. The most notable findings of the analysis presented in this section are that state strength and government effectiveness tend to vary as a function of countries’ position in the world-system. On the whole, states in the core of the world-system tend to be much stronger and much more effective than semiperipheral and peripheral states. The differentiation in state strength and government effectiveness does not imply that the economic role of the state decreases as countries take in a position lower in the global hierarchy. On the contrary, states across the world-system appear to play an important role as buffers against the influences emanating from the global political economy.

Concluding remarks

This chapter has focused on the current global political economy and, in particular, on the question to what extent the contemporary system should be understood as a global economy, a polycentric world or a system of nation-

states. The answer to this question has not been as clear-cut as either the supporters or the opponents of globalization would like to see them.

In Section 1.2, several interpretations of globalization were discussed. Apart from the outright supporters of globalization and liberalization – or, in the shorthand of some authors, neoliberal globalization – three important interpretations were derived from recent scholarship, two of which appeared to be skeptical of claims of recent globalization (Hirst and Thompson, and Chase-Dunn), and a third (Scholte) which took globalization as a significant phenomenon transforming the contemporary political, social and economic reality. The analyses reported in this chapter support various elements of all three positions, but do not lend complete support for any of the three.

The discussion in Section 1.3 focused on the extent to which economic relations have taken on a truly global character in recent times. The conclusion that the international financial sector shows clear signs of globalization provides some support for Jan Aart Scholte's concept of "supraterritoriality". Contemporary financial transactions appear to have little or no relationship to territorial units. The findings on international trade, which indicate that there appears to be an historically upward trend of global trade openness, and that the openness has reached an unprecedented level during the final half-decade of the twentieth century, partially bears out Christopher Chase-Dunn's world-systemic approach to trade globalization. At the same time, the data suggest that trade has increasingly become global, although it is too early to reach any definite conclusions about this now. Whatever the conclusion about global trade and finance is, however, the data that were surveyed make clear, in any case, that the globalization trend does not spread evenly across the world. Large parts of the developing world are only slightly, or not at all, involved in growing trade and financial flows.

Section 1.4 took the discussion of uneven or asymmetrical globalization one step further. Trade and investment appear to take place, to an important extent, within rather than between regional groups of countries. The countries of the triad (Western Europe, North America and Japan and East Asia) appear to be the most significant elements of the global trading system, while investment flows tend to remain focused on Western Europe and North America. Formal regional groupings of the developing countries, with the possible exception of Mercosur (Latin America) and ASEAN (South East Asia), remain relatively unimportant. Despite many claims to the contrary, the nature of trade transactions in the contemporary world still follows largely the core-semiperiphery-periphery distinction. Although the approaches of both Scholte and Hirst and Thompson have some significance for the asymmetry of globalization, the results of the analysis of the regional orientation of trade and investment seem to correspond rather closely with expectations of the world-system approach, represented here by Chase-Dunn.

Section 1.5 focused on the role of the state in the current global political economy. Of the approaches discussed in Section 1.2, Scholte's seemed to be

most skeptical about the position of the state in a globalizing world. The findings that indicate that the role of government in the economy appears to be dependent on countries' openness seem to support Hirst and Thompson's views on the place of governance in the contemporary world economy. Moreover, the findings on the covariance of state strength, government effectiveness and world-system position corroborate Chase-Dunn's approach to the political dimension of globalization.

The overall conclusion of this chapter is that the global political economy of the early twenty-first century is best understood as a partially, but highly unevenly globalized world in which the political role of the state continues to be important. Most of the data surveyed in this chapter seem to indicate gradual, instead of sudden changes in the key indicators related to the global political economy. It seems, therefore, a relatively safe bet that we can understand tomorrow's world on the basis of the insights we have obtained today.

Notes

- 1 Global average weighted trade openness is calculated as follows:

$$\text{Average weighted openness} = \frac{\sum_{i=1}^N \left[\left(\frac{\text{Imports}_i}{\text{GDP}_i} \right) \left(\frac{\text{Pop}_i}{\text{Avgpop}} \right) \right]}{N}$$

where i represents the individual country, N stands for the total number of countries for which data are available, Pop_i is a country's total population, and Avgpop is the average population of all countries in the sample. (Imports and GDP obviously refer to the value of imports and GDP, respectively.)

- 2 The first time point is the annual average of the 1988–1993 period.
- 3 Primary commodities are defined as products in SITC categories 0 to 4 and 68 (food and live animals; beverages and tobacco; crude materials, inedible; fuels, lubricants, etc; animal and vegetable oils, fats and wax; non-ferrous metals). Manufactured goods are defined as goods in SITC categories 5 to 8 minus 68 (chemicals and related products; manufactured goods; machines and transport equipment; miscellaneous manufactured articles).
- 4 Current government revenue includes all revenue to the central government from taxes and nonrepayable receipts (other than grants).
- 5 Total government expenditure includes both current and capital expenditures. General government consumption includes all government current expenditures for purchases of goods and services (including compensation of employees). Tax revenue comprises compulsory, unrequited, nonrepayable receipts for public purposes collected by central governments.

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2 Wealth and welfare of nations, continents and corporations

Phillip Anthony O'Hara

Introduction

Adam Smith's seminal contribution to political economy, *The Wealth of Nations* (1788), has provided us with both a profound statement of the nature of the science of political economy as well as some magisterial insights into the source and impact of wealth generation. The principle objectives of political economy, according to Smith, are "to provide a plentiful revenue or subsistence for the people, or more properly to enable them to provide such a revenue or subsistence for themselves" as well as to "supply the state or commonwealth with a revenue sufficient for the public services". Together, these objectives seek "to enrich both the people and the sovereign" (Smith 1788: Book IV, 1, 332). Smith challenges the mercantile perspective that precious metals are of prime importance by arguing that the relative productivity of labor is the critical source of the wealth of nations. Stephen Parente and Edward Prescott (1993: 1) assume from this that Smith's analysis "leads naturally to per-capita gross domestic product (GDP) as the appropriate measure of wealth".¹

Yet it must not be forgotten that Smith is the author of *The Theory of Moral Sentiment* (1759), and that even his *The Wealth of Nations* is imbued with philosophical and theological underpinnings. As A.M.C. Waterman (2002) argues, *The Wealth of Nations* "may be read as a work of natural theology", where human interests can be promoted only if the social institutions are well formed. In the *Theory of Moral Sentiments*, as well, Smith argues that an obsession with wealth and power and neglect of the poor and sick is "the most universal cause of the corruption of our moral sentiments" (Smith 1759: 61), which can adversely affect the health of the institutions as well as material output. It is, therefore, not surprising for authors to claim ethics as a critical form of wealth.

For instance, Thomas Donaldson (2001) argues in "The Ethical Wealth of Nations" that a suitable ethics upon which to base judgments and actions is necessary for the operation of any system, including a system of business and material output. He claims that prosperity cannot be attained without a suitable ethical fabric, including judgments about fairness in the distribution of

goods, better government, social cooperation and economic “duties” of citizens. These duties are linked to the respect for intellectual property, engaging in fair competition, not abusing relationships with government, providing accurate information to the market, avoiding bribery, respecting environmental integrity, and honoring contracts and commitments. Without an effective ethical system – which is a form of “social capital” – he claims the economy is subject to the instabilities and waste of crony capitalism, a “grabbing culture” of corporate and state corruption and fraud, where people are untrustworthy and lacking in human sentiment.

Once wealth is seen in this broad fashion – as constituting elements as apparently diverse as labor productivity and ethics – it opens up a Pandora’s Box. Indeed, this seems to be the fashion nowadays, in business and development studies plus the social sciences in general: to see wealth in all its many dimensions. Socioeconomic performance, in other words, is based on many different durable structures. Even welfare, such as happiness, quality of life and environmental sustainability, can be seen to be quite critical to the long-term production and reproduction of material life. Indeed, the more we move into a service economy, a postmodern world, a symbiotic reality, the less materialistic the forms of wealth become.

This chapter will attempt to examine in some detail the state of the world in relation to certain statistical indicators of performance, progress and welfare. After 20–30 years of “modern globalization” and neoliberalism, it is an opportune moment to take stock of where the world is heading and how well-off human beings are in different nations, regions and continents. It is also an opportune moment to assess the different structures of power that operate in the world, from the point of view of certain indicators of material or symbolic possession. This is done from the methodological view of a classical political economist, one who is imbued with the importance of taking a broadly historical approach, set within the context of institutions and relationships (see Eltis 1984, Rostow 1990).

In essence, then, this chapter seeks to utilize a classical style in examining the material and immaterial foundations of wealth and income in the global political economy. We examine not only nations, but also continents and corporations. We start by exploring the historical evolution of material income and wealth in a long-term analysis of motion and changing power relations and developments. Then we go on to concentrate on social, cultural and environmental factors in order to have a more holistic view of the standard of living, quality of life and socioeconomic welfare.

Long waves, GDP and technology

A look through university libraries and scholarly databases reveals a host of books and articles that purport to investigate the wealth of nations. For instance, Malcolm Caldwell (1977) used the term in a modified form in his book, *The Wealth of Some Nations*, to refer to his belief that the rules of

international trade and finance benefit some at the expense of others. For him, there are power relations in the world economy that create imperialism on the one hand and underdevelopment on the other. These economic and military power relations are said to have historically created a form of divergence between, for instance, the growth of the West and the underdeveloped nations of Africa, Latin America and parts of Asia. The Western world has contributed to the poverty of nations through imposing various forms of dominance – including cultural, political, social and educational – upon many nations in the periphery. In this connection, Cowling and Sugden (1999: 364) remind us of Stephen Hymer's law of uneven development, "the tendency of the system to produce poverty as well as wealth, underdevelopment as well as development".²

Caldwell and Hymer were working in a tradition linked with that of Paul Baran, which became extended through the work of Andre Gunder Frank, Samir Amin and Immanuel Wallerstein, and much of their analysis also did clearly emanate from the classical economics of Adam Smith, David Ricardo and (especially) Karl Marx. Frank coined the term "the development of underdevelopment" to refer to the notion of wealth and poverty being inextricably related: that the wealth of some nations may be created through the poverty of others, and that the process is circular and cumulative. Amin emphasized the process of uneven development through accumulation on a world scale. Wallerstein developed the notion of world-systems analysis, where for hundreds of years we have seen a global system in action; and this global dimension is nothing new. Perhaps it became more obviously global during the phase of imperialism (especially during the 1870s–1910s), and more recently during the phase of neoliberalism (1980s–2000s). But it has been inherently global for a very long time. This is related to the notions of center, periphery and semi-periphery, in which the power relations established between nations, areas, and cities largely determine the relative wealth of specific peoples and cultures.³

For many years the myth has developed that growth and development essentially arose in the West, and that Western science and technology provided the foundations for the first real world system through a boom in income, trade and wealth during the 1700s and 1800s. But this myth is now known to have been part of the Eurocentric vision of various scholars through the ages. The historical norm, it is now known, was for the development of African-Asian trade and production networks through a world system, with the West "rising" many hundreds of years later. Gunder Frank and Barry Gills (2000) believe that an Afro-Eurasian world system developed at least as early as the third century BC, extending from parts of North Africa through to the Middle East, and Central/South Asia, and later progressing through many other areas of the world. Marshall Hodgson (1993: 68) argues that the "Afro-Eurasian commercial network . . . cumulatively came into being, largely under Muslim auspices, by the middle of the second millennium [AD]". There are some differences in timing between various scholars,

Table 2.1 Shares of world GDP, 1000–1998

	1000	1500	1820	1870	1913	1973	1998
Asia	70.3	65.2	59.2	38.3	24.5	24.1	37.2
Africa	11.8	7.4	4.5	3.7	2.7	3.3	3.1
Western Europe	8.7	17.9	23.6	33.6	33.5	25.7	20.6
Western Offshoots	0.7	0.5	1.9	10.2	21.7	25.3	25.1
Eastern Europe and Russia	4.6	5.9	8.8	11.7	13.1	12.9	5.3
Latin America	3.9	2.9	2.0	2.5	4.5	8.7	8.7
World	100	100	100	100	100	100	100

Source: Adapted from Maddison (2000: 127).

but they all agree on the much earlier Afro-Asian initiated world system, that evolved and became transformed through the ages. By the beginning of the eleventh century, when our first figures emerge, the economic center of the world continued to be Asia, followed by Africa and then Europe. Table 2.1 summarizes GDP data for the past 10 centuries.

Asian relative dominance continued from the eleventh century with a gradual decline until well into the eighteenth century, when Western and specifically British hegemony commenced. Western dominance continued, passing from British dominance (1840–1870) in the eighteenth century, through to rivalry between nations (1880s–1930s), to US hegemony during the golden age (1940s–1960s). The brief recent period when there was no hegemonic nation or region – the 1970s and 1980s – may have passed into a renewal of US dominance in the 1990s through the early years of the twenty-first century. But the relatively brief period of Western dominance, from the mid-1800s through to the late 1900s, looks set to be transformed to a new period of potential (especially) Asian renewal through the next 50 years and more. This reemergence of particularly Asian wealth is reflected in the most recent wave of capitalism, the 1950s–1990s, as shown in Table 2.2.

A long wave upswing was experienced by the West as well as Japan and Eastern Europe during the 1950–1973 period. During this time, growth in these nations/areas was high. But as long wave downswing emerged during the 1970s–1990s, the West, Japan, the Eastern bloc and most of the rest of the world suffered through reduced growth rates, while the only positive momentum through the world was the increased growth experienced in East and South East Asia. Hence the long wave of growth of the second half of the twentieth century was an especially important one since it represented the reemergence of Asia after 100–150 of years being behind the West. The rise of the West was a fairly short period when compared to the long era of Asian dominance, and perhaps also compared with the future dominance, that is, once the newly industrializing nations of Asia (particularly China) experience a sustained reemergence, which may follow through to the rest of Asia and perhaps the Middle East. Indeed, such a momentum may spur a sustained

Table 2.2 Long wave pattern of GDP growth per capita in the global economy, 1950–2001

	<i>World</i>	<i>Advanced capitalist nations</i>	<i>Latin America</i>	<i>Africa</i>	<i>Eastern Europe</i>	<i>Asia (excluding Japan)</i>
1950–1973	2.93	3.72	2.52	2.07	3.49	2.92
1973–2001	1.43	1.98*	1.08	−0.38	−1.10*	3.54*
1980–1990	1.43	2.67	−0.77	−1.09	1.60	6.80#
1990–2001	1.13	1.77*	1.64	−0.24	−2.26*	4.20#

Source: Maddison (2000: 126, 129); World Bank (2003); IMF (2002: 172).

Note

* = 1973–2000 or 1990–2000.

= Newly industrialized Asian nations only.

growth period for capitalism into the foreseeable future, in order to counter the economic maturity and relative decline. However, according to Harry Bloch and Sam Tang (2004), Asian nations will need to enhance their innovative potential, rather than simply depend upon factor accumulation.

A holistic view of the income and wealth of nations is developed by Angus Maddison (1995) in *Explaining the Economic Performance of Nations*. Maddison, perhaps more than anybody else, follows the spirit of Smith's original analysis. His view of the income and wealth of nations and regions is realistic, institutional and pragmatic. Central to his theory is the importance of institutional and more technical factors. The foundation of the wealth of nations is said to be the institutional environment, such as the prevailing culture and the norms and mores that impinge upon the economy. For instance, the rise of the West from the 1600s onwards is said to be related to the "rise of the scientific ethos", the emasculation of feudal constraints and the emergence of nation states and democratic governments. The technical conditions that reinforced growth were said to be (in order of importance) the advancement of technology, education and skills, structural change and foreign trade. According to Maddison, the linkage between institutional and technical factors enabled the Western world and those who followed it to advance along the ladder of GDP per capita in an uneven pattern through comparatively recent historical time.

However, it is not just continents, regions and nations that have been developing income, but also institutions such as corporations. Were markets the only form of economic organization, there would be no need for corporate systems. The free market philosophy is incomplete for many reasons, the most obvious being that it is necessary for knowledge, organization and wealth to be embedded in complex systems of production and distribution, rather than simply being sold on open markets. Organizations such as firms can be efficient forms of economic development, due to the need for economies of scale, vertical and conglomerate as well as horizontal integration, tacit

knowledge and the promotion of research and development activities. The most successful economic forms have been American, European and Japanese transnational corporations in the oil, manufacturing and high-tech sectors. An indication of the wealth of corporations is given in Table 2.3, where the sales of dominant firms are compared with the income of certain continents and nations.

General Motors has a higher value of sales than the GDP of almost all nations of Latin America and Africa, as well as Russia, a former superpower. Walmart, Exxon, Ford and Daimler have larger sales than Hong Kong, Norway, Saudi Arabia and Finland. And Mitsui along with Mitsubishi, Toyota, General Electric and Royal Dutch Petroleum have higher gross sales than the GDP of Israel and Ireland. Clearly, the corporate form of production and distribution has been the great success story of capitalism, being critical for technological developments and global domination.

Influenced by the classical tradition are those who point to the development of science and technology as the main reason for the generation of wealth. Nathan Rosenberg *et al.* (1992), in *Technology and the Wealth of Nations*, for instance, argue that it is the ability of nations, corporations and peoples to develop knowledge and then, especially, to commercialize that knowledge that brings them to the leading edge of development. Joseph Schumpeter (1911) led the charge about the importance of “doing things differently in economic life” in developing surplus value and growth. For him, development occurred through applying new methods, products, raw materials, forms of organization and markets. The inability to promote innovation is said to be the root cause of poverty and underdevelopment. David Landes (1998) argues that the cultural system of practices and institutions is the main determinant of the technological wealth of nations. And Dennis Mueller (1999) believes that nations technologically decline (or fail to develop) when the collective rent-seeking ability of corporations, governments and other organizations sap the innovative energies and waste resources.⁴

Recently scholars have attempted to develop international indices of innovative activities. For instance, Meghnad Desai *et al.* (2002) calculate the Technology Achievement Index (TAI) to assess the comparative performance of nations. The TAI is a composite index of “technology creation” (patents and royalties), “diffusion of recent innovation” (internet hosts and technology exports), “diffusion of old innovations” (telephones and electricity consumption) and “human skills” (schooling and university studies). The main results of this index are shown in Table 2.4.

In terms of continents, the technological leaders include Western Europe (with 14 nations; 4 in the top 10), Asia (6 nations; 3 in the top 10), North America (2 nations in the top 10), and Oceania (2 nations in the top 15). At the lower end of the pecking order is Eastern Europe (8 nations; none in the top 20), Latin America (5 nations; none in the top 30), and Africa (1 nation; none in the top 38). Western Europe, Asia, North America and Oceania are thus the leaders in technology throughout the world. Eastern Europe holds a

Table 2.3 World league table of GDP and sales, 1999

Rank	Entity	GDP/sales \$US billion	% world GDP	Rank	Entity	GDP/sales \$US billion	% world GDP
1	World	31,228	100	53	Norway	153	0.48
2	North America	10,684	34.2	54	Indonesia	140	0.45
3	Europe	9656	30.9	56	Saudi Arabia	139	0.44
5	Asia and Pacific	9158	27.6	57	Finland	129	0.41
15	South America	1107	3.5	58	Greece	125	0.40
26	Africa	489	1.5	59	Thailand	123	0.39
43	General Motors	189	0.6	61	Mitsui	118	0.37
44	Russia	181	0.58	62	Mitsubishi	117	0.37
45	Denmark	174	0.55	63	Toyota	115	0.37
47	Walmart	166	0.53	64	South Africa	112	0.36
48	Exxon/Mobil	163	0.52	65	General Electric	111	0.35
49	Ford Motors	162	0.52	67	Portugal	108	0.34
50	Daimler/Chrysler	159	0.51	68	Royal Dutch Petroleum	105	0.33
51	Hong Kong	158	0.50	70	Israel	99	0.31
52	Poland	156	0.49	72	Ireland	93	0.29

Source: Adapted from Fred Maidment (2002: 70–72).

Note

If value added is used to measure corporate performance, the league table changes somewhat. According to UNCTAD (2000) using value added and a slightly different league table composition, General Motors ranks 47, Walmart 69, Exxon 45, Ford 55, Diamlec 56, Mitsui 77, Mitsubishi 76, Toyota 59, GE 58, and Royal Dutch Petroleum 62. UNCTAD argues that value added is a better comparison to GDP than sales.

Table 2.4 Technology achievement index: top 40 nations, 1999

Rank	Nation	Score	Rank	Nation	Score	Rank	Nation	Score
1	Finland	0.744	15	New Zealand	0.548	29	Poland	0.407
2	US	0.733	16	Austria	0.544	30	Malaysia	0.396
3	Sweden	0.703	17	France	0.535	31	Croatia	0.391
4	Japan	0.698	18	Israel	0.514	32	Mexico	0.389
5	South Korea	0.666	19	Spain	0.481	33	Cyprus	0.386
6	The Netherlands	0.630	20	Italy	0.471	34	Argentina	0.381
7	UK	0.606	21	Czech Republic	0.465	35	Romania	0.381
8	Singapore	0.591	22	Hungary	0.464	36	Costa Rica	0.358
9	Canada	0.589	23	Slovenia	0.458	37	Chile	0.357
10	Australia	0.587	24	Hong Kong	0.455	38	Uruguay	0.343
11	Germany	0.583	25	Slovakia	0.447	39	South Africa	0.340
12	Norway	0.579	26	Greece	0.437	40	Thailand	0.337
13	Ireland	0.566	27	Portugal	0.419			
14	Belgium	0.553	28	Bulgaria	0.411			

Source: Adapted from Desai *et al.* (2002: 103–104).

very respectable and rising position. Latin America has some potential. But the achievements of sub-Saharan Africa have been virtually non-existent, except for the Western offshoot of South Africa.

Social capital, the quality of life and the environment

An emphasis on traditional GDP figures and corporations, however, can distort the picture of wealth and income. For instance, it is well known that the switch from family production to market production can result in no effective increase in output. Calculating just the market output, therefore, is misleading from the view of the total income or wealth of nations and regions. This has led to a large literature on household production and domestic labor (see Parente *et al.* 2000, Hoppe and Dolsma 2004). Also, concentrating on material forms of wealth underestimates wealth in the form of language and ethics (see Nettle 2000, Donaldson 2001).⁵ Trust has also emerged in the literature as a critical dimension of wealth, being subsumed in the notion of social capital, which is quietly revolutionizing the social sciences and development studies at present.⁶

Along these lines, the World Bank and development scholars have recently been developing a more extensive explanation of the wealth of nations and continents. World Bank scholar Ismail Serageldin (1996), for instance, in *Sustainability and the Wealth of Nations*, developed a very broad definition of “wealth” in explaining differential development patterns around the world. Recently, scholars have used the term “capital” rather than wealth, for the stock of durable resources that provide a flow of services through time. Economics has traditionally concentrated on durable fixed capital (produced assets), such as the stock of machinery, warehouses and inventories. During the 1950s and 1960s the term human capital became institutionalized into the discipline, being the stock of knowledge embedded in individuals that may enhance productivity and innovation. Then gradually into the 1980s and 1990s the terms “natural capital” and “social capital” gained currency. Natural capital has come to mean the stock of bio-physical resources such as land, raw materials, water and plant/animal species that may provide a flow of services through time. Social capital is the stock of trust and association characterized by groups and communities that may enhance communication and sociability (see Robert Putman 1993). The thesis Serageldin and others put forward is that one must look at all the major forms of capital, and their relationship to each other, in order to comprehend the process of long-term socioeconomic performance. For instance, social and ecological capitals are collectively more important than produced assets in the growth and development of nations and regions. This is illustrated in Table 2.5.

Human resources are by far the most important form of wealth in the world. The two main forms of human resources include social and human capital. The clear leaders in this field are North America, Pacific OECD and Western Europe. Now that a broader understanding is emerging, we see that

Table 2.5 Wealth per capita and components by regions, 1994 (US\$'000)

	<i>Natural capital</i>	<i>Human resources</i>	<i>Produced assets</i>	<i>Total wealth</i>
North America	15	247	61	325
Pacific OECD	7	205	89	302
Western Europe	5	175	54	236
Middle East	63	55	27	146
South America	8	69	15	94
Eastern Europe etc	10	30	22	62
North Africa	2	37	14	54
Central America	3	40	7	51
East Asia	5	35	7	46
East/South Africa	2	19	7	29
South Asia	3	13	4	21

Source: Adapted from Dixon and Hamilton (1996: 16).

it is trust, association, communication, skills and knowledge that constitute the most important factors in development and growth. An understanding of why Western nations were able to develop such resources, while the rest of the world lagged behind, can provide answers to the main questions of global political economy.

Some studies have suggested that the most important aspect of social capital is “trust”: to be able to trust that people will do what they say they will, that they will not exploit your good will, and that they will have some sympathy for your perspectives and problems. Trust is important in providing a basis for investment activity (Zak and Knack 2001), national and regional trade (Helliwell 2000) and corporate networks (Yeung 1998). However, levels of trust have declined markedly throughout the world over the past two decades as the recent phase of globalization and neoliberalism have taken hold. This is illustrated in Table 2.6, which reports the major findings of the World Value Surveys (WVS).

The WVS is based on a random sample of interviews worldwide for “three waves”, i.e. the years 1981, 1990 and 1995–1997. People were asked “Can people be trusted?” The results shown are for the percentage of respondents who said “Yes, people can be trusted”, as opposed to “You cannot be too careful”. Around 100 nations were used in the sample for 1995–1997.⁷ The results are fairly straightforward. For all nations (on average), trust declined from 38 percent (1981) to 35 percent (1990) to 24 percent (1995–1997). Results for the individual nations mostly followed this general trend, although with some variation. For instance, as the table shows, between 1981 and 1995–1997 a major drop in trust occurred in the UK, South Africa and Argentina, and a fairly significance drop in trust occurred in the US and Australia. A major drop in trust occurred over the years 1990 to 1995–1997 in Russia and Poland, and a quite significant drop for China and Brazil, the latter nation exhibiting hardly any trust at all.

Table 2.6 Levels of trust: the world and various nations, 1981, 1990, 1995–1997 (percentage)

Area	World	UK	US	South Africa	Australia	Argentina	Brazil	China	Russia	Poland
1981	38.4	43.3	40.5	29.0	48.2	26.1	n.a.	n.a.	n.a.	n.a.
1990	34.6	43.7	51.1	29.1	n.a.	23.3	6.5	60.3	37.5	34.5
1995–1997	24.3	29.1	35.9	15.4	40.0	17.6	2.8	52.3	23.2	16.9

Source: Adapted from the ISR (2000).

Table 2.7 Trust in individuals and institutions, association and total social capital, United States, 1975–1994

	1975	1980	1985	1990	1994
A: Trust in individuals	0.495	0.470	0.445	0.420	0.395
B: Trust in institutions (highest category; average)	0.188	0.183	0.178	0.172	0.162
Total social capital	8.43	8.33	7.9	7.43	6.8
Total individual social capital	14.6	15.0	13.6	11.35	8.6

Source: Extracted from various parts of Paxton (1999: 115, 116, 120, 121).

The figures for the US are significant but uneven over the years. However, more detailed analysis demonstrates that the US experienced a very considerable drop in trust over the past couple of decades. These detailed results are shown in Table 2.7.

In total, the results for the US demonstrate a quite significant decline in social capital, especially for total individual social capital but also for social capital as a whole. This is the main conclusion, that trust in both individuals and institutions (for the highest categories) have declined significantly, especially for individuals. Individuals demonstrate a considerable lack of trust, but also (results not shown) a decline in the belief that people are “fair” and also that they are “helpful”; the degree of fairness and helpfulness actually declining more than trust. Overall, there is evidence that the social capital aspect of the community has declined considerably as trust (as well as “fairness” and “helpfulness”) has deteriorated over the past three decades.⁸

Drawing from these broad roots, it is possible to explore further the critical factors involved in determining the social, human and natural foundations of global welfare. Many scholars, for instance, have been examining the limitations of GDP as an indicator of the standard of living. Emerging from these studies are a number of supplementary indicators of wealth, some of which seek to examine the social dimensions in more detail and others that concentrate on the environment; while others merge all major factors together. In the social realm, the Wealth of Nations Index and the Human Development Index (HDI) both attempt to develop a socioeconomic indicator of the standard of living.⁹ The HDI, for instance, is a composite index of GDP per capita, life expectancy and education, with supplementary indexes of gender equality, regional variation and environmental quality. Comparing the HDI for 1992 and 2000, and the HDI with GDP rankings, gives an indication of changes in the standard of living of nations over the decade or so in Table 2.8, below:

There have been some major changes in the pattern of HDI over the past decade or so. First, with the exception of Japan, Asia has increased their HDI more than most over the decade, as have Eastern European nations, and a few other social democratic countries. Second, major relative increases in the HDI have been made by Poland, Hungary, Singapore, Luxembourg,

Table 2.8 Human Development Index, 1992, 2000: compared with GDP

Nation	HDI 1992 [Rank 1992]	HDI 2000 [Rank 2000]	GDP minus HDI 2000	Nation	HDI 1992 [Rank 1992]	HDI 2000 [Rank 2000]	GDP minus HDI 2000
Norway	0.932 [7]	0.942 [1]	+2	Spain	0.930 [9]	0.913 [21]	+4
Sweden	0.929 [10]	0.941 [2]	+15	Israel	0.907 [21]	0.896 [22]	+1
Canada	0.950 [1]	0.940 [3]	+4	Hong Kong	0.905 [24]	0.888 [23]	-9
Belgium	0.926 [12]	0.939 [4]	+5	Greece	0.907 [22]	0.885 [24]	+10
Australia	0.927 [11]	0.939 [5]	+7	Singapore	0.878 [35]	0.885 [25]	-4
US	0.937 [2]	0.939 [6]	-4	Cyprus	0.906 [23]	0.883 [26]	-4
Iceland	0.933 [6]	0.936 [7]	-2	Korea	0.882 [31]	0.882 [27]	+1
The Netherlands	0.936 [4]	0.935 [8]	5	Portugal	0.874 [36]	0.880 [28]	+2
Japan	0.937 [3]	0.933 [9]	2	Slovenia	n.a.	0.879 [29]	0
Finland	0.934 [5]	0.930 [10]	6	Malta	0.880 [34]	0.875 [30]	+1
Switzerland	0.925 [13]	0.928 [11]	-5	Barbados	0.900 [25]	0.871 [31]	+5
France	0.930 [8]	0.928 [12]	6	Brunei	0.868 [41]	0.856 [32]	+1
UK	0.916 [18]	0.928 [13]	7	Czech Republic	0.872 [38]	0.849 [33]	+6
Denmark	0.920 [16]	0.926 [14]	-6	Argentina	0.882 [30]	0.844 [34]	+10
Austria	0.925 [14]	0.926 [15]	-5	Hungary	0.856 [50]	0.835 [35]	+8
Luxembourg	0.893 [27]	0.925 [16]	-15	Slovakia	0.872 [40]	0.835 [36]	+10
Germany	0.921 [15]	0.925 [17]	-2	Poland	0.855 [51]	0.833 [37]	+16
Ireland	0.915 [19]	0.925 [18]	-14	Chile	0.880 [33]	0.831 [38]	+12
New Zealand	0.919 [17]	0.917 [19]	5	Bahrain	0.852 [44]	0.831 [39]	-2
Italy	0.912 [20]	0.913 [20]	-1	Uruguay	0.881 [32]	0.831 [40]	+14

Source: Adapted from UNDP (1995:155-165; 2002: 149-156).

Notes

n.a. not available. In some cases more recent or improved data may have emerged that are not incorporated in the above figures for 1992.

Portugal, Norway, Sweden, Belgium and Australia. Major relative declines have been experienced by Japan and Spain. And third, Sweden, Luxembourg, Greece, Argentina, Poland, Chile and Uruguay have much higher human development than is indicated by the GDP per capita figures. Luxembourg, Ireland and Hong Kong, on the other hand, have a much lower standard of living than is indicated by the GDP per capita figures. Clearly, it is important to supplement GDP per capita figures with those relating to life expectancy, literacy and education.

The real test for the HDI – in terms of recent changes in the global political economy – is whether the underdeveloped nations of Latin America and sub-Saharan Africa have improved their position. The results are very disappointing. In the case of Latin America, the general pattern is for a decline in both the absolute and relative HDI over the period 1992–2000: this is the case for the major nations such as Argentina, Chile, Mexico and Brazil, as well as Venezuela, Panama, Columbia, Ecuador and Granada. Only a few nations rose both absolutely and relatively, including Cuba, Peru and Guatemala. Sub-Saharan Africa also had a disappointing result, with major declines in both absolute and relative HDI for the Congo and Zaire; major declines in relative HDI for Madagascar, Zambia and the Central African Republic; and quite significant relative declines for Zimbabwe, Nigeria and Tanzania. Only in the Sudan and Angola did both the absolute and relative HDI improve. Overall, the past decade has been dismal for Latin America and Africa.

Others have sought to look at welfare in terms of the “quality of life” (QOL). The QOL is said to be the critical factor affecting people’s lifestyle and is seen as both a means and an end of socioeconomic existence. QOL is closely linked to “well being” (whether “objective” or “subjective” in nature), which has to do with perceptions of “life satisfaction”. Mark Peterson and Naresh Malhotra (1997), for instance, apply seven dimensions of the QOL to 146 nations at a point in time (1995), although the measure is thought to indicate a durable process operating through historical time; but being subject to potential changes and irregularities. A summary of the results are shown in Table 2.9.

The QOL index is a composite measure of the quality of life experiences and environments of the different nations, taking into account the cost of living, economy and infrastructure (more materialistic indicators), plus culture, health, freedom and the environment (immaterial indicators). Together, these materialistic and immaterial elements, it is argued, represent an indicator of the quality of life of “the people”. The results show that the QOL index varies from 79.9 for “developed nations”, such as the US, Japan and Sweden; through to the lowest index of 34 in the “heart of Africa”, including Zaire, Mali and Ethiopia. Near the top are “tourist resort” nations (71.7), those nations classified as “intensely cultivation” (68.5), followed by the “semiperiphery” (60.0). In the mid-ranges are the “transitional and emerging” economies such as Russia, Turkey, Mexico and Turkey (58.2),

Table 2.9 Quality of life estimates: 146 nations grouped in 12 clusters, 1995

Cluster of nations	Nations: number and examples	QOL index (average)	COL	Cult	Econ	Freed	Infra	Health	Envir
Developed	21: most OECD nations	79.9	-1.19	1.57	2.14	1.11	2.00	1.10	0.82
Tourist havens	9: Bahamas, Isle of Man, Cyprus, Ireland	71.7	0.06	1.05	0.66	1.01	1.12	1.00	0.20
Intensely cultivated	9: Barbados, Bermuda, South Korea, Monaco	68.5	-0.21	0.93	1.06	1.10	1.41	0.95	-1.70
Semiperiphery	22: Bolivia, Chile, Fiji, Peru, Venezuela	60.0	0.96	0.15	-0.23	0.48	-0.37	0.05	1.09
Transitional and emerging	38: Russia, South Africa, Turkey, Poland, Mexico	58.2	0.25	0.30	-0.37	0.40	-0.08	0.45	-0.04
Urban outposts	6: Bahrain, Kuwait, Taiwan, Macao	54.7	-0.15	0.30	0.87	-0.29	0.75	0.69	-2.39
Struggling	9: India, Mauritius, Slovenia, Nauru	50.0	1.02	-0.35	-0.19	0.48	-0.60	-0.40	-1.63
Authoritarian states	21: Saudi Arabia, Cuba, Egypt, North Korea, China	47.3	0.23	-0.10	-0.15	-1.46	-0.24	0.45	-0.17
Troubled pasts	15: Uganda, PNG Cambodia, Mozambique	45.6	0.16	-0.99	-0.72	0.23	-0.85	-1.27	0.31
Costly	9: Iran, Iraq, Senegal, Congo, Seychelles	42.1	-2.05	-0.69	-0.58	-0.62	-0.51	-0.40	-0.06
Troubled	21: Afghanistan, Indonesia, Rwanda, Sudan, Angola	36.2	0.35	-1.20	-0.76	-1.46	-0.89	-1.28	0.11
Heart of Africa	8: Zaire, Mali, Ethiopia, Guinea	34.0	-1.38	-1.59	-1.71	-0.66	-0.93	-2.14	0.24

Source: Adapted from Peterson and Malhotra (1997: 31-32).

the “urban outposts” such as Bahrain, Kuwait, Taiwan (54.7), nations that are “struggling”, such as India, Mauritius, Slovenia (50.0), and “authoritarian states” such as Saudi Arabia, Cuba, Egypt, North Korea, Qatar and China. Those states with the lowest quality of life are nations that are “costly” in terms of prices, economy and infrastructure (42.1), those experiencing great “trouble” (36.2), and especially those in the “heart of Africa” (34.0).

This study of the quality of life reveals some interesting results. For instance, the “developed” nations of the OECD gained the most points for all dimensions of the QOL except “cost of living”, the latter reflecting the high demand and creation of new needs and wants as “development” progresses (or perhaps as “overdevelopment” emerges). The worst achievers for the environment were “urban outposts”, those with “intense cultivation”, and “struggling nations”. Nations with the least social and economic freedom include authoritarian states *and* troubled areas (identical figures). And the factors with the greatest correlation with quality of life were “culture” and “health”, perhaps indicating that they link the most to the other factors, and are the most important in a holistic sense (on health see O’Boyle 2004).¹⁰

Another major index of welfare includes more social, economic and environmental factors in the national accounts, such as the Index of Sustainable Economic Welfare (ISEW) and the Genuine Progress Index (GPI). Eric Newmayer (1999) has critiqued the ISEW as not being based on sound theory, but the analysis of Stockhammer *et al.* (1997) and Philip Lawn (2003) have established the credentials for both ISEW and GPI. Both are designed to closely approximate the sustainable welfare of a nation’s citizens in terms of transactions that enhance human well-being. Adjustments are made to real GDP per capita to account for many social and environmental benefits and costs that GDP ignores, such as household labor, various forms of pollution, transport time and stress.

We are interested in estimates of ISEW/GPI for nations in as many continents as possible. However, since no assessments have been made for nations in Asia and Africa, we must make do with nations in Europe, North America, South America and Oceania. Earlier we saw that the rate of economic growth of most nations and continents (except for Asia) has declined during the 1970s–2000s, as long wave downswing set in. Figure 2.1 additionally shows that economic welfare also suffered substantially during the 1970s–1990s, after rising during the 1950s and 1960s.

The reasons for this have been the pressure of extra work, the costs of pollution and stress, and the instability associated with the breakdown of family and community relationships. Hence, the 1970–2000 period has been characterized by greater social and environmental costs and pressures and adversely affected the institutional and biospheric environments. The rate of GDP growth has declined since the 1970s, yet even the diminished GDP figures substantially overstate welfare, indicating that there has been a drop in welfare of a greater magnitude than the declining growth of GDP. Figure 2.2 compares GDP with ISEW and GPI over the past half a century.

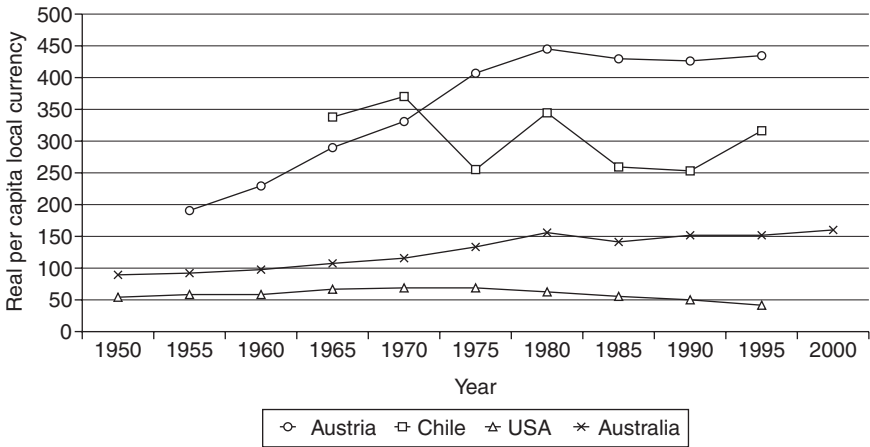


Figure 2.1 ISEW or GPI 1950–2000: 4 nations

Source: Adapted from FOE (2002).

These results show that, during the 1970s–1990s, there has been between a moderate increase and an escalation in the extent to which GDP overestimates the “psychic income” of nations. Again, this is due to the costs of pollution, stress, overwork, greater inequality and family/community breakdown. Not only has the long wave upswing adversely affected GDP growth in most nations and continents, but it has adversely affected welfare. The degree to which real GDP per capita does not reflect welfare is greater in the

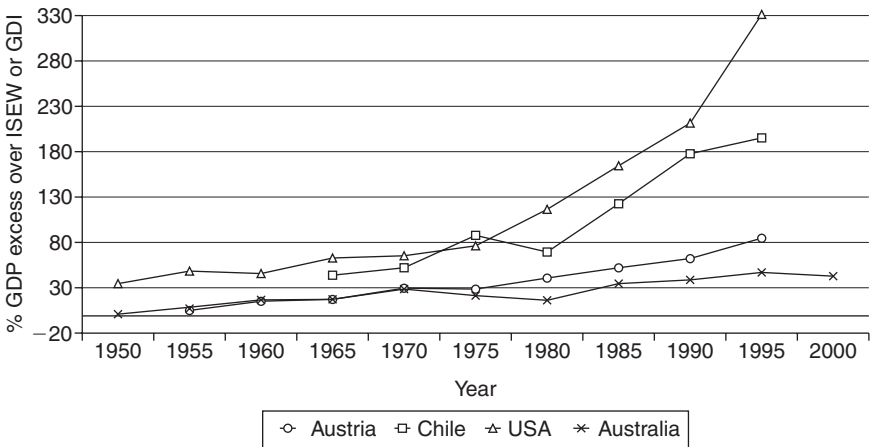


Figure 2.2 GDP excess over ISEW or GPI, 1950–2000: 4 nations

Source: Adapted from FOE (2002).

Table 2.10 Inequality: Gini coefficient, 1968–1998

	1970s	1980s	1990s
USA	0.39 [70]	0.40 [80]	0.46 [94]
UK	0.26 [75]	0.29 [85]	0.32 [95]
New Zealand	0.31 [73]	0.34 [82]	0.40 [90]
Australia	0.32 [68]	0.32 [81]	0.35 [94]
Brazil	0.55 [74]	0.56 [87]	0.61 [98]
Chile	0.46 [71]	0.53 [80]	0.57 [98]
Eastern Europe	n.a	0.28 [88]	0.35 [97]
China	n.a	0.20 [87]	0.28 [95]

Source: Adapted from OECD (2002); Milanovic (1997); Galbraith (2003); UNDP (2003).

Note

n.a. not available.

USA and Chile than in Austria and Australia, but the pattern of change is similar in all these nations.

The results also clearly show that the era of globalization and neoliberalism has resulted in an expansion of global inequality and family/community breakdown (see O'Hara 2004). The figures for inequality are shown in Table 2.10.

The above nations are a representative sample of countries that have enhanced both the degree of globalization as well as neoliberalism over the past 20 years. Nations where privatization, financial deregulation, reduction in capital controls and labor market liberalization have expanded are seeing more relative inequality over recent decades. This is understandable in view of the fact that such deregulation results in a drop in social safety nets for the poor and working classes and an increase in salaries and bonuses for executives and highly skilled workers. This also functions as a source of emulation, whereby the poorer sections of the community see the need to increase their level of debt as their relative position worsens yet they need to spend more intensely (in proportion to their income) in order to “keep up with the Joneses”.

Conclusion

The purpose of this chapter has been to explore the many dimensions of the wealth and welfare of nations, continents and corporations over the past few decades, within the context of the process of globalization, both historically and contemporaneously. We found that the production and distribution of wealth appears to be closely associated with the degree of relative power and authority that is developed in the “systems” under question. The most important of these systems is the world economy, including its political and social dynamics. In particular, we found it necessary to eschew the Eurocentric view that growth and development first emerged in a consistent and powerful fashion in the West during the 1700s–1800s. The evidence shows that world systems emerged many centuries ago that centered on the East,

and the rise of the West is but a recent and probably temporary phenomena. The most recent eras of globalization, during the late 1800s and early 1900s, as well as during the 1980s–2000s, emerged during the period of Western dominance, but the more recent era of globalization has been characterized by a (possible gradual) return to Asian ascendancy.

More broadly speaking, though, we need to go beyond material and market forms of wealth to scrutinize the social and cultural foundations of growth and development. The last couple of decades, in particular, have demonstrated the critical importance of trust, association, nature and culture in the wealth stakes. It has also brought to the fore the importance of taking a broader approach to the standard of living than just traditional GDP or fixed capital estimates of income and wealth. The standard of living, human development, quality of life and sustainable welfare are crucial measures of socio-economic performance that need to become more widespread in terms of data availability and analysis. Innovation, therefore, needs to include technological change but bring into the story the role of institutions, lifestyle, capability and opportunity. It is necessary to take into account the constraining and enabling role of family and community environment, gene pool, cultural traits as well as knowledge and health as forms of wealth.

It appears that over the past few decades a long wave downswing has emerged in the world economy, and that this downswing is comprehensible in terms of GDP, trust, inequality and welfare. GDP growth has declined in the Western world, Latin America and Africa, but just as importantly, so have the indices of sustainable economic welfare, levels of trust, and also inequality. Asia, on the other hand, seems to be in a long wave upswing, although constrained by various factors that came to the fore in the late 1990s and early 2000s. The (relative) controlling power and capabilities that Western economies have managed to develop over the last couple of centuries are dissipating to some degree, but this is not leading to the rise of Africa or Latin America. The real test of the wealth of nations, regions and the world is when the stock of ethics and trust is sufficient that the global society is able to provide for the requirements of most species and ethnicities of the world, without a dominating power or series of powers that oppress and reduce the capabilities of the rest.

Notes

- 1 Technically, of course, GDP is a flow rather than a stock. In the literature, a distinction emerged between wealth and income, with income primarily being earned through the holding of wealth. Thus the wealth of nations has a close linkage to the income of nations. Technically, wealth is the stock of durable assets, be they houses, factories, machinery, skills, knowledge, institutions and relationships. Income, on the other hand, represents a flow of potential or actual services from the durable assets, such as money generation, sales, wages, profit, rent, information, friendship, and so on (see Cannan 1930). The classical tradition seeks, however, not only to examine the relationship between these stocks and

flows, but – more especially – to understand the long-term national and global pattern and conflict over the production, distribution and exchange of these resources and services.

- 2 Specifically, apparently following the argument of Hymer, Cowling and Sugden (1999) associate the law of uneven development with “transnational corporate power”. As they say, “It would appear to us that a fundamental cause of today’s uneven development is that the wishes of the transnationals’ elite strategic decision-makers are in a sense imposed on everybody else in the world’s societies” (p. 365). See also the work of Amitava Dutt (2004), who goes beyond the rhetoric of Cowling and Sugden, in relation to the specific processes involved in uneven development.
- 3 M. Shahid Alam (2000), for instance, argued that Western nations adversely affected the performance and structure of African, Asian and Latin American nations by reducing the sovereignty of the people. He argues that lack of local, national or regional sovereignty of colonial areas inhibited their growth and development, and that countries that gained real independence from imperial powers have been successful in developing their institutions and potentialities. Wolfgang Hoeschele (2002), on the other hand, developed what is said to be a more comprehensive alternative to the core, periphery and semi-periphery model of development and underdevelopment.
- 4 Mueller (1999) stresses the potentially vested interest aspects of all major institutions and groupings. However, many other scholars are narrower in their formulation of vested interests. Mancur Olson (1982), for instance, tends to emphasize more the vested interests of governments, unions and other (non-corporate) institutions and groupings. Dowd (1989), on the other hand, pays more attention to the corporate and business wastage. Thus, Mueller’s analysis is more balanced and potentially provides a foundation for a general theory of waste and corruption.
- 5 On ethical wealth, for instance, Donaldson argues that

1. Morality may create economic advantages for nations in ways that extend beyond the notion of an idealized market; 2. In order for ethics to drive economic advantage, ethical concepts must rise to the status of intrinsic value; and 3. If claims for ethical success factors are true, then nations should attend to the issue of moral education.

(Donaldson 2001: 25)

And as Nettle says on linguistic fragmentation, “The preceding analysis shows that there is indeed some evidence of an inverse relationship between linguistic heterogeneity and the level of economic development” (Nettle 2000: 344). However, he goes on to say that “Given the lack of evidence for a direct causal interpretation, I would resist any argument . . . that language diversity should be discouraged” (p. 345).

- 6 These alternative-to-GDP measures of progress, welfare and flows of services are necessarily selective, but nevertheless fairly exhaustive in general terms. Most other measures are modifications of the ones selected here. For a myriad of alternative measures, see the many volumes of the journal, *Social Indicators Research*, which includes to date 57 whole volumes of research publication. Especially interesting to start with is the article by Lars Osberg and Andrew Sharpe (2002), which analyses time series data for economic well-being for the period 1980–1997 for Australia, Canada, Germany, Norway, Sweden, the UK and the US. See also, from a different perspective, the work of James Gwartney and Robert Lawson (2001) on the Index of Economic Freedom, from a fairly “free-market” perspective.

- 7 Specifically, the question that was asked respondents on the question of trust was: "Generally speaking, would you say that most people can be trusted or that you can't be too careful in dealing with people?" For the 1981, 1990 and 1995–1997 questionnaire, the two possible responses were: (1) "Most people can be trusted" or (2) "Can't be too careful". Additionally, in the 1995–1997 survey, the respondents were given the option (if queried) of answering (3) "Don't know". The nations that were included in the survey work were modified through time, and in the 1995–1997 survey they constituted 93 countries. There is also a fourth wave of surveys that have been undertaken, for the years 2000–2001, but they will not be made available until early-mid 2004 (see Ronald Inglehart 2000).
- 8 For the US, levels of association seem to be relatively stable through time. However, disaggregating associations reveals some interesting results (see Paxton 2002). First, working people and the poor have significantly reduced their participation in associations while middle and upper middle class people have kept their associational linkages relatively stable (Skocpol 2002). Second, there is a decline in the level of charitable and "helping" association as the level of trust declines and inequality increases. Associations dealing with "making money", job prospects and advocacy have expanded (Uslaner 2002). Third, there has indeed been a drop in civic engagement involving political activity. Many of these changes in association are occurring in other nations (as the World Value Surveys demonstrate).
- 9 The "Wealth of National Index" looks quite comprehensive in terms of its three major elements, which include (1) the economic environment, (2) information exchange and (3) the social environment. Each of these dimensions in turn include other elements. However, it has only been applied to underdeveloped, developing and a few industrial economies. So it is not comprehensive vis-à-vis the nations included, for comparative purposes (see MMI 2002). The HDI, on the other hand, is well known, comprehensive and includes considerable theoretical and empirical foundations (see UNDP 1995, 2002).
- 10 On the significance of health in the wealth of nations, see Bloom and Canning (2003). As they say,

Health is both a direct component of human well-being and a form of human capital that increases an individual's capabilities. We argue that these two views are complementary and that both can be used to justify increased investment in health in developing countries. In particular, we argue that the large effect improved health has on household incomes and economic growth makes it an important tool for poverty reduction.

(Bloom and Canning 2003: 47)

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3 Uneven development, convergence and North–South interaction*

Amitava Krishna Dutt

Introduction

Two phenomena regarding the global economy have received widespread academic and popular attention in recent years. The first is a long-run increase in international inequality and, more specifically, the gap between the rich and poor countries. The second is the process of globalization and the closer integration between rich and poor countries. This chapter is concerned with the question whether these two phenomena are related in the sense that the high and increasing level of interaction between rich and poor countries (which we will refer to as the North and the South) contributes toward exacerbating global disparities.

The question has long been a subject of intense academic debate. A large – albeit currently unfashionable – literature answers this question in the affirmative (see, for instance, Amin 1977, Baran 1957, Frank 1975, and Wallerstein 1974). Myrdal (1957) acknowledges the equalizing spread effects flowing from rich to poor regions but argues that they are outweighed by inequalizing backwash effects resulting from international trade, factor movements and other kinds of interaction. While it may be supposed that the congruence of divergence and globalization vindicates these views, most mainstream economic analysis eulogizes the benefits of greater interdependence for both rich and poor countries, due to the gains from trade, capital and labor flows and international technology transfers. In this view international inequalities are rooted in factors internal to countries, and that integration actually tends to mitigate global disparities. Most policy makers around the world accept this view, as do international organizations like the World Bank, the International Monetary Fund and the World Trade Organization, and international corporate interests. The dissident views of a minority of academics, together with those of some environmentalists, labor unions, non-government organizations concerned with poverty and other social issues, are often contemptuously dismissed as misguided at best or as representing special interests against the common good. The recent angry and sometimes violent protests against globalization have only served to crystallize this attitude.

This chapter attempts to contribute toward a more careful appraisal of the

question by briefly reviewing how the main forms of interaction between rich and poor countries can reduce or increase the disparities between rich and poor countries. To do so, it examines mainstream neoclassical models, alternative North–South models that have emerged from neoclassical and heterodox traditions, and the actual development experience. The next section summarizes the evidence on increasing international inequality and globalization, and makes some introductory remarks on their relationship. The three subsequent sections examine in turn the main channels of North–South interaction, that is, trade, capital and labor movements, and technology transfers. The final section offers a summary and some concluding remarks.

Divergence, globalization and uneven development

A large body of empirical research has examined changes in the level of international inequality and the gap between rich and poor countries. This issue has been investigated in various ways, usually with purchasing power parity adjusted per-capita real GDP figures. Many observers have employed standard indicators of inequality – such as the Lorenz curve, the Gini coefficient, and the Theil index – to show that inequality across countries has increased. Sala-i-Martin (1996) shows that the standard deviation of the log of per capita income for 110 countries increased more or less steadily between 1960 and 1990, implying what is called δ -divergence. Figure 3.1 shows how this statistic has changed using World Bank per capita real GDP figures from 1960 to 1999. An alternative technique regresses growth rates of per capita GDP for the 1960–1990 period on the logarithm of initial level of per capita GDP to find a positive coefficient, implying that richer countries on average grow faster, so that there is divergence (Sala-i-Martin 1996).

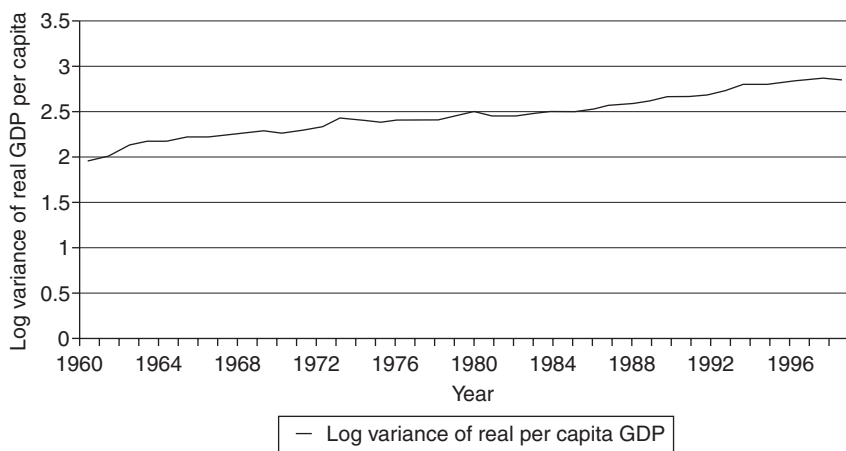


Figure 3.1 Global inequality, 1960–1999

Source: Adapted from World Bank (2001).

Quadratic regression equations involving the same variables find an inverse-U-shaped relationship, implying a positive relationship between starting income level and per capita growth for most of the sample, and a negative one for a small group of high-income countries (see Ros 2000). Quah (1993), examining the distribution of per capita GDP levels (relative to the world average), finds that the distribution tends over time to one with a thinning middle and accumulation at the two tails (the so-called twin peaks phenomenon), and that countries very seldom move from low to high ends of the distribution. In sum, these figures suggest growing inequality between countries, with convergence among a group of rich countries. Overall growth figures for groups of countries tell a similar story: according to World Bank data, the richest one-third of countries on average grew by an annual rate of 1.9 percent between 1970 and 1995, whereas the middle third grew by only 0.7 percent and the bottom third showed hardly any growth at all (Scott 2001: 162–163). Pritchett (1997), using different plausible estimates for initial levels of income for poor countries (for which hard data is not available), finds that there has been “divergence, big time” between rich and poor countries over the last 150 years.

These findings showing divergence, however, have been disputed by some analysts, who point out that by treating each country as one observation, most studies do not give adequate weight to the large low income countries, China (which is sometimes left out of the sample due to lack of data) and India, which have experienced relatively high rates of growth in recent years (Dollar and Kray 2002). They argue that correcting the problem yields the result that poor countries are – as a whole – growing faster than rich countries. However, there may be a case for giving each country an equal weight, given the fact that both China and India have followed special policies because of their specific histories, and have benefitted from their earlier dirigiste regimes, both for their excesses (since policy removed earlier shackles) and possible strengths (since the policies, including trade restrictions, may have laid the foundations for growth), factors which are arguably irrelevant for other less-developed countries (LDCs).

Much attention has also been devoted to the phenomenon of globalization, which is argued to be the result of technological changes involving the reduced cost of transport and communications and more open policies. A variety of measures, indeed, suggest an increase in international economic interaction (Baker, Epstein and Pollin 1998). World trade has grown significantly, the ratio of merchandise exports to GDP rising steadily from 7.0 percent in 1950 and 11.2 percent in 1973 to 13.5 percent in 1992. Figure 3.2 shows that the trend in world trade-GDP ratio between 1960 and 1999 has been clearly positive, although there have been fluctuations. Foreign direct investment (FDI) has increased significantly since the 1970s: world FDI stock as a percent of world output from 4.5 percent in 1975 to 12 percent in 1997, and world FDI inflows as a percentage of world gross capital formation from 1.4 percent to 5.2 percent. The increase in the world flow FDI-GDP ratio



Figure 3.2 World trade-GDP ratio, 1960–1999

Source: Adapted from World Bank (2001).

over the 1970 to 1999 is shown clearly in Figure 3.3, especially for the 1990s. Capital flows as measured by funds raised on international financial markets as a percentage of world exports increased dramatically from 1.8 percent in 1970 to 10.5 percent in 1990, and further to 20 percent in 1996. Transnational corporations (TNCs) manage 75 percent of world trade in manufactured goods, account for the same share of all industrial research and development in OECD economies, and dominate international transfers of technology in terms of technology payments (Chang 1998). Moreover, LDCs

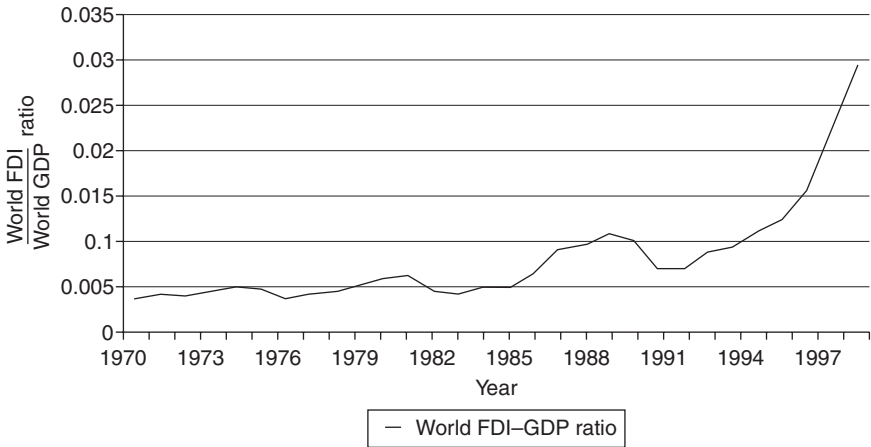


Figure 3.3 World FDI-GDP ratio, 1970–1999

Source: Adapted from World Bank (2001).

are increasingly being brought into this process. The recent rise in the proportion of manufacturing exports from them is unprecedented, and FDI to them has increased dramatically in recent years.

Some observers have argued that these trends should not lead us to exaggerate the extent of globalization and its effect on LDCs. By many measures the degree of globalization now is no greater than it was in the late nineteenth century, at the height of the gold standard, after railways and steamships lowered transport costs (see Rodrik 1997). Labor mobility, in particular, is much more restricted now than it was prior to World War I. There are numerous legal barriers to immigration in rich countries and the share of foreigners in the population changed very little over the 1980s in most advanced countries. Globalization mostly reflects trends among rich countries and, to the extent that LDCs have participated in the process, it has affected only a few countries. Indeed, large parts of the South have been unable to attract more than a trickle of FDI, despite following liberal FDI policies. During 1992–1998 about 70 percent of FDI flows was within the group of rich countries, eight LDCs received another 20 percent, and the rest was divided among more than 100 remaining poor countries, with the truly poor countries receiving less than 7 percent of all FDI flows to LDCs (Scott 2001).

For the rest of this chapter we define uneven development as North–South divergence caused by North–South economic interaction. Even if we accept that international inequality and economic interaction has increased – despite the caveats noted – it does not necessarily follow that North–South uneven development is occurring. This is because it is possible for conditions within countries to lead to divergence without any international interaction whatsoever. Growth theories are agnostic on the issue of convergence in the absence of interaction. Solow’s (1956) neoclassical model implies that if two regions with different levels of average income have identical structures (that is, production functions, saving rates and population and labor supply growth rates), the low-income region will grow faster than the other, so that there is convergence. This is because the latter’s higher capital-labor ratio makes it have a lower marginal and average productivity of the reproducible factor – capital – due to diminishing returns and therefore a lower rate of capital accumulation. If the two regions have different structures – for instance if the high-income region enjoys a higher savings rate or more productive technology – divergence becomes a possibility. New growth theory models which depart from the assumption of diminishing returns to capital imply non-convergence (the simple AK model implies identical growth rates for rich and poor regions with similar structures) or even divergence if we have increasing returns to capital (see Barro and Sala-i-Martin 1995). Neo-Keynesian models can imply higher growth rates for rich regions if greater uncertainty in poor regions implies weaker “animal spirits” and makes their desired investment function lower than that in rich countries. Neo-Marxian models can imply convergence due to a profit squeeze if tight labor markets lead to high wage

shares in total output (see Dutt 1990, for instance). If, in fact, rich countries have a tendency to grow faster than poor countries for internal reasons, divergence can occur even if globalization has an equalizing tendency.

Mainstream economists can therefore argue that globalization is equalizing. Ben-David (1993) points out that the sequence of trade liberalization measures adopted within the European Economic Community (EEC) is strongly correlated with subsequent increases in intra-EEC international trade and with income convergence within it. Dollar and Kray (2002) argue that those developing countries, like China and India, which have opened up recently, have experienced impressive rates of growth. Lucas (2000) develops a simulation model in which countries take off in sequence (depending on their internal conditions) and in which latecomers grow faster than leaders because they have access to technology and policy experience of the latter. He shows that it is possible for international inequality to increase initially (as it has), but “sooner or later everyone will join the industrial revolution, that economies will grow at the rate common to the wealthiest economies, and that percent differences in income levels will disappear” (Lucas 2000: 166).

North–South trade

The canonical neoclassical approaches to international trade are the textbook-Ricardian or Heckscher-Ohlin-Samuelson (HOS) theories of trade with their assumptions of constant returns to scale and perfect competition. According to them, countries export goods in the production of which they have relatively better technology, or which use their abundant factor intensively. Moreover, they both (normally) gain from trade essentially by reallocating their productive resources more efficiently by making use of their comparative advantage. The HOS approach, with the addition of the assumption of identical technology across trading partners and some other conditions, also implies – according to Samuelson’s factor price equalization theorem – that trade equalizes factor returns across countries even without any factor mobility between them. This is because, in effect, abundant factors move abroad embodied in traded goods, so that they receive higher returns. These implications of international trade theory are frequently invoked as proof of mutually beneficial North–South trade, and of convergence. The North is assumed to be capital abundant and the South labor abundant and, in some more recent versions, skilled-labor and unskilled-labor abundant, respectively. Thus, trade according to comparative advantage leads the South to export labor-intensive, especially unskilled-labor intensive products, gain from trade, and experience factor price equalization with the North.

It is not usually recognized in the policy discussions that mainstream trade theory does not really have such unambiguous implications. First, the factor price equalization requires that the North and South have identical technologies and that, without this assumption, there need not be a tendency toward either factor price equalization or toward income convergence due to trade

liberalization. There is much evidence to show that there are significant technological differences across countries (see Feenstra 1996), and such differences between rich and poor countries cannot be assumed away simply by noting that the latter have free access to the technology of the former (see section on technology transfers below). Second, the proposition that an economy necessarily gains from trade (or does so by moving from restricted trade to free trade) does not hold if the economy is “distorted” in some sense, either domestically or internationally. Domestic distortions can occur because wages are rigid or because of externalities in production (for instance, the level of activity of one producer or sector affects the production technology of other firms or sectors of the economy). International distortions can arise because the economy is a “large” one in the sense that its level of international trade affects the terms of trade at which it trades.

It has long been recognized that countries can possibly gain by restricting trade in the presence of externalities due to the so-called infant industry argument which allows nascent industries to expand sheltered by protective barriers till they gain enough experience to compete internationally. Mainstream economists often dismiss these uncomfortable exceptions to their gains from trade theorems by arguing that the long list of distortions discussed in the literature are more intellectual curiosa than important aspects of real economies, that government interference with trade (and other aspects of the economy) will in fact do more harm than good by giving rise to rent seeking and other directly unproductive activities, and that most distortions are more efficiently dealt with by internal taxes and subsidies (for instance, those on production) rather than by trade restrictions. In making these arguments they forget that the first two arguments need empirical support and the third ignores the question of the practical (for instance, on administrative and financial) feasibility of these alternative policy measures. Third, mainstream trade theory is no longer as dominated by the textbook Ricardian and HOS approaches, since new trade theory has developed models featuring increasing returns to scale, imperfect competition and intra-industry trade. These models provide additional reasons by which countries can gain from trade, for instance, by exploiting economies of scale from specialization, and by increasing product variety or obtaining goods with qualities closer to what is most preferred by consumers. But the models also suggest that trade can lead to losses by reducing the production of goods which could yield scale economies, due to competition from other countries which already reap the advantages of high levels of production. Although these theories are argued to be most relevant for trade within rich countries, there is some evidence of it in the North–South context, and the low level of such trade may in fact reflect opportunities lost to the South.

If we go beyond standard neoclassical models of trade and turn to North–South models which take into account important asymmetries between rich and poor countries, divergent patterns of growth between the North and the South appear not only to be possible, but also plausible. North–South models

which have emerged in the last 20 years or so attempt to take into account important structural differences between rich and poor regions. For instance, in Findlay's (1980) model the rich North grows under conditions of full employment, as depicted in Solow's neoclassical growth model, while the poor South has surplus labor and a fixed real wage, as in the Lewis model with unlimited supplies of labor; and Taylor's (1981) model, while making the same assumption for the South, assumes that Northern output and growth are limited by effective demand considerations as in Keynes-Kalecki models. A general framework which allows a comparative analysis of models such as these is developed in Dutt (1990) under the assumption that the North and South are completely specialized in production, fixed fractions of consumption expenditure in each region are spent on the two products (that is, preferences are homothetic), and trade between the two regions is balanced. The framework examines long-run equilibria in which the stocks of capital in the two regions grow at the same rate due to saving and investment. It allows an examination of the process of uneven development or divergence in which the long-run equilibrium ratio of Northern to Southern capital stock changes due to a variety of changes in the world economy represented by parametric shifts.

One specific mechanism which can explain the dynamics of uneven development relates to differences in income elasticities of demand for Northern and Southern goods. It has often been observed that rich countries specialize in sophisticated manufactured goods with high income elasticities and poor countries specialize in primary goods and simpler manufactured goods with low income elasticities. This implies that Southern demand for Northern goods is more income elastic than is Northern demand for Southern goods. Thirlwall (1979) has shown how this, with the assumption of balanced trade and a constant terms of trade, implies that the North must grow faster than the South to maintain balance of payments equilibrium. Dutt (2001a) extends the framework of Dutt (1990) to allow for non-homothetic preferences to show how Thirlwall's assumptions will in fact make the global economy tend to a long-run equilibrium with constant terms of trade in which there is uneven development in the sense of widening income disparity between the North and the South. The reason for this result is straightforward: for the South to balance its trade, it must grow more slowly than the North to compensate for the fact that identical rates of growth would imply that its imports would rise faster than its exports.

Allowing for capital flows does not change this result if one assumes that there are upper limits to the South's international borrowing or international debt as a ratio of its total production or exports. Moreover, Dutt (2001b) presents econometric evidence which suggests that in fact the income elasticity of Southern imports from the North is higher than that of Northern imports from the South, as is required for uneven development. While this theory implies uneven development in the sense that the pattern of North-South trade leads to unequal growth, the result is not strictly comparable to the

gains from trade theorems since it assumes complete specialization and does not directly show how globalization relates to international inequality. However, the theory can be related to the gains from trade theorems by showing how, starting with incomplete specialization, the North and South can end up specializing in high income elastic and low income elastic goods, for instance, due to endogenously determined region-of-origin quality effects of the form modeled by Basu and Chau (1998). Moreover, it can be argued that globalization leads to an increase in Southern income-elasticity for imports due to trade liberalization (as suggested by recent increases in it, see Dutt 2001b) and because of shifts in Southern preference toward Northern goods due to stronger international demonstration effects (see Dutt 1990).

Another mechanism that can explain uneven development relates to the specialization by the North in sectors that experience more rapid technological change due to learning by doing than the sectors in which the South specializes. This mechanism is illustrated by a second type of North–South models which, rather than postulating complete specialization and given structural differences between the two regions, assumes symmetry between the regions in all but one characteristic – the initial condition – to show how, even with incomplete specialization, uneven development can occur. Krugman (1981) develops such a model in which each region can produce two goods, a manufactured good and an agricultural good, where the manufactured good experiences increasing returns (or learning by doing) and the agricultural good does not. Assuming that both goods require labor for production, and only the manufactured good requires capital, it is possible to trace the time path of each region if they do not trade, where they accumulate capital (as a constant fraction of profits in manufacturing), produce more manufactured goods, and experience technological improvements due to learning in manufacturing. If the North has a higher initial stock of capital, and the two regions are allowed to trade with each other, the North will export the manufactured good and the South will import it. Consequently, while the North will experience more learning by doing and expand its capital stock faster, the South will experience less of it as it specializes in agricultural production. Even though both regions will gain initially by opening up trade, in the long run there will be divergence. Broadly similar results can be obtained from other models which allow for sector-specific scale economies or learning, such as those of Ethier (1982) and Boldrin and Schienkman (1988). This theory shows how uneven development occurs due to North–South trade, and it is clearly related to gains from trade theorems, given its closeness to the idea of infant-industry protection (making it appear, in fact, more ubiquitous).

Moreover, the theory does not require the South to export agricultural goods, but merely that the North exports technologically more sophisticated goods which generate more learning effects than what the South exports (with the latter possibly exporting manufactured goods as well). However, the theory should not lead one to expect that uneven development is

inevitable. For instance, it is possible that the North is becoming increasingly de-industrialized and specialized in service sectors with low productivity growth. But given that some service sectors can experience rapid productivity growth, and that many Southern countries are also experiencing rapid service sector growth, this countervailing tendency may not be very strong. It is also possible for there to be strong technological spillover effects into other sectors within regions so that Northern wages may rise in consequence to counter the benefits of productivity growth (see Dutt 1990), or internationally due to technology transfers which may improve Southern competitiveness, an issue to which we will turn in Section 3.5.

The models imply that given the nature of North–South trade, that is Northern specialization in goods that have strong technological spinoff effects or high income elasticity, and Southern specialization in other goods, uneven development is a likely result. If insights such as these have any theoretical validity, the policy implication for the South is to attempt to change its pattern of specialization with industrial and trade policies. Whether specific Southern countries can do so effectively is, of course, another matter. Their governments may or may not have the required administrative and political capacity. But the experiences of late industrializers in the past, such as the US and Germany (where such policies were espoused by Alexander Hamilton and Friedrich List) and Japan, and more recent successful industrializers, such as those of South Korea and Taiwan, certainly point to their importance.

Capital and labor mobility

From trade we now turn to the mobility of factors of production which, according to standard neoclassical theory, leads to convergence. The simplest argument can be made using Figure 3.4 for a one good, two-factor – capital and labor – world with standard assumptions of diminishing returns to factors of production, perfect competition, flexible prices and profit-maximizing behavior. The total world supply of a factor of production is measured by the length of the horizontal axis of the box in the figure. The marginal product and average product curves (marked MP_i and AP_i) of that factor for the two regions are shown starting from the two different origins 0_1 and 0_2 , given the amounts of the other factor in the two regions.

Starting with the case of capital mobility, we denote the origin for the North as 0_1 and that for the South as 0_2 , and assume that the initial supply of capital in the North and South are given by the amounts 0_1A and $A0_2$. With the rental rate on capital being perfectly flexible and with the marginal product curves of capital (given the fixed amounts of labor) being the demand curves for capital in the two regions, capital market clearing or demand–supply equilibrium in the two regions implies that the rental rates are determined at BA and CA in the North and South, respectively. If we now allow capital to move between the two regions and assume that it will move to the region where the rental rate is higher, capital will move from

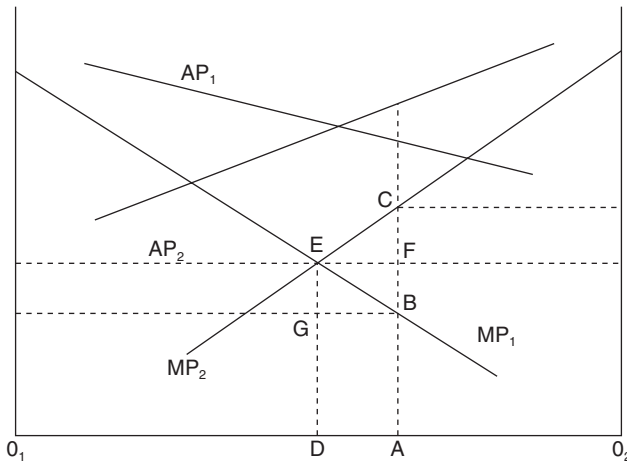


Figure 3.4 North-South model of convergence

the North to the South. The supply of capital line will move to the left as capital stock falls in the North and rises in the South. If capital moves until the rental rates are equalized, the allocation of world capital in the two regions will end at D, where the marginal product curves for capital for the two regions intersect with each other and the vertical capital supply line at point D. As a result of capital mobility, the rental rates in the two regions are equalized and determined at DE. Southern production increases by the area CADE (the increase in the area under its marginal product curve for capital) and Northern production falls by the area DABE. This means, as the populations of the two regions are assumed to be given, an increase in Southern GDP per capita and a fall in Northern GDP per capita, thereby implying convergence. Since the rental rate is DE, and since AD is the amount of capital that has moved, the South has to pay Northern capital owners the area DAFE as rental payments, so that Southern GNP actually increases by CFE, while Northern GNP also increases, by the area EFB, and world production and income rises by area ECB. The direction of changes will be the same even if capital mobility does not actually equalize rates of return interregionally. This approach shows clearly how capital moves from capital-rich to capital-poor countries, adding to saving and investment in the latter, increasing capital accumulation and hence causing growth in the South.

Neoclassical theory suggests a number of reasons why this happy outcome may not be achieved. The standard HOS approach with two goods shows that at given terms of trade the region receiving capital will have to pay the entire additional production as payment to the region sending the capital, because the assumption of constant returns to scale negates the force of diminishing returns which prevails with one good. Although Southern GDP

will increase due to capital mobility, GNP will not. In the presence of import tariffs, by increasing the production of importables tariff-jumping capital inflows will actually reduce Southern welfare by exacerbating the distortion due to the trade restriction. Moreover, if the Southern terms of trade are endogenous, and if capital inflows increase the production of the exportable and shift the terms of trade against the South, the South can lose due to capital inflows. These cases of what have been called in the literature immiserizing growth, can occur. However, it can be argued that the first type is due to distortionary policies and not due to some unavoidable characteristic of the South, and the second type is unlikely to occur since capital inflows in the South are actually likely to increase the production of capital intensive importables, not the exported commodity, and thereby improve the terms of trade. Moreover, if unemployed labor exists in the South due to a fixed real wage, capital inflows can increase Southern welfare by allowing some of the surplus labor to be hired. All of this assumes, of course, that capital moves from the North to the South. Neoclassical models have also been used to explain why capital does not often move from rich to poor countries (see Lucas 1990), as data on FDI mentioned earlier seems to suggest. For instance, increasing returns to scale can make the rental rate higher in the North than in the South, so that capital will in fact tend to move in the direction opposite to what is implied by the standard approach.

Going beyond neoclassical models to North–South models we find a number of reasons why capital flows need not lead to convergence. Burgstaller and Saavedra-Rivano (1984), extend Findlay's (1980) model to allow for capital mobility and compare steady state equilibria with and without capital mobility. They show that with capital mobility (where rates of return on capital are inter-regionally equalized) with some of the capital stock located in the South being owned by Northern capitalists, Northern per capita income will be higher, but Southern per-worker income will be lower (because of the payments that have to be made for foreign capital). Relative Southern employment will also fall if the Northern propensity to spend on the Southern good is less than that out of Southern profits, since there will be a reduction in the demand of the Southern good due to the redistribution of income caused by capital mobility. In Blecker's (1996) alternative model, the North is assumed to be demand constrained in the sense that growth depends on desired accumulation rather than on the rate of growth of labor supply as in Taylor's (1981) model, but the price of the Northern good is flexible and production fully utilizes capital. Investment by Northern capital owners in the North and the South responds to differences in profit rates in the two regions, and domestic Southern investment in the South is saving determined. The model is solved for a steady state equilibrium at which the capital stock of the North, the foreign capital in the South and the domestic capital in the South grow at the same rate, and the rate of profit in the South times a constant discount factor (less than one) is equated to the rate of profit in the North. A reduction in the discount factor (due to

lower risk or policy liberalization) makes the long run equilibrium ratio of the Southern to Northern rate of profit lower. Uneven development as shown by a higher ratio of Northern capital to Southern capital is the result. This occurs in this model because capital flows turn the terms of trade against the South as in the neoclassical large country immiserizing growth story – although this outcome appears much more plausible in this framework.

These formal results echo the ideas of Prebisch and Singer, among others. In some quarters, however, it is argued that the nature of international capital flows has now changed considerably, because the world economy is now deeply integrated. With capital scouring the globe to reduce production costs of different components of manufactured goods, it may no longer be appropriate to think of capital flows as increasing Southern production and turning the terms of trade against the South. Capital headed for the South can displace Northern production, creating concerns of job losses in the North. A model which depicts this kind of a global economy is developed in Dutt (1998a) where the North is assumed to have excess capacity, as in Taylor (1981). The model implies that it is possible for the ratio of Northern capital to Southern capital to either increase or fall indefinitely over time. In the former case, in which we have uneven development, the ratio of foreign capital to capital installed in the North falls over time, while in the latter case of even development, the ratio of foreign capital rises. The model suggests that FDI can help Southern development, but only if the South can actually attract such FDI and only if it can do so into the right sectors, rather than to sectors in which capital inflows turn the terms of trade against the South. We have seen earlier that FDI is not in fact attracted to many LDCs. The experience of successful Asian countries suggests that FDI is not necessarily attracted by liberal policies regarding FDI, but to economies that already achieved high rates of growth. FDI enters such countries to exploit domestic markets, and to exploit relatively cheap, but a disciplined and educated work force. These countries have sometimes also followed illiberal policies toward transnational corporations, imposing sectoral restrictions on them to channel them into the appropriate sectors, and imposing constraints on domestic requirements and export performance (see Dutt 1998b).

Another aspect of international capital flows is that all such flows of FDI do not fall, which increases the stock of productive capital. A significant part is, in fact, in the form of short-term flows of portfolio capital or bank borrowing. (Indeed, even the statistics on FDI can be misleading, since some of it is more appropriately thought of as portfolio investment and mergers and acquisitions). These inflows can be very large at times, and sometime lead to speculative bubbles. After the bubble bursts, there are huge outflows which lead to balance of payments crises even for relatively advanced LDCs. Many proponents of globalization have, indeed been skeptical of such “hot” flows of capital (see, for instance, Bhagwati 1998).

Turning next to labor flows, we start again with the simple neoclassical one-good model. Now we represent the North by region 2 and the South by

region 1, reversing the interpretation made for the case of capital mobility. With the initial allocation of labor given by point A, the (market-clearing) wages in the North and South are given by AC and BC, respectively. Since the wage is higher in the North, if labor moves from low-wage to high-wage regions, it will migrate from the South to the North. In consequence, the point showing the allocation of labor will move to the left. As this happens, diminishing returns will reduce the marginal product and the wage in the North while increasing it in the South. Since the average product of labor will rise in the South and fall in the North, there will be convergence in terms of per capita income and production (although there will be a fall in the welfare of those left behind in the South after the migration since they will lose the profits generated by the migrants).

As noted earlier, globalization has not operated in this way: labor is the absentee in the globalization process (see also Faini, de Melo and Zimmerman 1999). Moreover, the labor that actually moves is largely skilled labor, which can result in what is brain drain for the South (see, for instance, Bhagwati 1979, Wong and Yip 1999). The result may be divergence rather than convergence. A North–South model of the migration of skilled workers is developed in Dutt (2001a) in which unskilled workers and intermediate services are used in the production of the final good under conditions of constant returns to scale and perfect competition. Non-traded intermediate services are differentiated products, each produced by a monopolistic competitor under conditions of increasing returns with skilled labor as the only factor of production. Assuming that the wages of skilled workers is higher in the North than in the South, skilled labor will tend to move from the South to the North, which reduces (increases) the number of intermediate goods produced in the South (North) and hence reduces (increases) the production of the final good. There is a fall in the wage of skilled labor, a rise in the wage of unskilled labor and a rise in per capita income in the North, while there is a rise in the wage of skilled labor, a fall in the wage of unskilled labor and a fall in per capita income in the South. The result is uneven development in the sense of divergence in per capita income. This kind of migration also increases inequality in the South and reduces it in the North.

Technology transfers

The mechanism of technology transfers has received the pride of place in discussions of convergence due to globalization. Early on, Veblen (1915) and Gerschenkron (1952) stressed the advantages of relative backwardness, and the contribution of technology diffusion has been emphasized in discussion of post-World War II convergence within advanced countries (Baumol 1986, Abramovitz 1986). Convergence results obtained in endogenous growth models such as those of Grossman and Helpman (1991), Segerstrom, Anant and Dinopoulos (1990) and Rivera-Batiz and Roemer (1991) are due to the international diffusion of technological knowledge. As noted earlier, Lucas

(2000) also explains that the faster growth of latecomers which causes convergence, and this is largely due to the fact that "knowledge produced anywhere benefits producers everywhere."

In the theoretical literature the rate of technology transfer has usually been assumed to be proportional to the productivity gap between the North and the South: the higher the gap, the greater the potential for the South to import technology. Consider a model in which the two regions produce one good with labor alone under conditions of full employment, in which Northern productivity grows exogenously and technology transfer follows this rule. Such a model implies that in long run equilibrium global growth will be equal to Northern growth but the technology gap will persist (since the North will always be the leader which the South cannot surpass). This gap will be smaller the higher the speed of technology transfer. In a model which endogenizes the rate of Northern productivity change it is possible for the world rate of growth to increase with the rate of technology transfer because it makes Northern labor relocate from production to research, which speeds up Northern productivity growth (see Grossman and Helpman 1991). These results show that less stringent protection of international property rights can actually bring about some convergence, without necessarily hurting overall productivity growth. However, it does not show that there will be complete convergence of the type discussed by Lucas (2000), who assumes that followers will always grow faster than leaders so that they will catch up in the long run.

While technology transfers can lead to some degree of convergence for some countries of the South, it is not clear that this is true for the South as a whole. The assumption that the rate of technology transfer depend positively on the technology gap reflects an emphasis on the *potential* for transfers and ignores the Southern *ability* to actually import technology. Abramovitz (1986) argues that transfers are not automatic, but depend on a plethora of conditions in the recipient country, which he calls "social capability." If we define this narrowly as technological capability and follow a large recent literature (see Bell and Pavitt 1993) in arguing that the processes of innovation as not that different from invention, we can assume that the actual speed of technology transfer depends negatively on the technology gap: the further apart the two regions are technologically the more difficult it is for the South to transfer relatively more sophisticated technology. This assumption is confirmed by Baumol's (1986) observation that countries which are closer in terms of level of development and produce similar products will be more likely to learn from each other. When one combines the two hypothesis – that the rate of technology transfer depends positively on the speed of such transfers and on the gap, and that the speed depends negatively on the gap – even simple neoclassical models of full employment do not necessarily imply convergence. They imply that if the North and South are technologically not too far apart, convergence may be expected in the sense of the previous paragraph, but if they are sufficiently far apart, divergence will occur (see

Verspagen 1991, Dutt 2000). This implies that convergence due to technology transfers is not inevitable, and moreover, to be expected only for countries which are already developed technologically. This result may explain the U-shaped relation between initial per capita income and growth rates mentioned earlier.

In the context of discussing technological capability it is also worth bearing in mind that while transnational corporations may serve as conduits for technology transfers, as often emphasized in the discussion of globalization, they may also have a deleterious effect on the formation of domestic technological capability in developing countries (see Jenkins 1987: Ch. 4, Casson and Pearce 1987: 96–107 for reviews of the issues involved and the conflicting evidence). Moreover, changes in sectoral composition due to globalization and their adverse effects on learning by doing as discussed earlier (see van de Klundert and Smulders 1996 for a formalization) can also slow down the accumulation of technological capability. Both of these trends can serve to slow down effective technology transfers, prevent convergence and bring about uneven development.

Conclusion

Most mainstream neoclassical economists and many policy makers around the world believe that there will be convergence in the global economy in the sense that poor countries will close their development gap with rich countries, and that the process of globalization helps in this process. This chapter has argued that while some aspects of globalization can certainly help some developing countries, there is enough in neoclassical theories, in alternative North–South models, and in the actual experience of developed and developing countries to make one doubt that convergence will take place or that globalization is a panacea for development in poor countries. Our discussion of North–South trade, factor movements and technology transfers suggests that several aspects of the globalization process may actually exacerbate the forces of uneven development in the world economy, and cannot just be dismissed as unfashionable obscurantism.

We conclude with two remarks, one on the relevance of the issue of uneven development and the other on likely future trends. On the first, it can be argued that it is inappropriate to focus on uneven development and convergence, especially in discussions of the effects of globalization, because it ignores the absolute performance levels of rich and poor countries. Globalization can hurt rich countries by leaving them open to competition from low wage poor competition; while this may make development more even, it may be undesirable for the world economy. Moreover, although international inequality may have grown, many poor countries have done well in terms of absolute performance, which reflects important development gains. That the North can lose due to globalization is theoretically possible (as discussed in the FDI model in which Southern production competes with

Northern firms) and empirically plausible, especially in terms of its effects on lower income groups (see Rodrik 1997). Consequently, by slowing down Northern growth, the market for Southern good and therefore Southern investment may be adversely affected, despite the evenness of development. These are issues that are surely worth exploring, since it would be little consolation to the South to catch up with the North only because the North does poorly. However, there may be good reasons for focusing on convergence and divergence and not just be content with positive growth for the South. These reasons are related to those raised in discussions of inequality and poverty within countries (see Sen 1983) and relative consumption (Lichtenberg 1998), especially in a world where information flows are raising aspirations around the world, and because the gap in development may affect the ability of the South to import technology effectively.

On the second issue of likely future trends, it can be noted that within many advanced countries, such as the US, Japan, the countries of Western Europe, and within the European Economic Community as well, regions have shown a marked propensity to converge. Following Myrdal (1957), it can be argued that this convergence may have to some extent been due to the equalizing policies of national governments or the European authorities. Extending this line of reasoning, it can be asked if global inequalities will be mitigated in the future by international institutions which can fulfill the role of a world government. The activities of international institutions, however, give little hope in this regard. Institutions such as the World Bank and the International Monetary Fund, which promote neoliberal trade policies that give little room to LDCs for following industrial policies and often enforce restrictive macroeconomic policies which slow down their development (Pieper and Taylor 1998). The World Trade Organization not only enforces trade liberalization but also trade-related domestic policies, and is increasingly turning to reducing restrictions on FDI and technology transfers through its agreements on trade-related investment measures (TRIMs) and trade-related aspects of intellectual property rights (TRIPs), all of which can also be said to strengthen tendencies for uneven development discussed above. It remains to be seen whether international civil society comprising non-government organizations and diverse interest groups, and perhaps pressures from more and more people in the North who are more exposed to the living conditions of the poor in the South thanks to globalization, can provide the basis of a more democratic international body that can create stronger support for international egalitarian policies which will seek to mitigate international backwash effects and strengthen spread effects.

Note

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4 Recent performance of the developing East Asian economies*

Harry Bloch and Sam Hak Kan Tang

Introduction

Has the East Asian economic miracle come to an end? Can rapid growth be resumed or did the financial crisis of 1997 mark a turning point in economic development of the region? History will provide answers to these questions in due course, but in the meantime it is possible to speculate constructively on the outcome. More importantly, we can draw important lessons from assessing the reasons behind the rapid growth experience of East Asian developing economies and the more recent crisis and downturn. This provides a firmer basis for speculation about the future and also may provide some guidance for the design of development policies in East Asia and other parts of the developing world.

Some East Asian economies have been enjoying rapid growth for the past three decades (see Table 4.1). The high performing East Asian economies (HPAEs) (Hong Kong, Indonesia, Korea, Malaysia, Singapore, Taiwan and Thailand) each averaged annual growth rates above 7 percent over the period 1970–1996. At such growth rates, these economies are able to double their real production every 10 years. However, the crisis of 1997–1998 created concern and, more recently, growth rates fell sharply in 2001. The recovery from the Asian crisis appears to have only been temporary, adding to previously expressed doubts about the sustainability of the growth rates in the HPAEs.

Discussions of economic growth in the East Asian economies reflect sharp divisions on both the prospects and policies for continued growth. Among neoclassical economists, “growth optimists” note that government export-oriented policies have encouraged massive investments in physical capital and human capital that have been the main engine of growth in East Asia (see World Bank 1993). However, doubters, including Young (1995), note the heavy reliance of East Asian growth on the rapid expansion of inputs to production and argue that growth based on factor accumulation, which is subject to diminishing returns, cannot be sustained indefinitely. Thus, according to the “growth pessimists”, growth will eventually cease in East Asian economies unless there is an upsurge in technological advance and productivity gains.

Table 4.1 Per annum real GDP growth (percentage)

Country	1970– 1996 average	1997	1998	1999	2000	2001 ^a
China	8.5	8.8	7.8	7.1	7.9	7.3 ^c
Hong Kong	7.4	5.0	–5.1	2.9	10.5	0.2
Indonesia ^d	7.3	4.7	–13.0	0.3	4.8	3.3
Japan	4.0	1.6	–2.5	0.2	2.4	0.1
Korea	8.1	5.0	–6.7	10.7	8.8	3.0
Malaysia	7.5	7.3	–7.4	5.8	8.3	0.6
Philippines	3.6	5.2	–0.8	3.2	4.0	3.4
Singapore	8.6	8.2	0.4	5.4	9.9	–2.0
Taiwan (China) ^b	8.5	6.7	4.6	5.4	5.9	–2.2
Thailand	7.7	–1.7	–10.2	4.2	4.3	1.8
Vietnam	6.5 ^c	8.1	5.8	4.8	5.5	0.7

Source: Adapted from World Bank tables, GDP in constant prices.

Notes

a Data for 2001 are adapted from IMF, *International Financial Statistics Yearbook*, 2002.

b Data for Taiwan (China), adapted from The National Statistics Database at <http://www.stat.gov.tw/main.htm>.

c Average growth rates for Vietnam are for 1984–1996, as prior data are not available.

d Data for Indonesia was adapted from http://www.bi.go.id/bank_indonesia_english/main/statistics/.

e Data adapted from The World Bank website <http://www.worldbank.org/data/countrydata/countrydata.html>.

More broadly, developing countries in East Asia, as elsewhere, face the same constraints imposed by the structure of global capitalism. These include the unequal distribution of capital, difficult access to markets in the industrialized world and barriers to the transfer of proprietary technology. These impediments give rise to high levels of foreign debt, declining terms of trade and balance of payments difficulties that continually threaten the growth prospects for developing countries, independent of their chosen development strategy.

In the present paper, we consider the influences on the growth and development of East Asian economies under three headings: openness, technology and financial infrastructure. Under each heading we review the situation of East Asian economies, particularly the HPAEs that are the focus of discussion of the East Asian miracle. We conclude with a section containing our observations on the lessons for developing countries in general that might be learned from the East Asian experience.

Openness towards trade and investment

Economists have long argued for openness to trade as a contributor to the wealth of nations. Early arguments for free trade were based on the demon-

stration of gains in economic well-being from specialization in production according to absolute advantage (Smith 1776) and comparative advantage (Ricardo 1821). More recently, there has been substantial emphasis on the efficiency boosting impact of openness, including technology transfer, access to larger markets (hence achievement of scale economies) and the competitive influence of interaction with foreign firms in markets at home and abroad. The view in favour of openness has reflected the general bias towards free markets among economists, although there have always been dissenters within the profession. Some dissenters have attacked the general argument for free trade, while others have objected to application of specific types or sequences of liberalization to particular countries.

Measuring openness

An export orientation to economic development has the virtue that it allows a country to increase imports without encountering a balance of payments constraint (see McCombie and Thirlwall 1994). As shown in Table 4.2, the ratio of total trade (exports plus imports) to GDP has been generally increasing in the high performing developing countries of East Asia. Also, the ratios shown are high by comparison to other developing countries. For example, the World Bank (1993: Table 1.6), gives the ratio of total trade to GDP in 1970 for sub-Saharan Africa, South Asia plus Latin America and the Caribbean as 0.24, 0.11 and 0.20, respectively.

Table 4.2 Ratio of total trade to GDP

Country	1970	1985	2001 ^a	Year became open according to Sachs and Warner (1995)
China	n.a.	0.21	0.492	Never open (up to 1993)
Hong Kong	1.50	1.78	2.82	Always open
Indonesia	0.25	0.38	0.74	1970
Japan	0.19	0.23	0.20	1964
South Korea	0.32	0.66	0.83	1968
Malaysia	0.89	0.85	2.11	1963
Philippines	n.a.	0.32	0.97	1988
Singapore	2.12	2.77	3.20	1965
Taiwan ^b	0.61	0.95	0.96	1963
Thailand	0.28	0.44	1.26	Always open
Vietnam	n.a.	0.08	1.11	Not listed

Source: Figures for 1970 and 1985 are adapted from World Bank (1993: Table 1.6), except for China, the Philippines and Vietnam. Figures for the latter countries for 1985 are adapted from IMF, *International Financial Statistics Yearbook*.

Notes

a Data adapted from Country Profiles, World Bank On-Line Database <<http://www.worldbank.org/data/countrydata/countrydata.html>>.

b Data for Taiwan (China), adapted from the National Statistics Database at <<http://www.stat.gov.tw/main.htm>>.

While the ratio of trade flows to GDP has been widely used as a proxy for the degree of openness of an economy, the limitations are recognized. In particular, it is important to distinguish between the free-market approach to openness, which emphasizes the removal of trade barriers, and the East Asian approach, which promotes exports while often maintaining restrictions on imports. Sachs and Warner (1995) propose a different measure of degree of openness. They consider an economy to be open as long as it satisfies the following conditions: the black market premium on currency is no more than 20 percent, there are no extreme distortions due to export marketing boards, quotas cover no more than 40 percent of imports of intermediates and capital goods and the country is not classified as socialist. With the exceptions of China, the Philippines and Vietnam, all of the countries in Table 4.2 are classified as open by 1970 at the latest according to these criteria. In contrast, many countries in Africa are listed as never open (at least until 1993), primarily due to substantial black market premiums or extreme distortions due to export marketing boards.

Increasingly, discussions of openness have focused on international flows of inputs, rather than trade flows of products. Particularly important have been capital flows. Financial flows in general are taken up below in connection with the discussion of financial infrastructure. Here we focus solely on the role of foreign direct investment (FDI).

In a simple neoclassical model foreign direct investment adds to the well-being of both source and host countries. An added benefit to the host country occurs if there are positive external effects for domestic producers due to the transfer of technology to the local branch plant of the multinational. Other positive network effects are also possible through forward and backward linkages in the host economy, as well as through better access to the home markets of the multinational. Nonetheless, there is a substantial literature that casts doubt on the virtues of FDI in developing economies (see, for example, the classic critique of Hymer 1976).¹ Much of the concern is that multinationals use inappropriate technology, which damages the local environment and destroys traditional employment while suppressing the development of indigenous production methods. Accusations of corruption of local political and social systems are also common, as are allegations of the abuse of market power by multinationals leading to a more unequal international distribution of income. A general discussion of the advantages and disadvantages of multinational enterprises in developing countries is given by Caves (1996).

In the context of East Asia, a notable feature of FDI has been the role of multinationals in export activity. Foreign firms have been attracted by the combination of low wages and a relatively educated labour force, supplying capital equipment and technology from their home operations and using their international marketing networks to distribute the output. Japanese multinationals have been particularly noted for setting up assembly operations in Southeast Asia to produce for export to markets of North America and

Table 4.3 Inward FDI stocks as a proportion of GDP (percentage)

<i>Country</i>	<i>1980</i>	<i>1985</i>	<i>1990</i>	<i>1995</i>	<i>1999</i>
China	3.1	3.4	7.0	19.6	30.9
Hong Kong	487.0	413.6	217.5	135.4	255.5
Indonesia	14.2	28.6	34.0	25.0	46.2
Japan	0.3	0.4	0.3	0.7	1.0
South Korea	1.8	2.3	2.0	2.1	7.9
Malaysia	21.1	23.7	24.1	32.9	65.3
Philippines	3.9	8.5	7.4	8.2	14.9
Singapore	52.9	73.6	76.3	70.0	97.5
Taiwan	5.8	4.7	6.1	6.0	8.0
Thailand	3.0	5.1	9.6	10.4	17.5
Vietnam	0.2	0.6	3.6	31.1	55.6

Source: Adapted from UNCTAD (2001: various pages).

Europe, as well as for the Japanese domestic market (see Ishida 1998). More generally there is a strong association between foreign ownership and the export orientation of firms (see Ramsetter 1998 for evidence on Thailand, Indonesia and Singapore). Production for export emphasized by East Asian branch plants of multinationals contrasts sharply with the focus on production for the domestic market in European and North American branch plants.

Policy towards FDI has varied substantially across East Asian economies. Some economies, such as Hong Kong and Singapore, have actively sought out investment by multinationals, while others, such as Japan and South Korea, have strongly resisted foreign control of domestic production. Data on the level of accumulated investment, which provide the best measure of the importance of multinational enterprises in domestic production, are available for most of the East Asian countries since 1980. Table 4.3 shows that the relative importance of FDI in terms of the ratio of FDI to GDP varies substantially across East Asia, reflecting the differing policy stances towards FDI. Particularly noteworthy is the rapid rise in FDI in China and Vietnam as these economies move towards a market orientation. Also interesting is the rise, albeit from very low levels, in FDI in Thailand and South Korea as a partial response by these countries to the crisis of 1997 (exchanging the debt held by foreigners for equity control by foreigners of previously domestic firms).

Impact of openness on economic growth and development

The relationship, if any, between openness to foreign trade and investment and the growth and development of the domestic economy has been a controversial topic, particularly in relation to East Asian economies. The World Bank (1993) credits both outward orientation and targeted industrial policies

as contributing to the “miracle” growth performance of the HPAEs. More generally, there are two questions central to interpreting the role of openness in the growth experience of East Asian economies. First, is there a robust positive relationship between the degree of openness and the rate of increase in GDP per capita? Second, what causal meaning, if any, can be given to a positive relationship between growth and openness, particularly in the East Asian context?

The question of the robustness of the relationship between growth and openness to trade has been the subject of a substantial body of empirical literature, with the basic approach involving the application of regression analysis relating country growth rates to measures of trade openness. These regressions have used various data samples (differing by the group of countries or the time period) and various specifications of the estimating relationship (for example, the inclusion of additional explanatory variables or different measures of openness). In general, there is moderate to strong evidence of a positive relationship between economic growth and trade openness (see, for example, Sachs and Warner 1995, Edwards 1998 and Frankel and Romer 1999). However, critical reviews of the literature by Greenaway and Morgan (1998) and Harrison and Hanson (1999) raise doubts, particularly with regard to the impact of trade liberalization on growth.²

In addition to the direct effect of trade openness on growth, Balasubramanyam *et al.* (1996) suggest that trade openness has an important impact on the relationship between growth and FDI. They find evidence that the positive effect of FDI on economic growth is stronger in countries with an export orientation than in countries with an import substitution orientation. In a further study (Balasubramanyam *et al.* 2001), it is found that the impact of FDI on growth also interacts positively with measures of human capital. Interestingly from our focus on East Asia, after controlling for the influence of other variables, growth rates for Asian economies are found not to be significantly different from those for other countries in the sample.³

An inherent bias in studies of the relationship between openness and growth is generally ignored. Openness is generally associated with an expansion of market activity, as in a shift from subsistence agriculture to cash cropping or from rural activities with much home production to urban activity with heavier reliance on market provision of essentials. Only market activities are generally counted in GDP or other measures of national income, so replacement of home production with market activity raises the measured value of GDP without any change in the level of production or consumption.

The failure to recognize the impact of the shift from subsistence to market activities as economies become more market-oriented reflects a deeper lack of appreciation of the structural impact of openness. Shifting from a protected market can radically alter the composition of output in the economy. This has been particularly noticeable in the HPAEs. Nelson and Pack (1999: Table 1) show that many products with substantial output in Taiwan in 1990 were

not even produced in 1960, while Chen and Stocker (2002: Figure 6.6) show the associated dramatic changes in employment across Taiwanese manufacturing industries. In assessing the impacts of openness, it is essential to recognize that a modest change in aggregate growth may be the net effect of substantial positive and negative changes in the growth of constituent parts of an economy (particular products, firms, industries, regions, employment by skill groups, etc.). It is often these structural changes that seem to fuel social and political resistance to globalization.

Changes in the structure of exports have played some role in the sustaining East Asian growth to date, allowing substantial growth in exports without encountering falling prices associated with excessive supply. Sapsford and Balasubramanyam (2003) show strong downward trend and high volatility in the terms of trade of poorer developing countries that predominantly export primary commodities. Diversification of exports from primary products to manufactures has allowed East Asian countries to at least partially escape these adverse movements. However, Maizels *et al.* (1998) show that negative movement in the terms of trade has extended to manufacturing products coming from East and Southeast Asian countries.⁴

The interpretation of the apparently positive relationship between openness and growth has been subjected to substantial debate in the East Asian context. The essential issue is whether government industrial policy played a key role in the substantial growth in exports from East Asian economies or rather whether export orientation (and open markets) have led to economic growth. Rodrik (1995) in reviewing the experience of South Korea and Taiwan strongly favours the former explanation, suggesting that export orientation was not sufficient to explain the substantial growth in exports in these economies. In contrast, Lawrence and Weinstein (2001) argue that open markets are a key stimulus to growth (through promoting innovation and competition by domestic producers) and that Japan's economic growth would have been much enhanced had the country been more receptive to imports. With regard to FDI, Jomo (2001) notes forcefully that receptiveness to foreign investment has varied substantially across the HPAEs without any clear connection to relative growth performance. He further suggests that government guidance of FDI and its integration into the economic development of the local economy has been critical to the success of those countries that have actively sought FDI.

Technological innovation

A central role for technological innovation in economic progress has long been recognized. Schumpeter (1942), for example, argues that the main source of economic growth derives from innovation in the forms of new products, new processes, new markets and new management methods. The experience of industrialized countries in the last century has demonstrated the importance of this insight. It has been pointed out that successive waves of

technical change fuelled the growth of industrialized countries in the West since the Industrial Revolution and that “the successive industrial revolutions were based on the qualitative transformation of the economy by new technologies, rather than the simple quantitative growth of individual industries” (Freeman and Soete 1997: 20). In the US, in particular, empirical findings show technical advance as the main contributor of US growth over the period 1929–1969 (Denison 1974).

Total factor productivity growth (TFPG) is the most widely used measure of productivity change.⁵ It is calculated as follows:

$$TFPG = \dot{Y} - \omega_L \dot{L} - (1 - \omega_L) \dot{K} \quad (4.1)$$

In Equation 4.1, $\dot{Y}$, $\dot{K}$ and $\dot{L}$ represent the rate of change of output, capital and labour, respectively, while ω_L is the factor payment share of labour input. TFPG is calculated directly as a residual of the growth rate of output and the weighted growth of capital and labour. In the HPAEs, rapid output growth has been accompanied by even faster growth in capital input as well as by substantial growth in labour input. Thus, as shown in Table 4.4, TFPG has generally accounted for only a minor portion of output growth for the HPAEs in the period before the onset of the Asian financial crisis.⁶

Table 4.5 shows a general deterioration of TFPG in all HPAEs, following the onset of the Asian financial crisis. Hong Kong, for example, experienced a negative 2.0 percent per annum TFPG over the period 1997–1999. All other economies except Korea show negative TFPG over the same period. The general deterioration of TFPG is due to the violation of the assumption of long-run competitive equilibrium, which underlies the calculation of TFPG in Equation 4.1. One condition of long-run competitive equilibrium is full utilization of capital stock. However, capital stock is substantially under-utilized during a major downturn. Thus, negative output growth com-

Table 4.4 Growth and TFPG prior to the Asian financial crisis, 1960–1994

<i>Country</i>	<i>Output growth (%)</i>	<i>Capital growth (%)</i>	<i>Labour growth (%)</i>	<i>TFPG (%)</i>	<i>TFPG Share of output growth (%)</i>
Hong Kong	7.8	9.0	2.9	2.8	35.4
Indonesia	5.7	8.3	2.2	1.4	23.9
Korea	8.5	12.6	2.6	2.4	28.2
Malaysia	7.0	10.0	3.0	1.6	22.1
Singapore	8.3	13.1	2.7	2.0	23.6
Taiwan	8.1	12.2	2.7	2.1	25.6
Thailand	7.7	10.6	2.5	2.4	30.7

Source: Output growth, capital growth and labour growth rates are adapted from Collins and Bosworth (1996). TFPG values are calculated based on the assumption that capital's share of income is fixed at 0.35 in all countries. This assumption is justified by empirical studies of capital elasticity for developing countries (see Benhabib and Spiegel 1994).

Table 4.5 Growth and TFPG since the Asian financial crisis, 1997–2001

Country	Output growth (%)	Capital growth (%)	Labour growth (%)	TFPG (%)
Hong Kong	1.5	6.0	2.1	−2.0
Indonesia	−1.1	3.8	2.1	−3.8
Korea	2.9	4.9	0.8	0.7
Malaysia	1.0	4.0	2.8	−2.2
Singapore	2.8	7.3	3.3	−1.9
Taiwan	2.6	7.4	1.2	−0.7
Thailand	−0.4	1.1	−0.2	−0.7

Source: Post-Asian financial crisis capital growth is calculated using cumulating investment flows for 10 years (1987–1996) and a 6% depreciation rate that provides a benchmark capital stock for each economy in 1997; which is then extended to 2001 using the investment data for 1997–2001. Output growth and labour growth data are adapted from Latest Country Analysis, *The Economist Intelligence Unit*.

Note

TFPG values are calculated as indicated above in Table 4.3 notes.

bined with small positive growth in labour and capital stock result in negative TFPG. As such, the TFPG figures in Table 4.5 illustrate the problems that plague the use of Equation 4.1 for measurement of technical change.

Productivity growth provides a particularly favourable basis for output growth. Extra output achieved without extra input provides the basis for a higher standard of living.⁷ However, in the case of East Asia and other developing economies, the use of technology developed abroad may lead to license payments or profits of foreign owned subsidiaries going abroad.⁸ In such circumstances, the growth in GDP does not translate fully into growth in domestic income.

Perhaps more important for the future of East Asian economies is the argument that without productivity growth rapid output growth is unsustainable over long periods (see Krugman 1994 and Young 1995). Here, the worry of the “growth pessimists” is that the particularly rapid growth in capital input in East Asia will depress the returns to further investment as the productivity of extra capital declines. They contrast the experience of East Asia with that of the OECD countries, where productivity growth has generally accounted for the vast majority of output growth in recent decades. The 1997 Asian financial and economic crisis and short-lived recovery only up to 2000 provide some ammunition for proponents of the view that growth in East Asia is fragile and unsustainable.

Evidence is provided in Table 4.6 to support the contention that those East Asian economies that rely predominantly on factor accumulation rather than technological advance to boost growth suffered most heavily from the Asian financial crisis. In the second column of Table 4.6, we show the extent of depreciation against the US dollar during the Asian financial crisis in East Asian economies. The third column shows the percentage change in output

Table 4.6 Impact of 1997 Asian crisis on output growth and currency depreciation

Country	Currency depreciation (%)	Output growth in 1998 (%)	Output growth in 2000 (%)	Output growth in 2001 (%)	Factor accumulation (%)	Technical progress as share of output growth (%)
Hong Kong	0	-5.1	8.2	0.2	72	28
Indonesia	-77.3	-13.0	3.8	3.3	127	-27
Korea	-44.8	-6.7	8.6	3.0	99	1
Malaysia	-37.5	-7.4	8.6	0.6	89	11
Singapore	-13.4	0.4	9.1	-2.0	80	20
Taiwan	-14.0	4.6	7.0	-2.2	97	3
Thailand	-45.5	-10.2	5.0	1.8	85	15

Source: Adapted from Kim and Lau (1996).

for the economies in 1998 at the height of the impact on output. The final two columns show the relative importance of factor accumulation and technical progress as shown by Kim and Lau (1996).⁹ We observe a statistically significant direct correlation between the importance of factor accumulation and the size of the fall in GDP growth over the financial crisis. An economy that relies more on factor accumulation to boost growth suffers not only a larger fall in GDP growth from its historical benchmark growth rate, but also takes a longer time to return to its historical benchmark growth rate. Perhaps more interestingly, we also observe a statistically significant relationship between the extent of technical progress in the past and the extent of depreciation of the domestic currency over the financial crisis.¹⁰

The “growth optimists” argue that accumulation of physical and human capital encourages productivity growth as well. However, in East Asia there are economies that have experienced rapid factor accumulation with little or no productivity growth. The correlations that we observe in Table 4.6 highlight a tendency of substantial fluctuations and uncertainty in those economies that experience rapid growth without technological innovation and productivity gains. The short-lived recovery in all the East Asian economies since the crisis provides clear warning signals that growth without productivity improvement is precarious. The centrality of technical progress to economic growth and the wealth of nations should not be underestimated.¹¹

Financial infrastructure

Money serves as the lubricant for the economy that substantially increases the efficiency of real production and transactions. Likewise, the development of financial intermediaries facilitates production and enhances economic growth. We are, then, not surprised to observe that many of the rapidly growing East Asian economies have experienced a rapidly concurrent growth in the financial sector. Hong Kong, for example, experienced an average annual GDP growth of 16 percent in nominal terms between 1961 and 1994. For the same period, its banking sector grew roughly by 20 percent per annum and its stock market by 25 percent per annum.¹² Can we then draw a definitive conclusion that financial development must accompany economic growth? In this section we address two fundamental and related questions raised in the current literature: first, what is the exact mechanism that links financial intermediary development to economic growth? Second, must the development of financial intermediation precede growth or does it simply reflect economic growth?

Measurement of financial development

In Table 4.7, three widely used indicators of financial development are presented. In the second column, we list the presence of foreign banks in the

Table 4.7 Financial development in East Asian economies

<i>Country</i>	<i>Presence of foreign banks, 1994 or 1995 (world ranking)</i>	<i>Total equity market capitalization in US\$ millions, 1995 (world ranking)</i>	<i>Private credit per GDP</i>
Hong Kong	357 (2)	303,704 (9)	2.2861
Indonesia	<3 (>40)	n.a.	0.3020
Korea	75 (11)	181,955 (16)	0.5194
Malaysia	<3 (>40)	222,729 (12)	0.6590
Singapore	185 (5)	148,004 (18)	0.8429
Taiwan	39 (27)	187,206 (15)	n.a.
Thailand	60 (18)	141,507 (20)	0.5272

Sources and notes

- 1 Presence of foreign banks refers to the number of foreign banks at the end of 1994 or 1995 that includes branches, agencies, subsidiaries and representation offices in the capital city of the respective countries (adapted from Jao 1997: 31).
- 2 Total equity market capitalization for 1995 is adapted from Jao (1997: 42).
- 3 Private credit per GDP refers to the value of credits by financial intermediaries (banks and non-banks) to the private sector divided by GDP. The figure for Hong Kong is taken from 1999 (source: *Hong Kong Almanac 1999*: 391). Figures for other countries are averages for the early 1990s adapted from *International Financial Statistics* (IFS) lines 32d/line 99b.

capital city of the respective countries. This figure measures the importance of an economy as an international financial centre. Hong Kong, for example, is only behind London in terms of number of foreign banking establishments. Singapore is ranked fifth in the world as an international financial centre by using this criterion. The third column of Table 4.7 is the total equity market capitalization. It is a size rather than a liquidity measure, so it does not reflect market activity such as the turnover ratio. By this measure, Hong Kong ranks ninth and Singapore ranks eighteenth in the world, which is behind Malaysia and Taiwan. The last column of Table 4.7 is the most important and widely used measure of financial development: the value of credits by financial intermediaries to the private sector divided by GDP. The figure for Hong Kong, for example, shows that for every dollar of GDP, banks and near-banks in Hong Kong loaned out roughly HK\$2.30 to the private sector in 1999. Singapore is a distant second with a value of S\$0.84. In sum, figures in the last column of Table 4.7 indicate that Hong Kong and Singapore are by far the most financially developed economies in East Asia. Korea is the least financially developed, lagging behind all other East Asian economies except Indonesia.

Link between financial development and growth

There are two alternative views about the links between financial intermediary development and economic growth. Schumpeter (1911) was among the first to point out that banks can facilitate technological innovation in their

role as financial intermediaries. By assembling savings, evaluating investment projects, monitoring managers and facilitating transactions, banks are able to acquire detailed information about firms at a lower cost. They thus become the authorized agents of the economy to allocate savings to entrepreneurs and innovating firms. This Schumpeterian view states that the development of financial intermediaries has a direct impact on the pace of technical change and productivity growth, which feeds through to overall output growth. One important implication of this view is that financial intermediary development does not necessarily affect the savings rates per se, but rather the allocation of savings.

An alternative view originally put forward by Goldsmith (1969), McKinnon (1973) and Shaw (1973) emphasizes the role of capital accumulation in economic growth. Specifically, financial intermediary development lowers market friction, which increases domestic savings rates and attracts foreign capital. Financial intermediary development thus increases capital accumulation and reduces the costs of external finance to firms, leading to overall economic growth.¹³

The stock market is another important part of the financial sector. There are various potential channels through which the stock market is believed to contribute positively to economic growth. First, the stock market makes financing long-duration investment projects easier for firms. Second, the stock market reduces the level of risk faced by savers who can buy and sell quickly and cheaply in the stock market when altering their portfolios. Third, firms can use the stock market to mitigate the principal-agent problem by aligning the interests of managers and owners, such as warrants issued to managers (Diamond and Verrecchia 1982, Jensen and Murphy 1990). Improving the allocation of capital is an important ingredient of productivity and output growth.

There are, however, potential channels through which the stock market is believed to contribute negatively to economic growth. One such channel is that stock market liquidity may weaken corporate governance. This occurs when stockholders simply sell stocks quickly rather than exerting corporate control if they are dissatisfied with the performance of the firm. Another channel is the excessive price volatility in the stock market. As Arestis *et al.* (2001: 35) puts it: "If present, excessive volatility is likely to result in an inefficient allocation of resources, upward pressures on interest rates in view of the higher uncertainty, hampering both the volume and the productivity of investment and, therefore, reducing growth."

Empirical evidence for East Asian economies

Demetriades and Hussein (1996) conduct a variety of causality tests between financial intermediary development and real GDP for sixteen developing countries and find "considerable evidence of bi-directionality and some evidence of reverse causation" (p. 387). According to their results, Korea and

Thailand are the two East Asian economies that belong to a group of countries that exhibit a bi-directional relationship. Focusing on eight Asian economies in their study, Sinha and Macri (2001) do not support the general consensus view of a positive relationship between financial development and economic growth. They find a two-way relationship between growth and financial development for Indian and Malaysia, a one-way relationship from financial development to economic growth for Japan and Thailand and a reverse causality for Korea, Pakistan and the Philippines. In addition, Sri Lanka is found to have little evidence of causality in either direction.

Leigh (1996) applies co-integration techniques to study the relationship between financial development and economic growth in Singapore. His results are in line with the predictions of endogenous growth models. Specifically, he finds that financial development positively affects both transitional and long-run growth in Singapore. Spiegel (2001) reports that financial development has a positive impact on both total factor productivity growth and rates of factor accumulation, both of them contributing directly to economic growth. More importantly, his results show that countries in the Asia-Pacific region (APEC) are significantly more dependent on financial development for total factor productivity growth and rates of factor accumulation than the rest of the sample.

A recent study by Henry (2000) finds significant evidence that stock market liberalizations cause investment booms in Korea, Malaysia, the Philippines and Thailand. However, Levine and Zervos (1998) find little evidence that stock market liberalizations or international integrations cause a permanent increase in the growth rate of the capital stock. However, as noted by Schumpeter (1911) with regard to credit financing of innovation, development in the stock market can be growth enhancing with increasing saving rates or capital accumulation. Levine and Zervos (1998) find stock market liquidity is directly linked to growth. Arestis *et al.* (2001), however, caution that the contribution of the stock market to economic growth may have been exaggerated in studies that utilize cross-country growth regressions.

Is financial development necessary for growth?

The proposition that financial development must precede growth seems to receive little support from the growth experience of the East Asian economies. In particular, we observe that none of the rapidly growing economies of East Asia had any viable financial infrastructure to start off from before their economic take-off in the 1960s and 1970s. What is more evident from the experience of the East Asian economies is the concurrent development of financial intermediation with their rapid economic growth. This points to a bi-directional relationship between financial development and economic growth rather than a one-way causality relationship from financial growth to economic growth. The empirical literature offers little definitive evidence to settle the dispute. Bloch and Tang (2003) argue that most of the

cross-country studies support a one-way causality from financial development to growth, while many time-series studies reject such a generalization.

It is perhaps futile if one is to insist on searching for a solution for the egg-chicken problem of imposing causality on the relationship between financial development and economic growth. We believe that financial development generally enhances economic growth which, in turn, feeds back to financial development. However, we note a particular problem for East Asia arising from the general weakness of the countries in technological innovation as noted in the previous section. Schumpeter's argues that credit financing supports growth only when applied to financing innovation. Indeed, he argues that when credit financing is used for general accumulation, rather than innovation, it can help to spread inefficiency and over-expansion of credit, creating instability if too dominant.

Did the over-expansion of credit contribute to the Asian financial crisis of 1997? Superficially, a financial crisis is impossible without the extension of credit. Indeed, China escaped the crisis with a largely unchanged growth rate in 1998. However, Indonesia, with the lowest level of financial development according to the measures in Table 4.7, has the most negative GDP growth for 1998, shown in Table 4.1, and the largest currency depreciation, shown in Table 4.6. Korea, Malaysia and Thailand, each with relatively undeveloped financial intermediation, have substantial negative GDP growth for 1998 shown in Table 4.1 as well as substantial currency depreciations in Table 4.6. In contrast, Hong Kong and Singapore, with more developed financial intermediation, are shown to have suffered less severely. Thus, it is arguable that weak financial development exposed some East Asian economies to more severe disruption from the crisis of 1997.

Some researchers have gone beyond the stage of examining the relationship between financial development and economic growth. They are more concerned about the specific factors that affect the efficiency of the financial sector. For example, does weak corporate governance, corruption or an underdeveloped legal and regulatory system significantly reduce the efficiency of the financial sector of the East Asian economies? A recent study by Johnson *et al.* (2000) finds that the lack of protection for minority shareholders is responsible for much of the fall of the stock markets and exchange rate depreciations in the East Asian economies during the 1997 financial crisis, which led to a drastic and sudden reduction in the growth rates. Stiglitz (2000: 1082) argues that "developing countries should have strong financial institutions and regulatory structures in place before liberalizing their capital accounts". These studies provide advice that is readily useful by policymakers in the East Asian economies.

Conclusions

The growth experience of East Asian economies during the last three decades of the twentieth century has been truly remarkable, particularly when

contrasted to the dismal experience of most other developing economies. We have identified certain salient characteristics of these rapidly growing economies, namely rapid accumulation of capital, emphasis on export orientation in government policy and substantial changes in the structure of production. The role of other factors, such as FDI and financial development is less clear, as the presence of these factors varies substantially across successful economies. Relatively low levels of TFPG in East Asia do seem to have left countries more exposed to the adverse consequences of the crisis of 1997, with greatest downturns in GDP and currency value being felt by the economies with lowest TFPG. Further, the short-lived nature of the recovery from the crisis raises serious questions about the sustainability of long-run growth without technological innovation.

The experience of the East Asian economies has shown there is some potential for developing countries hoping to escape from poverty and underdevelopment. However, the path of growth followed by the East Asian countries, through exporting simply transformed manufactures to the industrialized countries, may not be open to replication. There is the constant worry that protectionist sentiments in the industrialized countries will lead to restricted market access. Alternatively, the attempt of many countries to follow the same path will lead to the same sort of declining terms of trade experience as previously encountered by developing economies that emphasized primary commodity exports. Also, other developing countries may not be able to achieve the key initial conditions observed in East Asia, namely stable governments, a reasonable level of education for the labour force and a relatively equal distribution of income. Finally, the role of culture and luck in identifying and pursuing sustainable paths for economic growth remains an open question.

One further issue relevant to the overriding theme of this volume is the implications of the East Asian growth experience for the world capitalist system. In particular, do the dynamics of East Asian growth, especially if extended to the transitional economies of the former Soviet bloc and to other developing countries, support long-run growth and provide the foundation for a long-run upswing of the world economy? Here, application of Schumpeter's (1942) notion of creative destruction is useful.

Creative destruction occurs when firms create new market positions for themselves by using innovative methods to destroy positions of market dominance held by established firms. The concept is usually applied to firms competing within a domestic economy. However, it is appropriate to consider competition more broadly in the modern global economy.

East Asian firms selling simply transformed manufactures have successfully attacked the market positions of firms from the advanced industrialized countries. The attack has been so successful that many branches of manufacturing, for example the manufacture of radio and television sets, have virtually disappeared from some advanced industrialized economies. Success contributes to capital accumulation and employment growth in East Asia, but depresses

accumulation and growth in the countries of the failing firms. Still, Schumpeter argues that the overall impact for growth is positive. Indeed, to him the structural transformation associated with creative destruction is essential to maintaining the dynamism of capitalism.

The successful attack of East Asian manufactures on the market dominance of firms from the advanced industrialized countries involves innovation in the geographical organization of production. Geographical separation of the design, production and marketing functions for mass-produced consumer goods lies at the heart of East Asian success. Indeed, many manufacturing operations in East Asia are subsidiaries of multinational firms, which have kept design and marketing functions in the home office. Even where the manufacturing operations are domestically owned, it has been important for the East Asian firms to develop alliances for design and marketing purposes with firms from the advanced industrialized countries. Eventually, some East Asian firms have developed integrated design, production and marketing capabilities, but still locate at least marketing functions in the target market.¹⁴

Can there be further innovation in the geographical organization of production by East Asian, transitional economies or other developing countries? Alternatively, can firms in these countries develop other innovations to successfully attack the market dominance positions of firms in the advanced industrialized countries? If so, then there is clearly a potential future contribution to a long-run upswing in growth of the world economy.

Successful attacks on positions of market dominance are rare, especially attacks by firms located outside the leading economies of the time. The successes by Japanese firms in the immediate post World War II period and by American firms in the late nineteenth century are notable among the rare examples. In this context, the terminology, East Asian economic miracle, is perhaps not surprising. Another miracle may be required for the East Asian, transitional economies or other developing countries to contribute to a long-run upswing in growth of the world economy. However, Schumpeter (1942) recounts that innovation and creative destruction have been very much at the heart of the dynamism of capitalism, suggesting that the possibility of such miracles should not be discounted.

Notes

- * Research assistance from Paula Haslehurst is gratefully acknowledged, as are helpful comments from Phil O'Hara, Dave Western and participants at the Curtin University of Technology, Department of Economics annual retreat in June 2002. The authors remain responsible for all errors and omissions.
- 1 Dutt (1998) uses a simple North–South growth model to show that the impact of FDI on developing countries (the South) depends very much on the type of goods produced by Northern-owned plants in the South and on the degree of integration of the Southern plants into the Northern production system.
- 2 Harrison and Hanson (1999) also question whether there is a positive employment impact of liberalization and suggest that liberalization might raise wage inequality.

- 3 The coefficient of a dummy variable for Asian economies is positive in a multi-variate regression explaining the growth rate of real GDP, but the coefficient is not statistically different from zero at the 10 percent significance level.
- 4 In discussing the prospects for growth in Southeast Asia, Jomo (2001: 500) notes “considerable evidence that commodity prices have been falling in recent years, including prices of most primary as well as manufactured products”.
- 5 There are a variety of other measures of technical progress, including parametric estimates from regressions estimating production or cost functions. Bloch and Tang (2000) show the existence of bias in using TFPG as a measure of technical change, compared to parametric estimates from cost functions, for Singapore manufacturing industries.
- 6 Nelson and Pack (1999) argue that technological advance and productivity gains play a major role in the success of East Asian economies. They stress that data constraints and limitations inherent in the neoclassical approach mean that quality improvements embodied in physical and human capital are not properly reflected in the measurement of technical change and productivity growth. They argue that embodied technical progress has been far more important than disembodied technical progress in explaining the growth of the East Asian economies. Further, Lucas (1993) argues that human capital (education and on-the-job training) is the main engine of growth in East Asian economies.
- 7 Of course there may have been a previous sacrifice of output, as when the increased productivity is achieved from technology developed through investment in research and development, or from the skills of increased human capital.
- 8 A survey study carried out by Ng, Hirono and Siy (1985) in the ASEAN countries, indicates that there are high costs incurred for the buyers of technology. For example, the outflows of funds (foreign remittances and expenses for imports) have exceeded fund inflows (foreign capital infusions and export receipts) among Thai joint ventures that have been paying copyrights fees and royalties. In Indonesia, the government is concerned with the unreasonably high prices for technology that Indonesian firms are being charged. In sum, the survey concludes that “the disadvantaged position of the buyer and his ignorance about the costs of alternative sources have resulted in unreasonably high profits for the owners of technology” (p. 21).
- 9 We use the decomposition of output growth from Kim and Lau (1996) in preference to measures of TFPG from Table 4.4 or adjusted TFPG from the World Bank (1993). The Kim and Lau methodology is designed to yield direct measures of technical change rather than the proxy measures given in TFPG calculations.
- 10 Using the non-parametric spearman rank correlation test, the correlation between factor accumulation (or technical progress) from the study of Kim and Lau (1996) and the 1998 GDP growth rate gap (defined by the difference between the average 1970–1996 GDP growth rate and that of the 1998) is significant at 10 percent significance level, while the correlation between factor accumulation (or technical progress) and the 2000 GDP growth rate gap is also significant at 10 percent significance level. Using the same test again, the correlation between factor accumulation (or technical progress) and the extent of depreciation is statistically significant at around 3 percent significance level.
- 11 Tang (2002 and 2003) estimates a positive relationship between growth volatility and technical progress, using regressions between the variance of GDP growth and various measures of technical progress, using a broader sample of countries, including the East Asian economies, the major OECD countries and a sample of developing economies.
- 12 Source: Census and Statistics Department, *Hong Kong Statistics 1947–1967*. Taken from Jao (1997: 51).

- 13 Schumpeter (1911) notes that when credit financing is used for general accumulation, rather than innovation, it can help to spread inefficiency and over-expansion of credit, creating instability if too dominant. Thus, the purpose to which credit financing is put is important in determining its impact on the economy.
- 14 It is perhaps ironic that the success of East Asian manufacturing firms reflects a major innovation when there is little evidence of rapid technical change by these firms. The distinction here is between innovation in the methods of production and innovation in cross-country organization of production. Gains from innovation in methods of production are reflected in measures such as total factor productivity growth for the individual firm or industry. In contrast, when firms in East Asia are successful in capturing the gains from cross-country organization, these gains are reflected in the real GDP growth of the East Asian economies (as productive resources are shifted from traditional industries to manufacturing for export). Alternatively, when competition between East Asian firms or the bargaining power of multinationals shifts the gains to the advanced industrialized countries, then these gains will be reflected in improvements in the terms of trade for the advanced industrialized countries or in large profits for the multinationals.

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5 Transformation to a market economy in Eastern Europe, the former Soviet Union and Asia

John Marangos

Introduction

The movement from a centrally administered economy to a market-based economy in Eastern Europe, the former Soviet Union (EEFSU) and Asia is commonly referred to as the ‘transition problem’. However, the word ‘transition’ – the passage from one state to another, in this case from a centrally administered to a market-based economy – does not seem appropriate; it does not explicitly capture all the complexities involved. The word ‘transition’ implies the achievement of a specific end-state; thus the attainment of the end-state completes the whole transition process. Most economists associate this end-state with the establishment of a capitalist economic system in which market relations are dominant, the majority of property is private as a result of privatisation of state enterprises, and effective property rights are respected and enforced. This again reflects the traditional, static notion of economic theory: with the dominant role of markets and private property along with property rights, the economic system naturally gravitates towards equilibrium as long as there are no impediments to reaching this position.

However, the transition process entailed superseding the essential properties of the centrally administered economy, consequently destabilising the entire economic system and replacing it with a market economy. Thus, from a global political economy perspective – viewing the economic system in a dynamic context, not in a static form of a procedure of establishing equilibrium – the movement towards a market economy is never-ending. A dynamic process of economic development and growth, independent of whether a market exists or not, involves a ‘transformation’ of the economic system in its totality as a means of integrating into the global political economy: it definitely does not involve ‘transition’. Nevertheless, since the terminology has become somewhat entrenched, I will use it in this paper, but challenge it at least in the title and the introduction! Let’s look in detail at the ‘transition’¹ processes adopted by different transition economies.

Eastern Europe and former Soviet Union

Shock therapy

The goal of the transition process, based on the shock therapy perspective, was the establishment, as quickly as possible, of individual self-interested behaviour to facilitate exchange in the market and the establishment of private property through a variety of privatisation methods. The shock therapy transition model derived its name from Poland's stabilisation and liberalisation program, initiated on 1 January 1990, which became known as 'shock therapy' or 'big bang'. The countries that followed the shock therapy approach were Czechoslovakia (starting January 1991), Bulgaria (February 1991), Russia (February 1992), Albania (July 1992), Estonia (September 1992) and Latvia (June 1993). Jeffrey Sachs and Andres Aslund, the architects of the shock therapy process, shared the belief that the transition economies were in such a terrible mess that a radical and comprehensive program was required to introduce any kind of rational order. There was no smooth transition, and no 'soft landing' appeared possible: there was only a need for harsh medicine (Aslund 1995: 16).

The shock therapy process of transition involved immediate price liberalisation, immediate privatisation and immediate stabilisation of transition economies. Jeffrey Sachs stated that 'Poland's goal is to establish the economic, legal and institutional basis for a private-sector market economy in just one year' (Sachs 1990: 19). The supporters of the shock therapy model argued that the elements of the model would have ensured growth at full employment with low inflation and stability. In summary, the shock therapy model was a neoclassical model of transition advocating the immediate implementation of the necessary reforms to establish a free-market process. The transition process demanded the introduction of a package of measures, containing the required reforms, which had to be approved by the political process and introduced immediately. Correspondingly, the reform process was not only an economic, but also a political, challenge (Sachs and Lipton 1990: 62–3). The set of transition policies recommended by the shock therapy supporters is presented in Table 5.1.

Gradualism

The fundamental basis of the gradualist approach to transition was the need to establish economic, institutional, political and ideological structures before any attempt at liberalisation was undertaken. Without this minimum foundation, radical reforms would have inhibited the development of a competitive market capitalist system. The aim of the gradualist transition process was to initiate profound and unique changes, a 'transformational recession' (Kornai 1993a: 182, 189; Kornai 1994: 41), to overcome the 'shortageflation' syndrome (Kolodko 1993: 21) by initiating 'preventive therapy' (Kornai 1997:

Table 5.1 Transition policies

<i>Transition policies</i>	<i>Shock therapy (Poland, Latvia, Czechoslovakia, Bulgaria, Russia, Albania, Estonia, Vietnam 1989–1991)</i>	<i>Gradualist (Romania, Hungary, Slovenia, Mongolia)</i>	<i>Non-pluralistic transition (China, Vietnam pre-1989)</i>
Price liberalisation Stabilisation	Immediate price liberalisation No state intervention	Gradual price liberalisation Gradual removal of sources of state intervention	Gradual price liberalisation Market planning and directives
Privatisation	Restitution, auctions and free distribution of vouchers	Restitution, auctions and free distribution of vouchers	Development of TVEs and private firms in special economic zones Leasing of land
Property relations	Minimum state	Minimum state	Majority social with some private property
Institutions	Formal and informal institutions product of market forces	Formal and informal institutions product of market forces	Informal institutions product of market forces
Monetary policy Financial system	Independent central bank and privately owned banks	Gradual establishment of independent central bank and gradual establishment of privately owned banks	State-controlled central bank and state-owned banks
Fiscal policy	Neutral taxing system and balanced budget	Gradual neutral taxation system and gradual balanced budget	Discretionary taxation system and discretionary fiscal policy
International trade Foreign aid	Free trade, fully convertible currency Conditional foreign aid	Gradual free trade, fully convertible currency Conditional foreign aid	Tariffs and non-tariffs barriers, discretionary exchange rate policy Non-conditional foreign aid
Social policy	Safety net	Gradual safety net	Enterprise funded Welfare Services

183). This was only possible by taking ‘the longest road’ (Abel and Bonin 1993: 230), or ‘rebuilding the boat in the open sea’ – the title of the Elster, Offe and Preuss (1997) book.

According to the gradualist approach, it was desirable to maintain a semi-centralised system, coupled with a combination of centralised markets. The distinguishing feature in the gradual transition process was that the ultimate goal of an approximation to competitive capitalism would have been achieved by the gradual elimination of centralisation. As such, the gradualist process of transition is based on neoclassical economic analysis advocating the gradual implementation of the necessary reforms. The gradualist transition process was implemented in Romania, in Hungary – which had a tradition of gradual transformation starting in 1968 with the New Economic Mechanism – in Slovenia, and in some of the republics of the former Soviet Union. The set of policies recommended by the gradualist supporters appear in Table 5.1.

Macroeconomic performance

The macroeconomic performance of the transition economies of Eastern Europe and the former Soviet Union is revealed in Table 5.2. All countries experienced a reduction in output. The cumulative output decline in Poland was only 6 percent while the largest was 78 percent in Georgia. As well, all countries experience inflation and most of them hyperinflation, with Hungary registering the lowest inflation rate in 1990 of 33.4 percent while Armenia in 1993 registered an inflation rate of 10,896 percent. All economies of the former Soviet Union experienced hyperinflation above 1281 percent. Most importantly for most countries, real GDP in 2000 was still below the 1990 level when the transition process was initiated. From a total of twenty-four, only five countries (Albania, Hungary, Poland, Romania and Slovenia) have recovered from the transitional recession and registered Real GDP above the 1990 level. By 2000 none of the former Soviet Union countries have yet to achieve the 1990 Real GDP level; Uzbekistan is the closest at 95 percent, while Georgia in 2000 was only producing 29 percent of the 1990 Real GDP. For a large majority of the Eastern European and the former Soviet Union economies, the ‘transition process’ (using the common terminology of an end-state) is not complete in terms of Real GDP and employment.

Asia

China

A quarter of a century ago, the Communist leadership, under Deng Xiaoping, initiated a marketisation process in China’s centrally administered socialist economic system. The start of these reforms is usually identified with the Communist Party Plenum in December 1978 (Nolan 1995: 1). Thus the

Table 5.2 Macroeconomic performance of transition economies of Eastern Europe and the former Soviet Union

Countries	Consecutive years of output decline	Cumulative output decline (percent)	Year in which output was the lowest	Ratio of lowest registered GDP to 1989 (percent)	Real GDP, 2000 (1990 = 100)	Years in which inflation peaked	Maximum end-year inflation rates
Albania	3.8	33	1992	60.4	110	1992	236.6
Bulgaria	4	16	1997	63.2	81	1997	42.1
Croatia	4	36	1993	59.5	87	1991	338.9
Czech Republic	3	12	1992	84.6	99	1997	578.6
Estonia	5	35	1994	60.8	85	1993	1149.0
Hungary	4	15	1993	81.9	109	1991	52.0
Latvia	6	51	1995	51.0	61	1992	953.5
Lithuania	5	44	1994	53.3	67	1990	33.4
Poland	2	6	1991	82.2	112	1992	959.0
Romania	3	21	1992	75.0	144	1992	1161.1
Slovak Republic	4	23	1993	75.0	82	1990	249.0
Slovenia	3	14	1992	82.0	105	1993	295.5
Armenia	4	63	1993	31.0	67	1997	151.4
Azerbaijan	6	60	1995	37.0	55	1991	58.3
Belarus	6	35	1995	62.7	88	1991	247.1
Georgia	5	78	1994	25.4	29	1993	10,896.0
Kazakhstan	6	41	1998	61.2	90	1994	1788.0
Kyrgyz Republic	6	50	1995	50.4	66	1996	1996
Moldova	7	63	1998	32.1	35	1998	181.7
Russia Federation	7	40	1998	55.3	64	1993	7487.9
Tajikistan	7	50	1996	39.2	48	1992	2984.1
Turkmenistan	8	48	1997	42.0	76	1993	1363.0
Ukraine	10	59	1998	36.6	43	1992	2198.0
Uzbekistan	6	18	1995	83.4	95	1992	2206.1
						1998	84.5
						1993	7343.7
						1993	9750.0
						1993	10,155.0
						1994	1281.0

Source: Adapted from the European Bank of Reconstruction and Development (1999; 63); World Bank (2002c: 5).

period of reform has been at least twice that in EEFSU. China's reforms differed markedly from those implemented in the transition economies of EEFSU. There were a few reasons for this. First, China was exhausted from 20 years of dealing with Mao's messianic vision. Second, the Chinese leadership was not willing to adopt shock therapy and there was no desire to replicate the experience of Western Europe. Third, China faced no economic crisis, only dissatisfaction with the pace of economic growth. In 1979 China was experiencing Real GDP growth rate of 7.6 percent and inflation of only 1.9 percent (Table 5.3).

Mao, like Marx, ruled out any role for the market in a socialist economy. In contrast, Deng Xiaoping highlighted the integral role of markets in a socialist economic system. Deng Xiaoping, the architect of economic reform, proclaimed that it did not matter whether the cat was red or white, as long it caught mice (Zwass 1999: 224). Deng also proclaimed the slogan 'enrich yourselves' and made it clear that it was all right for a few to get rich first and pull the others along with them later (Perkins 1988: 636). Market-oriented reforms, specifically the extension of markets and a significant reduction in the role of central planning, have been crucial elements in explaining China's economic success. Naturally, 'markets do not require private ownership to function' (Bowles and Xiao-Yuan 1994: 60).

By 1984 the Chinese government had become convinced of the necessity of a price reform. China was forced to move away from administrative means of controlling prices towards market instruments, as the administrative measures were inefficient in an increasingly liberalised financial setting. However, its approach to price liberalisation was to give social stability a high priority, and the maintenance of social cohesion was a key criterion by which price reform was to be implemented. It was decided to reform the structure of relative prices only gradually, and to do so in a controlled and planned fashion, recognising that price controls were necessary. The mechanism chosen and implemented in May 1984 was the two-track system. Under this system, there were centrally specified input and output quotas, within which sales and purchases were centrally directed at low prices, which were controlled. Above these quotas, and for production sectors which did not have quotas, firms producing outputs and inputs were allowed to set prices for their products according to market conditions. This formally established the double-track price system: the co-existence of centrally determined prices and market-determined prices. The establishment of the dual price system preserved planned allocation while incrementally drawing output into the market system and softening the risks of economic reform. By 'changing a big earthquake into several tremors', price reform was implemented (Chen, Jefferson and Singh 1992: 208–9). The incremental aspect of the dual-track system also allowed for the tandem implementation of price and enterprise reforms. The emergence of a market economy did not mean the immediate collapse of all components of the existing system. Rather, the granting of partial micro-autonomy represented a small crack in the traditional economic system.

Chinese economic reforms, not only price reform, had been progressing through a dual-track system. The dual-track system was also used in most of the other reform areas. The dual structure of ownership, while keeping state ownership relatively unchanged, meant that non-state sectors were encouraged to grow. The dual governance of the market and the plan included a dual-track pricing system, a dual exchange rate system and dual geographical divisions, with the establishment of special economic zones. The dual fiscal division of responsibilities and incentives was represented by a system of revenue-sharing contracts between different levels of government. The set of policies implemented by the Chinese reformers is presented in Table 5.1.

It has been widely accepted that the Chinese reforms have been successful. The economic growth rate is among the highest on record and fairly stable, it has been achieved without sacrificing external equilibrium, and inflation has been kept under control. In 1998, China was experiencing a Real GDP growth rate of 8.3 percent and deflation of 1 percent (Table 5.3). The experiences and outcomes of the various transition economies are puzzling. Why is it that shock therapy, which dismantled an inefficient economic structure in one shot, resulted in a large decline in economic growth, while in China, which initially preserved the inefficient planning system, a substantial increase in output resulted? Strangely enough, an argument used for the adoption of shock therapy by Sachs and Woo (1994: 105) was the supposed failure of the two-track Chinese approach. This suggests that there were serious problems with the methodology underlying the transition orthodoxy of shock therapy and that the Chinese experience offered a strong counter-example to the sweeping claim that the gradual reforms would fail. The Chinese experience with reform has been an embarrassment to orthodox economics.

Vietnam

As was to be expected, Vietnam's transition was greatly influenced by China's successful experience. Most importantly, the Communist Party is still in power in Vietnam – as in China but unlike EEFSU – and the development of a 'socialist society' is still the state's official goal. The start of market reforms dates back to the Sixth plenum of the Fourth Party Congress, in

Table 5.3 Macroeconomic performance of Asian transition economies

<i>Countries</i>	<i>China</i>		<i>Vietnam</i>		<i>Mongolia</i>	
	<i>1979</i>	<i>1998</i>	<i>1985</i>	<i>1998</i>	<i>1992</i>	<i>1998</i>
Real GDP growth (percent)	7.6	8.3	3.6	5.9	−9.5	3.7
Inflation (percent, end of period)	1.9	−1.0	223.3	9.2	325.5	6.5

Source: Adapted from Karla and Slok (1999: 4).

September 1979 (Riedel and Comer 1997: 191). The first of the two major reforms was the initiation of a 'contract' system in agriculture, which set quotas for household units rather than for entire cooperatives and allowed households units to retain and trade any output that exceeded their quota. The second major reform was directed at industry and became known as the 'three-plan system': state-owned enterprises were subject to three plans. Under Plan One, enterprises were provided with inputs at subsidised prices and in turn were required to supply set quantities of goods to the state. They were permitted to keep 50 percent of the profits they generated. Under Plan Two, the enterprise would produce beyond the amount specified in Plan One, and use revenues to purchase additional inputs. The state-owned enterprises could keep 60 percent of the profits earned. Plan Three gave enterprises the right to engage in sideline activities, in product areas not under state monopoly, more or less on a free-market basis, which became known as 'fence-breaking' (*xe rao*). Firms were allowed to keep 90 percent of the profits generated under Plan Three. The introduction of limited markets resulted in the early 1980s in acceleration of agricultural output and an increase in industrial growth by 9 percent (Porbert and Young 1995: 508).

In spite of the positive responses to economic liberalisation in agriculture and industry the influence of the anti-market-reformists in the Communist Party was restored by the mid-1980s, intensifying the pressure to force collectivisation of agriculture in the south. Market reforms were undermined by the emergence in the early 1980s of severe structural imbalances, reflected in galloping inflation, a spiralling budget deficit and severe balance of payments problems. In 1985 the real GDP growth rate was 3.6 percent (in contrast to China's 7.6 percent) while inflation was 223.3 percent (Diehl 1997: 118). By 1985, after 5 years of piecemeal economic reform combined with a more gradual approach to socialist transformation, Vietnam again found itself facing an economic crisis.

A far-reaching reform program in 1986, under the banner *doi moi* (renovation), was initiated (Riedel and Comer 1997: 188). In agriculture, farmers were no longer required to sell contracted amounts of output to the state, but instead could sell their product in the market after paying taxes and commissions. In addition, in 1988, households were given land tenure for at least 15 years and land was made transferable under certain circumstances. In 1988, the elimination of the state monopoly of foreign trade allowed the establishment of Foreign Trade Organizations (FTOs) and permitted some firms to engage directly in international trade outside the FTOs. But at the end of 1988, Vietnam faced a macroeconomic crisis not unlike the one encountered in 1986, with inflation running at an annual rate of 394 percent (Diehl 1997: 118) and a current account deficit, which had risen to about 10 percent of GDP. The current account deficit was largely financed by aid from the Soviet Union (including the provision of cheap petrol, fertiliser and steel) – aid that would no longer be forthcoming.

In 1989 the course of transition in Vietnam broke away from the Chinese

model and a shock therapy approach was adopted. The pace of reform in Vietnam from 1989 to 1991 was anything but gradual, and the stabilisation program adopted in 1989 was certainly as ambitious as the shock therapy approach in other transition economies. The radical stabilisation program 'was pure IMF orthodoxy, albeit without IMF behind it' (Riedel and Comer 1997: 196). The program involved: liberalisation of prices; elimination of the system of state procurement; raising interest rates; devaluing and unifying the exchange rate and reducing the budget deficit. Between 1989 and 1991 government expenditure was reduced by six percentage points of GDP. Subsidies to state enterprises were largely eliminated, the investment program was severely cut, a uniform tax treatment of state and non-state enterprises was implemented, wage increases for civil servants were restrained below the inflation rate, spending on education, health and other welfare services was cut, and about one-half million soldiers were demobilised. The outcome of the radical program was, nevertheless, very different from the one experienced in EEFSU, where shock therapy is associated with a sudden collapse in output.

In 1989 inflation was reduced to 35 percent and in 1990 and 1991 there was an increase in inflation to 67 and 68 percent respectively, but by 1994 inflation was reduced to 4 percent. Real GDP growth from 1989 to 1994 averaged an annual rate of 8.63 percent (Diehl 1997: 118) and during this period Vietnam had attracted foreign capital from both public and private sources. 'As it turned out, orthodox stabilisation worked nowhere more successfully than in the unorthodox economy of Vietnam' (Riedel and Comer 1997: 196).

Mongolia

Mongolia was the second-longest communist-ruled country after the Soviet Union. It has had virtually no historical experience of capitalism, while with the initiation of the transition process the aim was the development of a market economy. Surprisingly, this did not stop Mongolia from initiating the world's first voucher privatisation program. A peaceful revolution in 1990 led to a change in the course of Mongolia's direction. Mongolia's political leaders responded to civil protests by calling elections in early 1990, and Mongolia's first elected Parliament met in October 1990. The establishment of democracy was swift and, in retrospect, irreversible. After the mid-1990 election, the ex-communist party, the Mongolian People's Revolutionary Party (MPRP), formed a broad coalition government with the new parties. The new cabinet presented a reform program calling for the completion of most economic liberalisation measures in a step-by-step process. The following two years saw strong economic reform. The 1992 elections gave the MPRP an overwhelming majority in parliament, the partners left the coalition, and the MPRP governed alone for 4 years. During this time, economic reforms proceeded less swiftly, the new government was more conservative than the

previous one, but the general direction was maintained. In 1992, real GDP registered a reduction of 9.5 percent and an inflation rate of 325.5 percent (Table 5.3).

Despite the difficulties of establishing ownership in this poor and sparsely populated country in which the institutions of capitalism were unknown before 1991, privatisation was a cornerstone of the reform program. The goal of the reformers was to reduce the role of the state in the economy, and permanently change the nature of political power. Privatisation would be comprehensive and fast. A voucher scheme was chosen because of the low level of savings, the absence of private property, and a desire to allow the whole population to participate in the process (Boone *et al.* 1997: 116). The reformers emphasised the egalitarian nature of the scheme, using free privatisation vouchers to provide each citizen with an entitlement to an equal share of the country's assets. There would be a fundamental division between 'small privatisation' – encompassing small enterprises mostly in the trade and service sectors, livestock and housing – and 'large privatisation', comprising the cooperative farms, the state farms, and large enterprises. For a nominal fee, every citizen could buy a set of ten privatisation vouchers: three for the small privatisation and seven for the large. State assets would be sold only for these vouchers, not for cash. Vouchers would be the currency used on the stock exchange to buy state assets in large privatisation, while small privatisation would use the vouchers as currency in auctions.

The government gradually completed most price liberalisation measures, and has gradually but completely liberalised trade and the foreign exchange market. It has also passed new taxation laws, a budget law, a law to promote foreign investment and a securities law. Under this law the Bank of Mongolia was formally made independent of the government. However, the transition process was not without problems. One of the first liberalisation steps was to allow new private commercial banks to form before any regulations, such as reserve requirements or bank supervision, were in place. Of course, this was a recipe for inflation, and the money supply rose sharply as these banks grew in numbers between 1990 and 1991. In 1991 inflation reached 120 percent (Boone 1994: 343), and 325.5 percent in 1992 (Table 5.3). Inflation remained at about 50 percent in 1995 and in 1996. Growth resumed in mid-1993, but only after a fall in GDP of 20 percent (Anderson *et al.* 2000: 529). In 1998 Real GDP growth was 3.7 percent (Table 5.3). Mongolia was unable to escape the substantial reduction in output with the initiation of transition even though the reform was (relatively) gradual and the ex-communists retained power.

Inconsistencies in the transition processes

The implementation of the shock therapy model in the EEFSU was short-lived. Despite the substantial initial support for governments initiating the process in transition economies, considerable undesirable outcomes resulted,

such as unemployment and inflation. This led to the unpopularity of the governments. High inflation and unemployment caused social and political instability and threatened the fragile democratic governments. The risk was substantially increased by the adoption of proportional representation as the basis for parliamentary representation, which resulted in multi-party coalitions that were weak, fragile and easily pressured. As Boycko (1991: 44) argued, 'no matter how strong the purely economic case for "big bang" price decontrol is, this measure cannot be recommended to a politically weak government whose primary objective is to stay in power'. Transition governments suffered head-on confrontations with the powerful political and economic blocs, which resulted in populism, together with a public disillusioned with the shock therapy process. Intrinsically, these governments did not have the power to pursue the policies required by the shock therapy platform. In a democratic environment, the substantial reduction in output and employment associated with shock therapy resulted in the ultimate downfall of these governments through the electoral process. Foreign aid was not adequate to maintain support for the shock therapy process.

The gradualist approach entailed the maintenance of short-term inefficiencies. However, this presented an unfortunate policy dilemma for the gradualist economists. In order to secure macroeconomic stabilisation in the short run, important pricing, enterprise, banking, interest rate and international trade policies had to move counter to the ultimate goal of long-run liberalisation. Transition governments were encouraged by the gradualist economists to seize the financial assets of enterprises, command outputs through state orders, and re-institute price controls and other such devices. Consequently, the recommendations were for the re-regulation of the financial system, international trade and state enterprises (Kolodko 1999: 236, Stark 1990: 376). If competitive capitalism was the ultimate goal of gradualist economists, there was an apparent contradiction with the recommended strategy of transition. A competitive capitalist system required a government with no power of discretion. However, re-regulation and re-nationalisation occurred during the transition period. The government's discretionary power was increased in the name of gaining control of economic affairs. Yet there was a direct link between increased government power and the interests of the bureaucracy and other lobby groups. The crucial question was: how could the economy, from a system of increasing government power during the transition period, be transformed into a free market system? The gradualist economists failed to reveal how this would have been achieved. Strangely enough, the state was expected to 'wither away' (Csaba 1995: 89, Abel and Bonin 1993: 230). Stalin had advanced a similar argument: for the state to 'wither away', its power firstly had to be maximised. However, the state would never have 'withered away', as it was linked to the interests and privileges of the bureaucracy, and to other lobby groups and sectoral interests. These groups would have resisted their own dissolution, and state power and intervention would have continued. This argument was maintained by economists to explain the

lack of reform in the Stalinist system. Paradoxically, the same argument finds validity in the gradualist process of transition.

The reform movement in China, as in the Soviet Union and Eastern Europe, combined demands for both political and economic reform. Reform implied 'opening up' the party's monopoly to political pluralism and freeing the economy from state controls, so that market forces could be rejuvenated. Nevertheless, the emphasis placed on political relative to the economic reforms varied across countries, as did the decision whether they should have been attempted at the same time or with one preceding the other. Chinese reformers followed Mao who, in the development of the economy, supported 'putting politics in command' (Weil 1996: 218–19). There was a belief in China that only with the presence of the Communist Party could there be economic growth while still ensuring the construction of a socialist society. Deng consistently maintained that the only feasible political setting in which to reform the command economy successfully was under strong, unified party leadership (Nolan 1995: 163, 300).

Nevertheless, China, politically, may eventually have to be reformed. It would be naïve to assume that the commercialisation of economic relationships and the invigoration of the private sector would not have affected the country's political relations. People increasingly desire democracy, partly as a result of their better economic position and partly due to the influence of foreign investment. A more professionally run economy would eventually have to undermine China's non-pluralistic political environment. Decentralisation has reached a point where its advantages with respect to reform are close to being outweighed by the hurdles it puts in the way of policy-making and consensus-building. The political rules and their constitutional underpinnings need to be reappraised in light of changed economic circumstances. Without a new political contract that brings clarity to the rules that govern relations between the centre and provinces, no amount of tinkering with monetary and fiscal instruments will enhance effectiveness. The Chinese leaders seem to forget that within the current model there is still an unresolved tension between dynamic economic change and the continuing political centralisation. China will no doubt discover that an open-market economy is basically incompatible with a closed, repressive polity (Marangos 1997, Marangos 1999). While central administration 'does not necessarily have to end with an explosion', it can be brought to a conclusion 'by a confused and peacefully orchestrated process' (McNeill 1998: 68, 69).

The future reform challenges in Vietnam, as in China, will almost surely be political. Non-pluralistic Vietnam faces the profound task of defining relations between a weakening central government and a strengthening upper and middle class, to bring the requisite central power under democratic control and to build a democratic system of check and balances. What is interesting to note is that Vietnamese society itself is swiftly changing. The Ninth Party Congress accelerated the integration of 'socialist' Vietnam into the international political economy following the adoption of the Ten-year

Strategy. This plan had the tacit approval of the IMF and World Bank, which resulted in Vietnam reaching agreement with the IMF and World Bank on a multi-year program of specific actions concerning banking and state-owned-enterprise reform, trade policy, improving the climate for private enterprise, and public expenditure management. Even after the large closure of state enterprises (notwithstanding the redundancies), the implementation of state enterprise reform has slipped substantially and there is a real risk of not meeting the IMF and World Bank program targets (World Bank 2002a: x) with consequences, of course, for the provision of aid.

Currently, around 25 million people, accounting for 60 percent of the Vietnamese labour force, are unemployed or underemployed (World Bank 2002b: 1). It is expected that unemployment will increase, because when Vietnam joined the ASEAN Free Trade area in 1995 it agreed to reduce tariffs to between 0–5 percent by 2006. Vietnam has also applied to join the WTO and the Asia-Pacific Economic Cooperation, which of course requires the conditions of entry to be satisfied. While Vietnam's membership of the WTO is not imminent, its July 2000 trade agreement with the USA includes provisions concerning financial sector liberalisation that would expose Vietnam's banks to the international financial markets. Today, the IMF, the World Bank and the US Treasury are funding 'socialist' Vietnam's transition to the market by linking 'foreign aid' to the implementation of policies consistent with the Washington Consensus. This is something that used to be called 'imperialism'.

Interestingly, Anderson *et al.* (2000: 529) did not find private ownership in Mongolia effective as a means of boosting enterprise performance – indeed, in some cases they found that state ownership leads to significantly higher productivity than private ownership. It appears that when a government is forced to focus on economic performance it can do better than insiders and dispersed outsiders in pressuring inefficient enterprises. In the absence of formal market institutions, as in Mongolia, the enterprises with residual state ownership performed better than those with other owners (Anderson *et al.* 2000: 547). These observations raise the intriguing possibility that a workable privatisation in an environment of institutional poverty might include a significant amount of residual state ownership. Therefore, for privatisation to have its fullest effect, further legal developments are necessary, especially in Mongolia, where socialism was implanted in a feudal society with no experience of modern capitalism (Korsum and Murrell 1995: 479).

In Mongolia, despite the free distribution of shares, the overwhelming proportion of privatisation has simply resulted in the transfer of ownership to those already inside the organisations being privatised – that is, workers or managers, but mostly managers. In the agricultural sector, this occurred because of the political power of the rural sector. 'Small privatisation' occurred through a combination of political intervention and the collective action of the employees, whereas 'large privatisation' resulted from the way employees individually or collectively used their vouchers. Paradoxically, the

privatisation process might have achieved one of the primary objectives of its designers – speed – precisely because it did not achieve its other goal: the creation of a core of outside ownership (Korsum and Murrell 1995: 486).

The questions that need to be answered are: Why is it that shock therapy in EEFSU, which dismantled an inefficient economic structure in one shot, resulted in a large decline in output, while Vietnam, which effectively implemented the same strategy, registered a large increase in output? Why is it that gradualism in EEFSU and Mongolia, which maintained inefficiencies in the economic structure, resulted in a large decline in output – albeit less than shock therapy – while China, which effectively implemented the same strategy, registered a large increase in output? The reduction in output appears to be linked with democracy, as the experience of transition economies reveals, and not with the pace of reforms. It appears that it is not the speed of the transition process that determines the variation in output between transition strategies. Rather, the maintenance of authoritarian political control by the Communist Party in both China and Vietnam ensured, independently of the speed of transition, that what had to be done was done.

The reform processes in China and Vietnam have maintained political stability and, on the whole, state control of the macroeconomy. This stands in contrast to political instability, which has hindered EEFSU and Mongolia's transition. Democracy was too myopic and paid too much attention to meeting short-term political goals. Under circumstances where the economic system has not been fundamentally changed, the destabilising of the political structure would only make it impossible for the economic reform to proceed. China and Vietnam's non-pluralistic leaders did not need to be troubled about a loss of political legitimacy. Hence, while a weak and unstable government was likely to retard the progress of economic transformation, a strong and stable government was likely to accelerate it. 'Good government' did not necessarily imply democratic government (Nolan 1995: 318, Intriligator 1998: 241). As such, the relative stability enforced by non-pluralism in China and Vietnam deserved part of the credit for economic success. Thus, the initial debate, which focused on differences in the speed of transition – shock therapy as opposed to gradualism – has proven to be fruitless. The reduction in output appears to be linked with democracy, as the experience of transition economies reveals, and not with the pace of reforms.

A characteristic of all transition processes has been the reduction of government involvement in the economy. Privatisation, reduction in government expenditure, reduction in social outlays, dismantling of regulations and the goal associated with the achievement of a balanced (or even surplus) budget are features of the transition process consistent with the Washington Consensus strategy of global capitalism. But the decline in government expenditure was not substituted by increases in private expenditure, as orthodox theory postulates. In actual fact, recent research reveals that government expenditure on education, infrastructure, telecommunications, transport and health has a net crowding-in effect on private expenditure and

GDP and not crowding-out as the orthodox theory postulates (O'Hara 2004). The role of government in transition economies should have been to provide the necessary social structure that underpins economic growth by building the stock of public capital. Consistent with this line of thinking, deficit spending is vital to ensure an increase in aggregate demand and the net expansion of aggregate income. As a result, the net crowding-in outcome of government expenditure casts doubt on the effectiveness of policies and the motivation behind transition orthodoxy.

Lack of institutions and rise of corruption and crime in transition economies

The common feature of all the transition economies was the experience of the negative phenomenon of corruption, and with it a rise in crime. This compromised the economic reform program and led to inflation, inequalities and disillusionment with the transition goals in the eyes of the people. How did the alternative processes of transition explain the increase in corruption and crime?

Sachs (1995: 22) argued that corruption and crime were the result of a weak and disorganised civil society, and that corruption was not something new. The members of the party under the previous state of affairs used their political power for their own betterment by exploiting the country's resources, which 'were nominally owned by the state and thus by nobody' (Sachs 1995: 22). However, with the establishment of political pluralism, corruption could not have been hidden under the party shield of protection. The origins of corruption remained the same: the old guard, using the positions of power it had inherited, was able to build wealth illegally. Nevertheless, corruption was the result of a gradual process rather than of a shock therapy approach. For example, Boone and Federov (1997: 186) argued that there was no doubt that the gradual and ill-defined process of reform in Russia induced, and often was motivated by, corruption. The ill-defined laws and legal procedures, the piecemeal removal of price controls, the subsidies provided by the government, the maintenance of trade barriers and the inconsistent regulations were all the result of a gradual approach which led to the growth of corruption at every level of government. The only way to avoid becoming a Mafia economy and to cure corruption and crime was, and still is, radical liberalisation (Aslund 1995: 170, 1992: 174).

As such, the implementation of shock therapy resulted in 'maximal dislocation' of the existing institutional fabric of transition economies, which resulted in regressive institutional changes (Bush 2001: 523). This is in contrast to the principle of 'minimal dislocation' of institutional change advanced by neo-institutionalists. While dislocations are unavoidable during institutional change, dislocations should be minimised so as to result in an institutional structure conducive to higher levels of instrumental efficiency. In addition, the 'maximal dislocation' of the existing institutional structure was

imperative for the shock therapy process so as to transform the organisation of the economy from being based on relative prices administered by political authorities to an economy organised by price-making markets. Customs, relationships of trust, morals and culture were perceived as obstacles to the establishment of the dominant role of the market in the economy. The transition economies had to get rid of the 'embedded' social relationships. The 'disembedded' economies of EEFSU are dominated by market economic relationships over custom, trust, morals and culture, stimulating in this way corruption and crime.

Gradualists argued that the implementation of the shock therapy process without any institutional fundamentals in place resulted in 'bandit capitalism' in the transition economies (Kolodko 1999: 249). The rise of criminal activity and Mafia methods of imposing financial discipline were 'alarming and intolerable' (Kornai 1995: 153, 1993b: 327). Over the decade 1990–2000, the underground economy as a percentage of GDP increased in all transition countries of EEFSU except for Romania, Belarus and Slovenia. It could partly have been explained by the harmful side-effects of a healthy process, namely the abolition of the police state. It would have taken some time to develop the necessary legal infrastructure for property and contract rights to become secure in the long run. At the same time, the establishment of democracy and markets opened the curtains and made crime more visible. It revealed an unexpected amount of official corruption and Mafia-style crime, which was not compatible with a market economy (Olson 1995: 438, 457).

The development of the institutional structure for the shock therapy and gradualism appear to be quite similar. However, it is my view that while both argued that market institutions can only result from market forces, the proposals of the gradualist economists allowed institutions to develop concurrently with market relations. For shock therapy supporters, the first goal was the development of market relations, on the assumption that the institutions would have followed in due time. The gradualist argument suffered from the same flaws. Gradualist writings failed to offer a concrete process of institutional development. They simply left the end-state to be determined by the market, assuming that the most efficient institutions would have emerged. The gradualist break with shock therapy was far less complete than it appeared to be. At the end, both processes result in maximal dislocation and a disembedded economy.

Alternative transition processes

Were there any real alternative social democratic or democratic socialist models to the neoclassical shock therapy gradualist models of transition? Two readily come to mind, the Post Keynesian and pluralist market socialism models.

A Post Keynesian model of transition recommended a stabilisation package with gradual liberalisation and active government intervention. Post Keyne-

sians are in favour of a social democratic capitalist system, which implies a variety of property forms: a market with state intervention within a democratic political system. Post Keynesians are seeking only as much freedom as is compatible with a socially desirable outcome. They are, therefore, prepared to trade freedom for other dimensions such as equality, stability, security and social justice to bring about a novel synthesis. Post Keynesians value the primacy of individual values, the principle of private property and the advantages of the market, stressing their importance in conjunction with the common good, state property and planning. The private sector remains the employer of first resort, while the state is employer of last resort, making full employment the main goal of economic policy. State intervention ensured full employment, economic planning guaranteed the achievement of social goals, and state property avoided market failure.² This was in total contrast to the orthodox view, which was the dominant ideology imposed on EEFSU. However, international financial institutions, mature market economies or governments in transition economies, did not receive the Post Keynesian propositions positively. The association of extensive government intervention with centrally administered socialism did not allow the implementation of any of the Post Keynesian policies as transitional measures. The set of transition policies consistent with the Post Keynesians propositions are presented in Table 5.4.

A pluralistic market socialist model of transition is concerned with the optimal combination of public and private property, centralisation and decentralisation, markets and planning and individualism and the social good. What it offers is a different way of dealing with economic problems: conscious intervention by communal institutions, a 'visible hand', and greater social ownership through the reduction of private ownership of the means of production. It was argued that the failure of centrally administered socialism could have been avoided if the most important principles of pluralistic market socialism had been adopted by way of introducing markets and allowing the people to participate in the formation of the plans by establishing a democratic political process. Pluralistic market socialists aim to rectify market failures in a number of ways. First, market socialists endeavour to ensure full employment by the public regulation and democratic planning of investment. Second, market socialists strive for a reduction in inequality of income by encouraging the growth of enterprise forms in which primary income is distributed more equally. Third, market socialists intend to introduce a highly discretionary tax system to facilitate the redistribution of income. Pluralistic market socialism provides conscious social direction by combining markets with planning in a way that makes the best use of both instruments. The market is the only alternative to bureaucracy, and self-management is not in conflict with efficiency. Thus socialism is about equal entitlement to the means of production, with the question of how people choose to use their endowments in the production process left open.³ Pluralistic market socialism in Eastern Europe, the former Soviet Union and Mongolia was not attractive

Table 5.4 Alternative transition processes: Post Keynesian, pluralistic market socialist

<i>Transition policies</i>	<i>Post Keynesian</i>	<i>Pluralistic market socialism</i>
Price liberalisation	Gradual price liberalisation	Gradual price liberalisation
Stabilisation	Industry policy and regulation	Market planning
Privatisation	Restitution, free distribution of vouchers, state financial intermediaries, a combination of free distribution of vouchers and state financial intermediaries, labour managed firms	Appropriation of firm by workers (labour managed firms) Leasing of land and capital equipment, privatisation of small enterprises
Property relations	Majority private with some social property	Majority social with some private property
Institutions	Formal institutions product of state action and informal product of market forces	Formal institutions product of state action and informal product of market forces
Monetary policy	State-controlled central bank	State-controlled central bank
Financial system	and privately and state-owned banks	and state-owned banks
Fiscal policy	Discretionary taxation system and discretionary fiscal policy	Discretionary taxation system and discretionary fiscal policy
International trade	Clearing Union	Socialist Customs Union
Foreign aid	Conditional foreign aid	Non-conditional foreign aid
Social policy	Welfare State	Welfare State Guaranteed employment Guaranteed basic-liveable income

because any form of socialism was considered to be a form of Stalinism. Pluralistic market socialism in China and Vietnam was not attractive because the Communist Party was, and still is, not willing to give up its authoritarian power in favour of the participation of the people. The set of transition policies consistent with the pluralistic market socialist propositions are presented in Table 5.4.

Conclusion

The goal of the international financial organisations, mature market economies and the elite of the 'transition' economies was, and still is, the integration of the formerly centrally administered economies in the global political-economic structure to provide cheap inputs, new product markets and international financial markets for mature market economies. The transition economies lacked private capitalists with the necessary financial capital to purchase, run and finance enterprises, making foreign ownership the only alternative. It was not by coincidence that foreign capital came to the rescue

of transition economies. This was an act of purposeful action by the mature market economies, ensuring that foreign ownership was the only permissible medium of privatisation ensuring the viability of state owned enterprises. A process, like shock therapy, implicitly had the goal of initiating the destruction of any institutional barrier inhibiting the penetration, influence and power of foreign capital. The International Monetary Fund and the World Bank were responsible for creating the depression in transition economies through the collapse of domestic markets and COMECON, the development of the hard budget constraint, and the provision of foreign aid conditional on satisfying specific 'shock therapy' targets. Equally important was the pressure exerted on governments from transition economies to sell state assets and public utilities to multinational companies (the only possible buyers) to reduce fiscal deficits, lower inflation and discipline the labour market by inducing high unemployment. Effectively, multinationals practiced 'cherry-picking' in the name of global integration and national disintegration (Radice 1993: 10). Packages of incentives and legal regulations were often negotiated on a case-by-case basis, making the process appear arbitrary and even corrupt (Smyth 1998b: 366). In this way, the market-production-financial expansion of global capitalism into the former centrally administered economies undoubtedly had the aim to contribute to the viability of capitalism, which was and still is experiencing a crisis.

Today, the same domestic elite and 'foreign investors' that abused their power to appropriate state assets are calling for the establishment of effective private property rights. It is not by accident that the European Bank for Reconstruction and Development (1999: 39) longs for 'the hope for second decade of transition is that this voice for market supporting institutions will become stronger'. Ironically, the current lack of effective institutions is threatening the position of the domestic and international elite – the same elite that owes its privileged position to this same lack of institutions.

Notes

- 1 I will continue to use the word transition since it has become the convention.
- 2 Further readings on the Post Keynesian model of transition: John Marangos (2000, 2001a, 2001b, 2003).
- 3 Further reading on the pluralistic market socialist model of transition: John Marangos (forthcoming 2004).

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Part II

Global institutions and organizations

6 Transnational corporations

Dynamic structures, strategies, and processes*

John B. Davis

Introduction

Transnational corporations (TNCs) – also called multinational corporations, multinational enterprises, and global corporations – may be defined as firms that sell products in more than one country. They sell in countries other than their own both through exports from their home country locations and through sales from host country foreign affiliates (or subsidiaries) that have been created through the export of capital or foreign direct investment (FDI). According to the *World Investment Report 2002*, TNCs now number some 65,000 firms, and are associated with about 850,000 affiliates worldwide, with the world's 100 largest non-financial TNCs accounting for more than half of total sales of all foreign affiliates (UNCTAD 2002). The emergence of TNCs as a central force in the globalization process of the last two decades is closely tied to two developments, one a consequence of a long-term historical, technological evolution and the other a consequence of institutional change in the world economy largely initiated and carried out by a small number of advanced economy nations. The first is simply the continuing but recently more dramatic fall in goods transportation and information transfer costs. The second is the determination in the 1980s by many in the largest advanced economies to initiate an international financial liberalization. To understand the latter as a unique historical event that occurred against the backdrop of the former, the history leading up to the financial liberalization of the 1980s needs to be briefly reviewed.

Free capital movements had been excluded from the postwar Bretton Woods regime, which secured the principles of a liberal international trading regime after the disaster of interwar national protectionist policies, combined with a rescue system for countries in balance of payments difficulties in the form of the International Monetary Fund. Without the free flow of capital internationally, countries were able to peg their exchange rates, and freely pursue full employment policies and the expansion of the welfare state, effecting a temporary labor-capital accord with rising real wages linked to productivity growth, profits for industry, and increased social services. The breakdown of Bretton Woods – symbolized by US President Richard

Nixon's 1971 abandonment of dollar-gold convertibility – came about as a result of the US attempt to maintain both the “Great Society” war on poverty and wage war in Vietnam, and also because of the rising competitiveness of the Japanese and European economies that undermined the postwar US trade advantage and balance of payments surplus. However, when exchange rates became flexible and free-floating, firms engaged in international trade found it necessary to hedge their foreign exchange positions against fluctuation in currency values. This necessitated liberalizing short-term international capital flows, without which the expanded level of postwar international trade would have been jeopardized just as surely as if there had been a new era of protectionism.

But the broader logic of the situation did not escape the leadership of large national corporations. If one moved financial capital into foreign exchange positions as a hedge against loss in value of one's exports and imports, then one should also move production capital into foreign locations as a hedge against loss in value of one's national operations. Thus corresponding to short-term international capital flows there should also be long-term international capital flows. In part this conjunction came about because capital is fungible. Attempts at regulation were not likely to have been entirely successful in discriminating trade-financing capital movements from long-term capital movements. But more important was the recognition on the part of those in large national corporations that significant profit opportunities were available from relocating production to more countries. These were associated with being able to selectively dominate markets in new national locations when acquiring “local” reputation, tying supplier networks more closely to final goods markets, escaping costly home country regulatory structures while seeking regulatory concessions as a part of foreign location, transforming bargaining conditions at home and simultaneously gaining advantages elsewhere by relocating to countries where labor was either weakly organized or not organized at all, and gaining political influence vis-à-vis government authorities in foreign locations in which national economies were small relative to the TNC.

The second section of this chapter briefly reviews recent evidence concerning the importance of TNCs and their foreign affiliates in the world economy, including evidence regarding the extent of FDI which firms carry out in establishing foreign operations and achieving multinational status. The third section distinguishes four competing theories of TNCs: the market power approach, the transactions cost internalization approach, the Dunning eclectic paradigm, and the technological accumulation approach. Section four examines five transformational impacts that TNCs have had or may continue to have on the world economy in the future in the spread of their global operations. The final section provides concluding remarks on national sovereignty issues and the possible future role of TNCs in the world economy.

Evidence on TNCs and their foreign affiliates

One measure of the increasing importance of TNCs is the increased share of sales in world markets by their foreign affiliates. Rather than sell goods from home locations, since the mid-1980s TNCs have increasingly sold them from foreign locations, both in host country markets themselves where they have established production and distribution affiliates, and in the form of exports from these new locations. Whereas in 1990 the sales of foreign affiliates of TNCs were about equal to world exports, in 2001 sales of TNC foreign affiliates were almost twice as high as world exports. Over this same period the stock of outward FDI creating foreign affiliates increased from \$1.7 trillion to \$6.6 trillion. Foreign affiliates of TNCs now account for one-third of world exports and one-tenth of world GDP (UNCTAD 2002).¹ Table 6.1 shows the value of sales, gross product, total assets, and exports of foreign affiliates in constant prices for the years 1982, 1990, and 2001.

This increased role for TNC foreign affiliates reflects broad changes in the world economy in the relationships between national economies, trade, and FDI since the mid-1980s. Whereas from the 1970s to 1985 the growth rates of trade, FDI, and world GDP were similar, since then the growth rate of trade has significantly exceeded the growth rate of world GDP, while the growth rate of FDI has significantly exceeded the growth rate of trade (Table 6.2). This means that not only are national economies becoming more globalized in that national firms increasingly produce for export, but they are also becoming more globalized in that foreign firms are increasingly involved in countries' export and domestic markets. TNCs have thus not only substituted expanded exports for further growth in domestic sales, but they have also substituted expanded sales by their foreign affiliates for further growth in exports. Thus a world economy previously made up of nations engaged in production and trade through domestic firms is more and more being replaced by a world economy made up of TNCs engaged in production and trade with one another across nations. Beside the old model of trade between nations we now have a new model generally referred to as one involving an international system of production.

Table 6.1 Foreign affiliates sales, gross product, total assets, exports and employment, 1982, 1990, 2001 (constant prices, US\$ billion or '000 workers)

	1982	1990	2001
Sales of foreign affiliates	2541	5479	18,517
Gross product of foreign affiliates	594	1423	3495
Total assets of foreign affiliates	1959	5759	24,952
Exports of foreign affiliates	670	1169	2600
Employment of foreign affiliates ('000)	17,987	23,858	53,581

Source: Adapted from UNCTAD (2002: 4).

Table 6.2 FDI, GDP, and export growth rates (percentage)

<i>Item</i>	<i>1986–1990</i>	<i>1991–1995</i>	<i>1996–2000</i>
FDI inflows	23.6	20.0	40.1
FDI outflows	24.3	15.8	36.7
GDP (in current prices)	11.5	6.5	1.2
Exports	15.8	8.7	4.2

Source: Adapted from UNCTAD (2002: 4).

When corporations establish foreign affiliates, they do so through FDI, either by creating entirely new facilities (termed greenfield investment) or, more commonly, by purchasing existing firms and/or existing facilities through mergers and acquisitions (M&A). For 1999, the latter form constituted over 75 percent of total FDI, most of which was in the form of acquisitions rather than mergers, and two-thirds of which involved TNCs acquiring 100 percent interest in the acquired firm (UNCTAD 2000).² Thus when TNCs locate in other countries, they generally fully acquire existing national firms. This provides them with established production and/or distribution systems, including supplier networks, and any history of regulatory compliance. It also generally involves them taking over acquired firms' employees together with a history of the acquired firm's past labor agreements and expectations of management regarding those agreements.³ In this way, TNCs acquire earnings streams additional to those from their existing production, and – should they choose to introduce their own products alongside the continued manufacture and sale of acquired firms' products – they also gain the opportunity to produce and distribute their products where they may have been unable to do so before, either because of tariff and non-tariff structures, brand recognition problems, and/or the ability of host country firms to exclude competition from foreign firms. Thus expansion in other countries constitutes a broad-based strategy for TNCs long-term development the logic of which is likely to be sustained in the future.

TNCs are often ranked according to total foreign assets, since this gives an indication of the scope of their reliance on foreign affiliates. But a preferred measure of TNC multinational status, provided by the United Nations Conference on Trade and Development (UNCTAD), is the transnationality index (TNI) which is calculated as the average of three ratios: foreign assets to total assets, foreign sales to total sales, and foreign employment to total employment (UNCTAD 2002). To see what the index involves (see Table 6.3), note that Vodafone, the UK telecommunications TNC, was ranked first in 2000 in terms of total foreign assets, but fifteenth according to its TNI. Also, General Electric, the US electrical and electronic equipment TNC, was ranked second in 2000 in terms of total foreign assets, but only seventy-third according to its TNI. TNCs, then, that are simply very large in size, have many foreign affiliates, and have commensurately large foreign assets, may be

Table 6.3 The world's top 10 non-financial TNCs, 2000

<i>Ranking by foreign assets</i>	<i>Ranking by TNI</i>	<i>Corporation</i>	<i>Home economy</i>	<i>Industry</i>
1	15	Vodafone	UK	telecommunications
2	73	General Electric	US	electrical and electronic equipment
3	30	Exxon/Mobil	US	petroleum expl./ref./dist.
4	42	Vivendi/Universal	France	diversified
5	84	General Motors	US	motor vehicles
6	46	Royal Dutch/Shell	UK	petroleum expl./ref./dist.
7	24	BP	UK	petroleum expl./ref./dist.
8	80	Toyota Motor	Japan	motor vehicles
9	55	Telefónica	Spain	telecommunications
10	47	Fiat	Italy	motor vehicles

Source: Adapted from UNCTAD (2002: 86).

less integrated into the global economy relative to their size than smaller firms when affiliate sales and employment are considered. This is important for thinking about the internal culture and global view of different TNCs, since TNCs that have high TNIs probably have accumulated considerable experience in regard to how to carry out operations in host countries. Conversely, very large TNCs in terms of total foreign assets but with comparatively less extensive foreign sales and employment experience may be misled by their sheer size and tend to underestimate what is involved in foreign operations.

Competing theories of TNCs

There are four main explanations of the nature and behavior of TNCs:

- a the market power approach;
- b the transactions cost internalization approach;
- c the Dunning eclectic paradigm; and
- d the technological accumulation approach.

Market power approach

Steven Hymer's 1960 MIT PhD dissertation initiated theoretical investigation into TNCs and FDI (Hymer 1960). Hymer argued that neoclassical capital arbitrage theory of portfolio flows was inadequate for explaining the behavior of TNCs as firms and consequently also the long-term capital flows that these firms carried out. He focused on firms' efforts to acquire market power, and argued that, while firms increase their share of domestic markets in the early stages of growth by means of mergers and extension of capacity, at some

point they begin to invest monopoly profits earned at home in foreign operations. They thus strive to transfer the levels of concentration they have achieved domestically to foreign markets. Hymer's focus on firms helped to generate a new, interdisciplinary field of international business studies that emphasized realism and evidence, and amounted to an attempt "to escape the intellectual straitjacket of neoclassical-type trade and financial theory" (Dunning and Rugman 1985: 228). On this view, TNCs had two motivations for carrying out FDI. One was to try to reduce or eliminate international competition, and thereby establish monopoly advantages on a global basis. The other was to increase the returns from the particular advantages that they already possessed in home country markets through the creation of cost-reducing supplier networks that further increased monopoly profits.

Charles Kindleberger interpreted Hymer's thinking more in terms of the industrial organization tradition, employing the traditional structure-conduct-performance model of markets (Bain 1956). TNCs are seen to arise in certain types of market structures, and are less seen as agents involved in oligopolistic interaction actively creating barriers to entry and colluding with other firms in their industries. As he put it, "The nature of monopolistic advantages which produce direct investment can be indicated under a variety of headings – departure from perfect competition in goods markets, departure from perfect competition in factor markets, internal or external economies of scale, government limitations on output or entry" (Kindleberger 1969: 13). Kindleberger then added to this the idea that TNCs were engaged in monopolistic competition over differentiated products. Partly this change in focus reflected a change in the status quo. When Hymer first wrote, the main question to answer was why national firms located operations abroad. Twenty-five years later attention had shifted to how to analyze the advantages of TNCs already operating abroad as well as the way in which international production systems were being organized.

One interesting side to Hymer's work is that he was particularly critical of TNC activities in developing nations, arguing that TNC activity led to a "Law of Uneven Development" in which host countries' interests were subordinated to the interests of advanced nations (Hymer 1972). But the reality in the postwar period was that most FDI was directed toward the advanced countries. Whereas two-thirds of the world's stock of FDI had been located in developing countries in 1938, by the 1970s this share had fallen to about a quarter (Dunning 1983). This meant that much subsequent research on TNCs and FDI focused on the operations of firms in more well-established markets. This produced a change in the kinds of explanations offered to explain TNC behavior and motivations, with the internalization approach emerging as the leading view – associated with Richard Caves, Raymond Vernon, Alan Rugman, Peter Buckley, and Mark Casson.

Transactions cost internalization approach

The internalization approach drew on the transactions cost theories of Ronald Coase and Oliver Williamson, and focused on the efforts that firms made to become more efficient by minimizing transactions costs involved in international activities. The transactions cost framework constitutes a criticism of neoclassical economics that explains trade and investment solely in terms of exchange between independent individuals and/or groups of individuals. On the transactions costs view, when the costs of administered exchange are lower than those of arm's-length market exchange, the market is internalized and efficiency enhanced. Particularly costly to exchange in arm's-length transactions are intangible assets such as technology. Transactions involving technology acquisition are internalized when firms invest in or buy R&D facilities of other firms in other countries. Here technology is treated as being akin to information or potentially public knowledge, which is only one dimension it may assume (Cantwell 1994). Another important dimension of technology are those tacit capabilities that accumulate and become embedded in firms through collective learning processes. TNCs that acquire technology in this sense typically maintain acquired firms' R&D facilities relatively intact to preserve and utilize their embedded technologies. The savings involved stem from not having to buy technologies on open markets but rather in coordinating their development and use through administrative methods.

In the transactions costs approach, TNCs are defined as cost-minimizing organizers of non-market transactions, and opportunities for creating new internal "markets" constitute the overriding motivation for the growth of the firm. However, proponents of the internalization approach also recognize that TNCs may seek to raise profits by restricting competition, and that this may offset the efficiencies associated with overall cost minimization. "Welfare losses arise where multinationals maximize monopoly profits by restricting the output of . . . goods and services . . . where vertical integration is used as a barrier to entry . . . [and] because they provide a more suitable mechanism for exploiting an international monopoly than does a cartel" (Buckley 1985: 119). Nonetheless the internalization approach generally pays less attention to the structure of the final product market in order to focus on more efficient exchange of intermediate products, and thus ultimately shares relatively little with the Hymer market power approach. Indeed, most of the proponents of the internalization approach believe that markets are competitive. One influential individual who nonetheless attempted to combine the two frameworks is John Dunning, whose approach has come to be known as the eclectic paradigm.

Dunning eclectic paradigm

Dunning reasoned in terms of a combination of different types of "advantages" which he believed TNCs sought to act on in foreign locations, and

argued that the different questions one might have about TNCs made attention to one or another of these advantages relevant. Thus, the advantages of internalization were most relevant when concentrating on backward linkages, vertical integration, and resource extraction, whereas the advantages of exercising market power were more relevant when one considered TNCs strategies for competing in final goods markets. Dunning distinguished primarily between competitive or “ownership” advantages which TNCs had vis-à-vis their major rivals – such as are attributable to ownership of intangible assets (entrepreneurial capabilities of managers, reputation and credit worthiness, long-term business agreements with other firms, political contacts, etc.) – and internalization advantages – such as are associated with how more integrated firms are able to coordinate and better realize returns on networks of complementary assets in different countries. That Dunning offers an organizing framework rather than a particular theory of TNCs means that he does not presuppose any specific theory of the firm or definite view of the nature of competition. However, his own view is that competition among TNCs is generally more important than collusion among them: “It is not the orthodox type of monopoly advantages which give the enterprise an edge over its rivals – actual or potential – but the advantages which accrue through internalisation” (Dunning 1988: 32).

Technological accumulation approach

In the technological accumulation approach TNCs are seen to be in long-run technological competition with one another, and the development of technology itself is seen to be a cumulative process (Cantwell 1989). Technology development is a slow, painstaking process that depends upon continual interaction between the creation of new technologies and their use in production. This means that though firms in any given industry are likely to have fairly similar lines of technological development, the particular lines of development they each pursue are nonetheless unique and differentiated. That is, progress takes place in technological “silos”. Thus in order to diversify their technological development TNCs use FDI to become global organizers of entire international technology networks that combine different but complementary technology streams from different firms and industries. In this respect, the technological accumulation approach is different from internalization theory which also has been used to explain technology acquisition, since the primary object in this instance is not static efficiency gains in a market for technological knowledge but rather processes of innovation and learning across interlinked R&D centers that as a whole explain the general evolution of technological knowledge.

The technological accumulation approach can also be contrasted with Hymer’s market power approach in that the growing connections between technologies produces an increasing technological interrelatedness between TNCs that can be thought to heighten the intensity of competition

between them. One way in which this comes about is in the tendency for TNCs to be attracted to the same leading international centers of innovation where they then compete for the same resources. Collusive agreements in such circumstances tend to be temporary and unstable, and competition through the development of rival technologies may ultimately manifest itself in the form of product differentiation. The view, then, that market power and oligopolistic competition explains TNC behavior may better reflect the earlier postwar experience when FDI was more devoted to the production of standardized products in new national locations, and there were fewer TNCs in competition with one another. For the last two decades, however, the more rapid pace of technology change, combined with ever greater product differentiation tailored to end-users, seems to have led to heightened competition between TNCs on multiple levels.

Five transformational impacts of TNCs on the world economy

The relatively rapid extension of the number of TNCs, their affiliates, and extension in the scope of their operations have had a variety of effects on the world economy, but five transformational effects seem to have been particularly important:

- a the establishment of a neoliberal relationship between capital and labor across many of the world's economies;
- b the attenuation of comparative advantage as a comprehensive explanation of why countries trade;
- c a change in posture of the developing world toward TNC participation in their economies;
- d the re-organization of the ownership structure of capital across the world; and
- e a fundamental change in the scope for national politics in an increasingly globalized economy.

Establishment of a neoliberal relationship between capital and labor

Globalization is often understood as a process involving increasing integration between countries, peoples, and economies. However, this process of *integration* through trade and capital movements has been an important cause of a parallel process involving the *disintegration* of production and communities (Feenstra 1998). For most of the twentieth century production in the industrialized countries was organized vertically in that materials processing and the early stages of goods manufacture were carried out in the same productive concerns and the same locales as final stage assembly of goods. However, in the 1970s in the US, under the pressure of increasing international competition, large manufacturers began to sub-contract separable stages of the

production process to small, often non-unionized, highly competitive, low profit firms. This set a precedent for more extensive re-organization of the production process, or dis-integration of the value-chain, that was subsequently acted upon by TNCs across international boundaries as trade barriers came down in successive rounds of trade liberalization through the General Agreement on Trade and Tariffs (GATT) and later the World Trade Organization (WTO). Indeed, enhanced information control methods through computers and lowered transportation costs made it possible for firms to sub-contract whole stages of the production process to producers across the world. Not only, then, was the production process itself fragmented and transformed, but the social communities tied to formerly integrated production sites were fragmented and disrupted in an economic-social process widely understood as “deindustrialization” (Bluestone and Harrison 1982).

US trade legislation originally facilitated this development through off-shore assembly laws that restricted tariffs to only the foreign value-added on US components shipped abroad for further manufacture and subsequent re-import to the US (see US International Trade Commission 1997). A more recent worldwide development is the creation of entire export processing zones (EPZs) or foreign trade zones (FTZs) to which foreign goods can be shipped, further processed, and then re-exported without payment of normal duties and fees. These duty-free zones have become magnets for FDI as countries have expanded them into industrial and science clusters supported by linked infrastructural and human capital investments. Interlocking global networks of these expanded EPZs increasingly constitute TNC-created international production systems in which semi-processed to final goods are shipped around the world multiple times to undergo different stages of manufacture according to national production advantages and government incentives.

The impact on organized labor, especially in the US and the UK, has been significant. Having given up bargaining for wage increases in the period of general economic stagnation in the 1970s, trade unions made job retention their primary objective. But their efforts have only slowed the process of job loss as contracts expired, and firms closed down plants and operations by relocating them both domestically and internationally. Since this often involved the construction of new factories, and since it was believed by many in the US and the UK that much existing domestic productive capacity was obsolete in comparison with that of postwar Japan and Germany, new factories were often designed with new forms of flexible production. Flexible production involves having a capacity to re-structure and re-organize factory-level, shop-floor production methods to respond quickly and efficiently to design changes in products necessitated by changing markets and consumer tastes. From the point of view of labor, however, flexible production meant reduced commitments on the part of firms to wage growth, benefits, and long-term employment. Firms defended this new stand by arguing that *flexible production* in a world of competitive international markets implied a need

for *flexible labor markets*. Neoliberalism constituted the social ideology appropriate to this new state of affairs, because it explained individuals as independent and self-reliant, thereby undermining the view that employers and society more generally had any responsibilities toward employees. Thus an argument can be made that the emergence of neoliberalism at the end of the century is in large part a consequence of the development of an international system of production organized by TNCs.

Attenuation of the comparative advantage explanation of trade

For over 175 years David Ricardo's logic of comparative advantage has been used to explain the basis for international trade. Its full development came in the 1930s in the form of the neoclassical Heckscher-Ohlin theory, which explained that countries specialize in and export goods that are intensive in resources or factors with which they were well endowed relative to their trade partners, while importing goods that are intensive in factors with which their trade partners were relatively well-endowed. This scarcity-based conception had as its chief achievement the explanation of the prices (or the terms of trade) at which goods might be traded internationally. A principal assumption behind the theory dating from Ricardo's original explanation of the principle of comparative advantage is that resources are immobile between countries. When this is the case, countries can differ significantly in their resource endowments, and accordingly find it to their mutual advantage to trade with one another. The mobility and migration of capital through FDI, however, reduces resource endowment differences between countries, and raises the question whether new theories are needed to explain international trade. Indeed in the postwar period a number of new theories about the nature of international trade and the patterns of trade were advanced, including ones that emphasize imperfect competition, product cycles, economies of scale, and differences in tastes and incomes.

For our purposes, however, more interesting is the increasing importance of the distinction between "arm's-length" trade and intra-firm trade. The former involves trade *between* independent firms across national boundaries, and is the subject of standard trade theory. The latter involves trade *within* firms across national boundaries, or more accurately between a firm and its foreign affiliates and subsidiaries in other countries, and thus falls outside the bounds of standard trade theory. "Arm's-length" trade, because it is between independent firms, involves market exchange and market prices. Intra-firm trade, by definition, involves administrative decision-making and transfer prices. While the logic of comparative advantage can be applied to the former, it is not easily applied to the latter. TNCs employ transfer prices for a variety of reasons, including tax avoidance, inter-unit cross-subsidization strategies, and accounting purposes. Though there is no comprehensive theory of transfer pricing, the different explanations which have been offered have very little in common with traditional comparative advantage analysis.

What is important about this distinction is that the increase in the number of TNCs and the spread of their operations through FDI has increased intra-firm trade as a share of total world trade. By some estimates, US trade since the early 1990s has become about 50 percent intra-firm trade, with US TNCs trading with their foreign affiliates and subsidiaries abroad, and non-US TNCs trading with their foreign affiliates and subsidiaries in the US (Graham 1996: 14).⁴ The US case, however, differs from that of many other countries, since the strength of the US economy at the end of World War II led to an earlier emergence of outward FDI on the part of US TNCs. Thus, in the world as a whole, closer to a third of total imports and exports has been estimated to involve intra-firm trade (UNCTAD 1994). Arguably this share will continue to rise in the future, as TNCs from other countries become increasingly important, so that traditional trade theory will not only explain a decreasing share of world trade, but also fail to explain that type of trade arising from one of the most dynamic processes in recent years, the dramatic increase in TNC FDI activity.

Change in posture of the developing world toward TNCs

When Hymer first initiated serious investigation into the subject of TNCs and FDI in 1960, developing countries by and large subscribed to the neo-Marxist view that TNCs were agents of industrialized countries' imperialism. They reasoned that TNCs which were set up in their countries were engaged in a process of exploitation that involved removing more value than they created. Among the arguments for this were that resource extraction and agricultural production were carried out under agreements that paid far less to host countries than the value they created, that labor was paid wages lower than was paid in industrialized countries, that profits were always repatriated and never invested locally, and that host countries were compelled to subsidize TNC infra-structural needs without adequate compensation. Indeed, to the extent that TNC FDI in developing countries in the postwar period until relatively recently was predominantly for resource extraction and agricultural production, there was some truth to many of these arguments.

However, the increasing disintegration of manufacturing production in the industrialized countries (as explained above) has meant that recent FDI now involves a significant export of capital for manufacturing purposes. This combined with higher rates of technical advance in manufacturing has meant that the location of new plants and factories through FDI typically involve technology spillovers to host countries. These may arise from the training of local work forces to technology-sharing with local suppliers to "reverse" engineering learning opportunities created by the presence of new products and methods. Developing countries, then, have generally reversed their past thinking about the presence of TNCs in their economies, and sought to compete internationally for FDI flows.⁵ For a number of reasons, however, many countries (particularly in Africa) have to date been relatively unsuccess-

ful: their relative states of underdevelopment have often made them costly locations for foreign firms, despite their low wages; markets to which TNCs expect to supply goods are concentrated in the industrialized countries, making location closer to those markets advantageous; and, technology gains to TNCs from locating where technical progress is high are unavailable in most developing countries.

One important consequence of this is that growth rates between the advanced economies and the developing world continue to widen. Moreover, the fact that the extent and depth of poverty in the developing world seems to be becoming more intractable may lead to political instability, and thus create further disincentives to TNC operations and FDI there. Thus while recent *World Investment Reports* indicate an increasing number of countries have significant inward FDI flows, they also show that the share of FDI going to the poorest nations and regions of the world such as Africa is constant or decreasing. With government-to-government aid a very limited source of development support at the end of the twentieth century, the lowest income developing countries face particularly poor prospects for the future.

Re-organization of the ownership structure of capital across the world

Keynes argued in *The General Theory* (1936) that the first decades of the twentieth century saw a fundamental change in the way in which investment was carried out in the industrialized economies on account of the increasing separation of management and ownership in business firms. Whereas most firms at the end of the nineteenth century in the UK were owner-operated, in the space of a few decades professional managers had largely replaced owners, many of whom had lost their commitment to those firms in which they and their families had previously been involved. This increased the importance of stock exchanges as a vehicle for the pursuit of gain through the buying and selling of stocks by those who had inherited wealth – a new rentier class as Keynes termed it. Keynes's concern was that this change had produced an increase in speculative activity in capitalist economies, and that this led to greater instability in business investment and greater likelihood of business downturns. A parallel but slightly different state of affairs can now be argued to obtain in the more globalized postwar world economy. Whereas Keynes's experience was that of the creation of a *national* rentier class, our present experience is that of the creation of an *international* rentier class.

One fundamental change in recent decades is the increased ease of access for investors to different national stock exchanges and other property acquisitions, combined with a tendency toward centralization of national exchanges across borders as international exchanges. Though there remains a significant national bias in individuals' stock holdings, the tendency toward liberalization of rules for foreign participation in national stock exchanges (for example recently in Japan) opens up the possibility that the future will increasingly be

characterized by a class of international wealth-holders with little or no loyalty to any particular collection of national firms. This contrasts with Keynes's experience, where if investor attachment to particular firms could no longer be expected, nonetheless wealth-holders generally retained an attachment to national firms. Evidence of the more general problem of capital mobility this can produce can be found in the 1997 Asian financial crisis when large amounts of capital were quickly withdrawn from a number of the most dynamic East Asian economies when exchange rate depreciations appeared to be at hand. In contrast to short-term portfolio capital flows, much of this involved capital that took the form of lending to Asian banks, which had then made loans to domestic firms which in turn put up their equity as collateral (Eichengreen 1999). However, as it turned out, this foreign lending typically included contractual "escape" clauses, whereby foreign lenders could demand immediate re-payment of loans from banks in the event of significant changes in key national indicators, and banks were forced to demand repayment of the loans they had made to their customers. Essentially, then, the Asian crisis was a product of the mobility of highly footloose international capital in pursuit of gains unavailable in domestic markets. This suggests that international financial crises are likely to become more rather than less common in the future, with "contagion" risks across economies increasingly a problem.

Fundamental change in the scope for national politics

Dani Rodrik (2000) has argued that the world social-economic system is caught in an international trilemma involving fundamental choices over what form politics and economics will take in the future. His trilemma argument is that only two of the three following things can be combined in the future global system: survival of the nation state, the continuance of democratic or "mass" politics, and the integration of national economies. The immediate postwar period combined the nation state and mass politics in what Rodrik labels the Bretton Woods compromise. Global economic integration was limited to what was compatible with there being relatively independent national economic policies, which themselves were generally responsive to popular political pressures. In particular, capital mobility was highly limited. The current period is closer to what has been called the "Golden Strait-jacket" (Friedman 1999). Here it is mass politics which seems to have been curtailed as nations pursue liberalized trading regimes, and compete with one another for FDI, irrespective of whether this may involve job loss and erosion of social safety. Finally, a third possibility for the future is that mass politics will be re-established on a global, non-national basis through a variety of types of international political organizations, global economic integration will proceed apace, but the nation state will become increasingly irrelevant.

What does the future hold in Rodrik's view? On the one hand, it seems that the world cannot go back to the past and the Bretton Woods compro-

mise without significant disruption, since capital mobility and the current more liberalized world trading regime have dramatically transformed almost all of the world's economies, while creating GDP growth resulting in higher per capita income levels in many countries. On the other hand, the scenario that Rodrik prefers – that politics become global to catch up with an economic system that has become global – strikes him as utopian at the current point in time. This leaves the “Golden Straitjacket” which combines a globalizing world economy with nation states in competition with one another. For Rodrik, however, this is an unstable and unlikely permanent outcome, since it sacrifices democratic and mass politics which are deeply embedded in the history of the advanced economies. It also further threatens safety nets, and jeopardizes countries' cultural and social traditions. At the same time, nations' competition with one another for trade and FDI will almost certainly continue. Thus how politics and economics combine in the future is unclear, and perhaps the only thing one can be confident about is that the nation state will be a site of social conflict between those who regard it as a vehicle for countries' competition in the international economy and those who see it as having evolved not only as a democratic institution, but as the only significant means for democratic politics in the world today.

In this contest, TNCs are likely to be at the center of controversy. As intrinsically hierarchical institutions, they share little with the democratic political process. Yet as foreign firms they have a need to accommodate themselves to national priorities in the countries in which they locate, suggesting that they will at least attempt to engage national political constituencies. One complicating factor in this regard is the fact that many TNCs are economically close in size (measured in terms of sales) to the nations where they locate (measured in terms of GDP). Another complicating factor is that as specifically multinational firms, TNCs have multiple allegiances. In any event, what seems clear is that as agents of change in the global economy, TNCs will continue to play a major role in the future fortunes of nation states and democratic politics.

Conclusion

Many see the dramatic increase in FDI and TNC activity as evidence that TNCs are relatively autonomous agents in the world economy that are able to pursue their goals largely as they choose. But it may also be argued that TNCs are constrained and influenced in considerable degree by governments and social-political interests that seek to act on agendas contrary to TNC interests. One such example are the efforts of the US government to discourage foreign TNCs from carrying out activities in Cuba. US Cuba-phobic policies have been contested not only by foreign TNCs but also by their source-country governments. Further, foreign affiliates of US TNCs wishing to do business in Cuba find themselves at odds with US foreign policy. Thus, rather than being relatively autonomous agents, TNCs often find themselves

in circumstances such as these being caught up in conflicts between countries. Another example concerns NGO groups worldwide that seek to achieve their goals on a variety of social and environmental issues by applying pressure to TNCs. Since TNCs are often the visible agents of change in the countries in which they operate, NGOs have frequently worked to change the character of TNC operations and practices, especially when host countries themselves are reluctant to do so. These and other examples suggest that TNCs may often find themselves involved in operations less profitable and successful than originally anticipated when the FDI that created them was undertaken. In this regard they may well be worse off than domestic firms whose political support in their home countries is generally stronger. One might suppose that these types of insecurity would lead to TNCs being more mobile and less committed to long-term involvements in their foreign locations. Against this is the fact that long-term commitments are usually extracted in one form or another by host countries interested in stable economic growth, and that FDI investments are by nature long-term. Thus TNCs have important sources of social and political vulnerability that argues for a more moderate view of their autonomy in the world economy.

A final issue in regard to the influence that governments and countries have vis-à-vis TNCs concerns possible changes in the structure of world trade. Historically world trade has been dominated by trade in intermediate rather than final goods, reflecting national differences in countries' resource endowments and greater degrees of manufacturing development in the industrialized countries. But increasingly – with lower worldwide transportation and communication costs – production processes that transform intermediate goods into final goods are “footloose” or mobile among countries with newly industrializing economies (especially in EPZs) seizing larger shares of this type of production. Partly this reflects the greater importance of the “product cycle” in the development of goods across international markets, and partly it reflects the improved infrastructural capacities of the newly industrializing economies that were previously unattractive sites for FDI and new TNC operations. What this implies from a trade theory perspective is that the principle of comparative advantage – which has greater scope when international markets trade final goods – has now to be accompanied by the emphasis on the principle of absolute advantage, where this concerns relative labor costs and the provision of social overhead capital. Countries, then, that are low in the former respect and more able to address the latter stand to gain in capturing “footloose” production. This trend is likely to be reinforced as the advanced countries seek to be specialized in the most technologically sophisticated goods, thus giving up their earlier concentration in more “mature” final goods whose technologies are more easily copied by new producers. What this development implies for TNCs is that they will be pursued actively by newly industrializing economies that seek to climb the ladder of industrial development. TNC production affiliates offer faster start-ups than home-grown firms, and with technological spillovers leave permanent improvements in domestic production capacity.

TNCs, therefore, will likely experience an increasing importance in the world economy combined with greater controversy over their roles in host countries. Their central role in globalization is now fully recognized, and many across the world today see them as the source of problems and/or as an opportunity for leveraging the process of globalization. This integration into future political, social, and developmental scenarios makes a fully economic analysis of TNCs shortsighted. Rather TNCs need to be understood in political-economic terms, influencing and being influenced by the changing social and political organization and evolution of the international economy.

Notes

- * The author is grateful for comments on previous versions of this chapter to Joseph Daniels, Phil O'Hara, and Marc von der Ruhr.
- 1 In addition, TNCs carry out activities associated with a variety of types non-equity relationships (e.g. joint ventures, international subcontracting, licensing, contract manufactures) that indicate further impact.
- 2 However, the small share of world FDI going to less developed countries is predominantly greenfield investment. This reflects higher levels of investment in primary product industries, and the smaller numbers of firms in less developed countries that might be acquired.
- 3 Thus M&A FDI does not generate substantial employment gains. The smaller share of FDI in the form of greenfield investment does increase employment.
- 4 This has interesting implications for the US trade deficit, since it means that a significant share of the large volume of imports that contributes to that deficit are produced by the foreign affiliates of US firms that export goods back to the US. That is, in part the trade deficit is due to US firms selling to their US customers from foreign locations rather than domestic ones, suggesting that the US appetite for "foreign" goods is to some extent simply an appetite for "US" goods produced in foreign locations.
- 5 One factor in this regard has been widespread abandonment of the import-substitution paradigm of development in favor of the export-competitiveness paradigm. FDI is seen as the easiest way to create export platforms. China is an excellent example in this respect.

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7 Transnational financial institutions, global financial flows and the International Monetary Fund

Maureen Burton and Reynold Nesiba

Introduction

Transnational financial institutions, like other transnational corporations, operate on a global basis with little allegiance to country or community. Decision making is driven by a desire to maximize the corporation's global profitability. As relative production costs change, nonfinancial firms such as General Electric and Nike shift production from country to country with little regard for the effect of the shift on the local economy or population. However, it takes time and effort for such shifts to occur. In contrast, transnational financial institutions like J.P. Morgan Chase and Citigroup can shift their financial flows with the same lack of regard for the effects on the local economy and population but with far less effort. The time involved in moving "hot money" is literally the time it takes to make a few keystrokes. The fungibility of financial claims makes transnational financial institutions even more adept than their nonfinancial corporate counterparts at moving their inputs (sources of funds) to the least costly/most profitable venue (uses of funds). By understanding the institutions involved in the rapid movement of global financial flows described above, we hope the reader will better understand the importance and mechanics of international finance in the ongoing process of economic globalization. To that end, the primary purpose of this chapter is to explain and assess the roles played by transnational financial institutions, offshore banks, and the International Monetary Fund (IMF) in the generation and regulation of global financial flows.

In the first section of the chapter, we explore the rise of transnational financial institutions, offshore banking facilities, and recent attempts to regulate money laundering. In the second section we discuss debt flows, investment flows, and policy prescriptions for cooling down "hot" money and thereby ameliorating their most offensive consequences. In the third and final section of the chapter, we investigate the role of the IMF in overseeing the global financial system, in acting as lender of last resort, and the subsequent "conditionality" it imposes on countries in crisis to receive aid.

Transnational financial institutions and offshore banking facilities

Banks have been doing business across national borders for as long as there have been nation states. What has changed over the last few decades is:

- 1 the enormous volume and types of capital flows;
- 2 the extent to which transnational banking institutions facilitate trade, currency, and capital flows; and
- 3 the degree to which these institutions have transcended any allegiance to country of origin.

Who are these lenders? What role do they play in the global financial system? As our analysis below demonstrates, the answers to these questions are quite elusive for many reasons. However, it is clear that in the postwar period transnational financial institutions have become central players in the movement of trade, currency, and capital flows. This more intense globalization of financial markets has resulted from the deregulation and liberalization of financial markets and institutions, and technological changes that increased the fungibility of funds in global markets.

Rise of transnational financial institutions

The interests of those living in developing nations include the creation of quality jobs, access to education and medical care, a rising standard of living, industrial development, and the ongoing improvement in the nation's infrastructure. In the short term, these goals are at best incidental to the goals of profit and global dominance for transnational nonfinancial and financial firms. The transnational firm is a corporation that operates globally with little allegiance to any one country and whose identity transcends national borders. In the postwar period transnational banks have become central players in the movement of trade, currency, and capital flows. The transnational firm emerged as a natural outgrowth of the multinational corporation in a world characterized by declining trade and capital barriers, as well as sharp reductions in transportation and communication costs. The transnational firm has the power to move production, distribution, and financing to the least costly venue, and does so without consideration to the domestic, local, or national interest. The value of shareholders' equity supersedes all other considerations, or as David C. Korten asserts, "in their day-to-day operations, the allegiance of the world's largest corporations is purely to their own bottom lines – without regard to any national or local interest" (Korten 2001: 127).

A transnational banking firm or financial institution offers the same (usually complete) range of financial products and services to personal, commercial, corporate, and institutional clients in more than one country. Some transnational banks operate in only a few countries. For example, there are

approximately a dozen transnational banks that offer the same full range of services to Canadian and US residents (Comper 2002). Other transnational banks do business in many countries. Although the demarcation is rather vague, transnational financial institutions differ from international banks in that this latter group is more closely associated with one country. Transnational financial institutions not only do business in multiple countries but, because of their size and influence, transcend allegiance to any one country. In general, they also offer a wider range of financial services than do international banks.

As can be expected, the world's largest banks are virtually all international banks and some are transnational as well. *Bankers' Almanac* ranks the 3000 largest international banks by total assets in US dollars. As Table 7.1 shows, in October 2001, Sumitomo Mitsui Banking Corporation of Japan is the world's largest international bank with over \$900 billion in assets. Deutsche Bank AG, Germany, is second with over \$880 billion in assets. Note that Table 7.1 includes only bank assets. It does not include the total assets of a parent bank or financial holding company.

As Table 7.2 shows, *Bankers' Almanac* further reports that Japan has the largest international banking sector with over \$7.8 trillion in assets, Germany is second with over \$6.4 trillion in international banking assets, and the United States is third with over \$4.5 trillion in assets. Japan has seven of the world's top twenty-five international banks and nineteen of the top 100. As a region, Western Europe is the strongest region with 476 of the top 1000 international banks.

Just as the distinction between transnational and international financial institutions is blurred, many of these *institutions* are not traditional banks. As Houpt (1999) notes, many international banks have also established linkages with securities firms and markets to offer a larger array of financial products and services. In the United States, these institutions are known as bank holding companies or financial holding companies. Such ties, as well as mergers and acquisitions among traditional banks, have further consolidated international banking activities among fewer large players. Finally, Houpt (1999: 612) notes that:

The continuing growth of international banking and the strengthening of links between banking and securities markets have produced larger, more diversified financial institutions and further concentration of international activities among fewer U.S. banks. These trends are not unique to U.S. banking but apply to financial markets broadly. They are likely to continue as industry consolidation moves worldwide; the recently completed or proposed acquisitions by foreign banks of two large U.S. commercial banks, Bankers Trust and Republic National Bank of New York, support that point.

Table 7.1 Top ten international banks, 2001

Current rank October 2001	Previous rank July 2001	Bank	Assets (US\$ million) October 2001
1	—	Sumitomo Mitsui Banking Corporation	905,293
2	1	Deutsche Bank AG, Germany	882,577*
3	4	Bayerische Hypo-und Vereinsbank AG, Germany	672,720*
4	2	BNP Paribas SA, France	651,617*
5	3	Bank of Tokyo Mitsubishi Ltd, Japan	609,455*
6	5	Credit Suisse Group, Switzerland	609,338*
7	6	Bank of America NA, USA	584,284*
8	7	UBS AG, Switzerland	577,228*
9	9	ABN AMRO Holding NV, Netherlands	509,970*
10	10	Credit Agricole, France	502,291*

Source: Adapted from Bankers Almanac (2002).

Note

*Figures are consolidated.

Table 7.2 Top ten countries ranked by combined assets of international banks, 2001

<i>Country</i>	<i>Combined US\$ million assets of country's international banks, October 2001 (US\$)</i>
Japan	7,872,977
Germany	6,482,867
USA	4,598,969
United Kingdom	3,099,725
France	2,824,967
Switzerland	2,039,644
Peoples Republic of China	1,622,688
Italy	1,547,301
Netherlands	1,351,367
Canada	1,011,746

Source: Adapted from Bankers Almanac (2002).

Offshore banking facilities

Along with the globalization of financial markets and institutions has been the growing use of offshore banking facilities – some consisting of little more than telephone/computer jacks and terminals. These facilities are often set up in countries that have lax regulation, secrecy, and favorable tax laws. *Bankers' Almanac* offers a list of 260 offshore banking facilities engaging in such activities as private, retail, and wholesale commercial banking, and investment and merchant banking. The IMF has found that offshore banking and shell companies “played a catalytic role in the Asian and Latin American financial crises by hiding risk and loss that professional home country supervisors and auditors could not penetrate” (Komisar 1999: 48). Although all major industrial countries and emerging markets are domicile to offshore banking firms, areas of major offshore financial centers are in the United Kingdom, the Caribbean, Hong Kong, and Belgium-Luxembourg. According to Bendelow, offshore banking has been a key growth industry in the 1990s. Spurred by technological changes and the dismantling of capital barriers, capital has flowed to its highest return and often to offshore sites to avoid taxes and financial reporting requirements. It is the after-tax return that is most important to investors and thus, other factors equal, financial capital domiciled in low or no tax jurisdictions pays a higher return. Thus, tax avoidance (and sometimes tax evasion), changes in technology, and secrecy have been key reasons for the growth of offshore banking facilities. It is the secrecy surrounding these flows of funds that make it difficult to identify and track the flow of funds among transnational financial institutions.

Financial secrecy and lenient tax laws have attracted hedge funds to offshore banking facilities. These institutions often deal in supposedly higher risk derivative instruments. The risks that these institutions are taking are unknown to domestic regulators. One of the most famous (or infamous)

hedge funds was Long-Term Capital Management (LTCM) which was founded in 1994 by Nobel Prize winners Robert Merton and Myron Scholes, and by John Meriwether, formerly of Salomon Brothers. LTCM was licensed in the Cayman Islands and engaged in risky investment strategies in virtually every corner of the world with the goal of arbitraging profits regardless of whether prices of financial securities were going up or down. Regulators were unaware of the risks and leverage of LTCM that had \$1.25 trillion in leveraged assets or 1000 times their capital (Komisar 1999: 48). The hedge fund found itself *de facto* bankrupt after sustaining large daily losses as financial prices deviated from their traditional alignment immediately following the Russian default in 1998. The Federal Reserve organized a private sector bailout to prevent the liquidation of LTCM's \$200 billion in securities and probable frantic reaction and enormous financial crisis in global financial markets.

The growth of offshore banking has also facilitated the laundering of funds received in illegal transactions. This in turn mobilized government agencies to attempt to regulate these offshore facilities with regard to the money laundering of drug money, arms traffickers, and other criminal activity. Regulators were relatively successful as long as it was wealthy countries with the bulk of highly developed financial systems that participated in the global financial system. However, in the 1990s, technological advances have allowed the banking systems from developing and other offshore sites – that are often underregulated – to participate more fully in the international financial system. Wechsler (2001: 44) points out that “The result was a vast proliferation of rogue banking” where a “new breed of underregulated financial center moved from the fringes of the international banking system to full integration into the global economy”. More recently, since 11 September 2001, regulators are attempting to get a handle on the funds in these markets to assess the extent to which they fund terrorist activities.

The Financial Action Task Force (FATF) is an intergovernmental agency now consisting of twenty-nine governments that was established by the G7 in 1989 to regulate money-laundering activities by banks. The FATF rates the quality of government regulation and law enforcement in countries that host offshore financial institutions. Banks that lend to institutions in countries that do not have sufficient regulation must set aside larger reserves to compensate for greater credit risk. Thus, there is a disincentive to locate in such an offshore banking facility. In June 2000, FATF issued the results of a survey that grouped offshore centers into three groups from high quality to low quality with regards to reporting, supervision and international cooperation. Table 7.3 lists the countries that fall into the various groups. In addition to this categorization, the FATF found that fifteen offshore centers were “noncooperative” while another fourteen had serious deficiencies. The FATF list of “noncooperative” jurisdictions included the Bahamas, the Cayman Islands, the Cook Islands, Dominica, Israel, Lebanon, Liechtenstein, the Marshall Islands, Nauru, Niue, Panama, the Philippines, Russia, St. Kitts and Nevis,

Table 7.3 The FATF grouping of countries: quality of reporting, supervision and international cooperation

<i>High quality</i>	<i>Medium quality</i>	<i>Low quality</i>
Dublin (Republic of Ireland)	Bahrain	Bahamas
Hong Kong	Barbados	British Virgin Islands
Isle of Man	Bermuda	Cayman Islands
Luxembourg	Gibraltar	Mauritius
Singapore	Macau	Nauru
Switzerland	Monaco	Panama
Guernsey	Labuan (Malaysia)	St. Lucia
Jersey		Samoa
		Seychelles
		Vanuatu
		Antigua
		Antigua and Barbuda
		Aruba
		Netherlands Antilles
		Niue
		St. Vincent and the Grenadines
		Turks and Caicos
		Belize

Source: Adapted from FATF (2001).

and St. Vincent and the Grenadines. By July 2001, the Bahamas, the Cayman Islands, Liechtenstein, and Panama were removed from the list of non-cooperative countries because they had enacted legislation and practices to improve law enforcement and regulation in money laundering. Other countries had made less or no progress.

In short, many offshore banking centers are characterized by inconsistent accounting standards, underregulation, and lax enforcement which have made tracking international financial flows frustratingly difficult. Recent research by Francis E. Warnock and Chad Cleaver of the Federal Reserve (Warnock and Cleaver 2002) show that even when we have pretty good capital flow data, the assumptions we use to process it may cause problems. Warnock and Cleaver conducted a comprehensive study of capital flows and found that the current data used to measure bilateral capital flows – which is appropriate for balance of payments (BOPs) considerations – is ill-suited for other financial research purposes. This is because it presumes that the “transactor country is the same as the country in which the security’s issuer, ultimate purchaser or seller, is resident”. However, in many cases this is not the case. Transactions carried out through intermediaries in, say, London or offshore facilities in the Caribbean, routinely violate this assumption. The authors clarify with an example:

[I]f a German resident purchases a U.S. bond through a broker in London, U.S. capital flows data will show an inflow from the United

Kingdom. In practice, this means that in U.S. data a disproportionate amount of purchases and sales of securities are attributed to residents of financial centers.

(Warnock and Cleaver 2002)

A more accurate representation of these financial flows would show Germany as the originating country and the US as the destination. Warnock and Cleaver compared US capital flows data with estimates arrived at using benchmark studies that trace the origin and destination of securities from an individual security level. They report that the United States is now committed to conducting annual benchmark studies that will provide more accurate and timely data regarding global capital flows.

With the shortcomings of international financial data in mind, the second section of this chapter examines foreign exchange, debt, and investment flows. We will see that here too regulators have striven to keep pace with the structural and institutional changes in global finance.

Debt flows, investment flows, and policy prescriptions for slowing “hot” money

According to the Bank for International Settlements (BIS), every working day approximately \$1.5 trillion worth of currency is traded on the global foreign exchange (FX) market. Much of it is employed for speculative purposes. Part is used to finance trade in goods and services. The remainder is used to facilitate the global debt and investment flows at issue in this section.¹ These two broad types of financial capital flows require definition and discussion, which we provide in the next two subsections. We then turn to a discussion of their adverse affects. This section concludes by discussing the pros and cons of various policy proposals that may be of use in slowing hot money flows and ameliorating its most adverse effects.

Debt flows

As the name implies, debt flows involve financial flows between borrowers and lenders. Loans can be made indirectly through lender financing or directly through the issuance of bonds by the borrower. These debts can be categorized three ways based upon who serves as the lender. Loans can be 1) multilateral, 2) bilateral, or 3) private as well as short- or long-term. Multilateral loans are made by international agencies such as the IMF, World Bank, or various regional development banks. Bilateral lending occurs when governments make loans to other governments. Finally, private loans are those made by private lenders such as Citigroup, or J.P. Morgan Chase.

Table 7.4 summarizes recent changes in the total debt stock of all developing countries between 1995 and 2000 by region and by type of lender. At year-end 2000, approximately \$2.5 trillion was owed by developing coun-

tries. This is an increase of over \$300 billion since 1995. The most significant trend between 1995 and 2000 has been the changing composition of debt ownership. The last six columns in the table show the changes in debt type between 1995 and 2000. In every region of the world, except sub-Saharan Africa, the share of debt held by private lenders has increased. For developing countries as a whole, private debt now constitutes more than half (59 percent) of all debt outstanding. It is also worth noting that despite calls for debt repudiation, debt has increased in every region of the developing world except in two regions, the Middle East and North Africa, and sub-Saharan Africa. Although this table does not go back to the 1970s, to understand the genesis for large increases in debt flows, we need to go back about 30 years.

Why have debt flows grown since the 1970s?

In the wake of the sharp OPEC oil price increases in the 1970s, oil-exporting countries in the Middle East found themselves with a surplus of petrol dollars. Since most oil is exchanged for dollars, the revenue generated was deposited into US-based transnational banks and as Eurodollar deposits throughout the world.² These deposits created a surplus of loanable funds. US banks found that loans to developing countries offered high rates of return and a low perceived risk given the belief at the time that sovereign countries would not default on their financial obligations. As a result, large flows of loans (often in dollar terms, at floating interest rates and/or short terms to maturity) were made from both private banks and multi-lateral lenders such as the World Bank and IMF to developing countries (Burton *et al.* 2002: 352). Arthur MacEwan (1990, 53) notes that one of the leading private players in international lending at the time was Citibank. In fact, its aggressive international operations helped it become the largest US bank by the end of the 1990s.³

In October 1979 when the US Federal Reserve System – then headed by Fed Chair, Paul Volcker – sharply increased interest rates to stem domestic inflation, many of these international loans became unsustainable. The high US interest rates had two deleterious effects. First, they caused the servicing costs (debt payments) of variable rate loans to increase dramatically. Borrowers with fixed-rate loans who had borrowed short-term were also required to pay much higher rates to receive rollover financing. Second, the higher US interest rates led to a sharp appreciation of the dollar (depreciation of other currencies) making repayment more difficult in terms of a borrowing country's domestic currency. This change in monetary policy in the United States played a key part in creating a third-world debt crisis that hit Argentina in 1981, Chile and Mexico in 1982, and Brazil in 1983 (Stiglitz 2002: 267, footnote 15). Since then, global financial crises have had a less direct connection to tight Federal Reserve monetary policy. Nevertheless, financial crises – in Mexico (1994–1995), Southeast Asia (1997–1998), and thereafter in Russia (1998), Brazil (1998), Ecuador (1991), and Argentina (2001, 2002) – have continued to create turmoil in the developing world and in global financial

markets. An important source of this economic instability has been the volatility of international debt flows and their hasty reversals. In many respects, the same can be said of investment flows.

Investment flows: portfolio investment and foreign direct investment

A second way to classify global financial flows involves investment. These can be divided into two types: portfolio investment and foreign direct investment (FDI). The primary distinction between the two is that portfolio investment refers to the international purchases of securities such as stocks, bonds, bank loans, derivatives, and other forms of credit. The purchaser of these securities (i.e. the lender) does not gain meaningful control of the foreign entity (Neely 1999). An example would be an American mutual fund company buying the bonds issued by an Indonesian corporation.⁴

In contrast, foreign direct investment (FDI) refers to financial flows whereby a foreign investor does gain meaningful control of a foreign entity. This may happen through the purchase of real estate, production facilities, or substantial equity investment as occurs during a merger and acquisition (Neely 1999). Most scholars tend to see FDI as reflecting a longer-term relationship between an investor and foreign entity than does portfolio investment. The longer-term relationship of FDI suggests that these financial flows would be more stable than portfolio investment in the event of a financial crisis. This is because securities can be sold more easily than real assets.⁵ An example of FDI would be if a UK firm purchases a firm or sets up a subsidiary in Thailand.

Table 7.5 summarizes recent trends in FDI inflows and outflows by transnational corporations (TNCs). What is striking is the sharp increase in FDI from 1982 to 2000. In 1982 about \$57 billion of FDI flowed globally. By 2000 this had increased to \$1271 billion – a 22-fold increase in less than 20 years. What is not reflected in these aggregate statistics is that, according to UNCTAD (2001: 1), three-quarters of these flows end up in developed countries. More specifically, the United States, European Union, and Japan accounted for 71 percent of FDI inflows and 92 percent of FDI outflows. The largest single factor driving FDI flows are cross border mergers and acquisitions (M&As). In 2000, cross border M&A activity constituted \$1144 billion and most of this too occurred within developed countries. In contrast, the 49 least developed countries in the world received only 0.3 percent of the

Table 7.5 FDI of transnational corporations, 1982–2000 (US\$ billion constant 2000)

	1982	1990	2000
FDI inflows	57	202	1271
FDI outflows	37	235	1150

Source: Adapted from UNCTAD (2001: 2).

world's 2000 FDI inflows. This statistic is even more disappointing when one considers that most scholars view these scarce FDI flows as more stable than portfolio investment.

Problems with hot money

The primary public policy concern related to global financial flows has not been the skewed distribution of international investment flows described earlier. Instead, the main issue has been the ease with which capital flows of all kinds can be quickly reversed through transnational financial institutions and offshore banking centers. In short, these flows are viewed as "hot money" because like a hot potato they rarely rest in one person's hands for very long. One of the reasons for the depth and duration of the Asian financial crisis of 1997 and the subsequent Russian and Brazilian crises was the ease with which capital was whisked out of these countries at the first sign of trouble. Ilene Grabel (1999 and 2000) discusses the risks and problems created for developing countries by the inflow and outflow of hot money. A summary of the "stylized facts" about the Asian crisis provides an enlightening example into the types of problems caused by hot money movements.

Grabel (1999) argues that during the late 1980s and continuing through 1996, portfolio investment flows into Southeast Asia increased in the wake of financial liberalization. Banks and borrowers with access to hard-currency-denominated loans helped leverage these inflows and created a real estate boom. Since real estate is used as collateral for these loans, real estate price increases encouraged further lending. By 1996, three types of problems sparked this conflagration. First, a fall in real estate prices and hence collateral values caused considerable strains to the Philippine, South Korean, Indonesian, and Thai banking systems. Second, a slowing of the Japanese economy resulted in reduced foreign direct investment to the region. Third, and perhaps most importantly, the currencies of these countries were pegged to the dollar. When the dollar appreciated in the mid-1990s (in part due to overly restrictive US monetary policy), so did the value of these other currencies.

This in turn undermined the price competitiveness of their exports. In May 1997, a stock sell-off in Thailand was followed by an abandonment of the dollar peg and panic on the part of investors. In the absence of capital controls, billions of dollars of short-term funds were able to hastily escape not only from Thailand but also from other Southeast Asian countries. According to Wincoop and Yi (2000), most of these outflows had originated as banking flows. The flows moved first to offshore banks before eventually coming to rest in Europe and the United States where they helped buoy economies weakened by international financial uncertainty. Along the way these funds morphed from their initial form as short-term loans in Southeast Asia into FDI and portfolio investment in the United States and Europe. In Southeast Asia this hot money flight led to further decreases in the value of currencies

and stock markets. The falling value of the currency increased the amount of domestic currency required to pay back dollar-denominated international debt. Intervention by the IMF was required and – as will be discussed in the final section of this chapter – exacerbated an already unfortunate situation.

The recent spate of international financial crises has led many to reevaluate the ideology of market fundamentalism and its neoliberal policy prescriptions. Thus, finance ministers and economists are seeking alternatives to the *free* movement of international capital that ironically holds so many developing economies captive. This impulse has historical precedent and academic support. John Maynard Keynes and other Bretton Woods architects were strong supporters of the regulation of capital flight (Helleiner 2001). The broad category of policies aimed at limiting trade in financial and real assets are often referred to as capital controls. They come in two main flavors: 1) tax-based systems that work through the price mechanism and 2) restrictions or prohibitions that work by reducing or eliminating quantities of capital flow. They can be placed on either or both capital inflows and outflows. We discuss these two categories of capital controls in turn. We end this subsection by briefly discussing debt repudiation as a way to ameliorate some of the suffering caused by previously originated loans.

Capital control through the price mechanism – Tobin Tax

Neely (1999) notes that capital flows can influence the price mechanism in a variety of ways. A country could place a special tax on returns to international investment; the United States employed an interest equalization tax from 1963–1974; Malaysia has imposed “exit taxes” on funds leaving the country. A nation could tax specific types of transactions; a Tobin Tax, discussed below. Finally, a nation could mandate a reserve requirement on foreign investment; as did Chile from 1991 to 1998. Of the three tax-like approaches, the Tobin Tax appears to be the most popular and worthy of further discussion.

The idea of a Tobin Tax has been around since 1978 when James Tobin proposed it on the pages of the *Eastern Economic Journal*.⁶ The basic notion is that all foreign exchange transactions would be subject to a small, universal, and uniformly-applied tax. The intent in Tobin’s words is to “throw some sand in the well-greased wheels” of global financial speculation. This “sand” would serve two main purposes. First, by increasing transactions costs, currency speculation would be discouraged. However, a small enough tax would not fundamentally interfere with non-speculative trade and investment flows. An important consequence of this reduced speculation would be the enhanced autonomy countries would have in managing their own currency values. Second, the tax revenue collected could be used to fund economic development activities in low-income countries or to create what Wachtel (2001) calls a “Financial Stability Fund”. This fund could be mobilized in the event of crisis caused by hot money hastily retreating from a developing

economy. The Center for Environmental Economic Development (CEED) estimates that a tax of 10–25 cents per \$100 dollars of global currency exchanged could generate between \$100–300 billion per year. Wachtel estimates that a 0.1 percent tax would generate \$225 billion.

Despite its appeal, the Tobin Tax faces practical implementation difficulties. For the tax to be effective, critics argue that every government around the world would need to endorse it. A few countries serving as “Tobin tax-free havens” would create havoc for the global tax collector by wooing foreign exchange traders (or at least their funds) out of countries where the tax is applied. Critics further argue that since so much foreign exchange is traded in futures and forward market, a Tobin Tax would need to be levied not only on the spot market, but also on these more highly leveraged foreign exchange derivatives markets.

Advocates of the tax counter that implementation is possible. They say that a tax placed on trades among the US, UK, and Japan would cover the vast majority of daily FX transactions. They further argue that a tax costing a few pennies per \$100 of trade is unlikely to drive traders out of their very expensive London, New York, and Tokyo offices. Currency trades require specialized telecommunications infrastructure as well as a skilled workforce. If it were feasible to leave, traders would have found cheaper rents and lower wage workers long ago. Advocates also do not view the taxing of derivative transactions as fundamentally any more difficult than taxing spot market transactions.

Capital control through quantity restrictions

Capital controls can also be implemented more directly through restricting the quantities of capital inflow or outflow. This might involve rules requiring special authorization for new borrowing from abroad or on certain types of investment. For instance, Neely (1999) notes that Korea until recently prohibited long-term investment by foreigners. Similarly, China has limited capital flight by using a non-convertible currency and by restricting the repatriation of profits. China allows foreign exchange transactions to be conducted only through authorized banks and through the China Foreign Exchange Trade Centre itself. Chinese currency can be removed from the country only with an authorized certificate. Those engaging in unauthorized foreign exchange transactions face stiff fines.

Debt cancellation

The Jubilee movement and its friends such as the rock star, Bono, have been the most vocal advocates of debt relief for developing countries. The movement began in the late 1990s by churches in England and soon world-wide uniting together to push debt repudiation as a moral issue. Their basic argument is that debt payments by poor countries to rich countries stifles

spending on more pressing domestic priorities in the developing countries. The Jubilee Network would prefer that poor countries use scarce resources to meet basic needs and provide healthcare and education services rather than repaying banks and other lenders in rich countries. In a recent press release for the Jubilee USA network, Mara Vanderslice, declares, “The crisis of debt, which prevents poor countries from investing in health and education – demands complete debt cancellation, not just financing previous commitments”. It is worth noting that many in the movement avoid using the term “debt forgiveness”, since it connotes a previous sin in need of absolution. In many cases those being coerced into repaying the debt (and/or going without public services) received no benefit from the original loan or had any say in its use or terms. Thus, in many cases, they are blameless.

The international institution charged with assisting countries in managing their short-term liquidity needs and in overseeing the current programs for debt repudiation is the International Monetary Fund (IMF). In this third and final section of the chapter, we turn to a discussion of the role the IMF plays in the global financial system, and proposals for its reform.

International Monetary Fund (IMF)

Beginning in the early 1970s, the IMF redefined its role in the international financial system. The IMF’s new role represented an increase in influence and included, among other things, the “comprehensive and detailed surveillance, both of the economic performance of individual member states and of the world economy as a whole” (O’Brien *et al.* 2000: 162). The IMF continued to offer technical assistance to emerging economies and increased its intervention for both short-term corrections in the balance of payments and for medium and long-term structural adjustments.

As noted earlier, by the 1990s, changes in technology and financial liberalization had created a truly international financial system and globalized world economy that was characterized by enormous and volatile currency and capital flows. The magnitude and volatility of capital flows created new and virulent types of financial crises, which were characterized by stealth, fear, contagion, and flights to quality.

These new types of crises destroyed lives and wiped out hard-fought gains for people living in less developed countries. Initiatives spearheaded by the IMF to ameliorate various crises, may, after a time, restore stability – and bail out Western transnational firms and investors. However, they often did so at the expense of the poorest people living in developing countries. In this new environment, many economies, particularly small developing countries, lost the autonomy to control their own economies. The IMF could now prescribe conditionality requirements for countries to receive further lending – requirements that adversely impacted on the poorest members of the world community and benefited the most wealthy members.

Conditionality requirements and structural adjustment programs

The IMF assists countries that are experiencing a financial crisis by providing large-scale liquidity and technical assistance. The loans are conditioned on the acceptance of policies prescribed by the IMF. The Asian Crisis of the late 1990s is a case in point. As discussed earlier, the currencies of South East Asia were pegged to the dollar and had appreciated along with the dollar. Given large current account deficits and relatively small supplies of international reserves, the currencies, particularly the Thai baht, became overvalued. The IMF recommended devaluation along with substantial increases in interest rates in an attempt to stop a continuing slide of the currency values. The IMF made short-term loans to stabilize currency values, to restore investor confidence, and to reestablish the countries' access to international capital flows. The aid came with conditions. These included 1) requiring the countries to raise interest rates in an attempt to halt the slide in currency values and 2) to pursue contractionary fiscal policies designed to cut consumption. The fall in consumption would, theoretically, lead to a decrease in imports and a reduction in the current account deficit.

Both policies, typical for the IMF in similar situations, were extremely contractionary, and inflicted at a time when these economies were already in a downward spiral. Thus, the economic downturn in the developing country was aggravated by the IMF's conditioned "rescue". Such policies are particularly onerous to the poorest and most vulnerable people in the affected countries. Note that although the crisis emanated from excessive lending in the private sector (encouraged by the IMF and the opening of international capital markets), it was the public sector and ordinary people who were forced to reduce expenditures or go without government services.

In addition, the IMF required countries to introduce structural changes in their financial systems. The changes included increased regulation of and improved oversight of the financial system, and the avoidance of dependence on short-term financing particularly denominated in another foreign currency such as the dollar. The result of the policies was to prevent the default of the Asian economies on their short-term US dollar loans. Although US and investors from other developed countries lost funds, they lost far less than what they would have without the intervention. It is not as clear that the populations of the affected countries in general lost less than what they would have without the intervention.

The IMF, long before the Asian crisis, implemented policies favoring transnational firms. As Korten states, "The IMF has served as bill collector for Northern-based financial institutions" (Korten 2001: 173). Beginning with the rise in oil prices in the late 1970s, the debt of less developed countries exploded. From 1970 to 1980, the debt of low-income countries grew from \$21 billion to \$110 billion (University of Michigan (2002) *World Debt Tables, 1992-93*: 212).

As world interest rates soared and the debt became unserviceable, the IMF

stepped in and imposed structural adjustment programs (SAPs) on the debtor countries that in essence bailed out international lenders. The structural adjustments were conditioned on policies to ensure minimum losses to the international lenders. They included privatization, opening national economies, and restrictions on government spending. Higher growth rates followed due to the increase in exports and new foreign investment. The increases in exports were dominated by exports of natural resources and agriculture products and resulted in declining prices for natural resources and a deterioration of the terms of trade. Despite the growth, developing country trade deficits and international debt both increased as social conditions deteriorated.

Changing policies of the IMF

However, a large number of changes in the IMF governance procedures since the Asian crisis have modified its impact on nations somewhat. The big question is whether these changes will reduce financial instability and poverty or not. For instance, to strengthen safeguards on the use of IMF resources, in March 2000, the IMF began requiring assessments of central banks' compliance with desirable practices for internal control procedures, financial reporting, and audit mechanisms. In most cases, the IMF provides only a small portion of a country's external financing requirements. But because the approval of IMF lending signals that a country's economic policies are sound, it reassures transnational financial institutions and helps generate additional funds from them. "The IMF's ability to perform this catalytic role is based on the confidence that other lenders have in its operations and especially in the credibility of the policy conditionality attached to its lending" (Kletzer and Wright, 2000: 55). We should also note that when a country refuses to acquiesce to the IMF's conditionality requirements or structural adjustment programs it loses not only IMF assistance, but it risks being perceived as a global pariah to transnational financial institutions. In most cases, resistance is futile.

The IMF also provided significant technical assistance to developing countries with the goal of improving the institutional framework needed to meet the challenges of globalization. Included in this were a host of actions designed to enhance international accounting standards, strengthen bank supervision and regulation, as well as to encourage the transparency and dissemination of accounting and financial information. (For more on this see O'Hara 2003 and IMF 1997.)

Second, in the late 1990s the IMF created a comprehensive approach to debt reduction for the poorest countries whose debt-burdens were non-sustainable. This was called the *Heavily Indebted Poor Countries Initiative* (HIPC). By the IMF Staff's own admission (IMF 2000: Chart 1, Twentieth Century World Income Trends) clearly some international system of debt repudiation was required and is continuing to be negotiated under HIPC.

The IMF has also sponsored various initiatives, such as organizing debt relief packages – subject to IMF conditionality requirements – to restore stability in global financial markets. Just as the US Federal Reserve System has served as an effective lender of last resort for US banks since 1913, the IMF is increasingly taking on the role a (quasi) international lender of last resort (ILLR) to countries around the globe, albeit with less success. In recent years, this attempt to serve as a more effective (quasi) ILLR has been strengthened by two additional initiatives: a Supplementary Reserve Facility (SRF) and a Contingent Credit Line (CCL).

The SRF, which began in 1997, is designed to provide short-term loans to nations experiencing balance of payments problems caused by a large and sudden loss of market confidence. The loans are offered at penalty rates and are subject to conditionality requirements. If a *threat of contagion* exists and if this offer of liquidity is likely to aid the balance of payments problem, then the funds are available immediately. Korea (December 1997) and Russia (July 1998) have both availed themselves of this new program (O'Hara 2003).

Similarly, the CCL deepens the IMF's ILLR function by providing funds to countries *already experiencing contagion*. This policy was introduced in 1999 following the financial crises in Southeast Asia and Russia. The hope is that countries with otherwise strong macroeconomic fundamentals that are adversely affected by international capital markets can be inoculated with an infusion of cash to avert further contagion. Although no nation to date has made use of a CCL, funding commitments are expected to be in the 300–500 percent range of a nation's IMF quota. The loans are made at penalty rates, require conditionality, and are expected to be repaid in one and a half years (O'Hara 2003).

Unfortunately IMF policy prescriptions, including the new SRF and CCL, usually require higher (penalty) interest rates to stabilize currency values, which have the effect of, *ceteris paribus*, reducing domestic aggregate demand. Although exchange rates may have been stabilized, they were stabilized at invariably lower levels. The reduction in aggregate demand combined with lower exchange rates may make the situation worse rather than better (Wolfson 2002b). But it remains to be seen – in the wider governance environment – whether these quite significant changes since the Asian crisis will reduce instability and increase the ability of less developed nations to look after the poor during financial turmoil. Further investigation of the operational dynamics of the impact of IMF policies are needed in this respect.

Contrasting viewpoints of the IMF

At the present time, the IMF has adopted an ideology that is based on the free market, privatization of resources, and other neoliberal policies. Although the overall benefits of globalization are likely greater than the costs, the benefits are unquestionably weighted in the favor of transnational firms and the developed countries (Soros 2002). In such an environment, the IMF

sees its role as acting as the overseer of the international financial system and as lender of last resort.⁷

Criticism of the present structure and policies of the IMF can come from two extremes. The libertarian side believes the IMF intervenes too much creating a moral hazard problem. Why should a bank be careful about who they lend to, if they know that the IMF will bail them out anyway? In short these critics see IMF bailouts as encouraging lenders to take on more risk than they would otherwise, since they believe that the IMF will sweep to their rescue in case of a crisis. Libertarians generally believe in a limited role for government and that free markets will result in the greatest good for all. They ignore market failures caused by externalities and the vast income differentials among and within countries because of these market failures. Advocates of this position believe that the best results come from pure free market policies in a fully privatized world, with free trade and no barriers to capital flows.

On the other extreme are those who believe the IMF should be completely changed to ensure that the benefits of globalization are extended to the most vulnerable. These advocates believe worker's rights, human rights issues, and environmental issues need to be addressed in a global forum. They see a new and improved IMF as playing this role. One policy that would need to be eliminated would be conditionality. To these proponents conditionality is viewed as simply another form of colonization. From this perspective, developed countries control their poorer peers not through gunboat diplomacy, but instead through restricted access to global markets and from the capital needed for development and eventual economic independence.

Between these two extreme positions are moderates who suggest that IMF policies can be modified to take into account the poorest members of society and to see that the benefits of globalization are spread more evenly among developed and developing countries. Many supporters of this position have come to demand that the benefits of globalization be realized by all who participate in the global community, not just the most powerful countries and transnational lenders. They believe that the IMF needs to be reformed so that voices of the populations of the underrepresented developing nations are heard.

Moderates also recognize that moral hazard can be a problem and needs to be actively managed but want the IMF to be more open and to hold public meetings. Some stakeholders in this camp also suggest that the IMF's attempt at providing debt and poverty relief are attempts by the IMF to modify its original neoliberal position. Leadership by the IMF in opening dialogues about other reforms such as the Tobin Tax and/or support of increases in the more stable foreign direct investment relative to portfolio investment would be moves in the right direction.

Conclusion

A well-functioning international financial system is vitally important to the economic development of low-income countries and to the continued economic growth and stability of high-income countries. Unfortunately, as we show in this chapter, the system has become dominated by a relatively small number of insufficiently regulated transnational financial institutions. The interests of these firms (short-run profit maximization) are often at odds with the interests of ordinary people (high paying jobs, access to education and healthcare, industrial development, infrastructure improvements). At the speed of a keystroke, hot money in the form of global debt and investment flows move among countries, transnational financial institutions, and offshore banking centers. Too often over the last three decades the result has been economic chaos for those least able to manage it.

The challenge for twenty-first century policy makers (including IMF officials) will be to create a global financial system that balances the interests of transnational financial institutions against those of ordinary people – particularly those living in developing countries. Policy prescriptions prematurely thrown out by neoliberal economists, such as capital controls, a Tobin Tax, and debt cancellation, should be reconsidered on their own merits rather than discarded on ideological grounds. Finally, the IMF has long been criticized for the harshness of its policies on the poorest members of the world community. It remains to be seen what affect the recent policy changes will have, and also whether the new (quasi) lender of last resort policies will reduce the extent of crisis and contagion.

In the case of a currency crisis, the IMF needs to work with transnational financial institutions as well as with individual countries to counter the massive transfer of funds ignited by financial crises. New institutional arrangements are needed to facilitate cooperation among advanced economies, transnational financial institutions, and members of the affected regions. The goal of this multilateral effort should be to slow or stop the outflow of funds from the affected area, to stabilize the currency, to increase exports, and to maintain domestic aggregate demand. For the sake of the international financial system as well as for the poor, future rescue packages should include a more generous social safety net for the country in crisis. The basic safety net would include access to food, water, fuel, unemployment insurance, and other humanitarian subsidies as necessary to maintain aggregate spending to meet human need. The result will be not only a more humane world, but also one in which global financial stability is enhanced and global economic development is made more orderly and assured.

Notes

- 1 Some of these flows are also used for speculative purposes.
- 2 Eurodollar deposits are dollar-denominated accounts held outside of the United States. Burton *et al.* (2002: 197) note that the Eurodollar market started in the

1950s. Soviet officials worried that, in a crisis, the US government might freeze any US dollar deposits that the USSR held in the US banking system. To reduce this risk, the Soviets convinced London bankers to accept dollar-denominated deposits (hence the origin of the name). Since that time, financial institutions around the world have begun accepting dollar-denominated deposits. Regardless of whether US dollar-denominated deposits are held in Canada, Hong Kong, Japan, or Panama, we still refer to them as Eurodollars. Although Cold War tensions have eased, the Eurodollar market continues to grow for a variety of reasons. First, through the use of Eurodollar deposits, US-based banks can avoid reserve requirements and deposit insurance premiums on some of their liabilities. Second, transactions negotiated in London, or other locations, can be posted in the Bahamas or other offshore banking centers to take advantage of lower tax rates in these locations.

- 3 MacEwan notes that in 1977, 82.2 percent of Citibank's earnings were generated by its international operations.
- 4 Estimates of international portfolio investment flows made by the Institute for International Finance and by the IMF differ widely. UNCTAD (2001: 4) provides a comparison of estimates between the two agencies.
- 5 Neely (1999) cites a study by Goldstein (1995) who argues that physical assets can be used as collateral for loans and therefore easily converted to assets in another currency. This effectively moves capital back out of a country. Similarly, Wincoop and Yi (2000) point out that during the East Asian Crisis, the most unstable sources of funds arrived in the form of short-term loans from overseas banks. This suggests that for one to understand the instability of various types of financial flows, one should look further than the simple dichotomy between FDI and portfolio investment. In short, debate continues on this issue.
- 6 The Center for Environment Economic Development (CEED) has a web page dedicated to this topic. The site <<http://www.ceedweb.org/iirp/>> provides a Tobin Tax bibliography, estimates of revenue that could be generated from the tax, and updates from political campaigns around the world that are pushing for similar political initiatives. For a short bibliography, see Stiglitz (2002: 266, footnote 12).
- 7 The IMF also seeks to develop policies for establishing a framework for international financial stability that focuses on transparency, internal and external supervision, and banking systems that encourage the appropriate amount of risk-taking. To achieve transparency, the reporting of qualitative and quantitative financial information must be standardized. Reporting mandates include information about international reserves, external debt (both short- and long-term), and the health of the banking system. Financial and nonfinancial institutions are told to adopt international accounting standards that allow for effective international comparisons. International standards are encouraged for auditing, disclosure, bankruptcy, corporate governance, and the valuation of stocks, bonds, and other assets. Given the recent Enron, Global Crossings, and WorldCom debacles in the United States, this economic and accounting advice sounds more than a little ironic and hypocritical.

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8 The World Trade

Organization, free trade areas, and the distribution of wealth*

Hassan Bougrine

Introduction

This chapter critically examines the workings of the various forces shaping international trade. After a brief review of the classical trade theory, we argue that trade has not been ‘free’ largely because it is not always beneficial to all parties. We present evidence to show that the world trading system has been managed by the General Agreement on Tariffs and Trade (GATT) through the use of various strategic trade policies that were favourable to developed countries and to the interests of powerful groups within them. The World Trade Organization (WTO), which grew out of the GATT in 1995, is seeking to emasculate government intervention in all markets. However, a careful reading of the various agreements that now form the institutional framework of the WTO reveals that the ‘new rules’, like the old ones, are written by the powerful actors. This leads us to explore the important issue of how trade, and globalization in general, has led to a rise in inequality (in income and wealth), both within and between countries.

WTO: the free-trade dogma and the bias

Up until the eighteenth century, the dominant view of trade was mercantilism. According to mercantilists, a country would increase its national wealth if it exported more than it imported. Since all transactions were based on gold, countries with a trade surplus would add more gold to their governments’ coffers, thus allowing them to maintain larger and better armies and navies needed for the consolidation of power at home and the acquisition of more colonies. By the same token, a trade deficit meant that the country paid out more gold than it brought in, which implied a decline in its wealth. Gold became a symbol of wealth and power.

This view portrays trade as a zero-sum game in which the gains made by one country must necessarily come at the expense of another. Classical economists like Adam Smith and David Ricardo, on the other hand, argued that trade is a positive-sum game resulting in gains to all countries involved. According to Smith (reedited 1937), when a country is more efficient than

(or has an absolute advantage over) another in the production of a given commodity, but is less efficient (or has an absolute disadvantage) in the production of a second commodity, then both countries can gain by each specializing in the production of the commodity of its absolute advantage and exchanging some of it with the other country for the commodity of its absolute disadvantage. Because of such specialization, production of both commodities will rise and the increase will determine the size of the gains from trade. Smith concluded that free trade would ensure an efficient utilization of resources worldwide and, therefore, maximize world welfare. For this reason, Smith advocated a liberal, laissez-faire policy.

This idea was elaborated further by Ricardo (1817) who demonstrated that a country would gain by specializing in the production and export of those commodities which it can produce at a lower relative opportunity cost than its trading partners and by importing all other commodities (the comparative advantage theory). The major criticism levelled against the comparative advantage theory is that it implies that economic performance of a country is determined by what the country has, not by what it can create. This sort of economic determinism ignores the ability of the people of a country to create new opportunities that add to their already existing resources and improve their economic well being (e.g. through inventions of new production techniques that increase productivity and/or improve the quality of products). Such dynamism would give the country in question a competitive advantage and allow it to reap dynamic gains from trade as opposed to the static gains that arise from the simple reallocation of resources (from one sector to another as specialization increases) but tend to disappear when no further reallocation is possible (Thirlwall 2000).

The classical justifications of free trade, in addition to being contingent on some crucial assumptions, are general statements which ignore the political reality and social structure of countries. The validity of these statements has been questioned by several economists such as Bhagwati (1958), who demonstrated in his 'immiserizing growth' argument that the gains from trade can be offset by a decline in the terms of trade. In other words, the gains from trade depend on the actual relative price of the goods exchanged, which, in turn, is determined by the demand conditions for such goods. Moreover, if the production of one type of the goods exchanged is subject to diminishing returns, such as is the case for primary products, the reallocation of labour that follows from specialization will result in unemployment, which can offset the gains from trade. Thirlwall (1979) has shown that the classical models of Smith and Ricardo, as well as their modern extensions, also ignore the monetary or balance of payments consequences of trade. According to Thirlwall (2000: 133):

If a particular pattern of trade leads to balance of payments difficulties, and the balance of payments is not self-correcting through relative price (i.e. real exchange rate) movements, the gains from trade can easily be

offset by reductions in output and the increase in unemployment necessary to compress imports. This is an important consideration in thinking about the potential role of strategic protection and the speed of trade liberalization.

If free trade does not always necessarily benefit all the countries involved, then why is there so much support for it among policy makers? Economic theory predicts that trade can be fuelled either by asymmetry in factor endowments (and costs) or by economies of scale. In the first case, specialization occurs between industries and leads to inter-industry trade (Deardorff and Stern 1994). On the other hand, when trade is caused by scale economies, firms acquire a certain monopoly power and competitors can enter the markets only by producing differentiated products, in which case, trade induces specialization by product and occurs within industries (intra-industry) (see Krugman 1979, 1981). Hufbauer and Chilas (1974) used trade data from eight industrial countries to show that there has been no significant increase in the degree of their trade specialization (i.e. inter-industry trade) before and after World War II. In a study of nine European Community countries, Mardas (1994) argued that this situation reflects the absence of a common industrial policy that favours specialization between industries within the Community. Other studies have shown that there has been indeed a rise in intra-industry trade relative to inter-industry trade in most industrialized countries during the 1950s and 1960s (see Grubel and Lloyd 1975). However, if trade between industrialized countries was essentially confined to intra-industry commodities, GATT, meanwhile, had been promoting liberalization of inter-industry trade with less advanced economies, with some key exceptions allowing industrialized countries to protect, for instance, their textiles and agricultural products.

Therefore, liberalization of trade, particularly during the second half of the twentieth century, has not taken place within the idealized free-market model as described by early liberal economists. Liberalization during this period was carefully managed by the GATT, a trade regime in which the state intervened to strengthen, protect, or weaken the power of some of the major actors (*viz.* financial and industrial capital, farmers, labour). The strategic trade policies that ensued favoured the use of subsidies and tax incentives to encourage exports, quotas and tariffs to discourage imports, and other trade barriers to protect the interests of influential groups within society. For instance, to protect the interests of labour in advanced industrialized countries, policy makers have often invoked low wage costs (and labour standards in general) to block access to their markets by some exporters from the developing countries. To defend this position, advanced industrialized countries refer to the destructive 'race to the bottom' in which their societies will find themselves when firms and industries respond by cutting wages, benefits, and working conditions in order to stay competitive (see Reich 1994).

In his assessment of the experience of developing countries under GATT and WTO, Srinivasan (2000: 73) concluded that

forcing exporting countries to raise their labour standards in the expectation that their costs of production will rise will thus shift most, if not all, of the costs of adjustment to developing countries. Clearly, a social clause [a set of core labour standards] is nothing but a thinly veiled protectionist device in such a context.

The demand for higher or 'fair' labour standards in developing countries is often presented as a humanitarian concern about the poor working conditions of women and children. While most would agree that this is a legitimate concern, the means of achieving it are contested. For instance, Srinivasan (2000), among others, proposes that instead of relying on protectionism and trade sanctions, it would be more effective to pursue direct means such as lifting restrictions on immigration from countries with low labour standards or through an income transfer by paying a higher price for the imported goods.

The protectionist approach to trade was somewhat mitigated with the replacement of GATT by WTO, which sought to scrap trade-distorting measures and other forms of government intervention in international markets. This was achieved through the negotiation of various agreements, which were included in the Final Act of the (1986–1994) Uruguay Round leading to the establishment of the WTO. The Final Act was signed in Marrakech on 15 April 1994. In the summary of the legal texts, it is clearly stated that:

The agreement establishing the World Trade Organization (WTO) calls for a single institutional framework encompassing the GATT, as modified by the Uruguay Round, all agreements and arrangements concluded under its auspices and the complete results of the Uruguay Round. Its structure is headed by a Ministerial Conference meeting at least once every two years. A General Council oversees the operation of the agreement and ministerial decisions on a regular basis. This General Council acts as a Dispute Settlement Body and a Trade Policy Review Mechanism, which concern themselves with the full range of trade issues covered by the WTO, and has also established subsidiary bodies such as a Goods Council, a Services Council and a TRIPs Council. The WTO framework ensures a 'single undertaking approach' to the results of the Uruguay Round – thus, membership in the WTO entails accepting all the results of the Round without exception.

(WTO, *Legal Texts*)

The results of the Uruguay Round are the various agreements referred to above, which, according to the WTO, are binding commitments by member countries. For instance, the agreement on agriculture stipulated that:

Overall, the results of the negotiations provide a framework for the long-term reform of agricultural trade and domestic policies over the years to

come. It makes a decisive move towards the objective of increased market orientation in agricultural trade. . . . In the area of *market access*, non-tariff border measures are replaced by tariffs that provide substantially the same level of protection. Tariffs resulting from this 'tariffication' process, as well as other tariffs on agricultural products, are to be reduced by an average 36 per cent in the case of developed countries and 24 per cent in the case of developing countries, with minimum reductions for each tariff line being required [15 per cent for developed and 10 per cent for developing countries]. Reductions are to be undertaken over six years in the case of developed countries and over ten years in the case of developing countries. Least-developed countries are not required to reduce their tariffs.

(WTO, *Legal Texts*)

Note that an individual country can change its commitments (to these tariff reductions), but it can do so 'only after negotiating with its trading partners, which could mean compensating them for loss of trade' (WTO, *Legal Texts*).

Concerning trade in textiles and clothing, the Multifibre Arrangement (MFA) was negotiated in 1961 and, if everything works according to schedule, it will be phased out in 2005. The length of this transition period is clearly convenient for developed countries to circumvent the adjustment costs associated with freer trade in this area.¹ Note however that trade negotiations in other areas (e.g. manufacturing, services) have often insisted on a fast-track approach.

Indeed, the General Agreement on Trade in Services (GATS) explicitly states that each party 'shall accord immediately and unconditionally to services and service providers of any other Party, treatment no less favourable than that it accords to like services and service providers of any other country' (WTO, *Legal Texts*). Some exemptions may be allowed for specific cases and the conditions for such exemptions are given in an annex to the agreement. It is worth noting that the conditions provide for reviews after 5 years and that the duration of such exemptions cannot normally exceed 10 years. The agreement covers all internationally traded services ranging from telecommunications to financial services, insurance, and tourism.

The agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) covers many areas, including copyright and related rights (e.g. books, paintings, films), trademarks and service marks (brandnames and product logos), and patents and industrial designs. The agreement expands the Paris Convention for the protection of industrial property and the Berne Convention for the protection of literary and artistic works. The agreement on TRIPS gives the holders of patents, copyright and trademarks the exclusive right of exploitation for a period of time (20 years for patents, up to 50 years in the case of some copyrighted material, etc.).² As for the implementation of the agreement, developed countries were given one year (starting 1 January 1995) 'to ensure that their laws and practices conform with the

TRIPs agreement'. Developing countries and transition economies were given 5 years while the least developed countries were given 11 years.

The Trade-Related Investment Measures (TRIMs) are essentially requirements that transnational corporations have to fulfil in order to operate in a given country (for instance, commitments to export a specified proportion of output, to buy locally a specified proportion of inputs, or to hire a number of local managers). The WTO considers the TRIMs to be inconsistent with the basic provisions of GATT because they have trade restricting and distorting effects. The agreement on TRIMs sought to eliminate these restrictions and distortions. Therefore, the Final Act adopted in 1995 established the following calendar to eliminate all TRIMs: it gave 2 years to developed countries, 5 years to developing countries and 7 years to the least-developed countries.

Even though the WTO, and GATT before it, was created to promote free trade between nations in all sectors, the above discussion points out that there remain obvious limitations and/or restrictions on the flow of commodities, particularly between developing and developed countries.³ This situation has led many to argue that 'the multilateral process is slow to produce substantial progress towards further trade liberalization, and that regional free-trade arrangements will allow nations to speed up liberalization and ultimately produce a self-reinforcing process towards open markets' (Barfield 1995: vii). This view was recently echoed in the Doha WTO Ministerial Declaration (WTO 2001: 2) where it was stated that 'we stress our commitment to the WTO as the unique forum for global trade rule-making and liberalization, while also recognizing that regional trade agreements can play an important role in promoting the liberalization and expansion of trade and in fostering development.' While regional trade agreements (RTAs) are nothing new,⁴ the rate at which they have been growing recently (over 100 since the establishment of WTO in 1995) leads one to ask, as does the WTO, whether these regional groups help or hinder the multilateral trading system. The total number of RTAs identified by WTO is 240, of which 172 were in force as of July 2000. The remaining 68 RTAs are defined as being under negotiation, which includes those which have been signed but were not yet in force in July 2000 as well as those which are expected to become fully-fledged RTAs in 2005. Others, such as the Euro-Mediterranean Free-trade Area, are scheduled for 2010. Table 8.1 gives a summary of some of the major RTAs.

The majority of these RTAs have been negotiated between developed countries⁵ and they often go beyond trade in commodities and include agreements on environmental standards, investment, and competition policies. Given the momentum of the trend towards regionalism and the wide array of subjects covered by RTAs, the WTO organized a seminar to assess their meaning and significance for world trade. The general conclusion seems to be that 'liberalization within RTAs is second-best to multilateral liberalization. It does not open the economy to full international competition, but only to competition from neighbouring or associated countries which may not be efficient suppliers' (WTO 2002). However, most of the papers

Table 8.1 Some major regional trading agreements

<i>Americas</i>	<i>Europe</i>	<i>Africa</i>	<i>Asia-Pacific</i>
• North American Free Trade Area (NAFTA) • MERCOSUR • Andean Community (AC) • Caribbean Community (CARICOM) • Central American Common Market (CACM) • Free Trade Area of the Americas (FTAA)	• European Union (EU) • European Free Trade Association (EFTA) • Central European Free Trade Agreement (CEFTA) • Baltic Free Trade Area (BAFTA)	• Southern African Development Community (SADC) • Southern African Customs Union (SACU) • West African Economic Community of Western African States (ECOWAS) • Arab Maghreb Union (AMU) • Arab Free Trade Area (AFTA) • Common Market for Eastern and Southern Africa (COMESA)	• Association of South East Asian Nations (ASEAN) • South Asian Association for Regional Cooperation (SAARC) • Gulf Cooperation Council (GCC)

Source: Adapted from WTO (2000).

presented in the seminar concluded that RTAs go beyond the existing provisions in the WTO in many areas (e.g. intellectual property protection, government procurement) and therefore pave the way for further multilateral liberalization (see Heydon 2002).

According to the WTO (1999: 45) 'regional and multilateral integration initiatives are complements rather than alternatives in the pursuit of more open trade' even though 'it [WTO] recognizes that under some circumstances regional trading arrangements could hurt interests of other countries'. These regional trade agreements in fact violate the WTO's guiding principle of equal treatment for all trading partners or non-discrimination defined in Article I of GATT and Article II of GATS. Moreover, Article 24 of the GATT (now subsumed into WTO) allowed these agreements to be set up, but only as a special exception and provided some 'strict criteria' are met. However, this has not prevented countries of a particular RTA to increase discrimination against non-members by enacting rules concerning the origin of products or through other administrative procedures, including quotas and tariffs.⁶ Measures such as these are clear violations of the agreements and commitments made by other members of the WTO. When conflicts and disputes of this nature arise, the complainants must follow the rules and procedures set out in the dispute settlement mechanism. Since its establishment in January 1995, the WTO has recorded over 240 disputes. Under the procedures of the previous GATT, rulings were adopted only by consensus, which meant that a single objection could block the ruling. Under the WTO, 'rulings are automatically adopted unless there is a consensus to reject a ruling – any country wanting to block a ruling has to persuade all other WTO members (including its adversary in the case) to share its view' (WTO, *Legal Texts*). It may seem that the WTO has made an improvement in the process of settling disputes and in moving closer to a 'rules-based system'. However, the new procedures have in fact made the situation worse for poor and developing countries.

The difficulties encountered by developing countries in implementing the WTO agreements are freely acknowledged by the WTO in its recent Doha Declaration. Indeed, according to WTO 'No area of WTO work received more attention or generated more controversy in the two years before the Fourth Ministerial Conference in Doha, Qatar, than the issue of "implementation" – developing countries' problems in implementing the WTO Agreements'. Paragraph 3 of the Doha Declaration (WTO 2001: 2) adds that:

We recognize the particular vulnerability of the least-developed countries and the special structural difficulties they face in the global economy. We are committed to addressing the marginalization of least-developed countries in international trade and to improving their effective participation in the multilateral trading system.

Convinced of the positive role free trade plays in the promotion of economic development and the alleviation of poverty, the WTO pledges to achieve

these objectives by reaffirming its commitment to the principles of the Marrakech Agreement, which promotes free trade and globalization and rejects the use of protectionism.

Globalization and the distribution of income and wealth

The proponents of 'globalization' emphasize its virtues and benefits in terms of wealth creation and technological innovation. Some recent writers suggest that inequality is not necessarily a bad thing and that in fact it can be good for growth and progress. For instance, Bartlett (2000: 56) maintains that

the rich perform a public service when they engage in what Thorstein Veblen called 'conspicuous consumption'. They are, in effect, underwriting the cost of bringing new products to market that ultimately become ubiquitous and available to everyone. Since it's not much fun to be rich if everyone can enjoy the same products, the rich aid innovation by pushing the limit of what is possible, encouraging producers to meet their demand in return for large profits.

A new bold thesis is being propounded by globalization advocates, namely, that any recent increase in inequality has been due to the inability of including many less developed nations in the benefits of globalization (see Lindert and Williamson 2000). Thus, inequality is linked to inadequate foreign investment and trade. The main conclusion of the supporters of the globalization-equality thesis is that globalization benefits countries that participate fully in the process and penalizes those that maintain restrictions on trade and capital flows.

However, critics argue that it has increased the gap between the rich and the poor at all levels (local, national, and international), particularly since the 1980s. According to Streeten (1998: 125) the 'liberalization, the realignment of the economy ... technological change and the savage competition that accompanied globalization have contributed to an increase in poverty, inequality and labour insecurity' as well as to 'the weakening of social support institutions and systems, together with the erosion of identities and established values' (Streeten 1998: 125).

A major contribution of the endogenous growth literature is its emphasis on the importance of human capital in the creation of wealth and prosperity, both for individuals and for countries as a whole. Sala-i-Martin (1994) summarized the findings of empirical research on economic growth from this perspective by stating that 'countries with better educated work force tend to grow faster' (Sala-i-Martin 1994: 746). The policy implications of this finding are obvious: access to education will substantially increase the incomes of the disadvantaged, lower inequality and increase the growth rate of average incomes. For this reason, many scholars, and some non-governmental and

international organizations advocated policies that would achieve more egalitarian societies. This is necessary because inequality can erode social capital and increase society's tolerance for further inequities in the long-run (UNDP 2001: 17).

The question that concerns us in this chapter is to show whether there are any links between the pattern of trade since the establishment of the GATT and the rise in worldwide inequality.⁷ From our perspective, it is not free trade *per se* that necessarily leads to inequality. We will argue, instead, that much of the observed rise in inequality can be explained by the way in which trade has been managed for most of the twentieth century, and particularly since the establishment of the GATT. A closer look at this issue reveals that the adjustment costs arising from industry (or sector) specialization are often high because of the necessary reallocation of factors of production, which are often industry-specific. The time needed by these factors of production to adapt to new production techniques in the new sectors may be long, hence the possibility of long-term unemployment. However, given that factor mobility is higher within industries than across industries, factors of production, even when product-specific, can easily adjust from the production of a discontinued product to that of a similar but differentiated product and the costs of reallocation are likely to be less than in the first case. This explains why countries are more willing to engage in intra-industry trade and less inclined to impose trade restrictions than when trade develops along the lines of comparative advantage.

The reason for such preference should now be obvious. Intra-industry trade leads to product specialization and, therefore, does not entail the same adjustment costs as does inter-industry trade, i.e. it does not cause great harm to the relative wealth of factors of production. Trade policy, at least during the twentieth century, has been based on this recognition. The distribution of wealth between nations via trade flows has always been on the minds of trade negotiators and policy makers for the simple reason that higher export earnings increase the income (and wealth) of the exporters whereas higher payments for imports impose a transfer of income and wealth from the importing countries. In the 1950s, the classic works of Prebisch (1950) and Singer (1950) have documented such transfers of wealth from developing countries in the form of declining terms of trade. More recent data from UNCTAD indicate that the phenomenon continues to affect many developing, and particularly African, countries. According to UNCTAD (1999: 13) 'of 47 African countries, 39 are dependent on a mere two primary commodities for over 50 per cent of export earnings and the substantial drop in commodity prices in 1998 encompassed the entire range of African exports'. Between 1997 and 1998, the terms of trade faced by sub-Saharan Africa deteriorated by 9 per cent, which represents a loss of real income equivalent to 2.6 per cent of GDP (see UNCTAD 1999: 29).

Another argument linking trade to unequal distribution of income and wealth is based on the commodity or value chain approach. This argument

attempts to go beyond the simple description of data on the value of exports and imports and look for reasons to explain why the observed trend (of declining terms of trade) has taken place (see Gereffi 1999). The focus of the value chain approach is on the appropriation of economic rents by the various actors participating in the conception, design, production, and delivery of a given commodity. In his evaluation of the contribution of the value chain analysis to the explanation of income distribution, both between and within countries, Kaplinsky (2000: 128) argued that

because it focuses on the dynamics of rent, a value chain perspective forces the analysis to transcend economic branches and sectors. For example, in the forestry and furniture chain, the rent-rich activities are increasingly found in the genetics of seed design and in the design and branding of the furniture, rather than in the individual agricultural, industrial or service sub-sectors (which tend to be the domain of traditional branch and sectoral analyses).

Given that inequality is the outcome of the distribution of returns accruing to the different participants in the chain, Kaplinsky (2000: 127) argues

those who command rents, and have the ability to create new domains of rent when barriers to entry fall, are the beneficiaries. By contrast, those who are stuck in activities with low barriers to entry lose, and in a world of increasing competition, the extent of these losses will increase over time.

In this context, the relocation of manufacturing production to low-wage, newly industrialized, countries is viewed not only as an attempt on the part of global capital to improve its profitability (Frobel *et al.* 1980) but also, and perhaps more importantly, as an indication of falling barriers to entry in manufacturing. Indeed, producers from developing countries are now able to supply high quality manufactured products at a low cost; and according to Kaplinsky (2000:127) 'it is this which explains the diminishing terms of trade of developing countries exports of manufactures observed above'. Regardless of whether one uses a new international division of labour (Frobel *et al.* 1980) or a global division of labour framework, it appears that developing countries are getting 'stuck in activities with low barriers to entry', whereas high-income countries are developing 'new domains of rent' with a particular focus on research and development, thus quickly moving towards what is commonly described as a knowledge-based economy. In this regard, it can be said that since knowledge-related activities are increasingly characterized by high barriers to entry, the agreement on TRIPs discussed in the previous section appears to be a carefully designed tool to protect the economic rents of the major actors in the global economy.

Since globalization is by no means limited to trade flows, scholars like Gal-

braith (2002) and Galbraith and Kum (2002) have identified other factors that contributed to the rise in inequality. According to Galbraith (2002) the rise in inequality that began in the early 1980s coincided with a sharp increase in real interest rates, an event that had dramatic effects on poor countries, which were forced to reduce their imports, cut public spending and retreat from the welfare policies. The subsequent rise of the neoliberal ideology convinced policy makers to abandon trade policies and regulation of capital flows, which set the stage for the devastating financial crises of the 1980s and 1990s. The immediate effects of such crises was a rise in inequality both within and between countries. Therefore, Galbraith (2002: 25) concluded that

it is not trade *as such* that we should fear. Nor is technology the culprit. To focus on 'globalization' as such misstates the issue. The problem is a process of integration carried out since at least 1980 under circumstances of unsustainable finance, in which wealth has flowed upwards from the poor countries to the rich, and mainly to the upper financial strata of the richest countries.

(Galbraith 2002: 25; emphasis in original)

The index of income inequality between countries used by Bourguignon and Morrisson (2000) indicates that inequality has increased by a factor of 8 between 1820 and 1992, although it tended to slow down after 1950. Lindert and Williamson (2000) also agree that income inequality between countries has risen since 1820, and 'even probably since the sixteenth century'. According to the UNDP (2001: 16, Figure 1.5), with the exception of East Asia and the Pacific, the regional average GDP per capita as a ratio to that of high-income OECD countries declined between 1960 and 1998 and that 'in sub-Saharan Africa the situation has worsened dramatically: per capita income, around 1/9 of that in high-income OECD countries in 1960, deteriorated to around 1/18 by 1998.' The same study by the UNDP found that

[d]espite a reduction in the relative differences between many countries, absolute gaps in per capita income have increased. . . . Even for East Asia and the Pacific, the fastest growing region, the absolute difference in income with high-income OECD countries widened from about \$6,000 in 1960 to more than \$13,000 in 1998 (1985 PPP US\$).

The UNDP (2001: 20) summarized their results on world inequality by stating that the ratio of the income of the world's richest 10 per cent to that of the poorest 10 per cent has increased from 51:1 to 127:1 between 1970 and 1997 using exchange rates conversions and from 19:1 to 27:1 over the same period if, instead, purchasing power parity (PPP) conversions are used.

Concerning the evidence on inequality within countries, the UNDP (2001: 17) stated that 'a study of 77 countries with 82% of the world's people shows that between 1950s and 1990s inequality rose in 45 of the countries

and fell in 16.... In the remaining 16 countries either no clear trend emerged or income inequality initially declined, then levelled off'. Bourguignon and Morrisson (2000) maintain that, in their sample, within-country inequality index fell steadily between 1914 and 1950 and rose slightly after the 1950s. According to Galbraith and Kum (2002), the results based on the data developed by Deininger and Squire (1996) for the World Bank are not reliable because the quality of the data is particularly poor since these contain only a few observations for some countries.

Using the United Nations International Development Organization (UNIDO) Industrial Statistics, Galbraith and Kum (2002) were able to calculate measures of inequality in manufacturing pay, with nearly 3200 country/observations covering over 150 countries for the period 1963 to 1999. The main conclusions of their study were:

- (a) in general, within-group inequality measures are higher for developing countries; (b) both OECD and non-OECD countries experienced increasing pay inequality since the early 1980s, and (c) the gap in pay inequality between developed and developing countries remains nearly steady over four decades.

(Galbraith and Kum 2002: 6)

Inequality had started declining, albeit slowly in OECD countries since the 1960s and somewhat faster in developing countries since the 1970s. However, the trend was reversed in 1980 with a sharp rise of inequality within developing countries, thus preventing the gap (or inequality) between the two groups from being reduced. Although there was some improvement in inequality measures in developing countries prior to 1996, this seems to have quickly vanished, perhaps due to the effects of financial and economic crises in which many of these countries had plunged in the subsequent years.

Income inequality is only one aspect of socio-economic inequality, albeit, perhaps, the most important one. People with similar incomes can afford similar goods and services that directly affect their standard of living (e.g. quality of housing, education, health care, leisure). However, income inequality itself is exacerbated by many factors: inheritance of wealth, access to credit, access to benefits from publicly funded services (higher education, subsidies and capital grants, and so on). Concerning the first factor, it has long been recognized that unfettered inheritance of wealth perpetuates inequality and further polarizes society. Most scholars agree that differences in human capital have clear implications for inequality, but we must recognize that children's educational attainment and their earning capacity are greatly influenced by their parents' wealth and social status. The latter are also important assets that help the rich to easily build a network of social relations (social capital) which enable them to extract private returns (see Glaeser *et al.* 2000). A major conclusion of the literature on social capital is that, in addition to the social returns, it leads to better economic performance for individuals.

Sanders and Nee (1996) consider that social relations are crucial to the success of individual enterprise for three reasons: (a) they provide psychological help and support, (b) they provide access to 'productive information' such as knowledge about competitors, suppliers, and transfer of business acumen, and (c) they provide instrumental support in the form of start-up capital, interest-free loans, and free labour from family and friends to help with specific tasks.

Supporters of globalization maintain that it offers new opportunities for individuals to widen the scope of their social capital by establishing relations, and having quick access to information, through the internet, for instance. However, one should not forget that the number of internet providers in poor countries is insignificant and that about one-third of the world population (some two billion people) still lives on less than \$2 a day. This will not only limit access to those who can afford it (thereby widening the gap between the rich and the poor) but it will also mean that when communication improves and information becomes available, it will increase awareness among the poor of income inequalities and will heighten the pressure either to emigrate to rich countries or to engage in movements of social disobedience, thus destroying the social capital at the national level (trust in government and other societal institutions, norms, values, etc.; see Fukuyama 1995). In both cases, globalization seems to have failed because, first, control over emigration to the rich, industrialized countries is now stricter than it used to be during much of the twentieth century and up until the 1980s, thus preventing 'equalization and convergence' and, second, the number of oppositional movements is growing all over the world.

Conclusion

According to the classical-neoclassical theory, because of the benefits it bestows on all the parties involved, free trade is the optimal policy option. This chapter challenges this conclusion on both theoretical and empirical grounds. Theoretically, it was argued that the gains from trade can be offset by a decline in the terms of trade or by a balance of payments constraint. The evidence presented here suggests that, under the current trade regime, most developing countries continue to suffer losses which are largely caused by these interrelated problems. Moreover, it was argued that free 'inter-industry' trade often leads to higher adjustment costs (e.g. in terms of unemployment) than does 'intra-industry' trade. A close examination of the international trade regime since the establishment of the GATT reveals that, in an effort to avoid these adjustment costs, advanced industrialized countries encouraged 'intra-industry' rather than 'inter-industry' trade and maintained the use of strategic and discriminatory trade policies to protect or promote some key 'national' industries.

The protectionist approach to trade was somewhat mitigated with the replacement of GATT by WTO whose mandate is to eliminate trade-distorting measures and other forms of government intervention in

international markets. The objective is being achieved through the negotiation of various agreements covering practically all aspects of international trade. A careful reading of the legal texts indicates that the terms of these agreements are often more favourable to the developed countries. An outstanding example is the agreement on TRIPs, which clearly sets barriers to entry into rent-rich activities, thus protecting the economic rents of the powerful actors participating in the conception, design, production, and delivery of given commodities. This explains why producers of primary commodities such as coffee, cacao, etc., receive only a small percentage of the final value of their products whereas those who are well placed in the chain end up with the lion's share. This unequal distribution of the gains from trade is crucial to an understanding of the observed rise in inequality within and between countries during the last 20 years or so.

Notes

★ I wish to thank Phil O'Hara for comments and suggestions on an earlier version of this chapter.

1 Moreover, the agreement on textiles and clothing

also contains a specific transitional safeguard mechanism which could be applied to products not yet integrated into the GATT at any stage. Action under the safeguard mechanism could be taken against individual exporting countries if it were demonstrated by the importing country that overall imports of a product were entering the country in such increased quantities as to cause serious damage – or to threaten it – to the relevant domestic industry, and that there was a sharp and substantial increase of imports from the individual country concerned.

(WTO, *Legal Texts*)

2 According to WTO 'Intellectual property rights are the *rights* given to persons over the creations of their minds. They usually give the creator an exclusive right over the use of his/her creation for a certain period of time', adding that 'Society at large sees this temporary intellectual property protection as an incentive to encourage the development of new technology and creations which will eventually be available to all' (WTO, *Legal Texts*).

3 In a joint note on the Doha Development Agenda, the directors of the WTO, World Bank and IMF on 16 May 2002 warned that increased protectionism in the world's leading economies would undermine developing countries' efforts to reform through more open economies and wondered 'How can leaders in developing countries or in any capital argue for more open economies if leadership in this area is not forthcoming from wealthy nations' (WTO News: <http://www.wto.org/english/news_e/news02_e/joint_note_oecd_16may02_e.htm>).

4 Srinivasan (2000: 59) writes that 'regional trading agreements (RTAs) have long been a feature of the world trading system. For example, the trade among countries of the British Commonwealth and Empire took place on a preferential basis under the commonwealth preferences long before the founding of the GATT'.

5 According to the WTO, nearly 60 per cent of the RTAs in force at the end of 2000 have been concluded among European countries whereas RTAs concluded among developing countries represent about 15 per cent of the total (WTO

website: <http://www.wto.org/english/tratop_e/region_e/region_e.htm>. The same website also provides a comprehensive list of regional agreements since the 1950s. Heydon (2002: 3) estimates that the percentage of world trade accounted for by RTAs is expected to rise from 43 per cent in 2002 to 55 per cent by 2005.

- 6 Notable examples include EU's restrictions on Moroccan exports of tomatoes and other agricultural products, the 'banana war' between the USA and EU, NAFTA's rules of origin regarding automobiles and auto parts, US countervailing duties on imports of steel, etc.
- 7 The conclusions of the globalization-equality thesis are based on the predictions of the conventional economic theory according to which free trade (one aspect of globalization) will bring about convergence in commodity prices, and factor mobility (another aspect of globalization) will equalize factor incomes by raising the income of the abundant factor and lowering that of the scarce factor (the Stolper-Samuelson theorem). Therefore, in the context of trade between the developed and developing countries, one should expect that incomes of the working poor (the abundant factor) will rise and that returns to capital or even the incomes of highly skilled workers (the scarce factor) will fall. Free trade, therefore, according to this view, will reduce inequality.

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9 The global gender division of labor*

Hella Hoppe and Wilfred Dolfsma

Introduction

In this chapter we argue that there are important gender issues involved in the division of labor throughout the world. We claim that there is a Global Gender Division of Labor (GGDoL), suggest an institutionalist perspective to explain its existence and persistence, and finally draw attention to some important developments that have an impact on the GGDoL. The institutionalist perspective allows us to suggest what effects, such as global financial crises, trade liberalization, and information and communications technologies (ICT) have on the position of women and on the GGDoL. We argue that the effects on the position of women are through the institutions that make for the implicit gender contract, and that these effects are likely to influence the GGDoL in a way that is not always beneficial to women.

The United Nations Millennium Declaration identifies the central challenge the world faces today as shaping globalization such that it becomes fully inclusive and equitable. A key objective in realizing a peaceful, prosperous, and just world is “to promote gender equality and the empowerment of women as effective ways to combat poverty, hunger, and disease and to stimulate development that is truly sustainable” (United Nations 2000a). The UN stresses that there will be no progress in the twenty-first century if women’s situation in the world is not improved. The GGDoL is one important issue in this context (see also UNIFEM 2000; United Nations 2000b; World Bank 2001).

In the next section we present empirical facts and statistics related to the GGDoL. The following section is an institutional economic analysis of the division of labor between the sexes and points to the importance of including the institutional structure of the world economy to explain the GGDoL. The next section analyzes three interactions of globalization and gender with regard to the gender division of labor in particular (see also Ruppert 2002). First, we argue that globalization *affects* women’s and men’s lives and working conditions *differently*. Second, it is argued that globalization is *based on* gender-specific inequalities that precede the globalization process. And finally, we demonstrate that globalization *changes* the gender division of labor. The last

main section briefly explores some policy issues linked to the global gender division of labor.

Some salient facts and tendencies

Feminist economists argue that economics needs to change its methodology and include more than simply “hard” facts and logic. They underline the necessity of a “practice that is flexible, attentive to context, humanistic, and rich as well as strong, logical, scientific and precise” (Nelson 1995: 139, see also Dolfsma and Hoppe forthcoming). The overemphasis on objective facts, logic, and a value-free scientific practice, all metaphorically connected to masculinity, leads to foundationalist thinking in science (Barker 1999; Hoppe 1999, 2002; Klamer 1991; McCloskey 1993; Nelson 1996; Strassmann 1993). The axiomatic and reductionist assumptions and methods generally used in economics thus should not be a surprise.

Feminist economists, however, are not claiming that numbers are useless. To show the progress and deterioration of women’s situation in society, careful use of context- and gender-specific statistics is needed. Gender-specific information, such as statistics about maternal mortality, and gender-sensitive data, such as that about the earnings of women in comparison to those of men, are frequently missing or lacking in detail. Hence, efforts should be made to collect them at national and international levels in order to determine, for instance, the gender-specific implications of globalization (UNIFEM 2000: 62).

By not including unpaid and care-giving work, national accounts offer highly gendered descriptions of reality (Jefferson 1999: 460), since women’s unpaid work is “invisible” in the economy (Nyberg 2000: 14). One reason for the gender-blindness of, for instance, Gross Domestic Product (GDP), is the problem of how to measure unpaid work. Possible approaches are time-use studies in which domestic work is separated from personal care and free time by the third person criterion (Reid 1934). In this approach, productive activities are defined as those for which you can “pay someone else to do it for you”. The private sector is seen as the appropriate benchmark against which to evaluate the contribution of women to society and the economy. Thus, cooking is domestic work and productive activity, whereas, for example, eating is not (Nyberg 2000: 6). Time-use studies have been more common during the last few years for developed and developing countries (UNIFEM 2000: 101). These studies show that, in total, women work more hours than men do. Even when women have full-time positions they spend more time performing unpaid labor than men do. Moreover, the discrepancy between men’s and women’s paid and unpaid activities can be explained by women’s responsibility for family tasks (UNIFEM 2000: 101, 106ff.; Hyman 1999: 395).

In addition to household and care-giving work, women’s often-unpaid activity in small-sized family enterprises is not sufficiently recognized. The

United Nations (2000b: 118) argues that self-employed and own-account workers are often not financially able to employ regular or permanent paid employees. As a consequence, they are regularly dependent on unpaid female contributing family workers. For instance, in Northern Africa 25 percent of the female labor force and only 7 percent of the male labor force are unpaid family workers. In Western Asia 34 percent of the female and 7 percent of the male labor force are unpaid family workers. In Latin America, the Caribbean, and in developed regions, contributing family workers – either female or male – do not play a significant role in the economy (see Table 9.1). In addition to compiling statistics, more research needs to be done to analyse, for instance, to what extent unpaid family workers' bargaining position changes in households.

In most countries, women's share of unpaid family work, which includes care-giving activities for the family and housework, was much higher than men's toward the end of the 1990s. A regional analysis shows that Asia has the highest percentage of female family workers with 25 to 40 percent followed by Africa with 22 to 35 percent. One of the main problems with unpaid family work and contributing family workers is women's dependence on benefits from husbands and family. It is now well understood that in order to change the unequal gender distribution of resources and empowerment,

Table 9.1 Women and men as contributing family workers,^a 1990/1997,^b percent

	<i>Female labor force</i>	<i>Male labor force</i>
<i>Africa</i>		
Northern Africa	25	7
Southern Africa	22	14
Rest of sub-Saharan Africa ^c	35	18
<i>Latin America and the Caribbean</i>		
Caribbean	2	2
Central America	7	6
South America	7	3
<i>Asia</i>		
Eastern Asia	8	1
South-eastern Asia	25	9
Southern Asia	40	11
Western Asia ^c	34	7
<i>Developed regions</i>		
Eastern Europe	6	4
Western Europe	4	1
Other developed regions	3	1

Source: Adapted from United Nations (2000b: 119).

Notes

a Sometimes referred to as "unpaid family workers".

b The countries considered have data for one of the years in the survey years 1990 and 1997.

c Sparse data for these subregions; the average should be interpreted with caution.

women must be politically supported when setting up a business. Women's access to loans and credits is limited, despite the fact that they tend to be more reliable in repaying debt. Support can be realized, for instance, by promoting micro-credit initiatives, which may enhance women's decision-making potential, and promote financial independence (UNIFEM 2000: 87; ILO 2001a: 5).

The question of the GGDoL cannot be reduced simply to the relation of unpaid and paid work, however. It needs to include a fuller view of the labor market. Women's participation in the paid labor force increased in nearly all regions of the world in the last two decades. For example the share of women in the paid labor force in South America increased from 27 percent in 1980 to 28 percent in 1997 and in Western Europe from 36 percent to 42 percent (see Table 9.2). Exceptions to this trend are Central Asia and Eastern Europe where the share of women in the paid labor force slightly decreased or stagnated until 1997. This tendency was reinforced during the Asian financial crisis and the still serious economic situation in Eastern Europe.

The main reasons for women's increasing participation in the labor force are changing gender values, a decline in fertility, better education of women, and a growing service sector in most countries (United Nations 2000b: 109, 114ff.).

Table 9.2 Percent of women in the waged labor force: various regions, 1980, 1997

	1980	1997
<i>Africa</i>		
Northern Africa	20	26
Sub-Saharan Africa	42	43
<i>Latin America and the Caribbean</i>		
Caribbean	38	43
Central America	27	33
South America	27	38
<i>Asia</i>		
Eastern Asia	40	43
South-eastern Asia	41	43
Southern Asia	31	33
Central Asia	47	46
Western Asia	23	27
<i>Oceania^a</i>	35	38
<i>Developed regions</i>		
Eastern Europe	45	45
Western Europe	36	42
Other developed regions	39	44

Source: Adapted from United Nations (2000b: 110).

Note

a Sparse data for this subregion; average should be interpreted with caution.

There are a number of other important dimensions of global gender economics. Women earn on average less than men, which is the case in all 63 countries for which data is available (UNIFEM 2000: 92).¹ Rubery (2001) underlines that gender pay differentials can come to be embedded in the patterns of pay and structures of labor costs associated with particular sectors or occupations. The distribution of the labor force by sector differs between the sexes and partly explains the pay differentials. Table 9.3 illustrates that, apart from sub-Saharan Africa and Southern Asia where women work mainly in the agricultural sector, in all other regions most women are employed in the service sector. In contrast, more men work in the usually better paid industrial sector.

Changing this legacy entails changing the structures of market wages as well as sectoral and occupational differences between the sexes (Rubery 2001). Changes in hiring practices are needed too, to make sure that unemployment rates for women approach those of men, specifically during economic downturns (UNIFEM 2000: 71). But even if equality is realized it can be a result of a “race to the bottom”: “participation in the labor market does not automatically empower women, and [a] reduction in gender differentials in earning may be the result of harmonizing down rather than up” (Elson quoted in ILO 2001a: 6). Economic pressure owing partly to globalization might induce such a race.

The growing and highly heterogeneous informal sector, especially in developing countries, is another aspect of the GGDOL. Following the 1993 United Nations definition, the

informal sector is broadly characterized as consisting of units engaged in the production of goods or services with the primary objective of generating employment and income to the persons concerned. Production units in this sector operate at a low level of organization, with little or no division between capital and labor as factors of production, and on a small scale, and have the characteristic features of household enterprises, in which owners must raise the necessary funds at their own risk.

(United Nations 2000b: 126)

In 1999 the International Labour Organisation (ILO 2000a) developed a definition that refers to different categories within the workforce, including:

(a) owner-employers of micro enterprises, which employ a few paid workers, with or without apprentices; (b) own-account workers, who own and operate one-person business, who work alone or with the help of unpaid workers, generally family members and apprentices; and (c) dependent workers, paid or unpaid, including wage workers in micro enterprises, unpaid family workers, apprentices, contract labour, home-workers and paid domestic workers.

(ILO 2000a: 9)

Table 9.4, shows that on average more than one-third of all economically active women work in the informal sector (excluding agriculture). In some countries the percentage of the non-agricultural female labor force working in the informal sector is much higher, as in, for example, Kenya (83 percent) and Chad (97 percent). In Asian countries and in Latin America, the percentages are as high as in Africa, such as in India (91 percent), Indonesia (88 percent), and Bolivia (74 percent). Such data give an impression of the vulnerability of women in these societies. But it needs to be underlined that, although a high percentage of all working women are not part of the formal labor markets, women's and men's share of the informal sector is nearly balanced. For example, in the Philippines 46 percent of people working in the informal sector are women and 44 percent are men. In India 77 percent of all people who are active in the informal sector are men and only 23 percent are

Table 9.4 Proportion of labor force in the informal sector, by gender, 1991/1997*

	<i>Percentage of non-agricultural labor force that is in the informal sector, 1991/1997</i>		<i>Women's share of the informal sector in the non agricultural labor force, 1991/1997</i>
	<i>Women</i>	<i>Men</i>	
<i>Africa</i>			
Benin	97	83	62
Chad	97	59	53
Guinea	84	61	37
Kenya	83	59	60
Mali	96	91	59
South Africa	30	14	61
Tunisia	39	52	18
<i>Latin America</i>			
Bolivia	74	55	51
Brazil	67	55	47
Chile	44	31	46
Colombia	44	42	50
Costa Rica	48	46	40
El Salvador	69	47	58
Honduras	65	51	56
Mexico	55	44	44
Panama	41	35	44
Venezuela	47	47	38
<i>Asia</i>			
India	91	70	23
Indonesia	88	69	43
Philippines	64	66	46
Thailand	54	49	47

Source: Adapted from United Nations (2000b: 122).

Note

* Countries considered have data for one of the years in the survey years 1990 and 1997.

women. However, in India 91 percent of the total female labor force are working in the informal sector. That implies that only 9 percent work in agriculture or the formal labor markets.

The statistics mentioned can, however, only serve as a focusing device in describing the GGDOL. They highlight some elements of the GGDOL, showing that: women are increasingly entering the labor market in most countries; their unemployment rate and the percentage of part-time positions are (still) higher than those of men; equal pay is not yet realized; and labor markets are still segregated with women in low paid positions. Women work more hours than men since they are still primarily responsible for household and care-giving tasks. Further, a high percentage of all economically active women work in the informal sector. As will be clear in the next section, these seemingly detached facts are in fact related. The last main section will show that women's situations in various countries are interrelated. There is indeed a *global* gender division of labor; some of the causes and effects will be discussed below.

Institutionalist approaches to the gender division of labor

To understand the global gender division of labor, changes in the public and private, formal and informal institutional frameworks, and the resulting behavior of women and men need to be taken into account (Dolfsma and Hoppe 1998 and forthcoming). The gender division of labor is socially negotiated and influenced by culture, power relations, traditions, and norms. Although women and men are biologically different, most gender-related institutions are socially constructed and not biologically given. The fact that women give birth to children of course does not entail that they naturally need to take on care-giving responsibilities; such institutional arrangements develop over time and persist due to interrelations with other institutions in society.

Historically, the division of labor in paid and unpaid labor in Western cultures is explained in the context of industrialization and capitalist development in the eighteenth and nineteenth century (Hyman 1999: 394). Men mainly did paid work in industrial production whereas unpaid household and care-giving work was the private task of women. Although women of working-class families often had to earn extra money to increase family income, paid work did not change their individual social and financial dependency on men. Mirroring views in society, the writings of political economists in the eighteenth and nineteenth century mostly adopted this dichotomy of public and private work. Pujol writes: "As the divisions between the public and the private sphere, between the market and the home, between production and reproduction, are perfected, economic writings come to focus exclusively upon the first elements in these dichotomies" (Pujol 1992: 23). It was only in the 1960s that neoclassical and Marxist

economists started to look at domestic work and household relations in their theories (e.g. Agarwal 1997; Becker 1985, 1991; Gardiner 1999; Hartmann 1997; Hyman 1999; Ott 1995; Young 1981).

Although “globalization” is often presented as something that befalls society, in fact the shape it takes and the effects it has are contingent on the institutional setting that has emerged over time (see Dolfsma and Danneureuther 2002). The conception of ceremonial encapsulation, as originally developed by J. Fagg Foster and Clarence Ayres, provides a clarifying analysis of institutional change, analyzing the interplay of instrumental and ceremonial values. These opposing values shape institutions in society. Where ceremonial values are thought to constrain social progress and work to the benefit of only some groups of society, instrumental values lead to behavior that is beneficial to all, by dynamically solving problems and promoting technological change (Bush 1987; Reuter 1996; Waller 1982). Given an explanation of how values and institutions are related (see also Dolfsma 2002), this approach can explain why the GGDoL would persist. Even if in recent decades women have increasingly participated in the labor market worldwide, they mostly work part-time, are paid less, or are part of the informal sector as they are expected to do most of the unpaid work including care-giving tasks (Dolfsma and Hoppe 1998). The common belief that women are responsible for unpaid and care-giving work creates encapsulating ceremonial habits of thought and institutions that assign such “obligations” to women. The set of institutions that together form the gender contract cannot easily be changed as together they are “past binding” (Bush 1994).²

Western European welfare states, with an institutional setting oriented to the traditions and ideology of the past century, are past-binding. Originally created to protect women within the institutions of the family, they now increasingly conflict with the emancipated habits of thought of most women and some men. Public policy that helps redistribute unpaid and paid work between the sexes can generate a more equal division of labor, but do not always aim to do so and sometimes have the opposite effect on the gender division of labor. Institutions of social welfare, laws regulating the hours that shops are allowed to be open, and the like indirectly limit the extent to which women enter the formal labor market (for an elaboration, see Dolfsma and Hoppe 1998). Relations between women and men are shaped in a socio-cultural context and could be perceived in terms of a gender-contract – an idea based on social contract arguments that date back to such political philosophers as John Locke and Jean-Jacques Rousseau. In the traditional gender contract, women are mainly responsible for care-giving and domestic labor, and men for the economic and financial well-being of the family. The labor market tends to reinforce this gender division of labor. Once such a path of gender division of labor in society is taken, diversion from it is difficult, because institutions of inequality are interrelated with one another and with other institutions (OECD 1994; Dolfsma and Hoppe 1998).

An institutionalist approach to explain the GGDoL therefore requires an

integrated view of structures, power relations, and economic and social institutions in which labor markets and informal work are embedded. Institution-*alists* explain the impact of globalization on GGDoL as a highly complex and cross-cutting issue. More recently, the globalization process has fundamentally challenged the gender division of labor. Global financial crises, new information and communication technologies, free trade, and the power of transnational companies have worldwide consequences and necessarily concern the GGDoL. Therefore in the next section seven important areas are mentioned that are directly connected with the question of globalization and GGDoL: financial markets, trade liberalization, information and communication technologies, informal work, poverty, human trafficking, and core labor standards.

New global challenges for the gender division of labor

Elson and Cagatay (2000) and Elson (2002) show that a number of interlocking biases in policy of both national governments as well as supra-national organizations give rise to a situation unfavorable for women. Government policy to change the GGDoL must encompass more than just “economic” policy; in any case considerations of the effects on the gender contract need to be more central (Moser 2002). Changes in the GGDoL can also come about due to changes in the economy or society at large, such as that of globalization. The currently accelerating globalization process affects the GGDoL in multiple ways. Some important aspects are mentioned in the following sections.³

9.4.1 Global financial crises

The recent Asian financial crisis has had tremendous consequences on poverty, real wages, and employment. Recent studies (Lim 2000; Singh and Zammit 2000) show that women are more affected by economic and financial instabilities than men are. This can be explained largely by women’s role in providing care and by their socio-economic status. Young (2002) summarizes the major effects of the Asian financial crisis on women. First, more women than men lost their jobs in the labor market and were pushed into the informal economy. Second, structural adjustment programs aim mainly at cutting budget deficits. As a consequence, social services are reduced and previously public goods, such as health services, now involve fees. Third, wage reductions and rising food prices decrease the purchasing power of households. Fourth, women are faced with more difficulties in getting loans and credits.

As it turns out, the economic situation of women is more vulnerable than that of men. In particular, Elson (2002) points to three different biases: the male breadwinner, deflation, and privatization. Persistence of these biases lies

in both formal as well as informal institutions. An emphasis on measurable (monetary) value, notably in decisions on whether and how to privatize, is not favorable to women. Elson (2002) therefore argues for a gender-sensitive macroeconomic policy and especially for initiatives such as gender-sensitive budgeting. Gendered budget initiatives analyze public expenditure from a gender perspective and identify the implications and impacts for women and men, which is of high importance especially in crises (see also Cagatay 2001).

Trade liberalization

Cagatay (2001) points to various connections between trade liberalization and gender inequalities. In this context she relates gender inequality to employment, wages, and the care economy. Generally, export-orientation in developing countries has positive effects on the labor market situation of women mainly in the manufacturing sector and semi-industrialized economies. But these positive effects of increasing labor market participation of women are in danger of being negated due to substitution effects such as those described in the next section.

Trade liberalization in the agricultural sector in developing countries may cause disadvantages for women. Cagatay argues that

[t]rade reform tends to advantage large and medium producers, since small farmers, especially women, often lack access to credit, new technologies, marketing know-how and the like to take advantage of new markets. Moreover, even in cases where household income increases with increased production for export, the well-being of women and children may not improve. If the increase in family income is accompanied by a decrease in food crop production because women's labor is mobilized for cash crop production, the family nutritional intake might suffer while women's work burden increases.

(Cagatay 2001: 7)

Generally, gender inequalities in education, health, and access to production inputs constrain productivity and sustainable growth. Even if wage differentials of women and men may stimulate the export industry, in the long run wage differentials are not a solid base for women's progress. Such structural impacts of trade liberalization on gender relations motivates Williams (2002) to argue that it is important to integrate the gender perspective more fully in the different agreements of the WTO agenda.⁴

Innovations in ICTs

Information and communication technologies (ICT), driving forces behind the globalization process, affect the GGDOL as well. Contrary to what is generally assumed, they do not benefit women and men equally across the

world. Decreasing costs of ICT and technical innovations in wireless communications could allow for “leapfrogging” when developing countries get access to information and knowledge they did not have previously. Circumstances that allow for leapfrogging are not unlimited, however (Perez and Soete 1988). A recent survey by the International Telecommunication Union (ITU 2002) analyzes why ICTs are especially important to women entrepreneurs: they mainly profit from improved information sources, the opportunity to learn through shared experience, improved customer access and services, access to additional markets, improved supplier access and service, improved financing information options, and product distribution channels (ITU 2002). All these effects are positive for the labor market situation of women. But apart from high hopes for overnight gains, which may or may not materialize, new risks are emerging. Women especially have to take care that they do not end up on the losing side of the digital divide. The most important issues that need to be addressed for women are the general availability of ICT, the literacy level, the awareness of potential of ICT for women, ICT skills, telecommunication access costs, language abilities, and time availability (ITU 2002). Keeping in mind that two-thirds of all illiterates in the world are women, that two-thirds of girls of school age in developing countries do not have a basic school education, and that girls and women are underrepresented in computer and mathematics courses, the existence of a digital gender gap is a pertinent problem as ICT is adopted widely (United Nations 2000b: 95).

In addition, other short-term and long-term consequences of ICT for the gender division of labor arise. In Asia and Latin America, women were employed in IT manufacturing in the beginning of the IT revolution. Over time, however, increasing efforts to attain higher levels of productivity – induced by demands from those countries to which the products were shipped – led to rationalization, and women were pushed into the service industries. This has not left the GGDOL unaffected since:

women tend to be concentrated in end-user, lower skilled IT jobs related to word processing or data entry, comprising only small percentages of managerial, maintenance, and design personnel in networks, operating systems, or software development. Within the service sector, for example, the major employment for women is in information processing jobs, the high-tech equivalent of the secretarial positions that women traditionally held.

(Hafkin and Taggart 2001: 9)

ICT thus offers opportunities – in terms of “employment, education, and political empowerment, access to resources and information, and communication with a world outside the boundaries of home” (Hafkin and Taggart 2001: 13) – for qualified people, including women. Women in particular, however, run a higher risk of being excluded from enjoying the benefits

of these new technologies (UNIFEM 2000: 93), even in industrialized countries.

Informal work

Globalization and the GGD_oL are related through the informal sector as well. More women than men work in the informal sector because the gender contract prescribes a role in the household for women, caring for the elderly, the sick, and for children. The existence and recent growth of the informal sector is explained in a number of ways. Some understand the informal sector to be a result of inefficient public regulation. As soon as markets are deregulated the informal sector would fold into the formal economy. Others see the informal sector as a “reserve of cheap, flexible, unregulated labor which acts partially to subsidize (men’s) formal sector employment” (Katz 1999: 392).

So called “sweatshops” are to a certain extent part of this “reserve”. Textile, clothing, and footwear industries (TCF), often through commodity chains, shift labor-intensive production of goods to developing countries where labor costs – especially of women – are low. More recently, sweatshops exist not only in TCF but also in information and communication industries, called “sweatshops of the digital era” (ILO 2001b). Labor-intensive production in such “sweatshops” is often characterized by long working hours, low income, little or no labor law enforcement, and weak or nonexistent trade unions. A third position argues that transnational companies need high levels of productivity to be competitive in the world economy. Free export zones or subcontracting are results of globalized production processes and are interrelated with the informal sector (Altvater and Mahnkopf 2002).

As the informal sector consists of highly vulnerable individuals and fleeting institutional arrangements, the “social costs” of globalization are high. Especially in situations of crisis, women have to provide “non-market substitutes for marketed goods that their families can no longer afford to buy, and providing substitutes for public services that are no longer available” (Elson, quoted in ILO 2001a: 6). As a consequence, women are forced out of the formal sector and are even underprivileged in the informal sector since men have micro-enterprises while women are dependent on contributing family workers.

Poverty

Poverty reduction is a major requirement to ameliorate the GGD_oL and vice versa: increasing labor-market participation and creating better working conditions reduce poverty. To realize the commitment of the UN Millennium Declaration to cut the number of people living under the poverty line in half by 2015, various strategies to fight poverty need to be established at local, regional, and international levels.

Cagatay argues that “women are more vulnerable to chronic poverty because of gender inequalities in the distribution of income, access to productive inputs such as credit, command over property or control over earned income, as well as gender biases in labour markets” (Cagatay 2001: 6). Gender equality, in contrast, has a strong positive impact on sustainable growth and poverty reduction. One explanation is that more women than men invest their income in the health and education of their children. Another aspect is that a higher education rate of women decreases the incidence of HIV/AIDS. In addition and more generally, discrimination against women concerning loans and credits, property rights, and income jeopardizes basic needs such as food security and water supply, which in most countries are still the responsibility of women.

Although many goals have been reached, e.g. the implementation of the Heavily Indebted Poor Countries (HIPC) Initiative that allows many extremely poor countries to escape the debt trap, barriers to further progress are numerous. One is that institutions change slowly. This is a special problem when strategies against poverty are intended to be implemented in all important areas of economic and social policy. Another reason lies in the structures of the developing countries themselves which sometimes do not sufficiently mobilize their domestic resources. Finally, the fact that many developed countries do not provide Official Development Assistance (ODA) equal to 0.7 percent of their GNP is often a question of bargaining within the ministries. In Germany and other European countries, Ministries of Finance often focus on the Maastricht criteria of the European Union, whereas the Ministries for Economic Cooperation and Development argue in favor of an increasing rate of ODA. Already by 1970, under the umbrella of the United Nations, most developed countries committed themselves to the target of 0.7 percent of ODA. But in spite of ambitious plans, the levels of ODA have been steadily decreasing over the past several decades and in most countries never reached or even approached the target of 1970.

Human trafficking⁵

Following Truong (2000), human trafficking includes trafficking of migrants in search of work, trafficking of asylum seekers in search of a safe refuge, trafficking of women and children for the purpose of prostitution, and trafficking of human materials for medical purposes (see also Young 2002).⁶ Sassen (2000, 2002) argues that participation in trafficking is one alternative route to survival for women in a situation where a region is struck by an economic crisis with high unemployment and poverty, bankruptcies of many firms, and shrinking resources in the state to meet social needs. She argues that to secure household survival women engage in subsistence food production, informal work, emigration and prostitution. A recent study by UNICEF on trafficking in human beings in Southeastern Europe comes to a similar conclusion. UNICEF argues that “the reality of the post-conflict situation and economic

transition have weakened the position of women in the labour market, causing more women to be unemployed and the feminisation of poverty, which in turn has resulted in increased migration especially among younger women" (UNICEF 2002: 5). Another reason for the vulnerability of women concerns the discrimination against women in the labor market, their exclusion from decision-making processes, and the changing pattern of family life. In line with Sassen, UNICEF maintains that women increasingly have to take responsibility for the survival of the family.

Core labor standards

Social standards, especially core labor standards, may be one way to address the challenging task of protecting people, especially women and children, from bearing the "social costs" of globalization. Along the lines of the International Labor Organization's (ILO) "fundamental rights at work", the core labor standards comprise the freedom of association, the recognition of the right to collective bargaining, the elimination of forced or compulsory labor, the effective abolition of child work, and the elimination of discrimination. Unions, many NGOs, and churches in developing and developed countries suggest integrating the standards into the WTO framework, creating a global countervailing power of a social nature. Social standards could be embedded into a reformed international trade policy. Some governments and NGOs from the South argue that the ILO should be the institution responsible for monitoring labor standards. Others reject labor standards, arguing that such standards are or could become a new form of protectionism of the North. Many private companies already support codes of conduct induced by the OECD guidelines. It remains an open issue whether firms will adopt such codes voluntarily, partly forced by their own customers and partly for intrinsic reasons, or whether they should become obligatory. To alleviate some problems with the GGDOL, we argue that it is necessary to integrate the core labor standards into the WTO framework and for the ILO and the WTO to cooperate on enforcing these standards.

Another aspect in this context are the effects of Core Labor Standards on foreign direct investment (FDI) that is – in addition to ICT – a driving force of the globalization process. A recent study by Kucery (2002) shows that there is no solid evidence that foreign investors favor countries with lower labor standards. "Conventional wisdom" holds that the absence of labor standards – mainly no freedom of association and no collective bargaining rights – is associated with lower labor costs, which are then assumed to have a positive influence on FDI. Kucery's study shows the opposite. Countries that respect core labor standards attract FDI because they have higher political and social stability, which positively influences FDI location. In particular, there is no evidence that FDI favors countries with greater gender inequality. Therefore the discussion on the effects of labor standards on FDI cannot be reduced to "the labor cost-labor productivity nexus as a causal channel" (Kucery 2002).

Conclusions

We highlight in this article three ways in which globalization and gender interact (see also Ruppert 2002). Here, the term “global gender division of labor” signifies interactions of an economic nature between gender and globalization. The term refers to different effects on women’s and men’s lives and working conditions in the globalized world economy. Government policy could shape these interactions in favor of more gender equity. More gender-specific and gender-sensitive statistics are needed for policy formulation. The exclusion of household and family work and the informal sector from economic theory, for instance, must be acknowledged and amended. The GGDOL can be improved upon by reshaping globalization directly with a focused political agenda. Following are some policy implications of our necessarily brief analysis (cf. UNIFEM 2000).

First of all, women must be enabled to enter and to transform financial markets, for instance by extending micro-credits. Floro (2002) argues that micro credits give women the opportunity to create their own businesses, increase their productivity and earnings, and achieve greater empowerment. In many developing countries, especially in South Asia and Africa, micro credit projects have already been successfully established. Second, informal and formal institutions that bar women from the markets for labor, goods, and services need to be eradicated. This requires an integrated perspective on economic development, focusing on institutions that directly as well as indirectly affect women’s economic position. A third challenge concerns improved access for women to ICT. We showed above that access to and use of ICT for women are not automatically secured. ICT can either decrease or increase the digital divide, depending in part on government policy. In general, issues that affect women must play a greater role in setting economic policy-making agendas.

Globalization offers opportunities *and* risks for women. Formal as well as informal institutions affect the GGDOL, by affecting the implicit gender contract in society. Many economic and social policies that appear not to have any gender-specific impact do indeed concern the GGDOL: poverty reduction, sustainable development, and gender relations are closely connected; informal work and gender relations are closely connected; financial crises have different impacts on women and men; human trafficking is a special problem of women. It is now accepted in many international organizations that gender inequalities jeopardize sustainable development and social cohesion in the world. This idea is summarized in UNIFEM (2000: 154): “[R]eshaping globalization to promote the progress of women . . . will not just promote gender equality; it will also promote poverty reduction, human development, and the realization of human rights.” *Gender is an issue that cuts across policy domains and geographical borders; it is truly global.* Now more structures must be put in place and economic concepts used to help formulate policy on a global level to improve the situation of women in today’s globalizing economy.

Notes

- * The authors greatly appreciate comments from Phil O'Hara and Brigitte Young.
- 1 Gender-specific statistics on earnings differentials over time are frequently missing in many countries.
- 2 Bush (1994) also distinguishes future binding and "Lysenko" types of ceremonial encapsulation.
- 3 For more discussion, see special issues of *Feminist Economics* (vol. 6, no. 3) and *World Development* (vol. 28, no. 7); Deutscher Bundestag 2002 (<http://www.bundestag.de/gremien/welt/welt_gender_en/index.html> and <<http://e-education.uni-muenster.de/enquete/>>).
- 4 New international network forms of organization that are discussed in economic theory under the label of the global commodity chain perspective (GCC) are important to mention in this context. Referring to Gary Gereffi and Korzeniewicz (1994) the ILO summarizes that the global commodity chains "are broadly defined as sets of interorganizational networks clustered around one commodity or products, linking firms, households and communities to one another in the world-economy" (ILO 1998). Further research would allow combining the GCC perspective with gender to analyse the conditions under which women suffer or profit from the GCC. Until now, gender-related issues are not sufficiently discussed in the economic discourse in general and not within the GCC-perspective in particular (see also ILO 2000b).
- 5 Human trafficking means the forced recruitment and/or transportation of people within and across states for work or services.
- 6 Following the UN Protocol to Prevent, Suppress and Punish Trafficking in Persons, especially women, the definition of human trafficking is the following: Trafficking in persons means

the recruitment, transportation, transfer, harbouring or receipt in persons, by the threat or use of force, by abduction, fraud, [...] coercion or the abuse of power or by the giving or receiving of payments or benefits to achieve the consent of a person having control over another person, for the purpose of exploitation [...]; exploitation shall include, at minimum, [...] sexual exploitation, forced labour or services, slavery or practices similar to slavery, [the removal of organs for illicit purposes] [or servitude].

(<www.uncjin.org/documents/conventions>)

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10 Conspicuous consumption, fashion and style in the global marketplace

Doug Brown

Introduction

The marketplace of consumption is no longer predominantly an advanced industrial phenomenon as was the case a century ago. It is truly global, but it is also very unequally proportioned. To take a global perspective, as we must, suggests that there are two issues concerning consumption and consumerism: (1) the haves of the world are overconsuming, that is, consuming too much, while (2) the have-nots of our world are consuming too little. The overconsumption of the world's haves is threatening the earth's habitability by overusing its resources, polluting its biosphere, and ultimately undermining the earth's carrying capacity and sustainability. Their destructive patterns of consumerism and insatiable appetites for more of everything desirable are exhausting the earth. This type of overconsumption, or what has been labeled "affluenza" is a product in part of the worsening inequalities in wealth and income (de Graaf *et al.* 2001). The rich of the world consume too much, and although this might not have been an environmental problem in the previous century, it is today. The earth cannot sustain such insatiability.

On the other hand, for the poor of the world, although they are not subject to the pathological affluenza of the rich, they suffer both deprivation and the increasing degradation of their local environments. Their lack of consumption essentially requires them to overuse what resources and environmental integrity they do have. The result is environmental crisis caused by poverty. Deforestation in Africa and Latin America is a clear and observable example of this. Because the poor are denied access to more energy efficient and environmentally benign energy sources, they must cut down what trees are left in their localities in order to supply their cooking and heating needs. The result is the aggravation of an already serious problem of deforestation that has led not only to the loss of half of the world's forests since the Agricultural Revolution 10,000 years ago, but also to the intensification of global warming and climate change.

In effect, our global political and economic system of capitalism, although integrated, is one in which the severity of inequality is causing a crisis of social and environmental sustainability driven by overconsumption in the

northern hemisphere and underconsumption in the southern hemisphere. In fact, the richest 20 percent of the world's consumers account for 86 percent of all private consumption, while the poorest 20 percent consume only 1.3 percent of the world's goods and services (Rifkin 2000: 231). These very disparate consumption patterns are two sides of the same coin and both are threatening the earth's sustainability. The haves are creating a growth-driven crisis of sustainability alongside the have-nots' poverty-driven crisis. This is the most important conclusion one can draw from a cursory examination of consumption in the new global capitalism.

Additionally, there is another factor that compounds the haves-vs-have-nots consumption dichotomy: our global political economy today is a post-modern economy. Of course, the volumes that have been written about postmodernism are many. Briefly, in our New Economy of globalized production, computerization of life, and accelerated worldwide capital and labor mobility, life moves faster than many can effectively manage. Knowledge is dated overnight, decisions are instantaneous, communities come and go right along with their members. Nothing is for certain; everything is in a state of flux as the "compete or die" logic of global capitalism works both magic and devastation. What is the effect on human beings? They suffer an enormous identity crisis, what Fredric Jameson a decade ago called "psychic fragmentation" (Jameson 1991: 90). Who are we, what are we about, how should we be, how should we behave, what should we be like? With old foundations rapidly being undermined, people, both rich and poor, are asking themselves such fundamental questions as these.

And if they aren't asking themselves these questions, they frequently "go with the flow" of all that they see around them, join the crowd, find an "in" group to hang out with, or assimilate the dominant culture's point of view: "the good life is the goods life." Consumerism, first explained and theoretically developed by Thorstein Veblen at the turn of the last century, tells all people, whether they are searching for an identity or not, that happiness can be bought in the market (Veblen 1899). The mass identity crisis that is occurring today is largely an unintended consequence of the globalization of capitalism. This makes people search even harder for a sense of belonging, a sense of purpose, and a concrete feeling of who they are.

Yet in this new world of multiple subcultures, heterogeneity, diversity and the pastiche of life, fashion, style, conspicuous consumption, and emulation have found fertile ground. People are eager to embrace the latest fashion and the newest, trendy ideas, subcultures, habits of the "rich and famous," and all that's hip. They are hungry to be like those they see in the media, to emulate the celebrities, to hang out with the latest hipsters. The postmodern world is about "style." Style is the character of one's life that others envy. There is no single style in the postmodern world today. Style is being created with a vengeance by the commercialized purveyors of consumerism: the media giants and multinational corporations who profit directly from this mass identity crisis.

The Nike shoe corporation is only one of many for whom “it’s all about marketing.” What is being marketed is not only “style” but also a whole spectrum of styles that all ages, genders, ethnicities, and classes can pick and choose from. There is offered in the global market today every imaginable form of “lifestyle” that all those who long for a sense of purpose and belonging can “access” through the Internet, their schools, or their subculture. What is being marketed today is one’s “identity” itself.

What the global market has taken away by uprooting all traditional cultures, undermining customary forms of community, and subverting indigenously grounded identities, it is offering back in a commercialized form through conspicuous consumption, style, fashion, and emulation. As Veblen said a century ago, we are victims of an economy driven by the unthinking logic of “I’m better than you.” So although this may sound like pathology restricted to the world’s haves, it is not. And even though “Africa has only 37 televisions and 172 radios per 1000 people, a stark contrast to North America, where there are 798 television sets and 2017 radios per every 1000 people,” the Africans for the most part aspire not only to the elimination of their poverty, but to the realization of the North’s “goods life” (Rifkin 2000: 230). They tend to look north with the gaze of envy and the desire to emulate rather than with scorn, condemnation, and ridicule.

The whole world and its 6 billion members seem fixated on the logic of “more is better.” Surely, although this may not have been true for the former Taliban government of Afghanistan, who despised the affluenza of the West, the population under its rule thought otherwise. The Taliban is the exception that proves the rule. There are enclaves of indigenous people throughout the world, who like those in the Ladakh region of northern India, know who they are and want desperately to remain as they are. But even in their case, they cannot effectively block the onslaught of consumerist globalization. Environmentalists have well-documented evidence that the world cannot support a future in which the poorest 80 percent of its people, who now only consume 20 percent of its resources, live a high mass consumption lifestyle equivalent to today’s richest 20 percent. In other words, 6 billion people living like a typical American is absolutely impossible, even if desirable. It’s not sustainable. But, for instance, this is exactly what the 1.2 billion Chinese have in mind. There are not enough carrying capacity, resources, and recuperative power in the earth’s biosphere to handle this kind of consumerism.

As Gandhi asked, if it took Britain the entire globe to make its living standard possible, how many globes would it take for India to do likewise? The situation has only gotten worse in the last half-century since Gandhi asked this. The “ecological footprint” of the average “have” is 30 acres, while that of the average global citizen is 7 acres (Hawken, Lovins and Lovins 1999: 51; Wackernagel and Rees 1995; de Graaf *et al.* 2001: 91). Yet the world’s supply of available footprints, that is, the amount of ecological capacity available to sustain life, is a meager 5 acres per person. Unfortunately, it has been estimated by Mathis Wackernagel at Redefining Progress that “if all people lived

like the average American, with thirty-acre footprints, we'd need five more planets" (de Graaf *et al.* 2001: 91). We are overusing our capacity to sustain life to such an extent that only a miraculous technological fix can save us, unless we change our consumption behavior, get simple, and redistribute the available resources to the have-nots. But the New Economy, that is, global capitalism, is driven by insatiability and is churning inexorably in the opposite direction to sustainability.

Overconsumption by the haves

By far the paramount overconsumer with the most voracious and insatiable appetite is the United States. With 5 percent of the world's population it manages to consume 25 percent of its resources and creates an equal percentage of the world's pollution, including global warming, carbon emissions. Remarkably, its "annual production of solid waste would fill a convoy of garbage trucks stretching halfway to the moon. Americans have used up more resources than everyone who ever lived on earth before them" (de Graaf *et al.* 2001: 4). In fact,

Americans spend more for trash bags than ninety of the world's 210 countries spend for everything! In an average lifetime, each American consumes a reservoir of water (forty-three million gallons, including personal, industrial, and agricultural uses) and a small tanker full of oil (2,500 barrels).

(de Graaf *et al.* 2001: 85)

The amount spent in the US on consumer goods, \$6 trillion, accounts for two-thirds of its economy's growth over the last business cycle, and every year more is spent on shoes, jewelry, and watches (\$85 billion) than on higher education (\$65 billion) (de Graaf *et al.* 2001: 13).

The spending binge by the average American consumer continues despite the setback of the 2001 recession that ended the 1990s growth streak. As incomes rise so does consumption, and at a rising rate no less. "It seems that the propensity to consume has risen, instead of fallen, with rising incomes. No moderation of these trends is currently in sight" (Redmond 2001: 575). Between 1958 and 1999 in the US, personal disposable income rose 131 percent while personal consumption rose by 140 percent in per capita real terms. Also, consumer credit per household was \$13,170 in 1999: an increase of 149 percent from its 1958 levels (p. 575).

Unlike a decade ago, today in the US there are as many shopping malls as there are high schools (de Graaf *et al.* 2001: 13). The US is now in the "Age of Affluenza," that social disease of overconsumption, encompassing a spectrum of obsessive-compulsive behaviors associated with style, fashion, conspicuous consumption, "shop 'til you drop," buying-as-therapy, and the idealization of the goods life as the good life (pp. 15–17).

Additionally, affluenza is not restricted to adults. US corporations, whose goal is to capture as much potential market share as possible, have now targeted the children of the overconsumer economy. They have increased their advertising aimed at kids from \$100 million in 1980 to \$1.5 billion by 1997. "For the first time in human history, children are getting most of their information from entities whose goal is to sell them something, rather than from family, school, or religion" (de Graaf *et al.* 2001: 52). But we have merely *described* consumption in such have nations as the US. But *why* is there so much; why is there "over" consumption and a pathological virus of affluenza?

The roots of overconsumption and the causes of affluenza

First, it should be understood that consumption is a relatively new term in the lexicon of political economy. Before the emergence of the market economy in the sixteenth century, there was no articulated or rhetorical distinction between consumption and production. The economies that preceded capitalism were, as Karl Polanyi put it, embedded economies (Polanyi 1944). This means that there was no separate sphere of production, on the one hand, and consumption on the other. Feudal, slave, and tribal economies subordinated the individual pursuit of economic gain and self-interest to broader social, religious, and political needs. In other words, economic activity was embedded in, or subordinated to, social norms, customs, and traditions. Markets, to the extent that they existed, were highly controlled and regulated, as were prices, trade, money, and other mechanisms we frequently associate with capitalism. There weren't "consumers" and "producers." These earlier economies were largely self-sufficient, agricultural systems in which people were not distinguished by separable economic roles and functions. So consumption, as a particular mode of "buying" one's necessities and luxuries, simply did not exist. With capitalism we get consumption, and more importantly, *consumerism*.

Consumerism is a fundamental ideological pillar of capitalism. It is a culture in itself. We talk about the consumer culture, the goods life, the idea of "happiness-through-buying." It is what essentially justifies and reproduces capitalism in the hearts and minds of its workers and businesses. Consumerism is the term that we use to explain why so many people fall in love with the capitalist system. Capitalism and today's global political economy tend, or at least try, to make everyone into a happy consumer. The notion of "more is better" is a basic tenet of consumerism. What drives this system in many respects is the ready acceptance that the good life is the goods life.

Why businesses, and defenders of capitalism since Adam Smith in the eighteenth century, say "capitalism is the best of all possible worlds" is because it has the ability to produce goods and services at a level unheard of in all of human history. It is a wealth-producing juggernaut – an unstoppable

machine for the production of everything anybody with money wants to consume. The presumed purpose of capitalism, of separating production from consumption, and allowing for individual pursuit of profit and economic self-interest is precisely to meet material needs on an unlimited scale. Its purpose, as all its proponents have argued for 300 years, is to supply as many commodities as can possibly be consumed. Capitalism is all about consumerism, endless consumption, unlimited wants, the satisfaction of all needs through buying, and the commodification of life itself.

Clearly, it is in the interests of profit maximization and business success to have as much consumption as humanly and environmentally possible. The more we consume, the more revenue, income, and profit the firms make. As Karl Marx said, there would be no production without consumption (Marx 1857–1858: 89–92). To realize its income and profit the firm must sell its output, and obviously the more it sells, the more buyers it brings into its orbit, and the more new products it creates, the richer the owners become. There is no inherent limit on any of this, of course. There are constraints. Yet as long as people see the good life as the goods life and pursue happiness through buying things in markets, then firms will continue to try to meet these desires. They stand to gain by having as much consumption as possible. And as long as folks love having more and more goods, they'll love capitalism.

But why do people, most of whom have to work and sell their labor power, continue to see consumption as the ultimate means to satisfaction and happiness? This is more complicated. The first thing to understand is that capitalism is unique in the 3 million year history of humanity. Before the sixteenth century, virtually all forms of society, whether they consisted of hunter and gatherers, serfs, slaves, masters, or lords, had one feature in common: they were based on security. They were economies that were not driven by the quest for individual freedom, the endless search for profits, the insatiable desire to have all you can have, or be all you can be. None of them were “driven,” as understood by our modern notion of dynamic, get-ahead, energized economies. They were not driven by the insatiable desire for self or social improvement. They did not consider freedom and its realization or materialization to be the greatest value. The principle that informed their worlds was not freedom but security. What gave meaning to people's lives before capitalism was the need to take care of each other, not the need to pursue endless development of human potential. There was little personal freedom, but whether in authoritarian, patriarchal, or totalitarian form, the need and actualization of security grounded them (Brown 2002).

With capitalism all of that changed. Capitalism and especially today's New Economy of globalized production is about freedom. People who have it generally say they like capitalism, because it fosters and expresses a tremendous amount of it. If they don't have it, then they want it and fight for it. The culture of all economies before capitalism was that of security, while that of capitalism is the culture of insatiable freedom. And it is insatiable, as it represents the capacity in humans to be more tomorrow than they are today.

But what is important is that security in capitalism is not assured but has to be earned. An individual in our political economy today has the freedom, though not equally so, to earn his or her security by getting out into the market system, obtaining marketable skills, education, property, or entrepreneurship, and through achievements of work and business, to “get ahead” and be secure. We use our freedom, so to speak, to obtain and achieve our security. But we have to do this by participating in the market for both labor and saleable products. Clearly, this freedom to get ahead is very unequally distributed. Those with inherited wealth, with sufficient funds for a decent formal education, with earning power and family support have more freedom to actualize their potential than the poor, the disenfranchised, those of color, female, or third world.

But this is a world in which “you’re on your own, pal.” Unlike all previous societies, no one owes anybody else anything. There are no obligations to take care of each other. Even in feudal and slave societies, there were obligations for the richer to take care of, or at least look after, the poor (Hunt 1990; Polanyi 1944). These were societies of obligations for caring for each other but with little freedom, especially the freedom to “get ahead.” But capitalism is just the opposite. It is based upon insecurity. Despite the fact that the social democratic nations of Europe are mixed economies with a stronger welfare state than the US., they are ultimately a testament to the power of European working people to effectively protest this insecurity. But they haven’t removed it, and with globalization these safety net programs are under direct attack. We all suffer a fundamental insecurity, and this is what drives us into the market nexus and forces us to search for solutions to it. It is a competitive struggle, as well. The point is that capitalism is effectively powered by each and every individual’s desire to obtain security, but we all start from the initial situation of being insecure. We start with the condition of insecurity in capitalism (Brown 2002).

For example, to avoid economic hardship, those without property, have, as Marx said, only their labor power to sell. They must find a buyer if they are to achieve any security at all. But there is no guarantee that they will find a buyer. No one in the labor market is assured of this. Workers have to compete with each other in the hope of finding a business that will simultaneously find it profitable to hire them. There are no institutional requirements for this to happen. The government is not obligated to hire them, nor are the private, profit-motivated firms. It may happen, it may not, or they might be hired one day, and laid off or downsized the next. Everyone lives in a chronic state of insecurity unless they have enough wealth and property to opt out of the economic struggle of compete-or-die. Even firms face the same insecurity today. Their captains are not secure either. Corporate managers are being downsized continuously as mergers have become manic. Since no one controls the market system, since it is not a system regulated by anything other than the blind forces of impersonal competition, firms are just as insecure as workers. All have to compete. All face the insecurity of the

market system. All hope to do their best to win, and if they do, then they obtain security. There are no social obligations; you're on your own, pal!

But what does this have to do with overconsumption and affluenza? In order to obtain security, whether you are a corporate CEO or a shopfloor worker, what you have to do is "perform." First, to obtain security, one has to earn it. And this is done by getting out into the market, getting the best skills possible, getting educated, using one's money wisely, setting up a business, or finding a job. It means that we earn our security initially in the sphere of production by being ambitious, goal-driven, self-directed, and productive. Our chances of success are optimized by our assimilation of productivist values, that is, ambition, dedication, tenacity, self-motivation, and focus. We have to strive to be all we can be! And additionally, we then have to focus this energy in a "productive" economic activity. It means channeling one's ambition and desire to achieve in the sphere of production. Get educated, find the best job, save money to start a business, get some direction, and go for it. These are not new ideas to any of us. What does our culture say to those who clamor for security? Get serious, get going, hustle, and be all you can be. And focus it in either the labor market or in starting your business. Even if one is poor, the same litany is pronounced: get hustling; you can do it, just try harder.

And the key reward for this performance-driven productivism? You can make enough money, maybe even a lot of money, so that you can have all you can have. The ultimate reward for all one's goal-based productivism is the satisfaction of not only meeting basic needs for economic security, but the gratification derived from consumption, that is, happiness through buying stuff. The payoff and compensation for productivism is consumerism (Brown 2002: 82). These two spheres are mutually reinforcing. The ideology of the production sphere we call productivism, while that of the consumption sphere is consumerism. In short productivism is driven by capitalism's fundamental condition of insecurity and says to each person "be all you can be," that is, get motivated, get ambition, strive to achieve, actualize your potential, develop yourself, and channel it in the economy. On the other hand, consumerism says, "have all you can have," as this is your reward for being all you can be. For being all you can be, you can have all you can have. The only limit is your effort and performance, which ultimately limits your income. You can be a winner, this suggests,

What's the implication? *Both productivism and consumerism are insatiable.* There is always more one can accomplish or achieve in life and in the market, while simultaneously, there is always more one can have, that is buy in the market. This gives the global market system its character of "drivenness;" it is driven by the insatiability of desire for more of everything deemed good in life. The insatiable desire to be all one can be creates financial success and more income, which can then be spent on the insatiable desire to have all one can have. And moreover, it is the ability to have all one can have that also, along with insecurity, gives one the incentive to be productive and to

perform to the limit. Consumerism reinforces productivism and vice versa (Brown 2002). Clearly, the system operates with this self-reproducing quality and knows no limits other than physical resources, which humans always try to overcome by inventing new technologies. This is merely what the textbook definition of economics states: economics is the study of allocating finite resources (capital, materials, and labor) to infinite wants. What we conclude is that the propensity to overconsume and contract the pathological condition of affluenza is, in fact, built into the character of capitalism itself.

Why wouldn't people decide that enough is enough? Why wouldn't they decide to limit their wants and be content with a certain level of consumption and a certain amount of work? Couldn't they be satiable? Of course they could. But there are some logical biases at work. For one, businesses are in a competitive struggle with each other. In order to succeed at being all they can be, they have to endlessly pursue every angle that leads to more – more markets, more consumers, more profits, more production. They obviously have an observable imperative to produce as much as they can, and get people to buy as much as they can. They want to make all people into malleable, hungry consumers, with voracious and insatiable appetites for more consumer goods. Why else would American businesses spend almost a trillion dollars a year on advertising and marketing – an amount equal to the entire federal government budget and exceeding the entire world GDP a century ago (de Graaf *et al.* 2001: 154)?

More importantly, in today's globalized capitalism, corporations not only want to make everyone in the world into voracious consumers, as they continuously expand the orbit of their market reach, but they want to "brand" each consumer and keep their loyalty for life. As Jeremy Rifkin's book, *The Age of Access* (2000) argues, firms are no longer content to sell as many products to as many consumers as possible, they want to capture the consumer herself. That is, they seek the unfailing embrace and product loyalty of each one of us for the lifetime of our consumer experience. They want us from birth to death, our commitment to them, our devotion to their product line, and our life experience. The point for the corporation today is not to capture the market but the totality of the consumer's life. They want to own *us*, and this is called "lifetime value," or LTV, for short (Rifkin 2000: 98).

But even with the vested interests of business to sell as much as possible for as long as possible to as many as possible, couldn't consumers resist the excesses of overconsumption? Not exactly. In the US shortly after World War I, American firms began to realize that workers were still undecided about whether or not to pursue meaning in their lives through work or through consumption. The working class's experience in the nineteenth century and during the time that Marx wrote suggested that labor, that is, workers, were "alienated" from their jobs. Marx insisted that if workers could eventually control the workplace, direct the labor process in their interests instead of those of business owners, and have a measure of demo-

cratic participation on the job, they might find a kind of meaning and fulfillment that would obviate happiness-through-buying (Marx 1844).

In other words, it was understood that meaningful work might substitute for the goods life of consumerism. But for workers to choose such an option was a threat to business. Of course, Henry Ford knew this when he instituted the \$5-day. By the 1920s American firms realized that if they could get their workers to accept more income and the consumer goods it would buy in exchange for alienated and meaningless jobs, then the system would not bury itself as Marx predicted. There was a concerted effort on the part of business to foster this trade of the goods life and higher pay for submission to an alienated workplace controlled by managers and owners (Schor 1992, 1998; Ewen 1976; Ewen and Ewen 1992; Wachtel 1989). To the extent that workers, the world over in the last century, have been willing to surrender the desire for more meaningful work in exchange for better pay and the goods life, they have not sought to work fewer hours but have put their energy into buying happiness, satisfaction, and meaning through consumerism. The ideology of consumerism is more entrenched than ever. Working people have for the most part succumbed to the idea that it's easier to buy happiness in the market than it is to create it on the job.

Finally, there is another factor driving overconsumption: people increasingly buy things in order to obtain self and social esteem. This is where "conspicuous" consumption, style, and fashion enter our analysis. The first scholar to consider this was the American economist, Thorstein Veblen, whose book, *The Theory of the Leisure Class*, published in 1899, is a classic statement of how a capitalist economy is as much about producing goods to meet psychological needs as it is about producing goods to meet material needs (Veblen 1899). Veblen argues that the capitalist economy becomes a vehicle for more than supplying our needs for food, clothing, and shelter. It would be much simpler if that were all it did. Unfortunately, since people in capitalism start out with a basic condition of insecurity and are faced with having to earn it in the market, then as they receive their income they can spend it, or try to earn more of it, in order to enhance their feelings of self-worth and social reputability.

As Veblen observed a century ago, our insecurity forces us into a social game of "I'm better than you," or at least "I'm as good as you." Our feelings of self-worth are always up for grabs, and we measure our own success in life against those we feel are the most successful: the leisure class, that is, the corporate class. By looking at the "lifestyles of the rich and famous," we get a sense of what success is. It usually means "financial," or what Veblen called "pecuniary" success. We want to emulate them, live like them, and demonstrate our economic prowess. So what happens? We have conspicuous consumption by which we try to show off our wealth and emulate the status of those around us or even above us in the economic and social hierarchy. This means that many of the goods we buy are not simply to meet our material needs, but to demonstrate to others that we are either as good as them or

better, particularly in relation to “lifestyle” and “taste,” if not “fashion” and “being hip,” as such.

Veblen pointed out how such a system, driven by psychic needs, creates a population of insecure folks all chasing each other on a treadmill of “status emulation,” “invidious distinction,” and “pecuniary prowess.” We consume conspicuously in order to achieve the feelings of self-esteem we ultimately derive from how our peers view us. We want them to think we are good, competent, enviable, worthy, and reputable. We buy things that will promote this image of ourselves. So consumption, because of this character, is easily manipulated, or at least fundamentally conditioned, by business. They promote style and fashion, and we submit to it, because we want to be seen as successful and esteemed. What Veblen was getting at is the idea that we hear all too often of “keeping up with the Joneses.” And it’s insatiable. You can never have too much self or social esteem (Brown 2002: 123–126). Veblen said that “invidious comparison” is essentially insatiable since it is part of an endless social “struggle for pecuniary reputability.” Thus, “no approach to a definitive attainment is possible” (Veblen 1899: 32). Naturally, the insatiable dimension of conspicuous consumption can culminate in overconsumption and affluenza.

What about fashion and style today? Businesses want to keep consumers on the move; they want to be assured that we are always ready to change style, try the newest and the latest in products, and keep us constantly alerted to whatever is trendy – to whatever might influence our status needs. In the US,

in recent years more than ever, homes have become a symbol of conspicuous consumption, as beneficiaries of the recent stock market boom and unparalleled economic expansion have begun, in many communities, to buy real estate, bulldoze existing (and perfectly functional) homes and replace them with megahouses of 10,000 square feet and more.

(de Graaf *et al.* 2001: 25)

These are frequently called trophy homes, starter castles, and monster homes. After World War II the very rich were less conspicuous with their wealth than at the turn of the century. Yet in the US after Ronald Reagan’s election in 1980, they resurfaced with egregious candor. American television audiences witnessed the elite’s purchases of \$15,000 purses, \$10,000 Rolex watches, and \$65 million private jets. Conspicuous consumption was even larger than life, considering that 20 million households watched this on \$2000 big-screen TVs (de Graff *et al.* 2001: 30).

And as the rich buy more to impress themselves, the working class tries its best to emulate this. Overconsumption and the perpetuation of consumerism is the result. And for those who get hooked on the treadmill of productivism in order to accomplish this feat, there’s stress and possession overload (de Graaf *et al.* 2001: 39). Achieving the goods life doesn’t come easy today. Just

keeping up with the style and fashion changes can absorb one's weekends – that is, if work isn't absorbing them already. So “the thrill of shopping is only one aspect of the addiction to stuff. Many Americans are also hooked on building personal fortresses out of their purchases. Whether it's a new set of golf clubs or a walk-in closet full of sweaters and shoes, having the right stuff and sending the right signal somehow reassures addictive buyers” (p. 105).

The insatiability of it all and the have-nots of the world

What we've said about the haves of the world and their pathological consumerism is also infectious. But unequally so. The world's 358 billionaires are now richer than the poorest half of humanity combined (Rifkin 2000: 230). And Bill Gates has accumulated more wealth than the poorest half of America (p. 230). Eighty-nine nations are actually worse off today than 10 years ago, while Africans consume 20 percent less today than 25 years ago (p. 231). Even though worldwide inequality is worsening, the spread of consumerism is still infectious.

A recent study commissioned by the World Bank (Chen and Ravallion 2001) suggests that world poverty is decreasing as a result of the free trade policies of globalization. Yet much of this conclusion is biased by one fact: China. China's growth rates have been about the highest in the world over the last 15 years, and it is clearly climbing its way out of poverty (Hertsgaard 1998; Weller *et al.* 2001). But it also has a population of 1.2 billion – 20 percent of the world. The poverty-rate average for developing nations is clearly biased upward when China's growth rates are included. The problem with this is that the Chinese aspire to the same lifestyle – thus ecological footprint – that the haves now consider their own particular right. The world can't sustain an eventuality in which per capita car ownership in China is equivalent to that of the typical American.

This implies something about the future. Those who don't have, wish they did. Those that do, want more. It's insatiable. The poorest of the world need more consumption. But they apparently have the same attitude about the goods life that the haves manifest. There are many more have-nots in the world than haves. And it's getting worse. “In 1980, median income in the richest 10 percent of countries was 77 times greater than in the poorest 10 percent; by 1999 that gap had grown to 122 times” (Weller *et al.* 2001: 1). Also in 1980 the poorest 10 percent or about 400 million people lived on 72 cents a day. By 1999 their improvement was miniscule: they lived on 78 cents a day (p. 1). These folks are the poorest of the poor, as well. They suffer an economic and social hardship that is clearly unconscionable amid the affluenza of the wealthy. The global powers and their minions suggest, as always, the economic growth solution. Yet the earth can't sustain it. Economic growth has yet to solve any of the world's pressing problems related to inequality and poverty. There's no reason to believe at this point that the New Economy of globalized capitalism will change that.

The solution to the problems raised by consumerism involves a rethinking of the notion of insatiability. Wants may in fact be insatiable, but they can be intentionally and deliberately limited by new social policies. Redistribution from the haves to the have-nots is essential. The haves need to get off the production treadmill and live more simple and satiable lives. For doing so, they might actually welcome the reduced stress that would result. The have-nots need to enjoy the benefits of redistribution, not so that they can pursue the insatiable desire to have all they can have, but so they can also live more sustainable, satiable, and dignified lives of self-reliance, fair trade, and democratic participation in global affairs. Obviously, we need to fashion a less consumerist lifestyle that allows us to live fulfilling lives that are environmentally friendly. One way to think of this transition, if it is to happen, is to view it as a shift *from* investment in goods and services *to* investment in socially sustainable and personally meaningful life activities. In other words, we can redirect our priorities away from consumer goods and toward environmentally-benign but more spiritually-rewarding pursuits – what we might call social and cultural investment.

However, security is the key imperative. What needs to happen is that security must replace the modern world's obsession with insatiable freedom. The point is not to eliminate personal freedom, but to temper it with a global political economy that assures security to all its members, even if it reduces our freedom to have all we can have or be all we can be. Security is satiable! Freedom is not. The requirements of a sustainable world are security, justice, simplicity, and equality. If a worldwide *movement of progressive movements* was to emerge from the anti-globalization and environmental movements, these four values might provide a mobilizing nucleus to guide a transition to a new culture of security and satiability.

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Part III

Critical global and regional problems

11 Financial crises, crashes, and speculative bubbles

The regulation imperative in a critique of recent episodes*

Brenda Spotton Visano

Introduction

This chapter critically examines the origins, symptoms, and consequences of the last decade of financial crises, paying particular attention to the crises in Mexico (1994), Asia (1997–1998), Russia (1998) and Brazil (1998). The relationship of these crises to contemporaneous financial developments in the United States and Japan are mentioned as well, where a trail of hot money can be found leaving Japan, first moving into Asia and other emerging economies then through offshore banking centers into the United States. It argues for the necessity of effective financial regulation in attaining the potential allocative efficiency benefits of capital markets and concludes that a recent perceptible shift in IMF policy is promising. Adopting a schema best viewed as one that augments Hyman Minsky's Financial Instability Hypothesis, this chapter highlights the role of endogenous credit, prudential safeguards, linkages and contagion through credit markets, as well as the tendency for destabilizing speculation in deregulated financial systems. The IMF response to the Asian crisis represents a marked change in policy as it recognizes explicitly the importance of public goods such as financial and social stability.

Liberalization of financial markets in the 1980s and 1990s encouraged a significant increase in cross-border investment activity. Emerging economies became significantly more dependent on international capital flows and beneficiaries of an unprecedented popularity that both fed a belief in profitability and ensured it. Then, in one case after another, a whisper of debt default, of currency devaluation, or of unsustainable market gains – often in the face of weak economic fundamentals – undermined that confidence, caused a sudden reversal of investor opinion, and a speedy withdrawal of funds. The result, as we have witnessed, has been financial and economic collapse – with fragile economies experiencing the disastrous effects of the capricious whims of short-term lending or “hot money.” Where once there dominated a faith in the benefits of capital markets unfettered by regulation, the experience of the last decade has led some to rediscover the benefits of effective government oversight.

Too easily forgotten in periods of prosperity is the fundamental importance of effective government regulation. As prosperity continues and

memory recedes one tends to lose an appreciation for the many intangible and invisible benefits yielded by regulation. When combined and compounded by structural changes that render existing regulation outdated and cumbersome, the tendency has been to advocate for deregulation as a cost-reducing, efficiency-enhancing policy option. Not until a crisis forces a recall of the initial reasons for the presence of collectively orchestrated influence, might we hope the pendulum of public opinion reverses course with the role of government again explicitly valued in current memory.

Recent studies of contemporary financial crises underscore the importance of regulation in defining the “market” and in creating the conditions necessary to yield the social and economic benefits attributed to it. At a minimum, policies designed to ensure market integrity include standardizing accounting practices and imposing disclosure requirements to ensure quality information accessible to all. Externalities created by the contagion elements of crises require further regulation, in the form of a lender of last resort, for example, to ensure capital market, economic, and social stability. This suggests that the potential efficiency benefits of capital markets *are an outcome of* – not contrary to – *effective financial regulation*.

Efficiency benefits in this context appear in the form of allocating capital to its most productive uses. To ensure such efficiency, we desire an allocation to those uses that are accessible, inclusive of many sources and uses of funds, inclusive of many interests, and sustainable. Such an allocation is attainable only when the playing field is level, market power is absent, information is both reliable and widely accessible, and considerations of the longer-term collective future are accounted for in current decisions. In the absence of financial regulation, market imperfections such as collective externalities, market idiosyncrasies such as asymmetric information, and the successful attempts to amass financial power by self-interested agents with short investment horizons will yield a sub-optimal allocation of capital and contribute to the high risk of periodic collapse.

This chapter reviews the origins, symptoms, and consequences of the last decade of financial crises. Adopting a schema best viewed as one that augments Hyman Minsky’s Financial Instability Hypothesis, this chapter highlights the role of endogenous credit, prudential safeguards, linkages and contagion through credit markets, as well as the tendency for destabilizing speculation in deregulated financial systems. The theme is the inherent contradictions of uncontrolled capital markets and the implied necessity of effective regulation in attaining socioeconomic objectives. While suggesting broad considerations important in both the prevention and containment of crises, this paper does not specify in any legal detail precise policy options. Rather, this review suggests some critical regulatory guidelines and assesses in this context the apparent change in recent policy recommendations by the IMF and other international credit agencies. It concludes that the recent policy shifts are promising early indications of a heightened appreciation for the public good nature of financial and social stability and notes the

implications of this appreciation for the collective need to regulate financial markets effectively.¹

In particular, this paper focuses on those events that appear to be causally connected to the shift in regulatory sentiment. Mexico's crisis in 1994 was the "first major financial crisis to hit an emerging market economy in the new world of globalized financial markets" (Camdessus 1995).² The collapse of the Thai baht in July 1997 initiated a crisis that spread from Thailand to other East Asian countries (notably the Republic of Korea and Indonesia), out to Brazil and the Russian Federation. There was a close relationship of these crises to financial developments in the United States and Japan, where a trail of hot money can be found leaving Japan first moving into Asia and other emerging economies then through offshore banking centers into the United States. The realized threat of contagion in a global financial market "led to the most serious rethinking of the structure of international financial system since the breakdown of the Bretton Woods system in 1971" (Fischer 1999b).

Financial crisis definitions

Differentiating financial crisis from financial distress is subjective and somewhat arbitrary, depending as much on collective opinion as anything quantifiable. Moreover, in the midst of an episode, the collective opinion of the severity of the problems will itself influence the degree of distress to the extent agents' behavior is affected by their perception of the situation they face.³ Yet, to organize historical observation we require a sense of structure that must include a definition of the event we are examining.

In an IMF study of banking crises, V. Sundararajan and Tomas Baliño (1991: 3) offer the following definition.

[A] financial crisis is defined as a situation in which a significant group of financial institutions have liabilities exceeding the market value of their assets, leading to runs and other portfolio shifts, collapses of some financial firms, and government intervention. Thus the term crisis refers to a situation in which an increase in the share of nonperforming loans, an increase in losses . . . and a decrease in the value of investments cause generalized solvency problems in a financial system and lead to liquidation, mergers, and restructuring. These events usually follow a shock to the economy, and reinforce the subsequent declines in output (or slowing of economic growth) and balance of payments problems.

Unlike the implied symptomatic response of balance of payments crises to domestic bank crises above, Gerard Caprio of the World Bank suggests that a domestic financial crisis will necessarily follow a currency crisis but not vice versa. Reflecting the shift in perception shaped by the 1990s experience, Caprio (1998: 3–4) explains:

Currency crises involve a sudden movement in the exchange rate and sharp change in capital flows. Financial crises regularly originate in or induce insolvency in the banking system, and feature a collapse in asset prices, most often in equity and securities markets. . . . [A] financial crisis usually involves a corporate debt problem in the nonbank financial sector. . . . [F]inancial crises can occur without any currency crisis . . . [but] severe currency crises usually entail a crisis in the banking and nonbank sectors.

The financial crisis schema

The research agenda in orthodox finance has been dominated by a belief in the efficiency of financial markets – where markets equilibrate and individual asset prices fully and accurately reflect the existing information pertaining to the asset's income-earning potential. Trading risk against anticipated return, the rational investor constructs a portfolio so as to maximize individual wealth. When aggregated, these portfolios yield a socially optimal allocation of resources across investment projects. To obtain market efficiency, capital markets must be complete and distortions in price signals avoided. Proponents of efficient markets unsurprisingly advocate deregulation of any existing financial safeguards that are seen to inhibit rapid adjustments to an efficient market equilibrium and better price signals.

A troublesome possibility inherent in this framework is a speculative bubble – where expected deviations of asset prices from the discounted value of expected future income become self-fulfilling (see, for example, Blanchard and Watson 1982). Competitive bidding, motivated by repetitive and self-fulfilling expectations of capital gains, drives up an asset's price in excess of what should otherwise be warranted. The belief that a bubble must burst is popularly employed as an explanation for crises, although the orthodox theory itself has difficulty accommodating the structural shift of a bursting bubble.⁴ If it is believed that the bubble only remotely and temporarily interferes with the allocation function of prices, the possibility of a bubble and the consequent crisis do not mitigate advocacy of deregulation. If, on the other hand, the speculation-crisis phenomenon affects the economy's structure and future growth potential, intervention and regulation are instrumentally important.

A competing and more realistic explanation of the speculation-crisis phenomenon relies explicitly on the monetary and credit aspects of the asset-pricing process and stresses the non-separation of financial markets from wider economic developments. The Financial Instability Hypothesis (FIH) of Minsky (1986) focuses attention on streams of asset income (rather than on the fundamentals defined as the discounted value of these streams) in excess of contemporaneous changes in debt service costs. Fluctuations in these margins of safety explain the time path of asset prices; where financing incentives induce short-term borrowing to finance long-term expenditures and

financing constraints drive up debt service costs. As the rising debt service costs outpace increases in income, borrowers must rely more on capital gains (than sustainable income generated by the asset itself) to service debt – markedly increasing fragility. A limited memory of the maturity risks permits the activity to continue until such time as debt service costs swamp returns from all sources and bankruptcy is forced. The depth and breadth of the resulting bankruptcies critically interferes with the economy's ability to operate in this framework.

While internally consistent as a potential explanation of crises, an examination of high-profile historical episodes suggests that innovation may be an additional, important explanatory variable. Innovation of the type discussed by Schumpeter (1939), Rosenberg (1976; 1994), and others has arguably preceded many crises of historical note (see Kindleberger 1989: Appendix B; Spotton 1997). The introduction of such radical innovations as those first affecting the structure of financing, economic organization, or communications have ultimately altered the economic infrastructure. The time between the first introduction of the innovation and the realization of its full potential and its wider promise is long and marked by a spreading excitement focused on excess profitability – an excitement that encourages exceptional speculation, borrowing, and a disregard for risks possibly not measured (see Visano 2002). Where credit created feeds the speculative bubble, the interdependence of credit and collateral asset values yields the paradoxical result that the more debtors borrow, the more they own – with purchases of collateral assets inflating asset values above the real values of nominally fixed liabilities.⁵ Where the risk of default is not fully assumed by the speculator, but by lenders as well, the presence of moral hazard further distorts the assessment of risks assumed.

The proximate cause of crises remains, then, an excessive speculation driven by an unrestrained enthusiasm for profits and financed by borrowing. Unlike the FIH, however, where the absence of restraint lies in a problematic memory of past difficulties, the augmented FIH suggests the lack of restraint derives from an inability to relate these novel developments to anything previously known. An unbridled enthusiasm for the promise of higher yields sends speculators herding to buy assets related to the innovation. Where innovation motivates speculation, investor confidence is more capricious, playing a deciding role in the determination of income and margins of safety, and thus intensifies financial fragility.

The augmented FIH focuses attention on

large disturbances and dislocations in uncertain environments, with instability emerging as a symptom of responses to disequilibrium. These markets are incomplete, investors are ill-informed and susceptible to fashionable pressures, the relevant streams of income and debt obligations are mismatched at times, and individual investments are placed in the wider confines of aggregate developments.

(Spotton and Rowley 1998: 685)

The ability of the augmented FIH to explain recent crises implies the need to promote active policy measures to “smooth adjustments to transformational disturbances, to resist the repetition of earlier behavioral excesses, and to facilitate institutional safeguards” (Spotton and Rowley 1998: 679). It suggests we face a financial regulation imperative.⁶

Recent events

Origins

A pre-existing condition to historical crises is an economic environment that enjoys a well-grounded sense of economic prosperity, often derived from some fundamental restructuring of economic activity. Structural economic changes prior to the crises in question can be identified. Among these changes were those associated with financial liberalization in the form of relaxation or removal of capital controls, removal of interest rate ceilings, relaxation of restrictions on bank lending and the like, such as occurred in Russia, Thailand, Indonesia, Korea, Brazil, and Mexico. The belief that the economic growth enjoyed was derivative of the liberalization initiatives is apparent in the following IMF statement.

[T]he removal of restrictions on overseas investment by institutional investors, the elimination of capital controls in developing countries, . . . have all contributed to the unprecedented mobility of private capital today. . . . The benefits for recipient countries and investors are clear. The countries are able to achieve higher levels of investment, faster economic growth, and rising standards of living. . . . Investment in emerging markets . . . helps promote a more efficient allocation of resources and faster growth worldwide.

(Camdessus 1997)

At once, financial liberalization was part of the restructuring that created the boom conditions and provided access to the funds propelling the boom in Asian countries forward. The initial optimism was confirmed and appeared justified when growth in these economies began to outpace those of developed economies. Nowhere was this phenomenon more apparent than in the lending by Japanese banks. Financial liberalization had resulted in a decrease in the demand for domestic bank loans. The banks’ desire to seek replacement borrowers for those Japanese companies now raising funds directly in the debt markets appeared at a time when Japan was experiencing its lowest growth rate in four decades and one that was substantially below those of other Asian countries. By the end of the 1980s, cross-border lending by Japanese banks accounted for 60–70 percent of total lending to Southeast Asian countries by all reporting countries. Throughout the early to mid-1990s, Japanese banks aggressively shifted their lending from low growth

countries of Japan, Europe and the United States to Southeast Asia, increasing their lending to Asia two-fold (Peek and Rosengren 2001).⁷

An *ex post* examination of the crises point to various early indicators of increasing financial fragility and seek to explain the fact that the implied threats were ignored. Whether the lending to these crisis-prone countries continued because of improperly priced risks due to a global moral hazard problem (Yeyati 1999), a belief that some countries were simply too big to fail (Shaalan 1998), or blind speculative enthusiasm and herding speculators (Ghosh 2001) (or some combination of these and other factors), the fact remains that the onset of the crisis caught investors and policy makers alike by surprise. In Asia

no-one expected that countries whose economic policies and performance had for so long looked exemplary – they had experienced decades of extraordinary growth, based on outward-oriented policies, high rates of saving and investment, investment in human capital, governments oriented to economic development, and prudent macroeconomic policies – would get into a crisis, least of all as deep as it turned out to be.

(Fischer 1999a)

The collapse in Russia “was certainly a stark contrast from the euphoric mood that seemed to prevail amongst Russia-watchers only months earlier (in early to mid 1997)” (Fischer 1999a). Mexico was considered, prior to its crisis, a “remarkable success on many fronts. . . . Economic growth recovered from an average not much higher than zero in 1985–88 to 3 percent in 1989–1993. . . . Mexico therefore entered 1994 with a strengthened economy, and an economy more deeply integrated into global markets . . . promising to lock in many of the important reforms it had implemented” (Camdessus 1995).

As financial deregulation fuelled the boom phase by providing access to financing, so too did deregulation contribute and create conditions that ensured the severity of the subsequent crisis. The dramatic increase in the incidence of combined banking and currency crises is clearly linked to these changes (see Kaminsky and Reinhart 1999). Whereas no link appears between balance of payments and banking crises during the 1970s when financial markets were highly regulated, following financial liberalization and increased market access of the 1980s, these twin crises became closely intertwined.

Vulnerabilities

In the 1990s, increased access to international capital markets led to an escalation of debt finance in certain nations. But the dramatic increase in the inflow of foreign capital was into debt instruments of shorter maturities, denominated in hard currencies. International borrowing at the shorter end

of the maturity spectrum increased significantly the risk exposure of the domestic economy to external shocks, such as fluctuations in foreign interest rates, exchange rate changes, and shifts in investor sentiment. The liberalization initiatives did attract foreign funds, but most of it as large private inflows of “hot money” seeking quick speculative gains. For the individual investor, the liquid nature of the short-term funds reduced total risk; but what was true for the individual could not hold true for the collective, as these crises proved yet again (see Corsetti *et al.* 1999).

Short-term, external bank liabilities accounted for 50 to nearly 60 percent of total foreign bank borrowing in the emerging Asian markets in the mid-1990s (see Figure 11.1). In Indonesia, as in Thailand a few years earlier, 60 percent of the debt owed to foreign banks (mostly Japanese) carried a term to maturity of one year or less (see Figure 11.2). As Radelet (2001: 134) says:

By mid-1997, the total stock of claims outstanding to the private sector by Indonesian banks was the equivalent of about 56 percent of GDP, compared to over 140 percent of GDP in Thailand, Malaysia, and Korea. Lending in Indonesia financed a diffuse set of activities. Some loans financed large utility projects (especially electricity generation), heavy industries such as petrochemicals, and consumer durables such as automobile assembly. Other loans went to property and real estate.

In Korea, over 60 percent of the current account deficit was being financed by domestic banking institutions borrowings from abroad by 1996. Moreover, nearly 90 percent of those transactions were in the short-term debt market (see Figure 11.2). Assets of the banks were dominated by loans to the

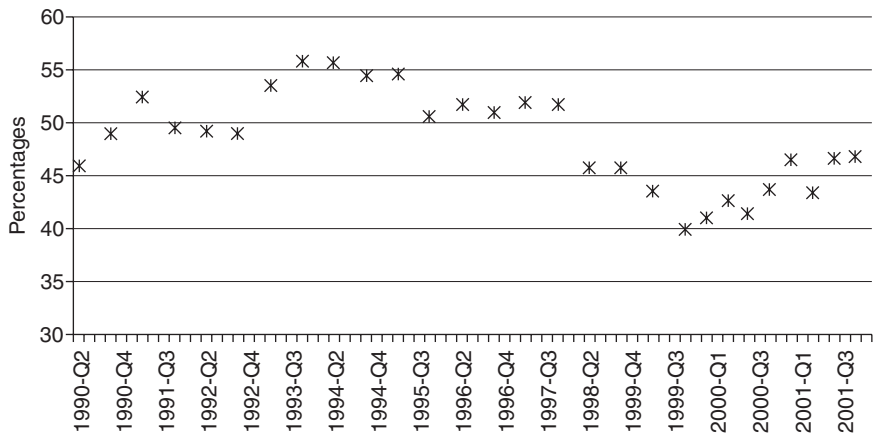


Figure 11.1 Short-term liabilities as percent of total external bank liabilities (total: Indonesia, South Korea, Thailand), 1990–2001

Source: Adapted from BIS-IMF-OECD-WB (2003).

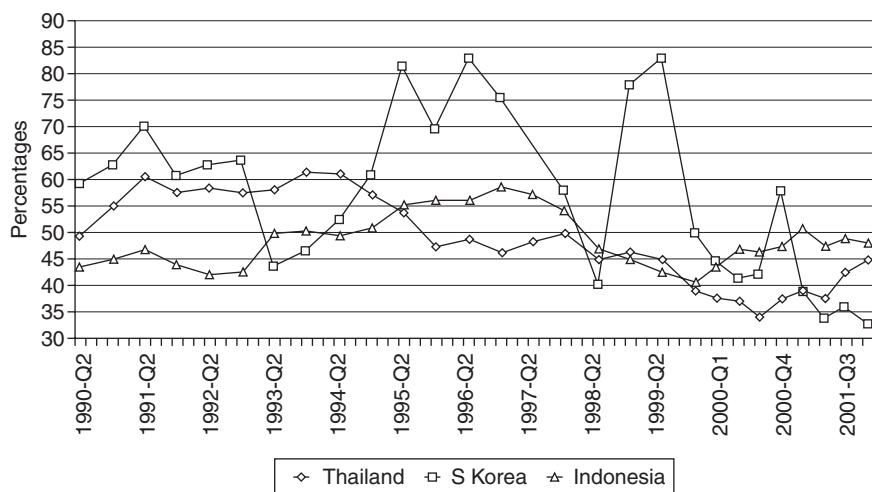


Figure 11.2 Short-term liabilities as percent of total external bank liabilities, 1990–2001

Source: Adapted from BIS-IMF-OECD-WB (2003).

real estate sector, suggesting a vulnerability that emanated from a gross mismatch of maturities in the domestic financial system portfolios (see Choi 2001).

In addition to the maturity risks, the currency risks, previously masked by an implicit guarantee of stable exchange rates, made a dramatic and pronounced reintroduction with sudden changes in the external value of the domestic currency in several countries, including the Asian countries, Brazil, and Mexico (see Figures 11.3 and 11.4). The low margin of safety between the streams of export income and foreign debt service costs was further eroded by the fact that the accumulation of foreign borrowing had previously exceeded by substantial margin the alternative liquid assets available to cover the foreign debt. The percent of short-term foreign debt to foreign exchange reserves was well over 100 for Indonesia and South Korea for most of the 1990s and for the 2 years prior to the crisis in Thailand (see Figures 11.5 and 11.6 and Ghosh 2001: 82). Similar situations had developed in Mexico and Russia prior to their respective problems.

Compounding the portfolio weaknesses resulting from enhanced capital mobility, attractive interest rate spreads, and the resulting speculative excitement, were the weaknesses stemming from the operation of the respective banking systems themselves. One key weakness in emerging market banking systems later exposed was connected lending or “crony capitalism.” While lending to bank owners, managers, and other interested parties is not uncommon around the world, it does raise concerns about the objectivity in any assessment of credit risk.⁸ Several authors cite this practice as a key bank

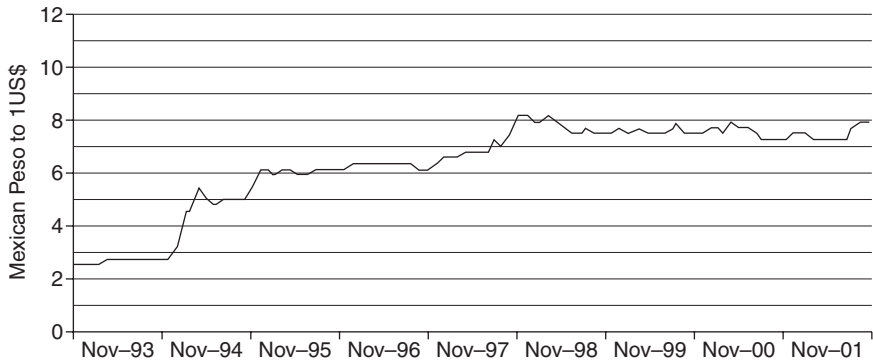


Figure 11.3 Mexico/US foreign exchange rate, 1 November 1993 to 1 July 2002

Source: Adapted from FRBSL (2002).

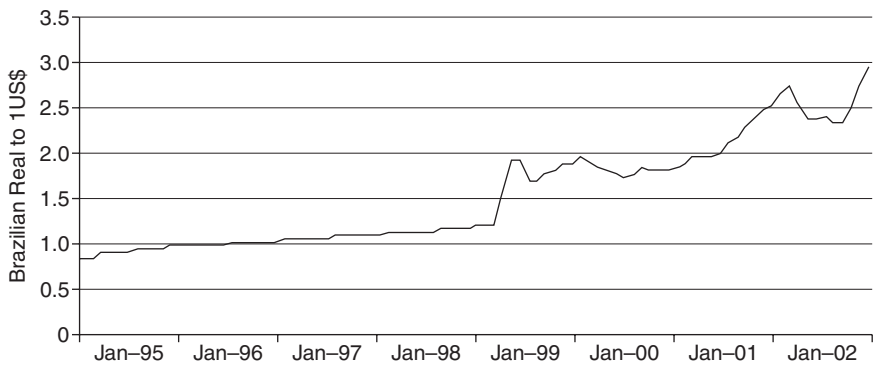


Figure 11.4 Brazil/US foreign exchange rate, 1 January 1995 to 1 July 2002

Source: Adapted from FRBSL (2002).

governance problem in several countries including Brazil, Thailand, and Indonesia (see, for example, Goldstein and Turner 1996). Where the debt crisis of the 1980s exposed vulnerabilities in the process of international syndicated bank lending activities, the most recent round of crises exposed problems with banking supervision and regulation. Fischer (1998a), noting this, identifies the fact that, as yet, no international system exists to ensure bank soundness: "Around the world, every major crisis we have seen in the last five years has been either caused by or accentuated by massive banking sector weaknesses. We do not have in the international system the ability to require countries to strengthen their banking systems."

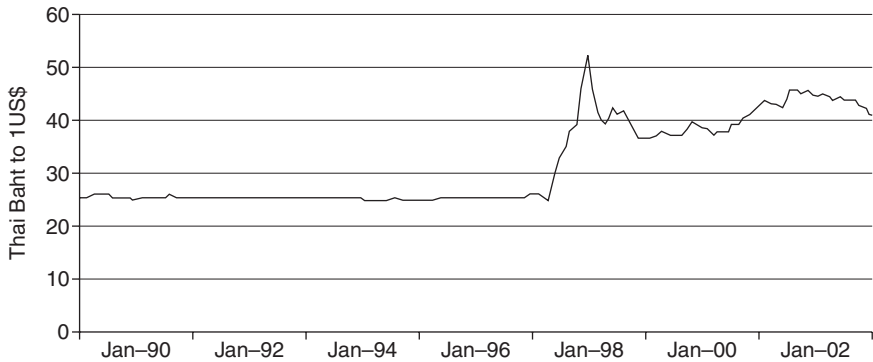


Figure 11.5 Thailand/US foreign exchange rate, 1 January 1990 to 1 July 2002

Source: Adapted from FRBSL (2002).

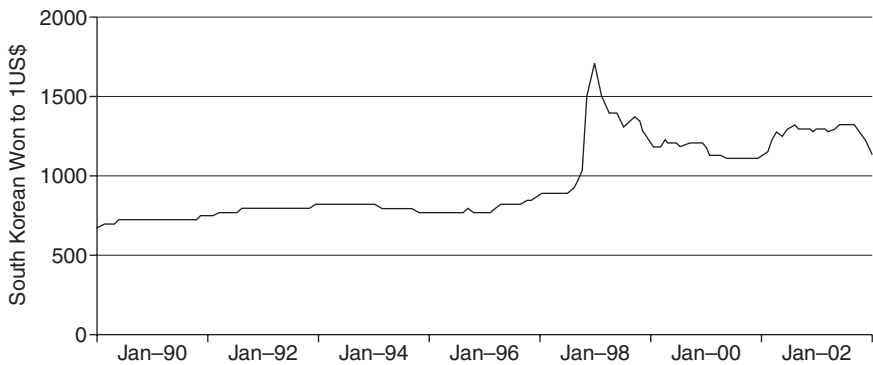


Figure 11.6 South Korea/US foreign exchange rate, 1 January 1990 to 1 July 2002

Source: Adapted from FRBSL (2002).

Consequences

In each instance, either the collapse of the currency values weakened to the point of threatening the banking system (as in Asia and Brazil) or the two collapsed together (as in Russia). The resulting domestic credit crunch severely constrained the economy and the first consequence was a dramatic decline in output. Through the channels defining greater regional and global integration, the distress spread. Distress in one region or country spread out to other regions and countries either through a trade link such as competitive devaluation and current account adjustments, or through investment – real and portfolio – links. Hernández and Valdés (2001) show that, in both the Brazilian and Thai experiences, contagion channels depended on the nature

of the crisis, as measured by different financial variables. In Russia, the contagion appeared to be clearly and uniquely related to financial links.

Forbes (2001) differentiates between those factors that are unique to a crisis situation (such as credit crunches, portfolio re-composition) and those that relate to pre-existing interdependencies (product competitiveness, income effects, and the like). In the Asian and Russian crises, the distress appeared to spread through firms producing in the same industries and with direct exposure to the crisis zone, suggesting that it is pre-existing interdependencies that contribute to the spread of distress. The crisis in Brazil was, according to the Governor of the Central Bank of Brazil, directly and uniquely related through financial links to the crisis in Russia and Asia before it. Fraga (2000) adds that

[A]fter Russia defaulted on its debt in August, capital flows to Brazil came to a halt. These events forced Brazil to float the real and led to a panic in January 1999. In February, the real plummeted to 2.15 to the dollar from 1.20 at the beginning of the year.

Paralleling the withdrawal of funds from and spread of financial distress to countries perceived to be similarly fragile is the redirection of financial flows to economies perceived as safer havens. The re-balancing of portfolios in the wake of the Asian crisis saw a flight of capital from Asia into Europe and the United States. Van Wincoop and Yi (2000) attempt to trace the flow of capital out of Asia and find a substantial part of it eventually reached the United States. The route by which Asian capital outflows become American financial inflows is indirect, first flowing into the offshore banking centers of Hong Kong, Cayman Islands, and Singapore, among others, to European banks. The avenues by which funds flow from Europe to the United States are less clear, save for the fact that they by-passed the American banking system. Many of these funds eventually found their way into the hi-tech stocks trading on the NASDAQ – thus feeding the recent hi-tech stock market bubble. Emmons and Schmid (2000) present evidence on large US firms to suggest that the Asian crisis resulted in increased stock market volatility in the United States and around the world. They also suggest that a shift in portfolio investments from Asia to the United States may explain why, despite increased uncertainty, increased stock market volatility, and falling after-tax earnings per share, share prices in the US rose to great heights in the late 1990s into the year 2000. As shown in Figure 11.7 the Nasdaq-100 Index of high-technology/innovative stocks rose by approximately 1100 percent between 1993 and 2000, but soon afterwards the Nasdaq bubble crashed by about 85 percent by mid-2002.

We know from these experiences, and the many preceding them, that financial system collapse in Asia sets off a chain reaction of crises in the production and social spheres. Yet a scan of the IMF speeches and public statements on the financial crises reveals no direct detailed attention to these real

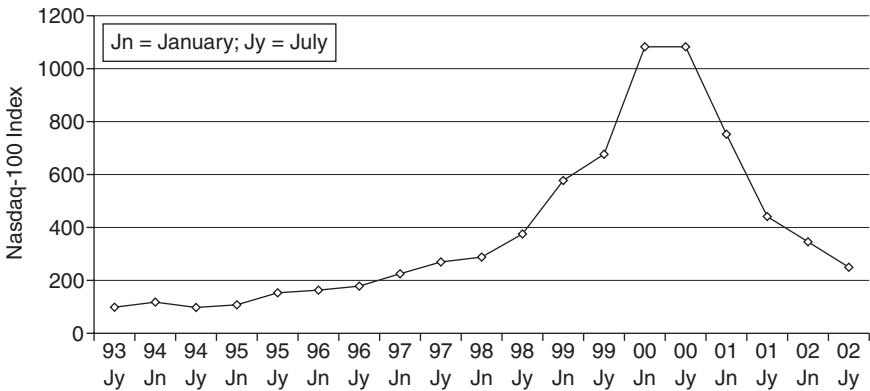


Figure 11.7 Nasdaq-100 Index: US 1993–2002 (1993 = 100)

Source: Adapted from O'Hara (2003: 34).

consequences. There are neither explicit discussions nor implicit indications of how best to address the specific stratified economic hardship in the context of discussing how to resolve the crises. There is acknowledgement of the importance of the financial sector to the overall operation of the economy. There are *separate* initiatives to address poverty, both generally (such as the IMF's Poverty Reduction and Growth Facility) and specifically to facilitate recovery of social welfare and safety nets (such as the World Bank's Asian Financial Crisis Response Trust Fund). Yet there continues to be absent a full account of the country-specific socio-economic impact of the crisis *directly* informing crisis resolution.

Policy guidelines

Preventive policies

With the inherent difficulties of identifying “over lending” and “over borrowing” *ex ante*, the best we can manage is a sensitivity analysis of potential fragility.⁹ To that end, several integrated initiatives spearheaded by the International Monetary Fund, the Financial Stability Forum, the Bank for International Settlements, International Organization of Securities Commissions and the like are underway to assess and oversee risks created by highly leveraged global investment. The objective is, ideally, to promote the allocation of funds to their most productive uses. Since “productive use” is unambiguously a longer-term fixed investment objective, seeking ways to promote long-term committed investment – avoiding the powerful vagaries of “hot money” – is arguably the single most important objective of international and domestic financial regulation. Carlson and Hernández provide evidence on the Asian and Mexican crises that suggest government policies can effectively

influence the mix of capital inflows. As they say: "Letting the exchange rate float tends to increase the share of short-term debt to capital inflows. Imposing restrictions on capital transactions on the other hand, tends to increase the share of (foreign direct investment)" (2002: 23).

The financial crises of the 1990s forced a reassessment of the international community's support for financial liberalization. Following the Asian crisis and its spread through other emerging markets, the IMF went on record promoting only a qualified openness. Fischer (1998b) states:

Although country circumstances differ, the general advice on international financial sector liberalization is first to open to longer-term investment, particularly foreign direct investment, and only to open at the short end when necessary preconditions, in the form of macroeconomic stability and a strong banking and financial system, are in place.

The G8 followed, officially recognizing financial stability as a "global public good," and promoting it as an objective to be adopted by the Multilateral Development Banks (G8 2001). Indeed, the indivisibility of the benefits derived from and the consolidation of the need for financial stability clearly suggests the need for a collective presence in ensuring financial stability.¹⁰ To the extent that financial stability enhances collective welfare there can be no market mechanism that will deliver the conditions necessary for the promotion of it. The challenge we face is to navigate the tenuous moral hazard terrain by which the means of promoting financial stability in turn risks increasing the possibility that crises will occur.

To the extent that financial linkages are responsible for the spread and contagion of crises, countries would best attempt the imposition of prudential capital account restrictions on capital inflows. If, however, the spread of distress is, instead, through non-financial channels determined by pre-existing interdependencies, then encouraging greater industrial and fixed investment diversity takes priority. Yet, regulation and supervision of institutions engaged in the intermediation of international capital remains limited to that which national authorities can co-ordinate. "At this time, the onus of supervising the activities of offshore or highly leveraged operations falls on existing national authorities, especially those in the countries where major financial centres are found" (Camdessus 1998). International established guidelines to co-ordinate national activities include: the Basle Committee's "Core Principles for Effective Banking Regulation" and the International Organization of Securities Commission's "Principles and Recommendations for the Regulation and Supervision of Securities Markets."

Containment policies

There is little debate over the important role of a lender of last resort in the containment of a crisis and the minimization of its spill over effects. Indeed,

one of the pillars of the new “international financial architecture” are (quasi) international last resort lending facilities provided by the IMF (see Fischer 1999b, and Goldstein 2001, for example). The IMF created the Contingency Credit Line (CCL) in 1999 offering “countries with sound policies a public ‘seal of approval’ and a way to bolster their official reserves at very low cost.” Yet, in its first 24 months of operation, no country applied for liquidity assistance pre-qualification. The Fund’s Supplemental Reserve (SRF) facility operates to similar end, advancing large amounts of funds for relatively short periods at penalty interest rates. “In lieu of collateral, Fund lending requires agreement with the borrower on economic policy measures that will improve its balance of payments and help it repay” (Krueger 2001). Most recently, Argentina accessed this facility but found itself unable to repay the loan, thus requiring an extension. Further, the implicit assignment of sole responsibility for a nation’s difficulties inherent in the 300 basis point penalty is contentious, from the viewpoint that debtors and creditors alike appropriately share responsibility for a currency collapse. Unlike the central bank that adopts this lender of last resort role, however, the IMF does not print or create money on any regular basis. Unless and until it adopts an active role in this regard, say by counter-cyclically managing the expansion and contraction of Special Drawing Rights, the ability to offer a lender of last resort facility will be constrained politically by what it is able to encourage developed country authorities to directly support. (See Chapter 7 for details of the CCL and SRF.)

As a by-product of the speculation-crisis event, there remains to address the egregiously regressive redistribution of wealth. There is a severe deficiency in our understanding of the extent and magnitude of wealth redistribution implicit in the speculative engagements and consequent bailouts of private creditors. Whatever the precise magnitude, most promising is the early work at formalizing a mechanism for the restructuring of sovereign debt (see, for example, Krueger 2001). In the early discussions that ultimately led to the creation of the IMF, there were strong arguments in favor of shared debtor and creditor responsibility to exchange rate misalignments and balance of payments debt. Re-framed in this new world of private portfolio capital flows, the onus of a financial crisis would fall on both the receiving nation *and* private creditors – a principle that, if implemented, may effectively reduce the moral hazard risk mentioned above.

Conclusion

Located in a framework that interprets crises as large dislocations occurring in uncertain environments, where instability emerges as a symptomatic response to disequilibrium, this examination underscores the imperative of regulation to smooth adjustments and facilitate institutional safeguards. Drawing on analyses conducted and policies promoted by primarily the IMF, this chapter sought to underscore a needed shift in the perceptual emphasis from one that

touts the benefits of “free” markets in capital to one that recognizes explicitly the critical role regulation plays in generating the desired outcomes. It has sought to encourage this shift in discourse toward the need to re-regulate, away from deregulate, in a financial world increasingly electronic in its operation and global in its outlook. Finally, it has sought to underscore the complementary importance of stability with productivity and efficiency. The conclusion is one that moderate voices have been advocating for some time. Eichengreen and Portes (1987: 234), for example, suggested back in the 1980s:

On both imperfect information and externality grounds, there is a rationale for government intervention. Financial crises pose a greater threat under some institutional configurations than others. Even when the benefits of financial deregulation are apparent, there is a role for regulatory policy in channelling financial innovation in directions that leave the world economy less vulnerable to financial collapse.

There remain, however, critical questions to answer and important issues to explore. An interesting inquiry would involve a comparison of the international financial community’s response to the recent Argentinian crises (during the early 2000s), with its response to the Asian and Brazilian crises. To know what is being done differently, both in terms of crisis response and policy recommendations, would shed light on how far the community has operationalized the shift in regulatory sentiment identified in this chapter, and how effective it has been. Further, while we know financial crises and the consequent attempts to resolve these crises impact adversely on the distribution of wealth, the magnitude and specific pattern of this redistribution remain unmapped. The research and political interests that inform the international financial community’s policy decisions continues to be absent representation of the interests of the majority of people who benefit less from the preceding growth but who bear the ultimate real and financial costs of resolving any subsequent crisis. These unexamined aspects leave a void in our knowledge base – a void that if filled will move us closer to a collective goal of ensuring an allocation of productive resources to best uses by regulating capital markets effectively.

Notes

* A debt of gratitude is owed Phil O’Hara, Chris Paraskevopolous, and Livy Visano for encouragement and comments on earlier drafts. Remaining errors are solely my own.

1 An important caveat is needed here. As a result of the 1980s’ spate of crises, the IMF was advocating a qualified need to support macroeconomic stabilization policies with

adequate supervision and prudential regulations, which are also necessary to make financial crises less likely and less costly. But regulatory authorities must

balance their concerns for the financial system's safety (which requires appropriate regulation and supervision) against the need to maximize efficiency (which requires that market forces play the main role in shaping the structure and operation of the system.

(Sundararajan and Baliño 1991: 37–38)

The point in this chapter is, that in the wake of a second decade of crises, and subsequent research suggesting financial liberalization is an important factor in explaining the increase and spread of the crises, international institutions like the IMF have further increased emphasis on the need for regulation.

- 2 The practice of dating crises typically assigns the date of the balance of payments crisis.
- 3 See for example, Choi (2001: 195) who compares the time profile of Korea's currency problems with the number of articles with the term "currency crisis" in their title appearing in ten principal daily Korean newspapers. Choi concludes "it is hard to tell whether pessimistic expectations of a currency crisis caused the currency crisis or deteriorating economic fundamentals actually led to the currency crisis. The increasing trend in the numbers of newspaper articles, though, implies that expectations of a currency crisis had heightened among opinion leaders in Korea."
- 4 See Spotton and O'Hara (1999: 1079–1082). Moreover, the orthodox theory of a speculative bubble is plagued empirically, as it fails as a testable *ex ante* proposition of an observed price increase. It may have been reasonable – but failed – expectations of increased profitability that motivated the initial speculation, rather than any irrational expectation of a capital gain motivating a buying spree that is inherently short lived. "In short, a ubiquitous problem in time-series test of market efficiency, with no clear solution, is that irrational stock prices are indistinguishable from rational time-varying expected returns" (Fama 1991: 1581).
- 5 The above characterization of bubbles – with explicit attention to the parallel evolution of supporting credit – is simply the converse of Fisher's (1933) debt-deflation paradox. A rapid sell-off of collateral assets risks driving down asset prices and increasing the real value of debt outstanding. The paradoxical result is that the more debtors pay the more they owe.
- 6 Initial, independent explanations of the Asian crisis relied heavily on panic, corruption, bubble-like over-investment, and moral hazard – all explanations that fit well within the orthodox framework and that are consistent with, if not actually support, deregulation. In subsequent reassessments, Paul Krugman, Steven Radelet, and Jeffrey Sachs came to lay more of the blame on weak and overly-liberalized international and domestic financial systems, and now support the call for a stronger regulatory infrastructure (see Radelet and Sachs 2001).
- 7 By the time of the Asian crisis in 1997, Japanese lending as percentage of total lending to these countries had dropped to 40–50 percent, diminishing relatively due to the five-fold increase in European bank lending to Asian countries from 1990 and 1996 (Peek and Rosengren 2001).
- 8 A similar situation in the United States was uncovered recently in the corporate reporting scandals. Perverse incentives and conflicts of interest influencing both senior corporate officials and auditors revealed themselves when the Texas-based energy firm Enron collapsed in December of 2001. This high-profile scandal has been followed by a spate of similar revelations. The subsequent investigation has resulted in calls to regulate better the auditing function, including calls to move the responsibility back to the government.
- 9 Contemporaneous estimates of "overlending" are relative to expected performance and are perforce imprecise. Only in the wake of financial collapse is it clear, to those involved, that less borrowing would have been desirable.
- 10 This is actually a paraphrase of Ugo Mazzola's 1890 definition of public goods in

terms of the “indivisibility of their use and the consolidation of need” (as discussed in McClure 1999).

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12 Environmental problems of the world

Global warming and biodiversity*

Andrew John Brennan

Introduction

Arguably the major problems in the global, regional, national and local systems of political economy are environmental in nature. Indeed, this is necessarily the case since the human species is part of and interrelated with other aspects of the ecological environment. Problems that beset humanity will affect other species and problems that impinge on non-human species will impact on humans through time. Wars, production, trade and other human activities impact on the environment and visa versa. Despite the desire of many humans to see themselves as “above animals and plants”, they are really part of the natural landscape, even if to some degree they have elevated themselves above the rest of the world, creating their own environments and trying to communicate with and exploring other worlds. The more humanity dominates the world the worse environmental problems become. The extent to which such anomalies can be ameliorated may well depend upon the extent to which humans recognize their place in the natural world and try and restore some sort of dynamic truce with other animals and plants.

In a world full of human institutions such as trade, finance, production, and international power struggles it is often difficult for humanity to respect nature. Showing some concern for nature may lead to defeat in battle, reduced competition in the global marketplace, and less growth and accumulation. But having concern for nature can be done in a way that enhances other forms of wealth or welfare such as the quality of life, natural capital, long-term survival of many species, and strong sustainability. The current chapter will focus on two critical problems of global warming and species extinction. Adequately dealing with these problems may well see the survival of many species in the long run, including humanity. We start the story with a brief overview of the Circuits of Life.

Ecological Circuits of Life and economy

In the Circuits of Life, illustrated in Figure 12.1, the sun provides the energy upon which Earth depends for its low-entropy materials such as life forms, raw materials and evolutionary processes. On Earth there are three major

sub-systems that interact in the reproduction of life. The first is ecological capital, which constitutes the structured processes that transform energy into various forms of matter such as renewable and non-renewable ecological resources, life support systems and diverse genetic materials. Included here are the various life forms, species, habitats, soils, and waterways. Second, the socioeconomic sub-system includes institutions, power relations, and production-distribution-consumption activities that transform low-entropic energy into (high-entropic) forms that become increasingly inaccessible. Included here are the global, regional, and national systems of corporate relations, parliamentary functions, and social relations which exploit the environment in the interests of certain classes, ethnicities and nationalities. And third, the natural sinks transform high-entropic wastes into forms that dilute and reduce its volatility. These sinks include oceans, soils, and forests that absorb pollution and render it somewhat harmless to plants and animals. These three levels of the Circuits of Life are closely interactive and together form the basis of life on Earth, a planet under the dominance of human beings, particularly in the areas above sea level and below the stratosphere.

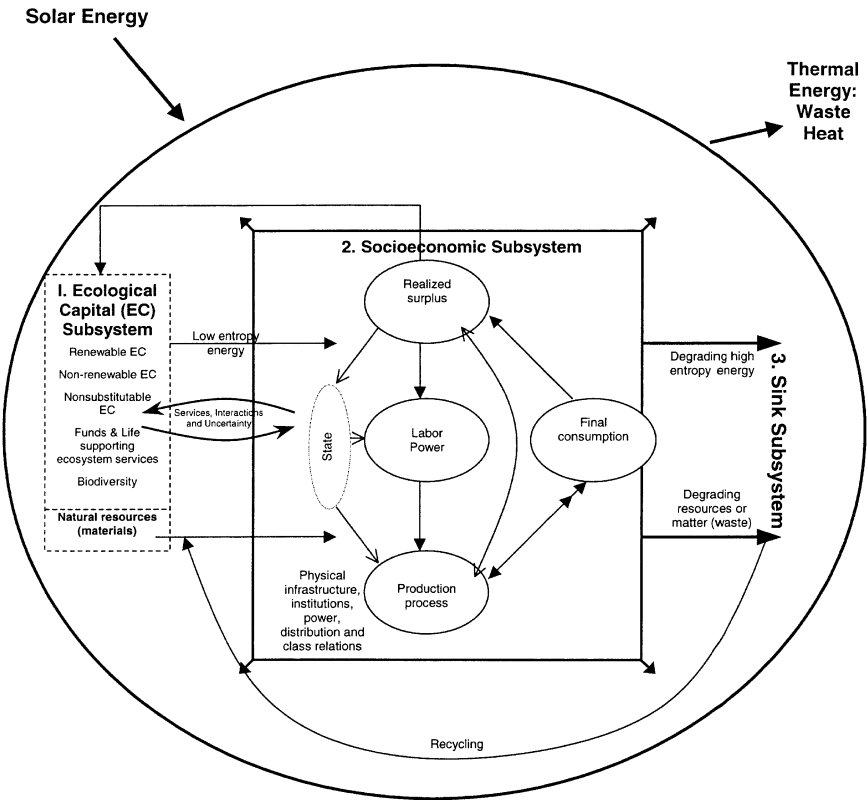


Figure 12.1 The Circuits of Life

The critical thing about the three levels of the Circuits of Life is that they are both interdependent and only to a certain limited extent autonomous. In particular, the socioeconomic system has relative autonomy from the structures of ecological capital and sink functions. But this autonomy is mainly psychological and emanates from human beings being able to put themselves above the natural environment ideologically and spatially. Looked at ecologically, however, this degree of relative autonomy is very slight, since human beings depend upon other species, habitats, and resources for their own lives, both socially and personally. In addition, the activities of humans impact upon the rest of the environment, through the use of low-entropic energy, which they then return to the environment as relatively inaccessible energy-forms and pollutants that often inhibit or destroy other life forms. The emasculation of other forms of life can in the long run reduce the availability of low-entropy energy, creating an environment where human survival may be questioned in the long-run. This is particularly the case when global systems of production, distribution, and exchange become too dominant, ignoring the long-run concerns of biodiversity and ecological survival.

Climate change and global warming

The UN established the Intergovernmental Panel on Climate Change (IPCC) (a body of scientists, economists, and policy makers) in 1988 to inform governments of the likely causes and effects of climate change. In their third major assessment of climate change, IPCC (2001) acknowledged that global warming has begun to increase sharply and will rise faster than previously thought. The IPCC's latest report shows that during the twentieth century there has been a 0.6°C rise in global temperature, up 0.15°C from the estimate in the *Second Assessment Report* in 1995.

Indeed, since 1750, atmospheric carbon dioxide (CO_2), the main heat trapping or "greenhouse gas", generated (for example) from the burning of fossil fuels, has expanded by approximately 32 percent. CO_2 accounts for about 60 percent of the total greenhouse gases (Bunyard 2001a). Other important sources of human-induced greenhouse trace gases that have increased since industrialization include methane (CH_4), nitrous oxide (N_2O), ozone (O_3), and halocarbons (see EPA 2002). According to the Union of Concerned Scientists (UCS 2002a), the combined warming effect, positive radiative force, from these other trace gases is approximately equal to that of CO_2 . Therefore, CO_2 supplies about half of the increase in temperature since the pre-industrial period. Fossil fuels include carbon and hydrogen, and it is especially the CO_2 emissions from the operations of transportation, such as automobiles, that are contributing the most to global warming. Greenhouse gases, such as CO_2 and N_2O , have an atmospheric lifetime of around 50 to 200 years (Bunyard and Retallack, 1999: 63). Figure 12.2 depicts the greenhouse effect.

Solar longwave radiation causes the greenhouse effect through the absorption of "heat trapping" gases. The greenhouse effect is the outcome of

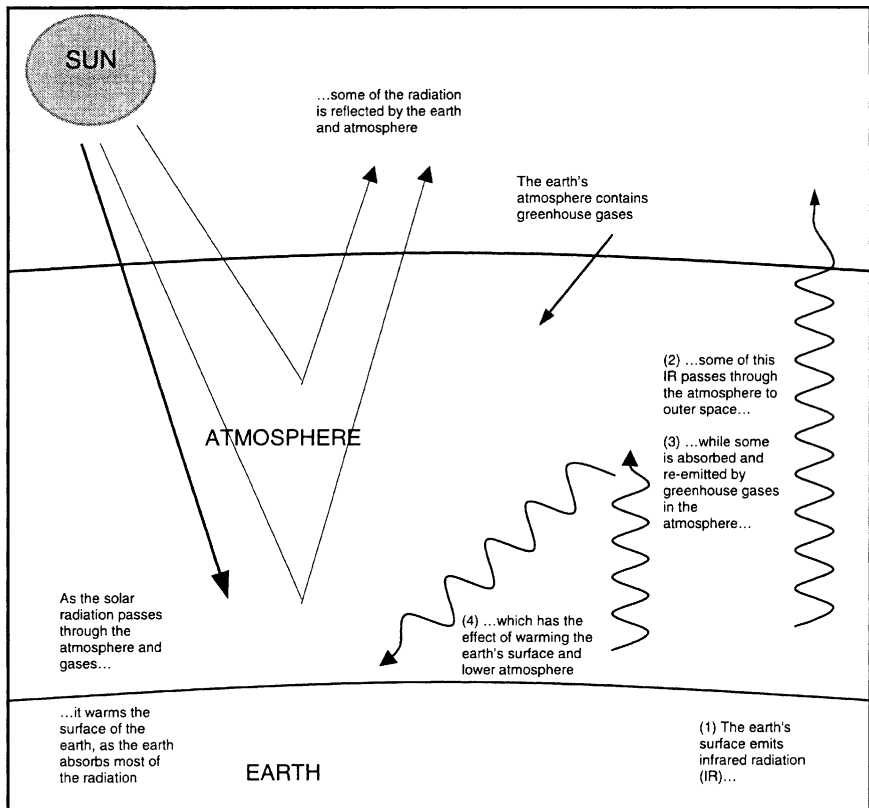


Figure 12.2 Global warming and the greenhouse effect

particular “heat trapping” gases, such as CO_2 and water vapor, in the lower atmosphere which then re-radiates some of the heat downwards and warms the earth. The *natural* “greenhouse effect” is good in itself as it regulates the temperature of the planet; without it, the temperature of Earth would be about -18°C instead of its present, 14°C (NOAA/NCDC 2002). The problem lies in the *additional* contributions of greenhouse gases by human activity, particularly CO_2 and CH_4 since industrial times, but also more recently, N_2O , O_3 and halocarbons (substitutes of CFCs). All of these anthropogenic activities have contributed to global warming. In summary, human activities are changing the atmospheric concentrations and distributions of greenhouse gases and aerosols, and these changes can produce a radiative forcing (heat and energy) by changing either the reflection or absorption of solar radiation, or the emission and absorption of terrestrial radiation (IPCC 1996). These different gases have spatially distinct effects on the atmosphere’s radiation balance vis-à-vis global warming potential (see EPA 2002).

The IPCC (2001) say that further increases in the concentration of carbon

dioxide will lead to more climate change. Globalization has encouraged greater final consumption in energy intensive products such as automobiles, electrical appliances, computers, and paper – to the detriment of ecology. Any increase in the overall volume of trade (and foreign direct investment) likely involves an increase in greenhouse-gas-emitting transportation of commodities. This especially applies to global shipping, air cargo, and the global expansion of industrial agriculture, as the need for international transport is progressively increasing. For example, in the US, the average distance that commodities travel from producer to consumer now reaches 1000 km (Retallack, 2001b: 25). Moreover, forests play an important role in the global carbon cycle and both influence and are influenced by climate change.¹ Since forests absorb carbon in the form of CO₂, clearing of forests leads to increases in atmospheric CO₂. Forest conversion, a major form of land clearing, has contributed an estimated 30 percent of the atmospheric build-up of CO₂ (WRI 2002c). If these types of activities continue to rise in the future, then global warming will increase.

In order to predict future CO₂ trends, the IPCC (2001) developed various scenarios based on different modes of development depending on various estimates, for example, of energy technologies, population and rates of economic growth. Before industrialization, our atmospheric CO₂ levels were 280 parts per million by volume (ppmv). Now our atmospheric CO₂ levels stand at 370 ppmv (IPCC 2001). The extreme scenario of some energy conservation into renewable energy but where fossil fuels remain the main source of energy reveals that the CO₂ levels will likely rise to approximately 1000 ppmv by 2100. This high-emission scenario, if realized, will likely result in an increase in the global average temperature of 5.8°C over 1992 levels by 2100. Alternatively, in the scenario of aggressive energy conservation and the adoption of alternative energy systems, CO₂ levels will increase to 540 ppmv; double that of the pre-industrial epoch. This would require reducing global emissions by about 80 percent by 2100 (Bunyard 2001b: 16). This conservative energy lower-emission scenario discussed by IPCC gives a global average temperature rise of 1.4°C by 2100. In short, global mean surface temperatures are projected to increase by between 1.4 and 5.8°C by 2100, depending on which strategy is adopted, the fastest rate of change since the end of the last ice age.

What is even more disturbing is that the IPCC's climate models and their scenarios to date do not take into account certain potential negative "feedbacks" in the biosphere, because of atmospheric CO₂ concentrations, that is, higher temperatures. This is important because the biosphere, which includes the carbon cycle, plays a crucial role in regulating the displacement of CO₂ in the atmosphere. The atmospheric concentration of CO₂ is reliant on the amount emitted, for instance, from fossil fuels burning, changes in land use and the strength of carbon sinks, such as the ocean and biosphere, which remove CO₂ from the atmosphere. For example, changes in circulation and mixing alter the ocean's ability to take up CO₂ from the atmosphere. In

addition, the warmer oceans absorb less CO₂. One of the world's leading centers on climate research, the Hadley Centre at the UK Met Office, incorporated carbon cycle feedbacks between terrestrial vegetation and soil micro-organisms, oceans and the climate into their models. This was done to show how the storage of carbon in oceans and on land in vegetation and the soil may change in the future. The Hadley model differs from the IPCC's (2001) model in that the "allowable" emissions are greatly reduced and finds that the feedbacks have a considerable affect on temperature – much higher than the ones predicted by the IPCC (see Hadley Centre 2002a). This is because there is a reduction in the strength of CO₂ sinks. As the result of higher climatic temperatures in the future, there is the potential for vegetation (forest) dieback and land that was permanently frozen to melt (permafrost melting). This will likely release as much additional carbon into the atmosphere in the form of CO₂ and methane as is currently there.² Given these above scenarios, what would life be like on the planet?

Climate change and global warming are very real phenomena. Climate change not only has major implications – albeit with some uncertainty – for humans but for ecological systems as well. In Alaska, people are feeling the recent effects of climate change and are noticing that the lakes are drying up, bears are hibernating earlier, and geese are harder to find (see Lynas 2001). Furthermore, there is now plenty of evidence that recent climate change has affected a wide range of organisms with diverse geographical distributions, ranging from polar terrestrial to tropical marine environments (e.g. McCarty 2001). The current evidence on the ecological impact of climate change within the past 30 years is disquieting.

One way for field biologists to track changes in the ecology of species in response to climate change is to look at the timing of seasonal activities of animals and plants (the phenology). Some of the common changes in the timing of spring activities induced by climate change include the early arrival of migrant birds, early choruses and spawning in amphibians, the early appearance of butterflies and early shooting and flowering of plants. In general, spring activities have happened progressively earlier since the 1960s. Phenological changes may have intense ecological consequences. For instance, earlier leaf unfolding engenders a longer growing season but may also increase the risk of damage by a late frost (Walther *et al.* 2002: 389–390).

Parmesan and Yohe's (2003) study reveals that the gradual warming associated with human-induced climate change is affecting the global movement of animals and plants northward. Their study provides critical quantitative evidence of observed climate warming and its affect on natural systems. Phenologically, their exposition shows that there was a mean shift toward earlier spring timing of 2.3 days per decade for amphibians, herbs, shrubs, trees, butterflies, and birds. This means earlier frog breeding, first flowering, tree bud bursts, bird nesting, and arrival of butterflies and migrant birds. Their analysis shows that the range shifts of species have moved on average 6.1 km per decade northward (Parmesan and Yohe 2003: 38). This movement is signific-

antly in the direction predicted by climate change. Parmesan and Yohe's (2003) study is consistent with IPCC's "very high confidence" that climate change is a significant impetus on natural systems.

With a steady rise in annual temperatures, non-native species may immigrate into or invade unwanted neighborhoods, spreading epidemic diseases. Some of the evidence of climate change is the expanding mosquito-borne diseases in the high lands of Asia, East Africa, and Latin America (Walther *et al.* 2002: 391). Climate change is likely to further increase species extinction because of the already prevalent loss and fragmentation of habitats.

Rich with biodiversity, tropical ocean temperatures (including reef communities) have increased by 1–2°C over the past 100 years. These trends are likely to strengthen over the next 50 years (Hoegh-Guldberg 1999). Whenever sea temperatures have exceeded long-term summer averages by more than 1.0°C for several weeks, coral reefs undergo mass coral bleaching. Since 1979, there have been six periods of mass coral bleaching and the occurrence of this is increasing in both frequency and intensity (see Hoegh-Guldberg 1999). In 1997–1998, bleaching occurred for the first time in Singapore. The year 1998 was the most severe period (helped by the El Niño variability), where it was estimated that 16 percent of the world's reef-building corals died (Walther *et al.* 2002: 392). This includes the Great Barrier Reef with some of the corals as old as 700 years of age dying.

Ecological systems are complex, and because of this, responses by individual species to climate change may upset their interactions with others at the same or adjacent trophic levels. That is, there are complex dynamical effects. For example, climate change is affecting the reproductive grounds of krill, which is a vital food source for higher predators such as whales, seals, penguins, and other seabirds (Walther *et al.* 2002: 393). This is adversely affecting its supply, having consequences for the food web, human economy and disrupting the Circuits of Life. Climate change alters ecological systems and inflicts negative ecological responses, which can indirectly affect humans. For example, lower fish populations from the North Atlantic Oscillation caused by climate change lead to less food for people around the globe (Walther *et al.* 2002: 393). This can have devastating affects on regional populations since more than 1 billion people rely on fish as their staple diet. Moreover, indirectly, human over-fishing may make fish populations more susceptible to oceanic warming.

However, apart from the direct ecological effects of climate change, there are also major implications for human populations. The frequency of great floods increased substantially during the twentieth century (Milly *et al.* 2002). Climate change has increased the intensity of the global water cycle and there is likely to be an increase in the risk of floods (IPCC 2001). Storms in the North Atlantic are getting fiercer, winds stronger, waves bigger. For example, the autumn and winter of 2000/2001 were the wettest on record in England and Wales, with widespread flooding, and there were floods that distressed Orissa during India's 2001 monsoon. However, it is difficult to detect

anthropogenically forced changes in flooding and the strong El Niño effect of 1997/1998 played a role. Although El Niño is a natural phenomenon, its impact is likely exacerbated by anthropogenic global warming and forest destruction (Bunyard and Retallack 1999: 62). Much of the rise in sea levels over the past 100 years (about 10 to 20 cm) has probably been related to the concurrent rise in the global temperature (IPCC 2001), and the extent of damage from storm surges can be directly linked to sea level variations (UNEP 2002: 272). According to IPCC (2001), in the twenty-first century there is likely to be widespread flooding of many human settlements affecting tens of millions of inhabitants from both heavy precipitation and rising sea-levels. The poorer people and countries are most vulnerable to the negative impacts of climate change with poorer crop yields and scarcer fresh water (see IPCC 2001).

All of these current problems of climate change require a global effort to respond to the very real cataclysmic effects of anthropogenic (human-induced) global warming. The important 1992 United Nations Conference on Environment and Development (UNCED) held in Rio de Janeiro, Brazil, recognized the significance of reducing anthropogenic greenhouse gases. In the 1992 Rio Earth Summit, the industrialized countries declared non-bindingly to the world that they would stabilize their emissions at 1990 levels by the year 2000. Most countries have been unsuccessful in achieving their 1990 levels. For instance, US greenhouse gas emissions are now 11.2 percent over 1990 levels; Japan 9.7 percent, Canada 13.2 percent, and Australia 14.5 percent (Retallack 2001a: 20).

Nevertheless, the Rio Summit, through the Convention on Climate Change, saw the furtherance of a Protocol aimed globally at formally combating emissions that contribute to global warming. Originally envisaged in 1997, the Kyoto Protocol is an essential innovation because it specifies setting legally binding targets to reduce greenhouse gas emissions for industrialized countries. In 2002, 186 countries, including the nations of the European Community, were Parties to the Convention on Climate Change, and the entry into force of the Kyoto Protocol is expected soon (see UNFCCC 2002). Under the Convention, one of the most important obligations for all the Parties involved is the requirement to report on their greenhouse gas emissions and climate change activities. The Kyoto Protocol has not quite yet been formalized (as of October 2003), since the rules for entry into force require 55 Parties to the Convention to ratify the Protocol (which has now been exceeded), and especially that Annex I Parties account for 55 percent of that group's carbon dioxide emissions in 1990 (which now depends on Russia's ratification) (see UNFCCC 2002).³

The heart of the Kyoto Protocol entails achieving a total cut in greenhouse gas emissions among all Annex I Parties of at least 5 percent from 1990 levels by 2008–2012. From the October/November 2001 Conference of the Parties (COP) 7 in Marrakesh, governments agreed to adopt the “Marrakesh Accords”, a set of detailed decisions and approaches to implement the emis-

sion targets. This gave effect to the Bonn Agreements in July 2001 at the COP 6 in Bonn, Germany. The adoption of the Marrakesh Accords thus marked the close of a major negotiating cycle. However, there is much controversy as to the implementation and implications of how to achieve each country's agreed emission targets. To meet their targets, Annex I Parties must put in place domestic policies and measures that cut their greenhouse gas emissions. In addition to domestic actions to gain credit for emissions reduced or greenhouse gases removed at lower cost abroad than at home, the Parties may also use three "flexible" mechanisms: joint implementation, the clean development mechanism and emissions trading (see UNFCCC 2002). No concrete limits are enforced by the Marrakesh Accords on the extent to which the mechanisms may be used to meet emissions targets (UNFCCC 2002).

Part of the controversy lies with the use of carbon sinks in other countries. Kyoto may have been saved at the UN climate negotiations in Bonn July 2001; however, precarious ways exist of achieving the cuts in emissions to reach the formal targets under "Kyoto". Thus there is little celebration for the global climate because loopholes dominate most of the arrangement. There is no formal obligation for countries to reduce their own domestic emissions. Also agreed in Bonn, countries are allowed to engage in the "flexible" trading mechanisms to achieve target cuts. For example, under the Clean Development Mechanism (CDM), countries gain carbon credits that assist in meeting emission targets by utilizing the use of carbon "sinks" through large tree plantations or via land use changes in other countries like Russia and Ukraine. In addition, under the CDM, countries can gain emission permits by investing in "cleaner technologies" in developing countries – nuclear power is classified as a "clean" technology. The idea, following the CDM, is that industrialized countries finance projects in developing countries that lead to an overall reduction in emissions and contribute to "environmentally sustainable economic development" (Bunyard 2001c: 55).

Relying solely on the use of sinks is very problematical. Moreover, it is based on an unreliable and highly uncertain science, as absorption of carbon is hard to measure and because trees fall victim to fire and rot as temperatures rise, releasing CO₂ back into the atmosphere in the process (see Retallack 2001a: 20). Betts (2000a, 2000b) points out that there are drawbacks for countries that rely on the simple reckoning of "carbon offsets" – where one country sells its capacity to grow forests to another so that it can circumvent having to lessen its own carbon emissions. Also, the use of sinks through CDM as stipulated above could threaten biodiversity and indigenous communities. CDM could be valuable if we started escalating the development of relatively clean power-generating technologies such as solar, wind, and tidal, but not nuclear. However, CDM may still not be fair on developing countries. Conceivably, the loopholes – such as having no formal obligation for countries to reduce their own domestic emissions and the use of carbon sinks in the CDM – do not provide an incentive for the industrialized

countries to lessen their own emissions. According to Bunyard (2001c: 55), this is the nature of the veracity of the commodification of climate change. Likewise, the outcome of the August–September 2002 World Summit on Sustainable Development (WSSD) in Johannesburg, South Africa does not require the US to adopt timetables for progressively cutting back on large fossil fuel subsidies, and has blocked the proposal of increasing the share of renewable energy sources to at least 5 percent of total primary energy supply by 2010.

Despite these known grave anthropogenic climate change consequences, the struggle to save the future condition and sustainability of the planet was hit yet another blow when the US, along with Australia, failed to ratify the Kyoto Protocol. They believe that developing countries are getting a competitive advantage, and are calling the Protocol “fatally flawed” and “unfair”. These claims have little relevance because the US is the world’s largest emitter of greenhouse gases per capita (see Retallack 2001a: 19); and by avoiding ratifying it will set a poor example for developing countries to reduce their emissions.

Therefore, radical cuts in CO₂ emissions are required, of around 80–90 percent within 50 years to keep close to the current atmospheric CO₂ concentration level of 370 ppmv (see Bunyard 2001b: 16). This is important given the negative feedback and irreversibility of climate change, and the stresses imposed on the natural world. However, it would require an extraordinary effort to achieve these radical cuts, for example, a move away from industrialized agriculture and enormous cuts in energy use. A crucial, viable and strategic way of avoiding the possible catastrophes of climate change – given our current knowledge and technologies – is to make a significant evolution from fossil fuels into renewable energies as quickly as possible. Unfortunately, the objections, largely from the US, in setting targets to raise renewable energies in the 2002 WSSD in Johannesburg are a major disappointment.^{3,4}

The Kyoto Protocol was never intended to solve the problem of climate change by the end of the first commitment period in 2008–2012. The total reduction required for greenhouse gas emissions under Kyoto in 1997 was only 5.2 percent below 1990 levels by 2012. Kyoto envisages a series of long-term processes of five-year commitment periods (see UNFCCC 2002). Ultimately, meeting the Kyoto targets is just a first step because the targets are far less than what the IPCC climatologists believe to be safe levels – the immediate cut of over 60 percent in greenhouse gases (Retallack 2001a: 19). For Kyoto to be successful, progress and further strategies must be made beyond the first commitment period. This is more critical than obtaining the greenhouse emission cuts by 2008–2012.

Lack of biodiversity and species extinction

Biodiversity is defined as diversity of life at all levels, for example terrestrial and marine, and the complex linkages between these different levels. This includes the totality of biological resources. The evolutionary processes, natural selection and adaptation mean that it has taken several million millennia for the vast biodiversity to form what we have today. The critical function of biodiversity is securing the functioning of life support systems. Yet it is often difficult to predict responses (or changes) from loss of biodiversity on ecosystem functioning because feedback processes are complex. None of the extant species and their individuals can exist without hundreds of interrelations with other organisms within the Circuits of Life. And the biodiversity of species (plants, animals and micro-organisms) has often complex and diverse interrelationships with other types of organisms, which in effect makes life possible.

Prugh *et al.* (1999: 57–60) emphasize the importance of *functional* diversity (what the different species in an ecosystem do) as a dimension to biodiversity, and not just species diversity. For example, a progressive loss of species presents a major problem, especially when the extinction proves to be *keystone* species where the loss sets off cascade effects to other species (see Wilson 1992: 347–348). There is potential for irreversibility and therefore the *lack of substitutability* of lost environmental services. This is intertwined with our lack of knowledge and *uncertainty* of ecological processes: we simply do not know everything about biodiversity and the functions of ecosystems. Hence, under uncertainty and novelty, the socioeconomic system interacts with ecological capital and is dependent on its services.⁵

Forests, which cover about one-third of the earth's land area, are a fundamental source of biodiversity (UNEP 2002: 91). They can be separated into two groups: tropical and temperate. Tropical forests can be further broken down into dry and moist forests. The moist tropical forests, which include rain forests, deciduous forests and mangroves, are the most important source of species diversity; they account for 50–90 percent of all existing species (estimated to be around 10 million) (WRI 2002a), yet tropical forests cover less than 10 percent of the world's surface (UNEP 2002: 120). There are estimated to be about 100,000 species of tree flora in the world, of which some 21,000 species are found in the temperate zones. For the tropics, the full extent of biological diversity in the number of tree species is incompletely known (Matthews *et al.* 2000: 49). About 45 percent of the world's vascular plant species occur in closed tropical forests, and an estimated 2600 avian species, which account for approximately 30 percent of the estimated global total, depend on tropical forests (WRI 2002d). Also, terrestrial grassland ecosystems, which include savannas, woodlands, shrublands, and tundra are critical sources of bird species (see White *et al.* 2000). It is the non-industrialized countries that feature the most diverse ecosystems in the world. For example, maximum species densities are found in tropical rain

forests in Central and West Africa, Central and South America, and East Asia.

Other important sources of biodiversity include marine systems: oceans and tropical and sub-tropical coral reefs. “Coral reefs are among the most productive and biologically diverse ecosystems on Earth” (Moberg and Folke 1999: 215). They provide a multitude of critical life supporting services, such as the buffering of waves and currents, regulation of ecosystem processes and functions, and play an imperative stabilizing role in the tropical coastal zone of mangroves and sea grass beds (through complex and dynamic interactions between networks of species within and between ecosystems). Coral reefs cover a small range (or 0.1–0.5 percent) of the ocean floor, but almost a third of the world’s marine fish species are found within them (Moberg and Folke, 1999: 216, 218, 233).

Freshwater ecosystems are also rich in biodiversity. In freshwater ecosystems, *relative* species richness is higher than marine or terrestrial systems. Yet freshwater systems occupy only 0.8 percent of the Earth’s surface (McAllister *et al.* 1997: 5) (see Table 12.1). One elementary service provided by freshwater systems is habitat for a wide range of species: an estimated 12 percent of all animal species live in fresh water (Abramovitz 1996: 7). Birds, mammals, and humans all depend on fresh water for their survival. Wetlands, which are part of freshwater ecosystems, play an primary role in regulating water flow and are of exceptional importance as habitats for large numbers of species (UNEP 2002: 123). The sources of biodiversity loss are global and therefore require a global approach.

Since the 1950s–1970s there has been a new breed of military products and technologies put into use that have increased the exploitation and destruction of life and habitat. Currently, the political expression for the response to the environmental problems is “development”, as first articulated in the 1972 Stockholm Conference (see Irwin 2001). By the 1980s, the International Union for the Conservation of Nature (IUCN) initiated the World Conservation Strategy (WCS), which brought together the United Nations Development and Environmental Program (UNDP, UNEP),

Table 12.1 Species richness by ecosystem, circa 1995

<i>Ecosystem</i>	<i>Habitat extent</i>	<i>Percent known species*</i>	<i>Relative species richness**</i>
Freshwater	0.8%	2.4%	3.0
Terrestrial	28.4%	77.5%	2.7
Marine	70.8%	14.7%	0.2

Source: Adapted from McAllister *et al.* (1997).

Notes

* Sum does not add to 100 percent because 5.3 percent of known symbiotic species are excluded.

** Calculated as the ratio between the percent species known and the percent area occupied by the ecosystem.

multinational banks and the Organization of American States. The WCS's main objective was to ensure the sustainable use of species, ecosystems, and resources, and it contributed to the synthesis in the Brundtland Commission Report of 1987. The Earth Summit in Rio de Janeiro, Brazil 1992 (and subsequent meetings) recognized the importance of development and the environment through Agenda 21. This Earth Summit was critical because of a major non-binding agreement, the Convention on Biological Diversity (CBD). The CBD was the most crucial response in the past 30 years to the biodiversity crisis and recognized the importance of ecosystem services.

It was the first global agreement on the conservation and sustainable use of biodiversity and serves as a blueprint for national action. However, despite the positive overtone of the Rio Earth Summit, and although it has had some success, one of the major problems with the CBD was the lack of implementation. Also, a recent UN study explains that few environmental treaties contain specific targets and timetables or adequate enforcement provisions, and financing is a constant problem (WRI 2002f: 24–25). In addition, there was a major contradiction to achieving ecological sustainability in Agenda 21, Section 1, where sustainable development would be achieved through international trade.⁶ In the words of the WRI (2002f: 24), “[i]nternational trade and investment agreements continue to be developed without attention to how they may unintentionally undermine national and international environmental objectives”. General global human unaccountability for biodiversity has led to considerable amounts of biodiversity loss.

We are seeing the highest species extinction rates ever on earth – biological diversity is being eroded as fast today as at any time since the dinosaurs died some 65 million years ago (Vitousek *et al.* 1997). In the United States, for example, about 1.5 percent of the well-studied plant and animal species that were there in 1900 are probably now extinct, and 22.2 percent are threatened or rare (UCS 2002b). Revenga *et al.* (2000: 4) state that most of the biodiversity loss is a result of habitat destruction. Mostly due to habitat destruction, over 20 percent of coastal or marine Important Bird Areas (IBAs) are classified as under high to moderate threats (Evans 1994: 32–35). Forests, grasslands, wetlands, and mangroves have been extensively converted to other uses; only tundra, the Poles, and deep-sea ecosystems have experienced relatively little change. Species are known to adapt over time, but the expansion of the industrial economies is too rapid for species to adapt as the economic system accelerates in time and expands in space (Altwater 1998). Yet, science has not described the vast majority of species, and many may disappear before they are even known (WRI 2002b). And because of the pure complexity and lack of knowledge of different ecosystems the range of studies is restricted. For instance, by a mixture of estimates, there are between 3 million to 30 million species on Earth, perhaps 1.8 million of which have been identified (Prugh *et al.* 1999: 73).

Globally, the net loss in forest area during the 1990s was an estimated 94 million ha (equivalent to 2.4 percent of total forests) (UNEP 2002: 92). The

majority of this deforestation happened in the tropics. Deforestation of tropical forests is almost 1 percent per year, which equates to a clearing rate of about 1 acre per second (FAO 2001: 44). About 17 million hectares of tropical forest are now being cleared annually. To give some indication, this is equivalent to an area approximately four times the size of Switzerland, and it is estimated that if these rates continue, approximately 5 to 10 percent of tropical forest species may face extinction within the next 30 years (WRI 2002a). Also, globally nearly as much temperate forest, an area about the size of Malaysia, has been devoured. However, there has been an increase in forest plantations, yet at the expense of biodiversity loss. Such deforestation threatens many species of birds and trees.

In excess of 8700 tree species, or almost 9 percent of the total, have been reported to be at risk of extinction. Almost 1300 tree species, 15 percent of all threatened trees, are estimated to be at risk of extinction partly because of logging, including both clear-cutting and selective felling, and logging roads. The fastest clearance rate of any major forest type is in tropical mountain forests. This is a significant problem because these forests have the rarest and most endangered species (Matthews *et al.* 2000: 48).

Table 12.2 reveals the world list of threatened trees. Notice that in Table 12.2 Asia has the greatest number of “extinct in the wild”, “critically endangered”, “endangered”, and “vulnerable” tree species. All continents except Europe feature a large number of vulnerable and endangered tree species. Logging and the introduction of invasive species are crucial direct explanations for deforestation. Canada holds over one-third of the world’s boreal forests, and about half of this is for wood production (Smith *et al.* 2000: 12). Logging, development and settlement (road construction including human induced fires) endanger moist and dry tropical forests. Also, industrial wood and cash crop plantations have comprehensively altered the subtropical forests, especially in South America and Australia. Furthermore, invasive species have threatened the biodiversity of forests in the United States. For example, the Asian long-horned beetle, which has no natural predators, introduced from China has infected many tree species (see Matthews *et al.* 2000: 53).

However, the major factor contributing to the losses and degradation of habitats is the conversion of forest to agricultural land. In the 1990s, forest conversion to agricultural land accounted for almost 70 percent of the total forest conversion (UNEP 2002: 92). Mangrove forests have also been severely threatened by activities such as over-harvesting, pollution, prolonged flooding and fluctuating sea levels and coastal developments. The rapidly expanding shrimp aquaculture industry poses the gravest threat – as much as 50 percent of recent mangrove destruction has been due to clear-cutting for shrimp farms (UNEP 2002: 93).

Human actions have also extensively altered terrestrial grasslands globally. There are not that many large expanses of unaltered grasslands left. Grassland species of birds have declined the most in the past 30 years, possibly due to increased mowing for hay production and problems associated with migrat-

Table 12.2 Global list of threatened tree species, circa 1995

	<i>Extinct</i>	<i>Extinct in wild</i>	<i>Critically endangered</i>	<i>Endangered</i>	<i>Vulnerable</i>	<i>Lower risk category</i>
North and Central America	20	4	239	540	833	397
Oceania	12	0	105	118	394	348
Asia	13	8	675	623	1492	776
South America	12	2	98	255	992	420
Africa	9	0	113	272	1329	413
Europe	0	1	15	11	40	43

Source: Adapted from Oldfield *et al.* (1998).

ory routes or wintering grounds. Studies in the 1980s and early 1990s found that songbird populations are declining as a result of fragmentation of habitats (White *et al.* 2000: 46).

Human settlement permanently changes grassland habitats to grow crops and pastures. This results in declining groups of birds in North America and around the world, particularly in temperate zone grasslands. For example, Gunn (1999) discovered that the Henslow's sparrow and the mountain plover are becoming threatened and endangered, and the bobolink and lark bunting are becoming scarcer: these were abundant several decades ago. Two significant key areas of agricultural development that have threatened grassland habitat are northern Argentina and southern Brazil. According to White *et al.* (2000), these habitats were rich in birdlife, but eleven bird species are threatened in the Peruvian High Andes alone. Also because of human settlements, migrations of herbivores, for example, wildebeest and zebra, across the savannas (grasslands) of Africa happen over a much smaller area.

Marine systems are more susceptible to changing environmental conditions such as climate change, pollution and over-harvesting than terrestrial ecosystems because the majority of human populations are concentrated near coasts – about 60 percent within 100 km of the coast (Vitousek *et al.* 1997). There has been a doubling in the global fish catch over the last 35 years, reaching 137 million tons today. Consequently, according to the UN, half of all fisheries are fully depleted and another 25 percent are over-fished (Lee 2002: 8). Commercial over-fishing is threatening global fish stocks. Some have almost disappeared. Sharks and swordfish species have decreased. On the IUCN list of threatened species are the Atlantic cod, yellowtail flounder and five pelagic species of tuna. Also added to the IUCN list are the sea moth and various species of seahorse because of widespread collection for traditional medicines. High-value specialty food market fish and aquarium fish have been collected extensively. This has resulted in a decrease in biodiversity (Burke *et al.* 2001: 45).

Although it is natural for some movement of species from area to area, global human activity has intensified the rates of movement of invasive species and the distances covered. For example, the propagation of introduced algae species in marine ecosystems has sometimes caused Harmful Algal Blooms (HABs) threatening biodiversity (e.g. Burke *et al.* 2001: 49).

Over-fishing of coral reefs or reef associated fish populations represents a major problem (Moberg and Folke 1999). Dangerous practices include pumping hundreds of tons of toxic cyanide into coral communities which stun live fish populations every year; mining the reef for building materials and the production of lime; uncontrolled tourism; and oil extraction. These kinds of practices (particularly over-fishing) have had devastating effects on the removal of particular keystone process species (e.g. important predators), which partly explains the outbreaks of the crown-of-thorns starfish and the coral-eating mollusc *Drupella* (Moberg and Folke 1999: 225).

Lack of biodiversity and species extinction in the form of lost genes present a major problem to life forms. Every sexually reproducing organism – whether plant or animal species – contains different combinations of genes. This genetic diversity allows populations to adapt to changes in the physical environment, climate, diseases, predators, and competitors. That is, the populations are workable when their gene pool is varied enough. The problem arises with a reduced gene pool. As animal populations become smaller and fragmented, their loss of genetic diversity eliminates the capacity to adapt to environmental changes (WRI 2002e). Consequently, populations risk extinction. For example, in the United States in 1970, 15 percent of its corn crop was lost when infected by a fungus, which spread rapidly because of the lack of genetic diversity (WRI 2002e). Only through the introduction of new corn varieties containing new genes was the fungus halted.

Conclusions

There are *proximate* and *underlying* causes to biodiversity loss (see Tacconi 2000). The proximate causes for biodiversity loss include habitat loss; alteration and fragmentation; species over-harvesting and introduction; pollution; global climate change; and industrial agriculture. The underlying causes of loss of biodiversity are all interrelated: consumption patterns that induce environmental degradation; population pressures; institutional structures; technology; uneven development; and poverty and affluence. Interconnected with this are the dynamics of the capitalist system where changes in value with respect to the environment and increased demand for economic growth occur.

Röpke (1999: 410) argues that the latest phase of industrial capitalism has seen two underlying tendencies that have led to social change: (1) intensified individualization and (2) the social structures and mechanisms and the institutions associated with the supply of commodities all over the world. Access to these goods has increasingly replaced social relationships. These two trends

have had a deep impact on the final consumption of resources. And as illustrated in the ecological Circuits of Life final consumption plays an important part in the economic subsystem. The ideologies and institutional structures embedded in global free capital emphasize economic growth, social power, and control over the social and physical environment.

Population growth is a critical source of ecological deprivation. But, for decades, global increases in consumption have significantly outpaced growth in population (see WRI 2000). Carvalho (2001) and Muradian and Martinez-Alier (2001) deem that uneven development contributes to the destruction of ecological capital. For instance, the increased desire for consumption goods in the developed core has further stressed the need to exploit natural resources in the underdeveloped periphery. This is illustrated, for instance, by the global demand for tropical hard timbers and the over-exploitation of forest resources in Southeast Asia and the Amazon basin (Bunyard 2002). Additionally, capitalist “solutions” to environmental problems, such as the technical solutions of certified tropical timber in which forests are “well managed” is highly problematical.

Furthermore, institutional and government failure are other important underlying causes of biodiversity loss. Ecosystems, such as wetlands, are simply not accounted for by markets – they are considered non-existent markets – and the current structure is one of an open access regime, especially in relation to the ocean (see Costanza 1999). Governments continually fail to reduce agricultural and road transportation subsidies that are ecologically harmful.

The ultimate factor underlying the ecological crisis is the Faustian will or attitude toward nature (see Faber *et al.* 1998) – a continuous will to enhance further our material well-being through capital accumulation, where nature is regarded as a passive object. Human beings believe they are quintessential. Particularly since industrialization, humankind (the economy) has claimed the “house of nature” (ecosystem) as its property, and has influenced and controlled natural processes to a considerable extent. The crux of the ecological crisis relies upon our ethical neglect of ecological capital. We need to increase our awareness of our own ignorance of ecological problems. We require long-term socioeconomic policies that progressively encourage biospheric-altruistic values, that motivate efforts to limit consumption in the name of ecological sustainability, which means moving away from the self-interested, consumer-oriented values that characterize the modern capitalist societies (e.g. see Röpke 1999). Relying upon capitalist technological solutions alone as currently expressed politically through “ecological modernization” or “eco-efficiency” will not achieve sustainability (e.g. see Hukkinen 2001).

Notes

- * I wish to thank Phil O’Hara for comments and discussions on the ideas examined in this chapter.

- 1 For a succinct explanation of the carbon cycle, see Hadley Centre (2002b).
- 2 However, it is important to note that uncertainty in the Hadley model predictions increase with time, and this will affect the carbon cycle positive feedback. Also according to Jarvis and Grace (2001), climate models such as the one used in Hadley do not necessarily represent reality because there may be future mitigation actions designed to protect and enhance the sink.
- 3 The decision for this is mostly political-economic: energy-efficient technologies (renewables such as wind and solar power) are widely available and of high quality, and the prices have fallen in recent years. The Bush administration has close ties with fossil fuel companies and is strongly suspected of protecting their short-term interests (Retallack 2001b: 19). And obviously there is a whole range of other factors to consider for environmental problems other than moving into renewable energy capitalist technologies.
- 4 On an encouraging note, the relative success of reducing harmful ozone destroying gases, such as chlorofluorocarbons (CFCs) associated with the international cooperation of the 1987 Montreal Protocol and later amendments suggests that global protocols can be viable international policies. According to the ACF (2002), the Australian CSIRO found that the ozone destroying chlorine from CFCs is declining for the first time in July 2002. There is hope for the international agreement of the Kyoto Protocol, given the relative success of the Montreal Protocol. However, complications with reference to Kyoto are more prominent than with the Montreal Protocol (e.g. Carter 2001: 237–244).
- 5 “The novelty and incessant innovation that is the mark of the technological society is matched by the novelty of uncontrolled and largely irreversible ecological change due to pollution and habitat disruption” (Funtowicz 1997: 80).
- 6 On the CBD treaty for agrobiodiversity, Görg and Brand (2000) discovered that the system of political international regulation is a highly contradictory process and is not resolving conflicts sufficiently, for example, in regulating the access to and agricultural use of the genetic resources rich in biodiversity. In relation to moderating elemental conflicts and contradictory processes, but not removing contradictions (the “regulation” approach), “the global ecological crisis must be regarded as an *institutional crisis* of the appropriation of nature by society” (Görg and Brand 2000: 374, emphasis in original). Another political problem is the dominance of mainstream economics over “sustainable development” discourse (O’Hara 2000). As Williams (2001: 39) argues, “the relationship between trade and the environment is the result of a specific discursive that privileges environmental economics at the expense of ecological and social approaches to sustainable development.”

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13 World poverty, hunger, and disease

Edward J. O'Boyle

Introduction

Poverty, hunger, and disease have been harsh and often cruel realities from the very beginning of the human experience. Most of humankind, even today, live in the shadow of the four horsemen of the apocalypse: war, famine, pestilence, and death. And we've known for more than 150 years – for certain ever since the Great Irish Famine of the 1840s – that hunger and most especially famine, engender disease which in the extreme leads to death in massive numbers, cutting life short for many of its victims. This article is organized along three central contours. The first three sections present the key facts of poverty, hunger, and disease. The next section outlines the fundamental causes. And the last section explores essential remedies to these problems.

Global poverty: key facts

Defining and measuring poverty

There are two standards by which poverty is defined and measured: the absolute or what I call the “minimal-living standard” and the relative or what I refer to as the “income-distribution standard” (see O'Boyle 1999: 281–301). The minimal-living standard addresses the question: How much does a human being or human family need to live at a minimally acceptable level? The income-distribution standard addresses the question: How much does one human being or one human family have relative to others?

Students of poverty are deeply divided as to which standard to use. In the United States, the official definition of poverty, from the very beginning, has incorporated the minimal-living concept, dismissing out of hand income-distribution. Some countries have opted for the income-distribution concept, rejecting minimal-living. At least one country, Ireland, employs both (O'Boyle 1999: 296–300). The difference in poverty estimates varies from country to country and possibly from time to time. In Spain, for example, using 50 percent of median income to define the poverty threshold, the

poverty rate is 10.4 percent. Using the purchasing power equivalent of US\$14.40 a day to define that threshold doubles the poverty rate. In Denmark, on the other hand, there is virtually no difference. The measured rate of poverty under the minimal-living standard is 7.6 percent; under the income-distribution standard it is 7.5 percent (UNDP 1999: 149).

This divide, which gives the impression that how one defines and measures poverty in the end is an arbitrary matter, is entirely unnecessary. There is nothing arbitrary about the question which is fundamental to the minimal-living standard. Indeed, it originates in the individuality of every human being. Every human is unique, truly one of a kind, distinct and apart from every other human being. Nor is there anything arbitrary about the question which is basic to the income-distribution standard. That question originates in the sociality of every human being. Every human being is alike, every one is raised in a human family, indeed every human being is brought into existence through the special intimacy of a man and a woman. The "family of man" and the "rugged individual" would not be clichés if they did not reflect something fundamentally true about human nature. We are at once individual beings and social beings, and human existence is a struggle in which both sides are vying for control.

Common sense alone tells us that outside the developed world, where hundreds of millions of human beings struggle to survive from one day to the next, poverty must be defined and measured first in terms of minimal living. It is meaningless to set the official poverty threshold at, say, one-half the median income for all persons when large numbers of persons above that threshold cannot afford the bare essentials for human survival. It is also meaningless to define as poor only those persons with incomes which place them in the lowest two or three deciles of the distribution when persons with higher incomes struggle to survive.

An income-distribution standard makes sense only in the developed world, where it should be used alongside the minimal-living standard; but never as a replacement for that standard. Employing both concepts not only allows us to incorporate both dimensions of human nature into the definition and measurement of poverty, but also lets us address the issue of the depth of poverty in a way which limits the arbitrariness that follows when that issue is addressed one dimensionally.

A person/family is not poor whenever personal/family income exceeds the thresholds established by both the income-distribution standard and the minimal-living standard. A person/family is marginally poor whenever its income is below one of the thresholds but above the other. They are poor whenever personal/family income falls below both thresholds. This scheme automatically provides better estimates of the extent and depth of poverty¹ as improvements are made in the way in which the threshold income figures are calculated.

In examining poverty on a global scale, however, it is necessary to put aside these important technical issues and based on the information available

focus attention on (1) the numbers and proportions of persons who are poor, and (2) changes in poverty with the passage of time. One source of information is the World Bank, which set the poverty threshold in 1998 at US\$1.08 a day – the median value of the ten lowest poverty thresholds in low-income countries for which threshold information is available – and which provides the same purchasing power as US\$1.00 a day in 1985. The World Bank regards this threshold as the income necessary to “purchase a basket of commodities that is roughly similar across the world” (World Bank 2002: 18). This is a threshold which appropriately incorporates in principle the minimal-living, not the income-distribution, concept because the World Bank applies this threshold only to developing countries and economies in developmental transition including China (World Bank 2002: 21). This threshold is miserably low by comparison to the US\$8316 a year or US\$22.78 a day poverty threshold in the United States (U.S. Census Bureau 2002: 1).

Estimating poverty

Table 13.1 presents data on poverty in 1998 using a minimal-living standard of \$1 a day per person as the poverty threshold. Nearly one-fourth of the world's population in 1998 was classified as poor under this standard. In sub-Saharan Africa close to 1 of every 2 persons had income of less than \$1 a day. In contrast, about 1 in 20 in Europe and Central Asia were living on less than \$1 a day, and in the Middle East and North Africa only 1 in 50 fell below the \$1 threshold. Table 13.1 also provides data on poverty which is defined as income below one-half of the country's median income. However, these data are not so instructive because in some cases they refer to poverty conditions in a country as long ago as 1989, and because for many countries they are not available at all.

Applying the minimal-living standard of \$1 a day, the World Bank estimated that in 1998 there were 1.2 billion poor persons in developing countries and economies in transition including China. The World Bank's estimate for 1987 is only slightly smaller. Reflecting the influence of population growth, the worldwide rate of poverty dropped from 28.3 percent in 1987 to 24.0 percent in 1998. These figures, however, are misleading. While there have been decreases in the numbers of poor persons in East Asia and Pacific, and the Middle East and North Africa, at the same time there have been increases in the numbers of poor persons living in Europe and Central Asia, Latin America and the Caribbean, South Asia, and sub-Saharan Africa. Of all these six regions in 1998 the Middle East and North Africa had the smallest proportions – 1.9 percent – of their population living in poverty. The region worst afflicted by poverty in 1998 was sub-Saharan Africa where 46.3 percent of the population were impoverished (World Bank 2002: 21–23).

Other statistical measures are indicative of the enormous and growing difference in living standards between the few who are rich and the many who

Table 13.1 Persons in poverty as percent of total population, by poverty standard, region, and human development status, various years

	<i>Minimal-living standard (percent)</i>	
	<i>\$1 a day in . . .</i>	
	<i>1987</i>	<i>1998</i>
Entire world	28.3	24.0
East Asia and Pacific	26.6	15.3
Europe and Central Asia	0.2	5.1
Latin America and Caribbean	15.3	15.6
Middle East and North Africa	4.3	1.9
South Asia	44.9	40.0
Sub-Saharan Africa	46.6	46.3
	<i>\$14.40 a day:</i>	<i>< 50 percent of</i>
	<i>1989–1995</i>	<i>median income:</i>
		<i>1989–1994</i>
High Human Development		
highest poverty rate	21.1	19.1
	(Spain)	(United States)
lowest poverty rate	2.0	5.5
	(Italy)	(Belgium)
Medium Human Development		
highest poverty rate	88.0*	22.1**
	(Kyrgyzstan)	(Russia)
lowest poverty rate	4.0	10.0**
	(Hungary)	(Hungary)
Low Human Development	n.a.	n.a.

Source: Adapted from UNDP (1999) and World Bank (2002).

Notes

* Highest among 14 countries in this human development status which define poverty as \$4 a day per person.

** Information available for only two of the countries classified in this development status.

are poor. The income gap between the fifth of humankind living in the richest countries and the fifth living in the poorest countries has widened from 30:1 in 1960 to 60:1 in 1990 and to 74:1 in 1997. In 1994 the total net worth of the 200 wealthiest persons in the world was US\$440 billion; by 1998 their net worth exceeded US\$1 trillion. Their assets are greater than the combined income of 41 percent of the world's population. The assets of the top three billionaires in the world are greater than the combined GNP of the 48 least developed countries with a total population of 600 million (UNDP 1999: 3, 36–38). Real GDP per capita for the richest 20 percent of the population in the richest country in the world – United States, US\$51,705 – is 575 greater than real GDP for the poorest 20 percent of the population in what arguably is the poorest country in the world – Guinea-

Bissau, US\$90 – where 87 percent of the population survive on less than US\$1 a day (UNDP 1999: 148–149).

Global hunger: key facts

The key facts regarding global hunger are reducible to these: 800 million persons worldwide go to bed hungry, and 24,000 of them die every day. In the developing world in 1995/1997, approximately 1 of every 5 persons was undernourished (see Table 13.2).² In 1995/1997 an estimated 70 percent of the population of Somalia was suffering undernourishment, followed closely by the Eritrea where 67 percent were undernourished.

On a global scale, hunger is being reduced by roughly 8 million persons per year. However, progress has been uneven. During the first half of the 1990s, 37 countries with undernourished populations achieved a reduction of 100 million hungry human beings. In the rest of the developing world, hunger increased by 60 million. The World Food Program feeds about 10 percent of the undernourished in the world.

One-fourth of the world's undernourished population live in sub-Saharan Africa. The problem is most severe in Central, East, and Southern Africa where 44 percent of the population of 340 million live in conditions of undernourishment. Other countries where the incidence is similarly high are Afghanistan, Bangladesh, Haiti, North Korea, Mongolia, and Yemen. The following groups are most vulnerable to undernourishment: victims of war, migrant workers and their families, and those who have been marginalized

Table 13.2 Proportion of population undernourished by region: 1979/1981, 1990/1992, 1995/1997

	1979/1981	1990/1992	1995/1997
Developing world	29	20	18
Asia and Pacific	32	21	17
East Asia	29	17	16
Southeast Asia	27	17	13
South Asia	38	26	23
Latin America and Caribbean	13	13	11
Near East and North Africa	9	8	9
Near East	10	10	12
North Africa	8	4	4
Sub-Saharan Africa	37	35	33
East Africa	35	45	42
Somalia	55	70*	73*
Southern Africa	32	45	44
West Africa	40	21	16

Source: Adapted from FAO (2002).

Note

* Highest incidence of undernourishment in the world.

for various reasons including persons living alone on small fixed incomes, the homeless, ethnic minorities, nomads, landless peasants, and the disabled (FAO 2002: 6, 8, 15; World Bank 2002: 1).

Global disease: key facts

Infant mortality

Infant mortality and life expectancy are two key though crude indicators of the human toll taken by disease (see Table 13.3). Throughout the entire world, infant mortality has fallen from 98 deaths per 1000 live births in 1970 to 58 deaths per 1000 live births in 1997. In the least developed countries, the rate has fallen from 149 to 104. In the industrialized countries there were 20 deaths per 1000 live births in 1970 which indicates that infant mortality in the least developed nations was five times higher in 1997 than it was in industrialized nations 27 years earlier. In 1997 infant mortality in the least developed countries was nearly 17 times higher than in the industrialized nations: 104 deaths per 1000 live births compared to only 6 deaths per 1000 live births. For a baby born in Niger, the country with the highest infant mortality in 1997, the risk of dying in infancy was 32 times greater than for a baby born in the industrialized world (UNDP 1999: 171).

Table 13.3 Infant mortality and life expectancy by region and development status, 1970, 1997

	<i>Infant mortality per 1000 live births</i>		<i>Life expectancy at birth (years)</i>	
	1970	1997	1970	1997
Entire world	98	58	59.1	66.7
Least developed countries	149	104	43.4	51.7
All developing countries	111	64	54.5	64.4
Industrialized countries	20	6	71.4	77.7
East Asia	83	37	62.0	70.0
South-East Asia and Pacific	97	45	51.0	65.9
South Asia	131	72	49.0	62.7
Eastern Europe and the CIS	37	26	68.8	68.6
Latin America and Caribbean	86	33	60.1	69.5
Arab States	125	53	50.6	65.1
Sub-Saharan Africa	137	105	44.1	48.9
Sierra Leone	206	182	34.4	37.2*
Niger	191	191**	38.3	48.5

Source: Adapted from UNDP (1999).

Notes

* Shortest life expectancy in the world.

** Highest infant mortality in the world.

Life expectancy

For all humankind, life expectancy at birth has improved from 59.1 years in 1970 to 66.7 years in 1997. As with infant mortality there are vast differences from place to place, especially as to level of economic development. Among industrialized countries, life expectancy increased to 77.7 years in 1997, an improvement of 6.3 years since 1970. At the same time, life expectancy in developing countries also improved, increasing by 9.9 years to 64.4 years in 1997. Among the least developed countries, life expectancy stood at 51.7 years in 1997, up from 43.4 years 27 years earlier. Several countries, however, have experienced actual *declines* in life expectancy between 1970 and 1997: Zambia, Uganda, Malawi, Rwanda, Burundi, Estonia, Lithuania, Russian Federation, Armenia, and Ukraine. Life expectancy in 1997 ranged from 80.0 years in Japan to 37.2 years in Sierra Leone. Life expectancy in Sierra Leone actually improved by 2.8 years during the 27-year period ending in 1997. Even so, in Sierra Leone life expectancy in 1997 was lower than life expectancy in every other country in the world in 1970 except Angola, Guinea, Gambia, and Guinea-Bissau (UNDP 1999: 168–171).

Infectious diseases

Our attention in the following is drawn to certain infectious diseases (to the exclusion of others such as multiple sclerosis, muscular dystrophy, cancer, ALS, and cardio-vascular diseases) in the main because 17.3 million persons died of these infectious and parasitic diseases in 1997 making those diseases the leading cause of death worldwide. At the same time, cancer claimed 6.2 million victims worldwide, another 7.2 million died of coronary heart disease, and cerebrovascular disease struck down 4.6 million (WHO 1998: 2). Specifically, we focus on six infectious diseases which the World Health Organization (WHO) identifies as major killers worldwide: pneumonia, diarrheal diseases, HIV/AIDS, tuberculosis, malaria, and viral hepatitis (see Table 13.4). The WHO estimates that worldwide 1500 persons die every hour from an infectious disease; half of these deaths occur among children less than 5 years old (NIAID 2001a: 4). Further, with two exceptions *there are no effective vaccines which prevent a human being from being infected by these major killers* (WHO 2000a: Preface and Ch. 4).

Pneumonia

Pneumococcal pneumonia worldwide strikes down an estimated 3.5 million persons every year, of whom more than one million are children under the age of five, mostly in developing countries. Including other acute respiratory infections raises the death toll among children under five to 2.6 million. Information regarding the number of newly infected persons, and total number of persons actively infected generally is not available, especially for

Table 13.4 Estimated number of persons newly infected, actively infected, and killed: infectious diseases: latest year data available, circa 1998–1999

	<i>Newly infected per year</i>	<i>Actively infected</i>	<i>Deaths per year</i>
Pneumonia			3.5 million ^a (1998)
Diarrheal diseases	4.0 billion ^b (1995)		2.2 million ^a (1998)
HIV/AIDS		33.6 million ^a (end of 1999)	2.6 million ^a (1999)
	5.3 million ^c (latest estimate)	36.1 million ^c (end of 2000)	
Tuberculosis	8.0 million ^c (latest estimate)	2.0 billion ^c (latest estimate)	2.5 million ^c (latest estimate)
Malaria	300–400 million ^a (latest estimate)		1.1 million ^a (1998)
	300–500 million ^c (latest estimate)		1.5–3.0 million ^c (latest estimate)
			0.7–2.7 million ^d (latest estimate)
Viral hepatitis	520 million ^a (latest estimate)		0.1 million ^c (1999)
Hepatitis C	3.0 million ^f (latest estimate)	170 million ^g (latest estimate)	4.0 percent ^h (latest estimate)
Hepatitis B		350 million ^g (latest estimate)	1.0 million ^g (latest estimate)

Sources (adapted): ^aWHO (2000a); ^bWHO (1996); ^cNIAID (2001a) (of the 2.5 million persons who die of tuberculosis, roughly 0.8 million are AIDS patients); ^dBremen (2001); ^eWHO (2000d); ^fWHO (2000c); ^gHFI (2001a); ^hHFI (2001b).

developing countries. In Europe and the United States pneumococcal pneumonia, which is the most common type of community-acquired bacterial pneumonia, infects about 100 per 100,000 adults every year (WHO 1999a: 177–179).

Pneumococcal pneumonia is caused by bacteria which invade the lungs, and when these bacteria invade the bloodstream or the tissues and fluids surrounding the brain and spinal cord – which happens in about 30 percent of the cases – the result is meningitis. Vaccines to prevent the onset of pneumococcal pneumonia are safe and effective. However, misdiagnosing this condition as a viral respiratory infection instead of a bacterial infection, which does happen because the two present similar clinical symptoms, and treating it with an antibiotic accelerates drug resistance. The World Health Organization estimates that an antibiotic is required in only 20 percent of all acute respiratory diseases (NIAID 2001b: 1, 3; WHO 2000a: Ch. 4).

Diarrheal diseases

Included among these diseases are three major killers: typhoid, cholera, and dysentery. Contaminated water and food are the chief means by which these

diseases are spread. In 1998, more than 2.2 million persons died through diarrheal diseases. The number of newly infected persons has been estimated at roughly 4 billion (WHO 1996: 2; WHO 2000a: Ch. 4).

Multi-drug resistance is a serious problem in the treatment of diarrheal diseases. The bacteria which causes *Shigella* dysentery, for example, is resistant to almost every drug available. This bacteria is highly virulent, killing both adults and children at times in a matter of days in the absence of treatment. At the moment a single drug, ciprofloxacin, is the only viable medication for treating this disease. It is just a matter of time before dysentery develops resistance, and the drug becomes ineffective. Persons infected with cholera have been responding well to treatment with antibiotics, notably tetracycline. Even so, cholera and typhoid are known to develop resistance quite easily. One strain of typhoid linked to salmonella already is resistant to third-line drugs. Typhoid is a relapsing disease which can kill up to 10 percent of those who become infected (WHO 2000a: Ch. 4).

HIV/AIDS

Unlike malaria, tuberculosis, and pneumonia which have devastated humankind for centuries, HIV (human immunodeficiency virus) was first identified in 1983. HIV destroys the immune system, exposing the victim to multiple opportunistic infections and certain types of cancers. AIDS (acquired immune deficiency syndrome), the disease that often results from HIV, is fatal and at present there is no vaccine available. More than 80 percent of HIV infections are transmitted by heterosexual intercourse. Among infants and children, more than 90 percent of all HIV infections are transmitted from mother to child. An estimated five youngsters between 15 and 24 years of age become infected every minute (WHO 2000a: Preface; NIAID 2001a: 8, 10).

More than 21 million humans have died from AIDS since the start of the epidemic. Among children, 4.3 million have succumbed and more than 13 million have been left orphans. The AIDS death toll in sub-Saharan Africa in 1998 exceeded the human cost of war: 2 million due to AIDS as compared to 308,000 due to war. Unless there is a major breakthrough in prevention or treatment, it is projected that by 2020 AIDS will have become the most catastrophic disease epidemic in human history (WHO 2002a: Introduction).

The annual death toll due to AIDS was 2.6 million in 1999 and 3.0 million in 2000. One-half of all pregnant women in Zimbabwe are infected with HIV. In Botswana over the last 25 years, AIDS has reduced life expectancy from 70 years to 50 years. Even in developed countries treatment is becoming more problematical for two main reasons: the development of drug resistant strains of the disease and the toxic side effects of powerful drug combinations (WHO 2000a: Ch. 4; WHO 2002a: Introduction).

Tuberculosis

Tuberculosis is a bacterial disease which is transmitted by tiny particles suspended in the air and which in general affects the lungs but can trigger disease in every organ of the body. Current vaccines are relatively ineffective against adult pulmonary TB and treatment is becoming increasingly difficult because more than 50 million persons worldwide are infected with multi-drug-resistant (MDR) strains of tuberculosis (NIAID 2001a: 30, 32; WHO 2000a: Ch. 4). The drugs which are effective in treating resistant forms of tuberculosis are more than 100 times more expensive than the first-line drugs used in the treatment of non-resistant forms of the disease (WHO 2002b: 1–2).

An estimated 1.7 million persons worldwide die each year from tuberculosis. The total number of TB deaths increases to 2.5 million per year when AIDS patients are included. Approximately 8 million persons are infected every year, or one person per second. About 3 million new cases occur in Southeast Asia and 1.5 million in sub-Saharan Africa. The number of new cases is rising rapidly because of the impact of the HIV/AIDS epidemic. The total number of persons actively infected worldwide is estimated at 2 billion (NIAID 2001a: 30, 32).

MDR-TB is particularly dangerous in crowded hospitals where patients with immune-system suppression have been admitted and are being treated (as with AIDS patients), because it puts at risk the very persons who normally provide the required health care. MDR-TB develops, is transmitted, and spreads across a population beset by war, poverty, overcrowding, mass migration, and breakdown of health-care providing institutions (WHO 2000a: Ch. 4).

Malaria

The parasite which causes malaria is carried by mosquitoes for which canals are important breeding sites. In Europe, which had been regarded as free of this disease, there is a heightened risk of a resurgence due to civil disorder, global warming, international travel, and increased irrigation (WHO 2000a: Ch. 4).

Estimates as to the number of persons who are infected every year vary from a low of 300 million worldwide to 500 million. Estimates of the number of persons who die as a result of malaria infection range from 0.7 million to 2.7 million. Though for more than 50 years the conventional wisdom has placed the annual death toll due to malaria at one million (NIH 2001: 1), Breman argues that the number who die every year is substantially higher. He estimates that as many as 2.7 million die annually from malaria, and that more than 75 percent are African children. Breman (2001) projects a doubling of the death toll over the next 20 years if intervention is not more effective (Breman 2001: 1). Death due to malaria strikes 250 times more often in the poorest countries of the world than in the richest countries (WHO 1999b: 51).

Malaria is resistant to chloroquine – the former preferred treatment of choice – in more than 70 of the 92 countries where it is a major killer. In addition, resistance is growing to newer second- and third-line drugs. This problem is further compounded by the emergence of insecticide-resistant mosquitoes (WHO 2000a: Ch. 4; NIAID 2001a: 20).

An analysis of the economic toll taken by malaria in Africa over the last 35 years suggests that GDP is 32 percent lower than it otherwise would have been. In the context of the US economy, this is equivalent to a GDP loss of US\$100 billion annually (WHO 2002a: Introduction). Gallup and Sachs assert that there is a strong linkage between malaria and poverty. Specifically, controlling for tropical location, colonial history, and geographical isolation, countries in which malaria thrives had incomes in 1995 which were one-third the incomes of countries not afflicted by this disease, whether or not those countries were African. Ecological conditions which provide support to the breeding sites of the disease-carrying mosquito more so than poverty determine the intensity of malaria (Gallup and Sachs 2001: 85).

Viral hepatitis

Both hepatitis B and C are transmitted by means of contaminated blood and injection drug use. Additionally, hepatitis B (HBV) is contracted through sexual intercourse and other close contact. Hepatitis C (HCV) also may be contracted through sexual contact in persons already infected with HIV. A vaccine is available to prevent chronic HBV infection from developing which is 95 percent effective. And there is a new and effective HBV vaccine which is given to babies in the first year, but there is no vaccine available for HCV. Both viruses kill by attacking liver cells where they trigger liver failure and other complications. Because HCV shares the same transmission routes as HIV, co-infection is common, and progression of HCV-related liver disease among persons with HIV may take place in less than 10 years. Among persons who are actively infected with HCV but not HIV, progression toward cirrhosis, liver cancer, and liver failure may affect as many as one in five and take up to 20 to 30 years (WHO 2000a: Ch. 4; WHO 2000b: 1; Sulkowski 1999: 1).

An estimated 350 million persons worldwide are infected with HBV and approximately one million die every year from HBV complications. Though HBV is 50–100 times more infectious than HIV, 95 percent of all adults who are infected develop antibodies and recover spontaneously within 6 months, develop immunity, and are not infectious to others (HFI 2001a: 2; WHO 2000b: 1–2).

Worldwide an estimated 170 million persons are actively infected with HCV and 3 million are newly infected every year (WHO 2000: 1). It was not known until 1988 that HCV causes inflammation of the liver and it was 1992 before an antibody test was available. The death rate among HCV-infected persons is 4 percent. About one-half of all liver transplants in the United States are performed on patients with end-stage HCV (HFI 2001b: 1, 3).

Excluding liver transplants, the annual medical and lost worktime costs of HCV in the United States are US\$600 million (HRF 2002: 2).

Fundamental causes

There are a host of reasons that account for the poverty, hunger, and disease which beset much of humankind today. Some of those reasons are natural and more or less uncontrollable phenomena: drought, hurricanes, earthquakes, monsoons, volcanic eruptions, floods, and the like. Others are instances of human greed, exploitation, and discrimination: war, the power vacuum that followed the end of the colonial period, and the objectification and enslavement of adults and children (especially females).

Other factors relate to economic globalization; for instance, the development and widespread utilization of modern transportation and delivery systems which allow the overnight transmission of a disease from one part of the world to another via human and animal carriers and parcel and freight traffic. The recent SARS virus outbreak through Asia and other nations is a classic example of this. Also contributing are the economic vulnerability and failure of small, family-owned enterprises in poor nations due to the vastly greater power of global companies that many justify on grounds of improved market efficiency. Some factors relate to fundamental human failure or frailty: to prescribe the correct medication or dosage, to continue a drug regimen as directed, to remain faithful to one's spouse, to support one's children, to turn away from the huge but often illicit financial rewards of the present in order to pursue long-term personal development and the dividends which follow from that development in the future.

Three other related factors contribute powerfully to disease and thereby to hunger and poverty. The first is the unfortunate, though at times inevitable, consequences of using powerful drugs to fight infectious disease. Resistance to life-saving drugs is a natural and unstoppable biological process wherein the exposure of certain microbes to an antibiotic leads to a mutation and the emergence of microbes that are resistant to that antibiotic. Second, the very same hospital wards which offer hope for successful treatment of injury and disease have become the breeding ground and transmission system for "super infections" which now are regarded as a major health care crisis. In United States hospitals alone, drug-resistant microbes infect and kill 14,000 persons every year. Third, and as a consequence of antimicrobial resistance, pharmaceutical companies are called upon to discover, develop, and manufacture new antimicrobials, but every new compound brought to market costs approximately US\$500 million for research and development (WHO 2000a: Chs. 2, 4). In this regard, the World Health Organization in 2000 sounded the following ominous warning:

This report . . . documents how once life-saving medicines are increasingly having as little effect as a sugar pill. Microbial resistance to treat-

ment could bring the world back to a pre-antibiotic age. . . . The potential of drug resistance to catapult us all back into a world of premature death and chronic illness is all too real.

(WHO 2000a: Preface and Epilogue)

There are and continue to be at work five factors which probe more deeply into the nature and the causes of poverty, hunger, and disease, and thereby contribute to a better understanding as to why those problems persist in certain parts of the world and not in others. Forty years ago, Barbara Ward identified four revolutions which have swept over the Western world since the 1850s but which are not widely evidenced in the poor countries of the world. The four are the *biological* revolution which broke through the cycle of peaceful population growth and violent diminution, the *intellectual* revolution of materialism and this-worldliness, the *political* revolution of equality, and the *scientific and technological* revolution which involves the application of savings and the scientific method and insight to everyday business affairs (Ward 1962: 40–41). We would add one more: the *sexual* revolution which encourages individual freedom to initiate a relationship and to leave as the circumstances warrant, and thereby to have multiple partners either coincidentally or sequentially.

Before the biological revolution of modern medicine and sanitation began to reduce mortality and extend life expectancy, populations (especially among tribal peoples) tended to grow until the limits of economic resources had been reached, and then decline due to malnutrition and starvation or war with a neighboring tribe over control of resources. Until this revolution, tribal war, and with it disease and hunger, were revisited in every generation. Wars of this type even today are being waged in Rwanda, Burundi, Eritrea, Somalia, and Afghanistan to name several.

By the intellectual revolution, Ward means that archaic civilizations, notably tribal in nature, are backward-looking, tend to hold on to the old ways, to mystery and magic rather than hard work and reason. Holding fast to tradition and not being able to embrace change surely is descriptive of Native American Indian tribes and in part accounts for their impoverishment.

There is no concept of formal political equality in traditional societies. Wisdom resides entirely with the elders, and the young must wait their turn before their ideas are given a hearing. Extreme conservatism is the order of the day. The political revolution of equality breaks down the hierarchical nature of traditional societies, and the backward-looking ways which dominate such societies and which subordinate merchants to kings, warriors, and landlords.

In tribal societies there is little or no science. Mystery and magic predominate, effectively putting the exercise of the human will before the use of the human intellect in the manipulation of the physical matter of the universe for human ends. And there is no sustained saving in traditional societies, which blocks investment in infrastructure and thereby holds back economic development (Ward 1962: 40–61).

Confirmation of Ward's insights came most recently from Pakistani President Musharraf, who at a conference of ministers from Muslim countries in 2002 offered the following assessment of living conditions in the Islamic world: "Today we are the poorest, the most illiterate, the most backward, the most unhealthy, the most un-enlightened, the most deprived, and the weakest of all the human race" (Abbas 2002: 1).

GNP in "all Muslim countries", he said, is about 20 percent of Japan's GNP. Musharraf cited one central reason for these conditions: a lack of attention throughout the Muslim world to educational and scientific development. There are 430 universities in Muslim countries compared to more than 1000 in Japan. Britain confers 3000 doctoral degrees in science every year. The entire Muslim world awards 500 doctorates in science (Abbas 2002: 2; DAWN 2002: 3; MSNBC 2002: 2).

The sexual revolution, which took hold after Ward's remarks were published, has influenced disease, poverty, and hunger in several ways. The father who walks away from his wife and their children for another partner often leaves them in a state of poverty when her earnings and his failure to provide drop the mother and children below the poverty threshold. One reason gay men were among the first to become infected with HIV is that anal intercourse is more forceful than vaginal intercourse and for that reason tends to break open blood vessels exposing the circulatory system to the virus. As with homosexual intercourse, heterosexual intercourse with multiple partners puts a person at risk of contracting an infectious disease passed to those partners by any one of their prior partners. The only certain protection against contracting a sexually transmitted disease is for both partners to have intercourse with no one but one another. Further, drug resistance makes it difficult or even impossible to cure certain sexually transmitted diseases, such as genital herpes. Eric Noji of the National Center for Infectious Diseases asserted recently that the most important reason why public health officials worldwide underestimated the serious threat of infectious disease was that they had not anticipated that economic growth and prosperity would "lead to a change in sexual mores and to drug abuse, thereby facilitating the microbe to launch an offensive far more devastating than the threat of antibiotics and vaccines had briefly presented to its existence" (Noji 2001: 231).

Essential remedies

If economic development truly depends on four revolutions, it follows that development remedies should be designed to contribute to the advancement those revolutions in the developing world. In the following we suggest one remedy for each of the aforementioned revolutions, excluding the sexual revolution,³ in terms of the need which calls forth the remedy (actuating principle) and the limits beyond which that remedy cannot or should not be applied (limiting principle). Limits often mean hard choices must be made and in some instances lead squarely to a dilemma.⁴

Regarding the biological revolution of modern medicine and sanitation, spraying homes and the breeding sites of mosquitoes with DDT reduced the incidence of malaria significantly in the post-World War II period (Bate 2000: 697). But even though Bate asserts that there is no scientific study which demonstrates the harmful effects of DDT on human health, a paper published in 2001 suggests the danger inherent in the use of DDT which is “still highly persistent in the environment and (is) uniformly present in the lipid-containing tissues of humans and in breast milk samples” (Reigart and Roberts 2001: 1193). The authors’ first recommendation is to “*limit as much as possible the use of pesticides in the home*” (Reigart and Roberts 2001: 1195; emphasis added). Most important for economics is that with the enactment of the Food Quality Protection Act of 1996 in the United States regulatory intervention no longer is justified in terms of a favorable cost-benefit calculation but instead requires reasonable certainty of *no harm to human health* (Reigart and Roberts 2001: 1194; emphasis added).

The intellectual revolution of materialism and this-worldliness is necessary for better provisioning the needs of the human body. Even so, there are other human needs – the needs of the human spirit for truth, goodness, and beauty – which cannot be disregarded in the implementation of an economic development remedy. As with Galileo and the Church centuries ago, and creationism and evolution much more recently, faith and reason must be reconciled lest the one dominate or destroy the other. Failing to achieve that reconciliation can impoverish the human body, the human spirit, or both. If truth is one, and if faith and reason are two authentic pathways to the one truth, reconciliation is possible. Settling this conflict has clear implications for economic development, in the Muslim world especially.

Following Ward again, the political revolution of formal equality is also necessary for economic development, in particular in relation to tribal, class, or caste societies that operate on the exclusionary rule, the practice of systematically including some and excluding others. But that rule is necessary in the formation and successful functioning of any group, whether the group in the economic order is a producer or consumer cooperative, trade association, labor union, business establishment or in civil society is garden club, political party, or friends of a symphony orchestra. The pursuit of equality encounters the constraint of individual freedom which is necessary to unleash competitive energies. By freedom we mean both types affirmed by Berlin and Sen: noninterference from others or negative freedom (“liberty” to some), and the fullness of person – the absence of imperfections such as physical disability, illiteracy, mental illness – or positive freedom (Waters 1993: 273–274).

Indeed in a system of markets, both freedom and formal political equality are necessary for economic development, and both are at once actuating and limiting principles. The key to a proper balancing of the two is in how the exclusionary rule is administered. Groups should be free to exclude as long as exclusion is not discrimination by intent or impact. Thus political equality can be achieved without sacrificing freedom.

As for the revolution which Ward identified as the most important of all, it is clear that human well-being depends critically on science and technology in ways which are obvious even to the casual observer. For example, entrepreneurial ideas and schemes often originate in the scientific method and are technologically expressed in the form of new products and services, new materials, and new processes of production.

Two limits apply. The first is the destructive impact on human beings from the implementation of new technologies: loss of employment, loss of work which is creative and meaningful, loss of a sense of oneness with others in the workplace. Discount retailing chains which sever the personal connection between shopkeeper and customer and synthesizer-produced music exemplify what can beset humans when this limit is ignored. The second limit is the pernicious consequences for natural resources and the environment: depletion of renewable and nonrenewable resources, contamination of the air, soil, and water upon which all living creatures depend. Strip mining and clear-cutting timber are examples of what can happen when this limit is disregarded.

There is one remedy linked to the scientific/technological revolution that seems to offer great promise. Distance learning facilitated by the internet and other innovations in telecommunications make it possible to bring science and technology to developing countries at a fraction of the cost of building traditional brick and mortar institutions of science and technology and hiring the persons competent to handle the teaching responsibilities. It is encouraging to see so many conventional colleges and universities in developed countries moving in this direction, not to mention the "virtual universities" which are reaching students without massive investments in classroom, library, and residential facilities. In this regard, closing the "digital gap" between rich and poor nations is critically important. Besides, distance learning offers reasonably safe personal access to this revolution and the intellectual revolution in those nations where religion dominates reason.

Given the serious problems associated with economic development remedies in the past which have had two effects, one positive, the other negative, the principle of the double effect is instructive. Four conditions must be met in order to remove objections to a specific remedy. First, the positive effect must outweigh the negative effect. Second, the two effects must be inseparably linked proceeding directly from the same remedy, rather than the one effect whether positive or negative being triggered by the other. Put in different ethical terminology, the end does not justify the means. Third, when the two effects are inseparably linked, there is no way to achieve the positive effect and at the same time escape the negative effect. Even so, the negative effect must not be the intended outcome of the remedy undertaken but an unavoidable and unfortunate consequence of that remedy. Finally, the remedy must not be unethical *per se*. Once more, the end does not justify the means (Grisez and Shaw 1974: 138–149).

The four horsemen of the apocalypse are as terrifying and destructive today as at any time in human history. Bringing a complete end to the

scourge of war, famine, pestilence, and death simply is impossible. However, reining them is possible, and the experience of developed countries over more than 150 years points the way. The very heart of the problem lies in helping developing countries embrace the scientific/technological revolution. Developed countries should be under no illusion: this task will take many more years and much greater and smarter human effort.

Notes

- 1 Amartya Sen called attention to defining and measuring poverty in a way that accounts for the depth of poverty problem. He has endorsed the human development index as a supplement to GNP in measuring human development and human deprivation. This index incorporates three indicators of human well-being: life expectancy, education, and income per capita (UNDP 1999: 23). We do not make use of the index here because our task is to address poverty, hunger, and disease (see Chapter 2 of this volume).
- 2 Undernourishment – not having sufficient food to supply the calories to meet basic energy needs – is estimated on the basis of the size of the population and the amount of available food (FAO 2002: 6).
- 3 For more on the sexual revolution, traditional family life in the US and the macro-economy, see O'Hara (1995: 105–114).
- 4 We are confirmed in this approach by three recently published studies of poverty in developing countries which assert that “more work should be done as to why men and women become poor” (Quisumbing *et al.* 2001: 262), “where we find in the developing world good environments for households and firms to save and invest, we generally observe poverty reduction” (Collier and Dollar 2001: 1800), and there is a need for “more micro, country-specific, research on the factors determining why some poor people are able to take up the opportunities afforded by an expanding economy – and so add to its expansion while others are not” (Ravallion 2001: 1813).

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14 Ethnic and religious tension in the world

A political-economic perspective

Asoka Bandarage

Introduction

The world is exploding from tensions attributed to ethnic and cultural differences such as race, tribe, religion, language and geographical region. Many recent and on-going conflicts, such as the genocide in Rwanda, ethnic cleansing in Bosnia, the Palestinian struggle, secessionist conflicts in Northern Ireland and South Asia, hate crimes against immigrants and people of color in Europe and the USA, are commonly seen as localized ethno-religious violence. However, following the horrific attacks on the World Trade Center in New York on 11 September 2001, ethno-religious conflict is increasingly recognized as a global, transnational force. Conservatives and liberals agree that ethno-religious conflict has replaced Communism as the main threat to global security and prosperity in the post Cold War period. This chapter identifies shortcomings of the dominant perspectives and outlines an alternative political-economic perspective that can contribute to the search for non-violent solutions.

Dominant perspectives

Extremist socio-biological perspectives, such as 'scientific racism' which see ethnic hierarchies and loyalties as genetically based and cultural antagonism as the driving force of history, are not new (see Gould 1991). However, many intellectuals and politicians are now refashioning these views, attributing contemporary ethno-religious fundamentalism, racism and other manifestations of inter-group hostility to the strength of primordial sentiments. The primordial perspective assumes that blood ties and ascriptive identities such as religion and language inevitably claim the deepest of human attachments.

This view has gained international prominence in recent years with the publication of Harvard political scientist, Samuel Huntington's book, *The Clash of Civilizations*. Claiming that the major wars of the twenty-first century will be fought along cultural or civilizational lines, Huntington (1996) calls for strategic planning and increased military strength to maintain Western dominance over competing Islamic, Confucian and other civilizations (see also Kaplan 2000).

Similar thinking underlies US President George W. Bush's depiction of the attacks on 11 September as a war between good and evil axes, specifically virtuous Christianity and terrorist Islam. Of course, such 'us vs. them' polarizations are not peculiar to conservatives and right-wing Christian fundamentalists in the West. Even more extreme positions are upheld by some ideologues and political leaders of ethno-religious fundamentalist groups based in other parts of the world such as al-Qaida, suspected of the 11 September attacks, and the LTTE (Liberation Tigers of Tamil Eelam) fighting for an exclusively Tamil state in Sri Lanka.

The massive increase in political violence attributed to supposedly traditional identities poses a crisis for the forces of rational individualism, secular democracy and universal human rights associated with the European Enlightenment and the scientific Revolution. The assumption that with the industrial revolution and modernization, individualism and achieved identities, such as professional status would displace familial, ascriptive identities, has not proved to be entirely correct (Geertz 1963). Both the liberal and Marxist traditions which envisage a unilinear human evolution along the Western individualist or socialist lines have been challenged by seemingly persistent primordial sentiments and their modern adaptations (Young 1989). Cultural identity and consciousness are not merely thriving in the non-Western world; they are very much alive, as can be seen, for example, in the resurgence of right-wing ethno-religious fundamentalism in Europe and North America (Marty and Appleby 1993; Hainsworth 2000).

Uncontrolled growth of populations 'in societies that did not experience the rational scientific and liberal assumptions of the Enlightenment' is frequently identified as a threat to Western values of human rights, religious tolerance and democracy (Kennedy 1993: 45–46). Linking cultural conflict to population pressure, Yale historian, Paul Kennedy, among others, has advocated fertility increase in the richer countries and fertility decreases in the poor countries (Kennedy 1993: 343; see Bandarage 1997: 51). Malthusian theories, which attribute political violence as well as poverty and environmental destruction to population pressure, have been popular among ruling groups since the time of the Industrial revolution. Today, conflicts in Rwanda, the West Bank and the Gaza, for example, are frequently linked to high fertility and the presence of an excess of 'energetic, angry young men' in those regions (Kennedy 1993: 34).

Fear of the widening demographic gap between the white West and the rest of the world and increasing immigration of non-whites into the West also underlie neo-Malthusian calls for population control and right-wing demands for immigration restriction (Bandarage 1997: 38–39). But the population 'explosion' and cultural conflict are not primordial or biological problems as much as historically created social structural phenomena. For deeper understanding and lasting solutions to these problems, we need to move beyond narrow perspectives such as Malthusianism and primordialism to more nuanced theoretical formulations.

The new perspective of postmodernism, especially its Cultural Studies and post-colonialism variants, have introduced concepts that help move the debate on cultural identity beyond the mainstream liberal and conservative views. Unlike classical liberals, postmodern theorists tend to accept the continuing salience of cultural identity in the contemporary world. They recognize that modernization does not entirely displace traditional cultural categories. But, unlike conservatives, they do not see cultural identity as a fixed, universal phenomenon as much as a socially constructed one. By recognizing that self and other are contextual and fluid categories, postmodern theorists have signaled the dangers of essentialist interpretations of culture and of gender (Anderson 1995; Ahmad 1992; Wait 1998).

Despite these contributions, the postmodernist approach has not yielded a comprehensive political-economic and psychological analysis of contemporary ethno-religious conflicts or effective solutions to them. Part of the reason for these shortcomings may lie in the focus of postmodernism on literary criticism as opposed to analysis of actual socio-historical events (Gellner 1992). The popularity of Cultural Studies and identity politics has also inhibited analyses of social class dynamics associated with consciousness and identity formation. This has contributed to a multiculturalism which upholds the absorption of difference within the market economy and dominant Western culture rather than the development of genuinely alternative cultures (Lasch-Quinn 2001). Identity politics is now the 'basic point of departure' for the new 'postmodern politics' within liberal academic and NGO activist arenas and the media. But this diverts attention from the inequities and conflicts stemming from corporate-led globalization. In many ways, the 'new identity discourse' helps perpetuate ethno-religious stereotypes and polarizations rather than transcend them (Petras and Veltmeyer 2001: 130–135; see also Allen and Seaton 1999).

However, culturally-based attachments and political mobilization cannot be attributed to a simplistic Marxist notion of 'false consciousness' and elite manipulation of mass sentiments. It is necessary to move beyond the primordial as well as the instrumentalist perspective which sees cultural categories as 'available for instant manipulation by those . . . seeking power' (Mamdani 2001). Rather, we need to examine why post Cold War conditions are generating violent conflicts in such abundance and why political identity is being shaped largely along the lines of ethnicity and culture.

Cultural identity is increasingly important to people searching for a sense of belonging and meaning in an increasingly atomized global society where the bonds of family and community are being eroded. There is a deep yearning for human connection in a world that is more and more connected through the impersonal mechanisms of the market, technology and bureaucracy. To understand the mobilization of discontent along cultural lines and the attraction of political extremism, it is essential to examine global political and economic forces that are contributing to widening economic inequality and environmental, social and cultural destruction. These include the expansion of capital, modern technology and militarism.

A political economy perspective

Gatherer-hunter societies where humanity spent nearly 99 percent of history were ethnically homogeneous, small, kin-based communities. While there were elements of both cooperation and conflict over access to resources both within and between these groups, there is no evidence that inter-group relations were inherently antagonistic or that enmity was primordial. In fact, many anthropological studies suggest that gatherer-hunter existence was relatively egalitarian and peaceful (Shostack 1983).

However, with the development of settled agriculture, social class and gender hierarchies evolved. With the emergence of feudal kingdoms and expansion of states, cultural differences came to be employed in the justification for dynastic wars. Religion was frequently used to sanctify social domination, as for example, in the Hindu ideologies of caste and color. Despite biological and moral claims made to justify hierarchy, cultural differences did not always connote domination. Even in highly stratified societies, such as in medieval India, assimilation between different ethnic and religious groups was not entirely ruled out, although such intermingling took place slowly over time (Basham 1954).

However, with large scale incursions, especially that of Arabs and Islam (westward since the seventh century AD and eastward since the eighth century AD), the pace of cultural change quickened. While conversion to Islam involved the use of force, Islam appealed to conquered people because of the openness of its community (*umma*) to all, regardless of color and class. Economic incentives and the availability of an 'enormous free-trade area' for anyone wishing to participate in trade and the religion, perhaps, were even more appealing (Mann 1986; see also Ali 2002). Moreover, polygamy, sanctioned by Islam, became both a strategy for male dominance and a means for expanding the Muslim community.

Colonial transformation

With European colonial expansion beginning in the late fifteenth century and the subordination of local and regional rivals including Muslim traders and rulers, the whole world came to be integrated into a global capitalist political and economic system. The 'enormous demographic explosion' and migration of Europeans played a critical role in consolidating Western hegemony over the world (Bandarage 1983: 129). Despite the language of rationality and progress, European conquest and capitalist development were based on militarism and the supposed superiority of Western civilization. The ideology of white supremacy was used to justify the African slave trade, as well as genocidal wars and pillage, and plunder of local communities and resources around the world (Editors 1992: 131–147).

The result of colonialism was neither a continuation of pre-colonial social formations and identities nor a uniform assimilation into the capitalist

economy and Western culture. Colonialism incorporated regions as well as social groups, including classes, cultures and the sexes, into the new political economy and culture in an uneven and unequal fashion (Bandarage 1983: Ch. 8). Those who resisted colonial domination were socially marginalized or even killed. Many indigenous tribes as in the Americas, whose cosmology and earth-based life styles were the most antithetical to colonial capitalist norms, were completely wiped out (Bandarage 1997: 132). On the other hand, some individuals and groups more willing and able to assimilate benefited from social changes associated with colonialism. But, over time, colonized people as a whole came to look at themselves and their cultures through the colonizers' eyes, internalizing the belief in their own inferiority (Fanon 1967).

Christian missionaries played a key role in justifying European imperialism from the beginning. Like Islam, Christianity is a salvation religion which seeks universalism through world conquest (today, Christians constitute 33.6 percent of the global population and Muslims 18.3 percent; Geohive 2002). Although its faith is open to all, within the global Christian community, racial hierarchy and white supremacy have remained alive due to colonial associations. Many early conversions to Christianity were violently enforced, entire communities of indigenous tribes, for example, having been converted at the point of the gun. But some colonized people also converted for economic reasons, and the social mobility allowed Christians who were seen as more trustworthy than the 'heathen' elements. Christian education, which imparted Western languages and world view helped create a favored elite identified with the West, but, increasingly separated from the local cultures.

Colonial powers used pre-existing ethnic and religious differences to their own advantage in establishing and consolidating their power. Being a minority, the Europeans needed local groups to fulfill different functions in the colonial political economy. For example, certain entrepreneurial groups, including Muslims, who vehemently resisted conversion to Christianity, were allowed to function as 'middlemen minorities' specializing in local trade, while the more lucrative long distance trade remained a European monopoly (Bonacich 1982). More Westernized and Christianized ethnic and religious minorities and social classes were selected to run the lower echelons of the colonial administration. In Sri Lanka (colonial Ceylon) for instance, the British employed proportionately more minority Tamils than the majority Sinhalese in the local administration. In Rwanda, the French colonial administration employed the minority Tutsi to control the majority Hutu. European policies of labor import and export, population transfer and re-settlement implemented for developing plantations, mines and other interests also created new tensions and imbalances among local populations. While many of the ensuing conflicts have come to be labeled 'primordial', they were products of the colonial transformation (Bandarage 1983; Mandami 2001; Norberg-Hodge 2001).

As J.S. Furnivall (1948), and later 'plural society' theorists have argued, ethnic groups are not inherently antagonistic toward one another merely by

reason of the differentiation along cultural lines. Rather, conflicts emerge out of the hierarchical integration of groups within the colonial political economy and the lack of a 'common will' or cultural integration among them. This argument has been extended to the imperial countries themselves by Robert Blauner (1972) and others within the theoretical framework of 'internal colonialism'. They argue that in societies such as the United States, cultural conflicts have been socially and historically created through a racially- and ethnically-based occupational hierarchy. They point to the roles of Blacks as slaves, Chinese as coolies, Hispanics as migrant labor, etc. and their social segregation in ghettos, Chinatowns, barrios, reservations and so on (see also Hechter 1975).

Furnivall (1948) and others argued that conflicts among cultural groups became most severe with the removal of the colonial state and its role in maintaining order through external force. But, as noted earlier, the colonial state was never an impartial arbiter. At decolonization following World War II, many societies were left with ethnically- and culturally-based electoral representation and nation states demarcated along ethno-religious lines, as for example, in India and Africa. This colonial legacy led to new forms of political competition among local groups in the post independence era. Colonial models of political integration into the modern world have allowed opportunistic elites to compete for electoral power and try to carve out new nation states in the name of primordial ethnic and religious identities. As Mahmood Mamdani has pointed out, colonial policies created new political identities based on race, ethnicity, religion and geographical origin. As colonially defined political identities, for example, natives vs. settlers, were 'legally enforced and ... reproduced', they became 'institutionally durable'. Over time, these political categories began to be accepted as cultural, if not biological entities (Mamdani 2001: 15, 20, 22).

Some theorists argue that the removal of external force (superpowers) in the post Cold War period has opened 'new spaces' in fragile multiethnic states for playing out of the struggles for devolution of power (Telhami 1995: 292; see also Garfinkle 2001). But, ethno-religious conflicts in the contemporary period did not result simply from the removal of Cold War rivalry. The rise of extremist ethno-religious political forces in the contemporary period, must also be addressed as a contradiction of corporate-led globalization.

Corporate globalization

Global capitalist expansion has greatly accelerated in the current era, increasing the control of transnational corporations in all regions and spheres of life. Both conservatives and liberals uphold corporate-led globalization as the harbinger of economic growth and prosperity. This occurs in spite of the fact that right-wing conservatives oppose political and cultural forces historically associated with capitalist expansion, such as the secular state and democratic

norms. Even religious extremists opposed to US military and political power and Western culture are not averse to capitalism *per se*; they rely on capitalist enterprises and Western technology to achieve their political goals. As corporate globalization is increasingly accepted as irreversible, capitalism has become a monolithic force and its ideology of growth, a form of economic fundamentalism.

Like the earlier phases of capitalist development, the current phase is also replete with uneven developments and inequalities. Global resources and wealth are more and more concentrated in the hands of a few large corporations based in the industrialized North. The top 200 corporations account for nearly 30 percent of global economic activity. The 20 percent or so of the world population living in the North, which includes most of the white minority in the world, control about 85 percent of all global wealth, whereas the majority of the world's population living in the impoverished South, predominantly people of color, subsist on about 15 percent of total global income (Bandarage 1997: 13). Within regions and countries too, there are enormous economic disparities, with a mostly non-white underclass living in poverty in the North and a cosmopolitan upper class living the consumerist life style in the South. As we shall discuss later, both in the South and the North, mass resentment is mobilized increasingly along ethno-religious lines.

Despite the tremendous advances in global information and technology, the absolute number of people living under the poverty level is increasing. The natural environment and traditional modes of living are destroyed by the combined effects of new economic and technological developments, such as industrialized agriculture and the export of natural resources. Food security is severely threatened by corporate monopoly of hybrid seed and plant varieties, chemical fertilizers and other in-puts. About one-third of the population in the South, most of them children, live without access to basic necessities such as food, clean water, education and health care. According to the ILO, about 30 percent of the global labor force is unemployed (Bandarage 1997: 1–2). This means that the unemployed must survive doing whatever they can in the informal economy, be it crime or soldiering, for whatever political faction. So-called 'complex emergencies' are on the rise due to the confluence of poverty, drought, famine, disease, war, destitution and population pressure. Currently, there are 50 million refugees world wide, many of them displaced in their own lands, due largely to so-called ethnic and religious conflicts (UNHCR 2002: 7).

Even the meager social welfare services earlier provided by local states have been dismantled by IMF and World Bank imposed structural adjustment, privatization and other policies (Bandarage 1997: 198–204). As the state is displaced from its socio-economic functions, it is reduced to being an institution of patronage and corruption and a vehicle for maintaining law and order. As economic crises worsen, ethnic cleavages sharpen, escalating into conflicts and even large-scale civil wars (Bangura 1995). Then besieged states come to rely more and more on militarism and the buying of weapons from the arms exporting countries of the North.

The permanent members of the United Nations Security Council are the primary weapons producers and exporters in the world. The United States, the world's military super power, accounts for about 50 percent of all global conventional weapons sales (Bandarage 1997: 206). The arms trade is a lucrative corporate business, if not the most lucrative business in the global economy. It also helps control global populations. Globalization is, indeed, a violent enterprise. Tensions and conflicts in the modern world, then, have to be understood as a dialectic between two forms of fundamentalism: economic fundamentalism of neoliberalism or monopoly capitalism and ethno-religious fundamentalism of political extremism (Ali 2002).

Primordial arguments aside, without the proliferation of weapons, especially small arms, cultural tensions and conflicts in the world would not be as bloody as they are today. In many regions beset by war, guns are more readily available than food, even to children. In Pakistan, almost every third male is said to be armed with automatic weapons (Ahmad 2001: 35). Children raised in a culture of violence, promoted by the global media and entertainment industry, are susceptible to the use of weaponry at a young age (Boothby and Knudsen 2000: 60–65).

The frustration and anger of the masses of the poor – the 'surplus population' – of the world, provide fertile soil for mobilizing resentment along religious, ethnic and other cultural differences. But ethno-religious mobilization today is hardly a traditional phenomenon. While contemporary ethno-religious movements invoke the ideologies of what has been called 'imagined communities' and a return to a glorious past of ethnic or religious purity, they are highly sophisticated ventures adept at using modern media, fund raising and other means.

What is being called Islamic Jihad today is not just the traditional ideology of the triumphant Muslim empire. It is a modern ideology fashioned in reaction to globalization and Western imperialism. The leaders of militant Islam, as of some other extremist ethno-religious factions, may be opportunistic, if not fanatical men seeking their own glory; the young zealots awaiting martyrdom, may be thoroughly brainwashed. But some of the underlying grievances go beyond mere 'civilizational' differences between the West and Islam. In the case of militant Islam, the major grievances include Western, specifically US control of oil and militarization of the Middle East region and support for Israel (Ahmad 1992).

Indeed, the religious or ethnic fundamentalist challenge to Western imperialism does not take the form of proletarian revolution as predicted by Marx. Ethno-religious aggression such as the destruction of the World Trade Center on 11 September 2001, and other forms of right-wing militia aggression such as the Oklahoma City bombing in 1995, have already destabilized the global social order and weakened the power of states. The challenges emanating from ethno-religious movements are not constructive but utterly destructive. However, it is important that they are not treated merely as reflections of primordial hatreds which can only be dealt with by greater aggression and

violence. To deal seriously with the threats they represent, it is imperative to understand their attraction to young people, particularly those from disaffected social classes around the world.

Ethno-religious mobilization

Traditional families, communities and cultural traditions are breaking down in the face of massive economic and cultural changes associated with globalization, including large scale migration, consumerism and the spread of the competitive individualist ethos.

The rapid expansion of Western corporate culture and the English language are undermining local cultures and languages, creating deep inner conflicts in people. Many young people brought up watching American television have been made to feel that their traditional cultures are inferior and worthless. On the other hand, they also feel they can never succeed in the modern world because they lack access to the English language, Western education and the social connections necessary to obtain decent employment. The resultant feeling of not belonging has created a mixture of fear, anxiety, despair and anger among younger generations around the world (Norberg-Hodge 1991).

As has been revealed in the aftermath of 11 September, even members of relatively privileged classes, including immigrants to the North and white youth, have not been immune from feeling marginalized in the dominant culture and susceptible to extremist forces. Individuals feeling betrayed or neglected by their traditional religious and political leaders and institutions and lacking community and family support, are more amenable to new movements that promise a sense of community and social betterment.

Political and economic forces that claim to fill the economic and emotional vacuums created in people's lives by the instability and fear accompanying corporate globalization and militarism are thriving in all parts of the world. They are most active among the poorest populations. In desperate situations of poverty, war and insecurity, people look to whatever sources of comfort and support they can find. The growing success of fundamentalist movements such as evangelical Christianity and radical Islam lies not so much in the strength of traditional loyalties as in desperate contemporary social conditions. The simple messages of obedience to God or a charismatic leader and the structure, stability and discipline of an authoritarian cultural and political movement are attractive to people whose lives have been thrown into disarray by forces beyond their control.

But the main reason for the success of religious proselytization and conversion among vulnerable communities may not be the emotional support as much as the economic incentives. Access to employment, education, money and even food and other items of survival are routinely provided by the many hundreds of evangelical Christian sects, operating in the global South and the former Soviet bloc. Most of these sects, like the Pentecostals, have their

origin and continued support and funding from well organized networks of parent churches in the US (Barker 2000). Fundamentalist Islamic groups, not infrequently funded from the oil rich Middle East, also provide basic needs to those willing to join their community. Islamic schools in poor countries such as Pakistan and Indonesia are 'total institutions'. They look after the basic needs of students, inculcating in them a politically activist Islam which helps equate faith with martyrdom (Juergensmeyer 2000).

The influence wielded by Christian charity groups and NGOs from the North and by pan-Islamic forces over local political processes create suspicion among established religious communities. The crises of survival facing such communities gives rise to their own fundamentalist mobilization and violence. Recent attacks against Christian missionaries in India by militant Hindus is an example. While such aggression must never be condoned, it is important not to categorize them simply as primordial or majority violence against minorities. Rather, it is necessary to examine how the poverty and powerlessness engendered by globalization has created ground for unethical conversions (using economic incentives) and how freedom of choice and belief are thereby curtailed (compare with international population control, Bandarage 1997: Ch. 2).

Grass roots mobilization and support allow fundamentalist movements to become politicized and influence the public arena to further their own agendas. Unlike Christian Liberation Theology which mobilized the poor to fight for social justice and empowerment in Latin America in earlier decades, widespread evangelical Christian sects active among indigenous communities in Latin America and poor communities in other parts of the world today are directing mass despair and anger toward inner salvation at the expense of efforts for social transformation (Levine 2000: 120–141). In fact, evangelical sects thrive under poverty and dictatorship of brutal regimes, in places such as sub-Saharan Africa, precisely because they fail to challenge them (Hackett 2000: 102–119). Thus, religious fundamentalism, especially Christian fundamentalism, can provide a social and psychological foundation to corporate globalization and militarism. Ethno-religious fundamentalism provides a similar function for maintaining patriarchal authority by encouraging women to play the traditional roles of dutiful wife and mother and reject supposedly misguided feminist notions of women's freedom.

Many of the strategies of fundamentalist grass roots mobilization and politicization have their origin in the United States, where Christian education and curriculum development, fund raising, engagement in electoral politics and the media have all been successfully undertaken. In the US too, it is largely members of the lower and lower middle classes disaffected by neoliberal economic policies of recent decades who have been recruited into the right-wing Christian fundamentalist movement. As elsewhere, their dissatisfaction and resentment have been mobilized against cultural others – Jews, non-white minorities, new immigrants, feminists, gays and so on – rather than corporate hegemony or state militarism (Hardisty 1999).

The resulting identity politics and conflicts have at times turned violent as evidenced by bombing of abortion clinics and hate crimes against minorities and immigrants. Although not always explicitly identified as Christian, right-wing neo-Nazi groups in the US have a close affinity with religious fundamentalism. They draw their cadres from among desperate white youth from the lower social classes, without much education or opportunities for social betterment. They too direct their anger and resentment toward cultural others as well as the state, which they see as a representative of the allegedly evil 'New World Order'. Investigations following the Oklahoma City bombing have suggested connections between Christian identity doctrine, white supremacist ideology and the rise of right-wing militias (Ansell 2001; Juergensmeyer 2000).

Christian fundamentalism in the US is not a fringe movement, but the mainstream. In the past few decades, it has helped shift the entire political spectrum to the right. European countries experiencing economic and social crises and rising immigration are also moving in the same direction. There too, class-based politics, such as union organizing is giving way to identity-based politics and the growing popularity of xenophobic political leaders and neo-Nazi youth groups. The former Soviet bloc countries struggling with massive economic and social upheavals, seem also to be engulfed more and more in ethno-religious rivalries and political extremism, ex-Yugoslavia being a most tragic example (Hainsworth 2000).

Creating primordial nation states

The genocide in former Yugoslavia did not stem from mere primordial antagonisms as popularly portrayed. The different ethnic and religious groups had lived in relative harmony for long periods of time and inter-marriage and cultural mixing were widespread. It was the worsening economic conditions in the post Cold War period and new economic policies including excessive borrowing and debt, IMF economic restructuring, cutbacks in social, education and health services that set the stage for ethnic conflicts. When the Serbian leader Milosevic and his state allies began to use extremist ethnocentric propaganda to aggrandize their own power, ordinary Serbs and Croats too began to direct their anger and hostility against each other in the most brutal ways (Bandarage 1997: 294). The subsequent demarcation of Yugoslavia into separate ethno-religious states have not brought lasting peace to the region. It has turned cultural differences into primordial hatreds and dismembered communities and families.

In Sri Lanka too, the framing of social discontent along ethnic lines has undermined the common class experience of the Sinhala majority and Tamil minority and the traditions of tolerance and co-existence between them. The fuelling of ethnic hatred by politicians and intellectuals on both sides has created a situation of extreme nationalism where thousands of poor children from both sides have been killed (Stoddard 1986). A continuation of

ethnically-based approaches and solutions is likely to further cultural polarization and violence.

It is questionable if an unjust peace brokered by the West which gives into the demand for an ethnically cleansed, exclusive Tamil state would bring lasting peace when the majority of Tamils live among the Sinhalese outside the demarcations of the imaginary 'Tamil homeland'. It is also highly unlikely that under a repressive LTTE regime, Tamils could enjoy the freedom they long for. The balkanization of Sri Lanka along ethnic lines could set a dangerous precedent for the rest of South Asia where other secessionist movements are at play. A lasting peace in Sri Lanka requires economic, political and cultural survival of all religious and ethnic groups, including the right of all individuals to live anywhere on the island (Stoddard 1986).

In the long run, a lasting solution to the Palestinian struggle with its brutal suicide bombings and daily massacres may not come from a mere separation of states either. While the United States and the UN Security Council are now seeking to give in to Palestinian demands for a separate state, the Western powers were also responsible for the creation of the ethno-religious state of Israel some half a century ago. The state of Israel will soon have more Arabs than Jews living in the territory, and the underlying issues of land and resource distribution need to be urgently addressed (Carey 2001). Similarly, the creation of a separate Hutuland and a Tutsiland in Rwanda, as proposed by some policymakers, would reproduce 'minority' problems in each of those ethnically separate states (Mamdani 2001).

Demarcation of nation state boundaries by Western powers is a not a panacea to the larger problems of justice and peace. Ethnocentric demarcations tend to solidify separation and hatred, discouraging reconciliation. Given massive rates of migration across borders and the increasingly international nature of religious and ethnic identities, it is doubtful that needs and demands of different groups can continue to be met within localized regions and nation states. To better understand and improve life in a globalized world with overlapping and changing identities, we need broader analyses and more creative solutions. To comprehend the depths of the contemporary human dilemma and to find effective solutions, it is necessary to incorporate political-economic and materialist approaches within a still deeper humanist and ecological framework.

Toward an ecological perspective

Neither the classical liberal nor Marxist approaches or even mainstream feminist approaches have addressed human needs beyond rational instrumental and material ones. This neglect of human emotional and spiritual needs has allowed right-wing fundamentalist groups to claim the realms of family and community as their own, as well as to impose patriarchal domination over women and children in the name of traditional culture. As corporate globalization, especially biotechnology and genetic engineering advance,

giving rise to cloning and transgenic species, human life will become more and more a technological commodity. As new forms of difference, hierarchy and conflict emerge along the lines of technological manipulation and commodification, the resistance by so-called ethno-religious primordialism could take even more desperate and violent forms.

In this context, it would be more important than ever to uphold the inherent interdependence and equality of all human beings, the sanctity of life and a deep commitment to non-violent strategies of conflict resolution. In order to quell the rising tide of opportunism and violence represented by extremist forces, it is necessary to develop a perspective that identifies not only differences but also the inherent unity within human and planetary life (Bandarage 1997: Ch. 8). A universal ethical approach which identifies material as well as human emotional and social needs is urgently needed.

To find lasting solutions to contemporary problems, we have to strive for a middle path between the extremes of both corporate-economic and ethno-religious fundamentalism. Both the 'anti-globalization' movement and the movements for cultural preservation need to be re-conceptualized. Positive attributes of globalization, such as dynamism and innovation, and the positive aspects of ethno-religious mobilization, such as the emphasis on tradition and sense of belonging, need identification. However, to create more balanced models of human and planetary development, we have to move from philosophy and vision to social activism and concrete strategies for change.

Social change activism

The 'anti-globalization' movement suffered a serious set-back when the focus of global social change organizing shifted from social justice and environmental preservation to security and anti-terrorism after 11 September. Expanding the arms trade and militarism will only deepen the fear, insecurity and violence in the world. Unless the issues raised by peace, social justice and environmental movements are addressed, continued ethno-religious mobilization will only exacerbate the global crises of insecurity and terrorism. Calls for ethnic and religious tolerance and multiculturalism, human rights, women's rights and secular democracies around the world need urgently to be connected to the demands for greater economic equality. Otherwise, the spread of identity politics will only help perpetuate rather than change the global status-quo.

Unbridled corporate growth must not be accepted as an inevitable force. Rather, ethical, social, environmental and cultural criteria must be introduced into corporate decision making (Bandarage 1997: Ch. 8). Satisfaction of basic human needs for food, water, shelter, education and emotional security is essential for curtailing ethno-religious conflicts. So is the control of the production and distribution of weapons and violence in the global mass media.

While much of the contemporary ethno-religious violence may seem to come from the impoverished global South, the roots of many of the global

problems lie in the industrialized North. As such, the burden of individual and social change cannot be left entirely up to people in the South. Individuals in the North must be more actively responsible in exercising their power as electoral voters, corporate stockholders and the like. They can help democratize political and economic institutions, notably governments and corporations, through efforts such as campaign finance reform and socially- and environmentally-responsible investment (Bandarage 1997: Ch. 8). Ultimately, they need to move toward a simpler, ecologically and community-based life style that will allow greater fulfillment, peace and security for themselves and the rest of the world.

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15 The war on terrorism, political-economic contradictions and policy issues*

Phillip Anthony O'Hara

Introduction

Over the past decade, in particular, many planned attacks on civilians and others throughout the world have made terrorism a central concern in the global political economy. The vast majority of these attacks were agents of war. The “event” that “changed the world” was the 11 September 2001 attacks on the World Trade Center and the Pentagon in the United States, which killed around 3000 people. Since then there have been several other such attacks, such as the October 2002 suicide bombing in Bali which killed 202 people, and the May 2003 bombing in Casablanca which killed 43 people. These and others are said to be part of a wider, worldwide plan of attack by radical Islamic networks against US hegemony in the Middle East, the Persian Gulf and elsewhere.

Of special concern to Osama bin Laden and his *al-Qaida* “terrorist” network is the aggression they see the US as having wielded over Islamic nations. For instance, they complain the US has troops stationed in Saudi Arabia, a holy land of Islam. The US has historically strongly supported Israel – militarily and diplomatically – against the “Palestinian people”. The US and its closest allies (the UK and Australia) are seen as having invaded Iraq with insufficient evidence of weapons of mass destruction. The UN – with the US at its head (when it supported the UN) – disarmed and then stood by while some 100,000 ethnic Albanians were slaughtered in 1998. And a recent ally of the US, Russia, has been trying to defeat (or destroy) the Chechen Islamic radicals in their bid for dominance in the area.

These actions and others have incensed bin Laden and his followers. He had earlier issued a *Fatwa* to all Muslims declaring a *Jihad* or holy war on the US and its allies:

[W]e issue [t]he . . . ruling [that] to kill . . . Americans and their allies – civilians and military – is an individual duty for every Muslim who can do it in any country in which it is possible to do it, in order to liberate the al-Aqsa Mosque and the holy mosque [Mecca] from their grip, and in order for their armies to move out of all the lands of Islam, defeated and unable to threaten any Muslim. This is in accordance with the words

of Almighty God, [to] . . . “fight the pagans all together as they fight you all together,” and “fight them until there is no more tumult or oppression, and there prevail justice and faith in God.”

(bin Laden *et al.* 1998: 2)¹

After around 3000 people were killed in the 2001 attacks on New York and Washington, D.C., George W. Bush ordered the Taliban to give bin Laden up to face a military or international tribunal. They refused and in the midst of sympathetic UN resolutions favoring anti-terrorist actions, the Afghan War started in November 2001. A new, more unilateralist policy has been instigated by the US, under the influence of the American Enterprise Institute and others, to rid the world of so-called renegade states and the “axis of evil”. The combined air and ground forces of the US, NATO, other nations, plus the Northern Alliance managed to destroy most of the resistance put up by the Taliban, and a more broadly-based Afghan government was able to be installed by February 2002. Hundreds of captured Taliban and *al-Qaida* fighters are being held in Guantanamo Bay in Cuba for interrogation. The US and its strongest allies then went into Iraq in 2003 to defeat Saddam Hussein on the pretext of that state having weapons of mass destruction and having association with Islamic terrorists.

What are we to make of the continuing political-economic significance of these conflicts for the world and its people? Does it represent, as Lawrence Freedman (2001–2002) asks, the start of a Third World War that will impact greatly for some years to come? Does it represent, as Samuel Huntington (1996) believes, a major clash of civilizations, Islam and West, which will impact for many decades to come? Or could it be, as Charles Amjad-Ali (2001–2002) proposes, a passing phase of the evolution of the world-system where the US seeks a meaningful form of dialogue with Islam? The aim of this chapter is to find out some of the answers to these and related questions.

Contemporary terrorism: nature and trends

There are literally dozens of definitions of terrorism posited in the literature, which reveal its multifaceted nature, and lead to difficulties in obtaining consistent statistics. Close to the mark is M.V. Naidu’s (2001: 2) perspective that:

terrorism is the phenomenon in which a community is subjected to fear and terror through threats to human well being, and/or through . . . destruction of life, liberty and property of some individuals or groups [and where the] . . . targets of these threats and/or attacks are essentially [the] civilian population, . . . in pursuit of racist, religious, and ideological or political goals.

Usually when people talk of terrorism – as in this definition – they mean that certain actions have been taken by a group to kill, wound, threaten or infect

civilians, and propel fear and intimidation within the social-psychology of a wider population.²

Terrorism is unleashed on civilians in many forms. Michael Walzer (2002), for instance, differentiates between revolutionary terror, war terror and state terror; and I would add a fourth, namely "cultural terrorism". Of course, all four forms could be operating simultaneously, and are often closely related. *Revolutionary* (or "*political*") *terrorism* includes the actions of a liberation movement (or its enemies) to force the hands of political leaders to yield on particular issues. Examples include the Irish Republican Army, the Palestine Liberation Organization, the Basque Separatist Movement, and the Algerian National Liberation Front. Recently, Islamic radicals are taking vague or very *general concerns at a global or regional level* as a basis of action.

War terrorism is an attempt by a government or army to kill civilians in large numbers during a full-scale war in order to force the opposing army or government to surrender. The classic example is the dropping of atom bombs on Hiroshima and Nagasaki by the US during World War II, resulting in the killing of over 100,000 civilians and the surrender of the Japanese government.

State terrorism usually includes war terrorism but is supposed to mean the targeting of civilians in peacetime, or the use of a state apparatus in one country to support an army that targets civilians in another. State terrorism in general (including the use of the state for war terrorism) is the most common form of terrorism – the greatest menace – and has elicited the greatest number of civilian deaths (see Sherman 2002). A good example is the destruction of native American culture and peoples by colonial and government armies during the 1700s and 1800s. Another is the attempted extermination of Aborigines in *Terra Australas* in the late 1700s and 1800s by the British and local authorities, especially through the introduction of smallpox viruses into the indigenous community (see Butlin 1983), and systematic shooting and other means.

There is a fourth form of terrorism, what might be called *cultural terrorism*, where a dominant ethnic (or other) group kills or instills fear and intimidation into members of another group as part of the normal course of life. Usually, though, this requires the support of the state or other institutions, such as the Church. Often those who are killed, intimidated or denied due process are looked upon as inconsequential, since they are "no better than dogs", "savages", "underlings", whose life is said to be "worthless". A good example is the lynching of African Americans by the Ku Klux Klan and their associates between the 1870s and the 1950s.

The new radical Islamic terrorism is closely related to other forms of terrorism. Specifically, it is a form of revolutionary terrorism; but it is also done within the context of a global war of radical Islam against the US and its closest allies. It is undertaken in response to what it sees as US state terrorism, war terrorism in Iraq, and the support of reactionary state and organized terrorism in Israel and elsewhere. In order to comprehend the causes of the war

on terrorism and the war on US hegemony, it is necessary to study the conflicting tendencies and processes of modern terrorism and the global political economy. Such conflicting tendencies are not simple; they are complex. One has to examine the strategic nature of terrorism, and the major sources of conflict emanating within the global political economy (see Kennedy 1998). Why does *al-Qaida* want to engage in weapons of mass destruction? Why do they use modern forms of technology? Why are they against US hegemony? Why hasn't globalization led the whole world to successfully join the club of business networks establishing shareholder value? How can there be different interpretations of Islam? It is to these questions that we now proceed.

Terrorism: low fatality risk, high system risk

This chapter seeks to critically evaluate the recent terrorism issue on the basis of the political economy notion of "contradiction". Contradictions are positive and negative aspects of a phenomenon that are inherently related to its operational dynamics: aspects that cannot easily be separated from it. These inner contradictory dynamics are the forces that lead the phenomena to operate, but also the forces that lead to conflict and instability. It is critical for an understanding of political economy processes to analyze such contradictions, with a view to investigating whether they are capable of being moderated and, if so, how (see O'Hara 2001). Hence this chapter examines four major contradictory dynamics of terrorism in the contemporary environment.

The first contradictory aspect of the inner motion of terrorism is this: terrorism has a relatively low risk of death for specific individuals, yet at the same time it usually elicits a high level of social-psychological fear and uncertainty among the population. Historically, as shown by Table 15.1, compared with other risks of death – such as car accidents, suicide, murder, TB and meningitis – terrorism poses an insignificant threat to the lives of human beings in the United States and most other places on Earth. The risk of being killed by terrorist acts is infinitesimal compared with these other major causes of death.

Table 15.1 Worldwide fatalities of various sources of death per 100,000 population, 1983–1997

Year	Car accidents	Suicide	Murder	Tuberculosis	Terrorism
1983	14.90	12.10	8.30	0.80	0.120
1987	19.12	12.71	8.30	0.70	0.003
1993	16.30	11.30	9.50	0.60	0.002
1997	15.80	10.80*	6.80	0.40	0.003

Source: Adapted from Falkenrath (2001: 170).

Note
* 1996.

On the other hand, again historically, the political leadership and general public have a tendency to perceive terrorism as being a critical threat to their livelihood. People under the threat of terrorism tend to systematically overestimate terrorism as a threat to their life and livelihood. This is linked with the greater fear, intimidation, horror and indignity that terrorist actions – especially the new form bent on mass killings – tend to create in the collective social consciousness. As a result, terrorist threats may create mass uncertainty and fear as people become more inward-looking, or reduce their use of airline travel, or no longer go to certain strategic destinations.

According to opinion polling done by the Chicago Council on Foreign Relations in 1998–99 – before the 11 September actions – 84 percent of the general public identified international terrorism as a “critical threat” to the United States, more than any other issue. Sixty-one percent of “leaders” identified international terrorism as a “critical threat”, putting it just behind nuclear proliferation (67 percent) and chemical and biological weapons (64 percent).

(Falkenrath 2001: 170)

Yet a similar concern (or campaign) against motor vehicle fatalities or suicide is nowhere in sight, despite the much higher fatalities from these sources.

A paradox, which is implicit in the contradictory “multiplier” effects of terrorism, is that there appears to be an inverse relationship between the social psychological consequences of certain fatalities and their fatality probability or frequency, as shown in Figure 15.1:³

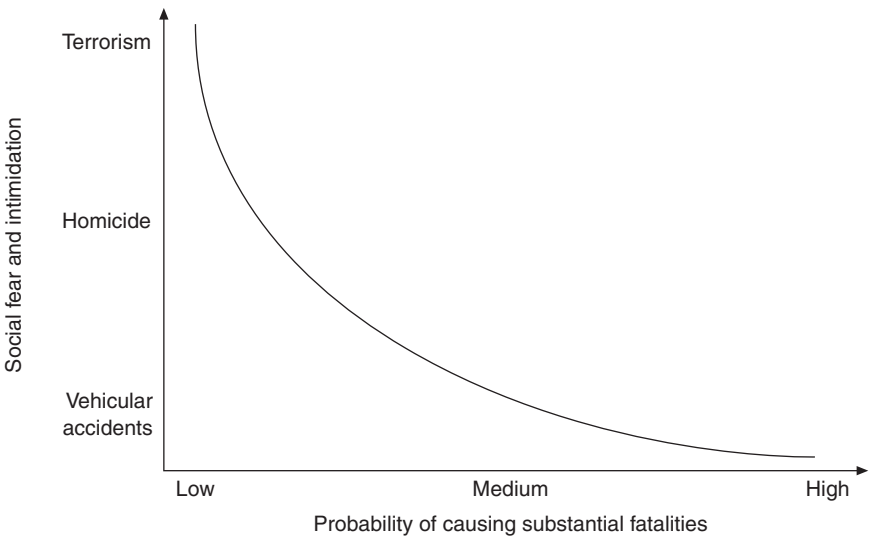


Figure 15.1 Terrorism consequences-probability trade-off

There are many reasons for the fact that people are more fearful of terrorist actions that are extremely unlikely to kill or maim them than they are of motor accident deaths, suicide and murder that are much more likely to affect them directly. The first is that people are more fearful from conscious acts of killing than from activities that kill as a by-product of something useful, such as driving a car. Second, people are more fearful of terrorist acts that seek to kill as a political statement, than they are from many ad hoc killings that may be “crimes of passion” or the isolated acts of psychopaths. Third, people become more scared from a small number of critical fatalities spread over time in specific sites than they do from many more fatalities spread over a larger time period in many locations.⁴ And fourth, rarely does a government seriously stimulate community debate about the nature of so-called terrorism, because they are interested in their military or strategic response and their desire to exploit the short-term advantages of being involved in patriotic fervor.

The general source of this dynamic is that there appears to be no real threat of fatality to the individual in the recent terrorist attacks, since anyone could have been hit, if they were near the source of the attacks. It is not a statistical problem for the individual, compared with other types of fatalities. But it surely is an attack on the system of US hegemony. Hence the general contradiction between individual and society: recent terrorism was unleashed so that there could be socioeconomic crises to upset the US and other economies. Individuals were not targeted, only people who happened to be in or near architectural and economic icons of US capitalism associated with trade (the WTC), finance (Wall Street) and military dominance (the Pentagon); or tourist destinations and areas sympathetic to US interests.

Terrorists take advantage of this contradictory (or paradoxical) state of affairs: that terrorist acts pose a low risk to specific individuals, yet those same individuals feel fear and intimidation, nevertheless, due to social forces. Indeed, this is precisely the reason terrorists use such actions to advance their political or other objectives. It has a high impact action with a relatively low rate of fatality. Or more specific to *al-Qaida's* (and their allies') objectives, it creates massive fear and intimidation with relatively low cost for putting into operation. Hence *al-Qaida* were able to “produce” a high cost of death and destruction (“social costs” to the US), ranging from estimates of \$60 billion to \$1 trillion (Homer-Dixon 2002: 58; Luke 2001: 141).

These social costs are related to the circular and cumulative motion of modern terrorism. This shows how the terrorists use their belief system and *Jihad* as the principal stimulus to action. The action manifests itself in the creation of various terrorist networks, which plan and activate strategic attacks, using various technologies. This new radical Islamic terrorism tends to depend upon two sorts of networks. One is an internal network of committed comrades, linked to a loose collection of like-minded radicals, as well as being supported by a diverse group of sympathizers, in turn associated with various governments and businesses. The second is the total network, including the

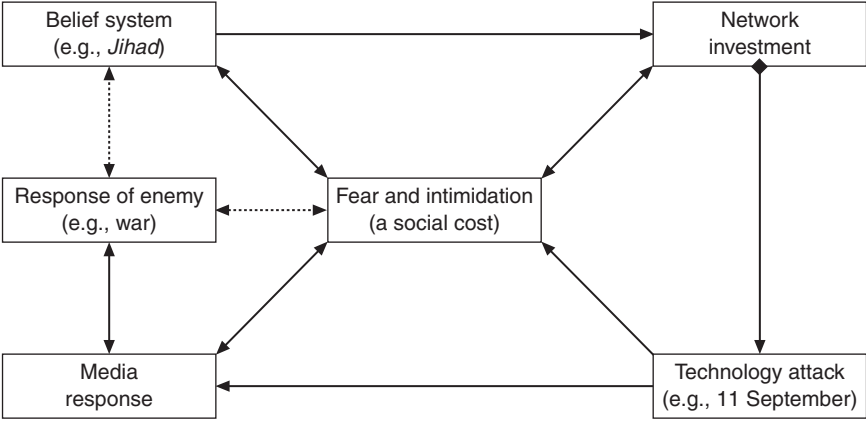


Figure 15.2 Circular and cumulative network effects of terrorism

media, the fatalities and the population linked to the targeted group. The wider network is the source of its economies of scale and broad effectiveness, and is shown in Figure 15.2.

This multiplier effect is a product of the effective use of technology, media response and national sentiment. The governments of the affected population then respond to the situation. The combined influence of all these factors tend to create a circular and cumulative impact on the whole process. Successful attacks reinforce fear and intimidation, greater media coverage, and so on in a circular and cumulative fashion, with the cycle perhaps continuing through several runs. Many variants of the process are possible, such as a further attack, pro-terrorist actions or war activated by the affected-population's government, and so on.

Technology promotes terrorism

The latest opposition religious groups against US capitalism and hegemony are much stronger, powerful, and more concerned with mass casualties than just getting attention to their cause. They want to destroy US hegemony over Islamic nations and the Persian Gulf. They find that US power corrupts people, dominates whole nations, and that the cultural foundations of outside dominance are morally repugnant. Instead, they believe in a particular reading of the *Koran*, reestablishing certain Islamic values and practices. Ironically, though, they appear to be using the power of capital, and some of the methods of production and reproduction typical of capital, to enhance their cause.

We thus come to the second contradiction. Contemporary capitalism is producing a massive technological infrastructure of machines, computers, airlines, weapons, buildings and roadways that enhances its creative regenera-

tion, accumulation, profitability and systemic reproduction. But the very structures and dynamics of this technology can be just as effectively used by terrorists to *sabotage* – as Thorstein Veblen (1921) called it – both the system of technology and the institutions and relationships of capitalism. Sabotage refers to the process whereby the technological and network processes that propel production and reproduction of institutions and material output are being destroyed or adversely affected through conscious decisions of classes or other groups. In the process, they are able to increase fear, uncertainty and instability, while reducing expected profit and accumulation for the system. This goes to the very heart of capitalism and US hegemony. A simple illustration of this contradictory relationship can be shown in Figure 15.3.

This shows that as the technological sophistication of capitalism increases, the potential for terrorism to utilize these structures of knowledge and technical competence to destroy such technology expands through historical time. The ability to sabotage is positively related to the degree of technological sophistication, at an accelerating rate; a point may be reached where the fear and intimidation starts to inhibit technology. Hence sabotage could feasibly lead to a decline in technological sophistication through a sufficient acceleration of fear and intimidation. The fact is that the technological structures and dynamics of capitalism are becoming increasingly capable of being used against itself by this new form of terrorism committed to the overthrow of US hegemony in the region. Modern technologies make it possible for the effective use of cyber-terrorism and weapons of mass destruction in the pursuit of extreme political, religious and social beliefs that may completely disrupt society. The attacks on the World Trade Center and the Pentagon were not low tech-events, as some analysts have suggested. The

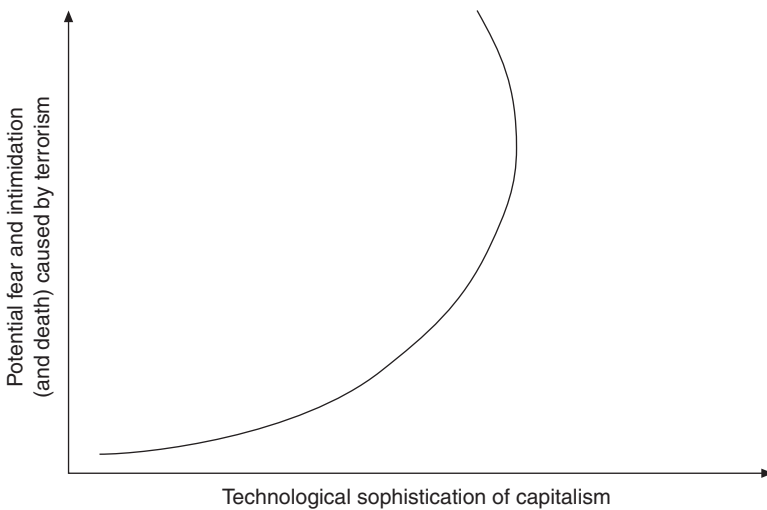


Figure 15.3 Contradictions of technology

al-Qaida network used simple objects such as box-cutters, knowledge of flying and physics to convert commercial planes and jet fuel into modes of mass destruction – or at least high-tech killing machines – capable of killing thousands of people and destroying icons or US power and capability. As Juan Corradi (2001: 149) states:

Contemporary societies make instruments of destruction possible as so many other commodities and make themselves, by that token, vulnerable. The more advanced and the freer the society, the greater the availability of do-it-yourself destruction. The means and opportunities have multiplied. The motives have evolved as well. . . . Technology makes it virtually impossible to distinguish between “peaceful” and “destructive” research and output. In a nutshell, contemporary violence, far from being a midwife of a new social system, is a state into which existing systems easily lapse.

The systems that are capable of being destroyed are networks or nodes of businesses, computer-information, highways, fiber-optic cables, railways, and defense arrangements that are interconnected and complex relationships between institutions and people. As Gunnar Myrdal (1978) realized in his theory of circular and cumulative causation, the closer and more complex the network of interrelationships that are generated by these systems, the greater potential uncertainty, instability and chaos that can result from their dislocation or destruction. An effective computer virus may destroy a whole network of business arrangements. A plane flown into a major building can reduce the perceived level of personal safety of a whole nation. A series of anthrax-laced letters has the potential to destroy a mail system. A nuclear device detonated in a series of major “public” spaces simultaneously – such as Grand Central Station in peak period, Congress in mid-session, and a major league game in an exciting final quarter – can destroy the perceived security of a nation.

There are three main causes or dimensions of technological vulnerability. First, modern technology has central nodes: critical sections, spaces or areas that are the hub of the system, and that can be disrupted quite easily. For instance, the “root servers” of computers are of this type. Second, capitalism has historically undergone various forms of centralization and concentration in particular areas and specific businesses. This is because of economies of scale and scope, and the high positive externalities of geographic location. Tacit knowledge, for instance, is often best developed in specific areas, such as Silicon Valley, Wall Street, Parliament. And third, these centers and networks do not simply affect physical reality, but also virtual reality; and, more especially, the psycho-social networks associated with national symbols, national-consciousness and media outlets. The media is or has the potential to be the advertising agents of the terrorists – be they state-terrorists, religious terrorists or liberation-movement terrorists – either wittingly or unwittingly.

A critical factor enabling terrorists to “redirect the energies of our intricate societies against us” (Homer-Dixon 2001: 58) is their degree of tacit knowledge. Explicit knowledge is the information necessary for the operation of a machine or other system: the blueprint that needs to be codified, or the instructions that need to be put into practice. Much more difficult is the tacit knowledge, which includes the experience of the practitioner, or knowledge gained through intuition that cannot easily be copied, or the knowledge that effectively applies something in practice (B. Jackson 2001: 187). It is this that the 11 September terrorists demonstrated to have an excellent grasp of.⁵ They showed great novelty by using a plane hijacking in a completely different way, almost as a series of simultaneous bombing campaigns. In this they benefitted from a sustained process of research and development and the existence of a sound, decentralized form of network capital.

Reestablishment of strategic US hegemony propelled terrorism

During the 1950s–1960s the US enjoyed hegemonic dominance in the world, with a caveat: there was also a relative *military* “balance” between the US and the USSR (Wallerstein 1983; Bowles *et al.* 1992). In economic terms – production, commerce and finance – the US (in association with other Western nations) ruled the world, through the provision of leadership and at times coercion to establish public goods functions of stability and conflict resolution. Many authors concluded that, by the early 1970s, US hegemony had declined, reflected in defeat in Vietnam, declining productivity, plus global and financial instability. Deep recession and financial instability of a periodic nature were common during the 1970s–2000s. By the beginnings of the 1990s the Eastern Bloc variety of so-called communism – or what some Western Marxists called “state capitalism” (Resnick and Wolff 1995) – was in absolute decline. The emergence of market socialism in China and Vietnam furthered the worldwide belief in market systems and, by the beginning of the twenty-first century (or near the end of the last millennium), US hegemony was becoming firmly established as a result of a series of military campaigns and the long boom of the 1990s.

During the 1980s the CIA did what it could to promote opposition to Soviet power and then “control” in Afghanistan (as well as to the power elite in Iraq and Yugoslavia). In doing so, it established a *de facto* strategic alliance with radical Islamic groups in Pakistan, Iraq, Afghanistan and other nations. It supplied military, financial and strategic support, for instance, to the *Mujahideen*, enabling the Taliban to come to power in Afghanistan. It continued to supply strategic and logistic support for these groups through the 1990s and early 2000s. Congressional reports of these activities are providing substantial support to this, according to Michael Chossudovsky (2001: 35, 39; emphasis added), who says:

The various [US] Congressional reports confirm that the U.S. government has been working hand in glove with Osama bin Laden's *al-Qaida*. . . . The evidence amply confirms that the CIA never severed its ties to the "Islamic Militant Network"; the ties have become increasingly sophisticated. . . . The role of the CIA in supporting and developing international terrorist organizations during the Cold War *and its aftermath* is casually ignored or downplayed by the Western media.

What this implies is a central, third, contradiction: the current power of the *al-Qaida* and many other Islamic terrorist networks is part and parcel of the decline of the Soviet system and the support the US and specifically the CIA provided for the radical Islamic groups in the fight against international communism and secular Islamic governments such as Iraq. As Michael Mann (2001: 66) says, "religious revivals have come to replace many socialist movements as self-proclaimed resisters of imperialism". In short, the US hired the Muslim radicals – "combat fundamentalists", as Mann calls them – to fight secularity and communism, and in the process provided the foundation for the rise of international terrorism as a sophisticated network of worldwide groups and individuals. The World Trade Center and Pentagon terrorist actions were thus influenced by US *strategic* support for terrorist organizations right up until the new millennium to help in its quest for renewed hegemony. This is a critical form of conflict emanating within the global political economy.

It is not simply that the US supported terrorist organizations, but that it did so for purely *strategic* reasons, in order to promote the decline of Russian communism and the Iraqi state. It did not embrace the central concerns of the radical Islamic groups or attempt to include them in a durable set of diplomatic, military and economic institutions. As the *Mujahideen* mercenaries, bin Laden and later the Taliban realized, they were effectively being used in the interests of US foreign policy and military hegemony. No attempt was made to seriously and empathetically engage in theological debate on Islam, nor on the question of US influence in Saudi Arabia and support of a repressive administration there, and also not in relation to nationhood for Palestine (until very recently). US consumer capitalism and culture also symbolized the worst of sexual immorality, neocolonialism and lack of respect for Islamic customs.

Hence, the US not only encouraged terrorism but did it in such a way that the terrorists involved would not support the US in the long-run, i.e., it remained a purely strategic and short-run alliance. The US abused any long-term, durable alliance with the radical groups by entrenching their power in the Middle East. American troops were stationed in Saudi Arabia in an agreement with that government after the "first" Iraqi War; this humiliated bin Laden and his associates, being as it is, the holy land of Islam. American weapons and diplomatic support was also given to Israel against the Palestinians, Palestine being another holy land of Islam.

In response to what is perceived as US arrogance and dominance, Radical Islamic groups retaliated by bombing the World Trade Center in 1993 (6 deaths, US\$500 million damage); bombing US embassies in Tanzania and Kenya (1998, 220+ deaths); bombing the US embassy in Nairobi in 2001; undertaking the 11 September 2001 attacks on the WTC and Pentagon (2001, 3000 deaths; \$60 billion economic costs); plus more recent attacks mentioned earlier (Falkenrath 2001: 165; Bergen 2001: 430; Burke 2001–2002: 136; Luke 2001: 141). The attempt to reestablish US hegemony was thus undertaken in a crude fashion, without assessing the system-problems that emerge when the hegemonic power recklessly acts in regions such as the Middle East.

Global deregulation expands terrorism and radical Islam

This, fourth, contradiction has three aspects to it. The first is that the emergence of globalization and neoliberal deregulation over the past two decades has seen the freer movement of capital – money, production and goods – throughout most regions of the world; and that this has aided political terrorists by making it easier to build a global organizational terrorist network of human, social, financial, technological, advertising and strategic capitals. Deregulation of global capital makes it easier for the terrorists to build resources against such a system, and in the process help to build a new structure of governance with more regulation on private capitals.⁶

The second dimension of this contradiction is that neoliberal globalization has led to an increase in relative poverty and oppression – particularly between the West and the Islamic world – which is a breeding ground for terrorism.⁷ The spread of deregulated globalization increases the degree of uneven development in the world, which promotes rebelliousness in some of those areas that suffer in relative terms (Alehabib 1999). An increase in the number of graduates who are unable to find employment or meaningful activities promotes the stock of those capable of being the leading cadres in the radical Islamic movement against all of the “infidels” of the world.

This is linked to a third dimension of the contradiction: the double standard of the US and Western diplomats, who talk about the need for human rights, cultural sensitivities, peace and democracy – while at the same time seemingly showing little concern for the rights, cultural peculiarities, property and governance structures of the Islamic people. Many see this as a double standard.⁸ For instance, the US will often unilaterally decide to intervene in a country if it thinks it is in its best interests. It also has historically supported its own forms of “state terrorism” against the civilian population of various – especially Islamic – nations.

These three dimensions – (1) deregulation and terrorism, (2) globalization and uneven development, and (3) the double standards of the US – create various conflicts and instabilities. One particularly damaging result is the deep

feelings in the Islamic world against the US. Evelin Lindner (2001), for instance, isolates the humiliation of Islamic peoples: when the US continues to support Israel against the "Palestinians"; when it settles its troops in Saudi Arabia and supports a corrupt government (also in Egypt and the Sudan); when the US and its allies invade Afghanistan without (as they see it) direct material evidence about complicity in the 11 September attacks; and when it invades Iraq without adequate evidence of weapons of mass destruction. For instance, in March 1985 the CIA organized a car bombing in Beirut that killed 80 civilians and wounded 256 while they were attending Friday prayers at the Imam Rida Mosque; it was "timed to kill the maximum number of people as they left" the service (missing their target, Shi'ite leader Sheikh Fadlallah) (Chomsky 2001). Also, over 100,000 civilians were killed in the US-led Gulf War of the early 1990s and, according to Madeleine Albright, during 1991–2001 an estimated 500,000 children could have died as a result of US-inspired sanctions against Iraq (Editors 2001).

The lack of empathy on the part of the US for Islamic ways and interests, and the inability of globalization and US power to positively influence the quality of life of many Islamic nations, has led many to engage in the "new" form of terrorism. Searching for roots of a better way of life for Islamic peoples that transcend corrupt regimes and outside dominance, *al-Qaida* and its supporters represent a new generation of scholars, fighters and common people seeking to reestablish self-respect and salvation for Islamic peoples. But they are just as much against so-called corrupt forms of Islam as they are for attacking the US. As Appleby and Marty (2002) state:

Social context and the local or regional political culture have much to say about the directions that fundamentalism takes. Within the abode of Islam, nation states are either weak or failing, on the one hand, or dictatorial or repressive, on the other. Both contexts encourage violent variants of fundamentalism bent on replacing the state (as the Taliban did in Afghanistan) or overthrowing it (as the Shi'ites did in Iran and as radical Islamic groups have hoped to do in Egypt, Algeria, Saudi Arabia and elsewhere).

Policy issues and measures

Here we center on policy measures that directly link to each of the conflicting, contradictory tendencies. Some general points need to be mentioned first, however. A coherent global strategy needs to be formulated that deals with all levels of the problem, from prevention to deterrence to defense. Included here is a whole stream of dimensions, including the upgrade of intelligence work, homeland security, global cooperation, missile defense, conventional forces, consequence management and nonproliferation agreements. Especially important is the building of global cooperation through institutions and relationships. Also critical is prevention and deterrence,

because once a terrorist attack has been activated it may be difficult to ascertain precisely the source of the attack. Future attacks may be even more obscure and difficult to pin down. And lastly, it is not sufficient to devise strategies to minimize “political terrorism”, since all dimensions of the problem from “political”, to “war” and “state”, to “cultural” terrorism are all critical to minimize in the global political economy. Quite often, as well, terrorism is inextricably linked to war and other forms of conflict, so this needs to be factored in as well.

In relation to the first contradiction, the vast majority of people have little knowledge of the statistics of relative fatalities and the ways in which terrorists use “big events” and the media to multiply and amplify their problems and concerns. The public needs to become more aware of these factors, while the media needs to be more responsible in not playing into the hands of terrorists in this fashion. Second, there needs to be a concerted effort to promote what William Perry (2002) calls “consequence management”. This is the management of the human after-effects of terrorist tragedies, including the strengthening of the operations of firefighters, police, national guard, reserve units and the centers of disease control. It is critical to have sufficient reserves and an adequate system of activation against biological agents such as poisons and disease microbes. Sufficient stocks of antidotes, antisera, antibiotics and inoculations may reduce the degree of fear and intimidation.

In response to the “technology-terrorism” link of the second contradiction, a potentially useful policy response can be “circuit breakers” to reduce the circular and cumulative technological and system network effects and relationships linked to terrorism. They intervene in the negative feedback effects of terrorism, or promote additional buffers as alternative sources of supply. It is necessary to reduce the number and importance of “critical non-redundant nodes” – or central information centers – so that there are alternative sources of knowledge and data storage.⁹ Decentralization of industry and the promotion of alternative sources of energy – as well as the creation of an alternative government “in hiding” (which is in motion in the US) – can reduce the negative consequences of terrorism. Promoting local autonomy of food production can also help, in the case of national or transnational systems of supply being interrupted. Reducing the extent of just-in-time production methods can have the same effect (Homer-Dixon 2001). Ensuring that there is a degree of decentralization of information through the Internet and institutional information systems is also important.

A national missile defense capability may provide an insurance policy against a sophisticated attack, although it does not help against the more likely attacks. An effective campaign against the proliferation of nuclear and biological weapons is necessary. Continuing the existing Nonproliferation Treaty, the Biological Weapons Convention, and the Strategic Arms Reduction Treaty (START), as well as activating treaties not yet formalized or implemented such as START II and III, those between the US and North Korea, the Comprehensive Test Ban Treaty, and the Trilateral Agreement

between the US, Russia and the Ukraine, will help (Perry 2002). Putting more resources into a more conventional defense system makes sense – such as the modernization of aircraft carriers, modern information technology and specialist battle troops. (Although this may stimulate forms of state terrorism, which needs to be guarded against.)

There are many limits to the extent that “political” terrorists can effectively use chemical, biological, radiological and nuclear (CBRN) means to generate weapons of mass destruction (WMD) (Hoffman 2001). Nevertheless, even if it were true that most sources of WMD are unlikely, there are plenty of other materials – chemicals, microorganisms and nuclear energy – that could conceivably be effective, even if difficult to deliver on a mass scale. Examples include smallpox (formerly thought to be scarce), weapons-grade nuclear material (if not nuclear weapons), nerve gases such as sarin (used by Aum Shinrikyo in a Tokyo subway in 1995), and dozens of more freely available chemicals and toxins. The supply of microorganisms, nuclear material, nerve gas and the like on the global black market poses grave problems of supply.

With regards to the third contradictory tendency, involving US hegemony, a survey (March 2002) has shown that the Islamic world tends to view the US as an aggressive and arrogant imperial force. For instance, 53 percent of respondents from nine Muslim nations have a “unfavorable” opinion of the US. Seventy-seven percent believe that US military action in Afghanistan is “morally unjustified”. And 61 percent did not believe that the 11 September attacks were undertaken by Arabs (Gallup Poll 2002). Clearly, the US has a terrible image in these nations, especially in Pakistan, Saudi Arabia, Iran and Jordan. The support for radical Islam is growing, and a critical way to reduce actual and potential conflict with the area is by having better cultural, political and economic linkages to those nations. In short, multilateralism needs to be deepened, expanded and rooted in effective participation and dialogue with Islam that goes way beyond questions of “national interest”. As Jonathan Stevenson (2001: 44) says: “Constructive but cautious engagement with lesser evils – be they terrorist groups or their suspected state sponsors – is a price worth paying for the capacity to confront the greater evil without quarter.”

In relation to an aspect of contradiction four, concerning deregulation and globalization, a new balance between security and freedom will be necessary, where the key to success will be close global cooperation against terrorist networks, including state terrorism. New governance measures will be necessary to regulate the global transfer of money, particularly to increase the level of transparency. Export controls will be required to check merchandise and supply chains. Suitable measures are in place at many airports for travelers, but these will need to be incorporated into the flows of money and capital as well. Certain basic regulations will be required on the global Internet, cyberways and computer systems.

Terrorists are currently working on is what is called *Offensive Information Warfare*, an example of which is *netwar*, a type of cyberterrorism, used either

to sabotage or gain information globally, nationally or regionally. However, there will be problems in applying regulations: for instance, the difficulties in having a truly transatlantic (and beyond) system of governance in place (Bartsch 2001). Terrorists try to impair the trust that the public and corporations have developed in the use of the Internet and information technology. They are currently trying to corrupt strategic nodules in the system and infiltrate official networks to gain strategic information. *Al-Qaida* are known to be actively involved in cyberspace (Wheeler 2001), and many of their leading members have a considerable amount of technical knowledge and university training. The corruption of information technology nodules can potentially destroy the positive externalities associated with the Internet, due to the complex interdependencies involved. Sabotage of this type could disrupt whole global networks of business, causing a major recession or worse. It is thus critical to develop more alternative nodules, a reduction in the tightness of the information fit, and alternative sources and storage of data. As Valery and Knights recognize (2000), however, this will require a radical increase in the level of priority given to information and systems security in companies and government departments. The evidence shows that company executives tend to be reactive rather than proactive to security breaches (Dampousse *et al.* 1998).¹⁰

Islam has progressive elements in its thought, particularly well illustrated through the tenets of Islamic political economy.¹¹ But a “spectre is haunting the world – the spectre of Muslim fundamentalism” (Hyman 1985: 3) – and, as a result, a crisis has existed within traditional Islamic thought and practice for some time. The relative decline of Sufi spiritualism, and Islamic secular-nationalism, colonial domination and the existence of certain demagogic notionally Islamic governments, left a spiritual vacuum that fundamentalism has sought to reconstruct along more activist lines. But there are alternatives to fundamentalism, and many scholars and officials have called for Islamic renewal – along traditional cultural lines – as a way of denting the impact of radical Islam and hence political terrorism. This is said to be in line with the tenets of Islam for a periodic renewal or revival of Islamic faith and the emergence of “fresh impulses”.

Richard Bulliet (2002), for instance, believes that the foundations of this renewal are already in motion; for instance, in a revival of Sufism in Iran, Central Asia and other areas; the advocacy of participatory governing institutions by people such as Hezbollah leader Sheikh Muhammad Fadlallah; and a series of progressive Islamic institutions such as the Institute of Islamic and Arabic Sciences in America. Murad Hofman (2001) puts forward a program of renewal, which has similarities with other programs, based around (a) the division of power, (b) female empowerment and (c) general emancipation. Hofman suggests to counter the influence of radical Islam and political terrorism through the promotion in Muslim nations of public participation, individual rights, female inclusion, transparency of institutions, reduced inequality, innovation plus increases in both productivity and literacy.

He links these notions to Islamic tenets and philosophies, particularly stressing the need to eschew "Muslims [trying to] catch up with the Joneses in a consumerist spirit . . . since Muslim life should never be dominated by economic considerations" (Hofman 2001: 303). Nevertheless, issues of livelihood, power and governance are critical to Islam. The advocacy of such principles and programs are needed in tandem with religious authorities "able to declare that the killing of innocents by terrorist attacks is contrary to Islam and . . . Muslims can stand firmly against terrorism without seeming to embrace the United States and its policies" (p. 16). Sherman Jackson (2001: 293) demonstrates philosophically the ways in which terrorism may be in contradistinction to Islam.¹² As a policy issue, the renewal of Islam in this fashion is critical to the fight against the killing of innocent civilians.

Conclusion

The purpose of this chapter was to examine the nature of terrorism in the current environment; especially the dynamic contradictory tendencies that propel it as a tool of action, and policies that may be effective against various forms of terrorism. The first inner dynamic tendency is that terrorism has a low rate of fatality when compared to the major causes of death such as car accidents and murder, but that it manages to instill a relatively high rate of fear and intimidation into the population in spite of such low fatalities. The second dynamic tendency is that the very foundations of modern technology and knowledge in the advanced nations can be used by the terrorists as an attack on these foundations. The third dynamic tendency is that the very forces that were put into practice to reestablish US hegemony on the world against so-called communism helped to create this new form of terrorism that emerged from the power vacuum in the global political economy. And the fourth conflicting tendency is multifaceted. In general it relates to the forces of globalization and neoliberalism around the world that helped to create the terrorist networks.

In order to develop proper strategies against terrorism one must recognize these conflicting processes and employ measures that specifically address them. The prime policy must be based on the recognition of the multifarious nature of terrorism: that the main form is state terrorism; and that it is difficult to address issues of terrorism without questions associated with war and conflict in general. The US and their allies should ensure that state terrorism is minimized, and that they reshape their strategies where they contribute to world conflict.

In relation to the policies that link with contradictory tendency one (fatalities and risks), it is necessary to put into practice policies that are able both to reduce fatalities – which should reduce the degree of fear and intimidation – and also to reduce the multiplier effect between fatalities and fear. This includes measures such as an education process among the population about the nature of terrorism and how it works, as well as the need to create a strat-

egy through the mass media to reduce their level of complicity in the fear and intimidation process. Also important is a proper emergency and maintenance team that works on the ground to reduce the impact of attacks.

Contradictory tendency two relates to technology and knowledge. It is important to put in place a system of prevention, containment and defense against both ordinary terrorist means and also weapons of mass destruction. The critical policy here should concentrate on the terrorist networks that are the life-blood of the attacks. The gathering of intelligence about the membership of the networks, as well as the circuit of money, goods and technology linked with the network is critical. Being able to create effective global cooperation of intelligence and regulations that relate to the structure and movement of people, goods, finance and technology is critical. WMD can also be targeted through strengthening existing agreements and policies – and developing new ones – against such proliferation.

Contradictory tendency three links to US hegemony and the need to form a multilateral alliance of states and interests against terrorism. But to be effective, the US needs to moderate its tendency to act in a unilateral fashion in support of its narrow interests. It needs to consolidate and strengthen multilateral alliances to include not simply its traditional allies, plus Russia and China, but also to act more in the interests of the common good, and build effective linkages with Islamic nations. Central to this policy is the need to think beyond just the interests of the US, and reinforce institutions, protocols and treaties that have a wider concern. In particular, it could start by supporting the Kyoto protocol, relinquishing its desire to eschew the Ballistic Missile treaty with Russia, and rethinking aspects of the Bush Doctrine about the “axis of evil” (Iran, Iraq and North Korea).

And last, contradictory tendency four indicates that it would help to reduce terrorism by nations of the world being more proactive in the fight against what some see as the clash of civilizations. Measures need to put in place to moderate this *potential* clash. The West could participate through being more interested and concerned about Islam and the plight of the Arabs, encouraging the pace of reform in Iran and Libya, and being more proactive in support of a Palestinian homeland for Arabs. Islamic nations can contribute through developing forms of reinvention along lines of philosophy, gender and power. Perhaps the Islamic belief in a balance between economic and social/spiritual concerns can be a point of departure for policy makers in this respect. More than anything it is important to promote an ethical and just society and not simply one based on conspicuous consumption and material conditions. Policies that help promote such trends – in the long run – are best in the struggle against terrorism.

Notes

- * I wish to thank Hassan Bougrine, Jim Devine, Reynold Nesiba and Howard Sherman for comments on a previous version of this chapter. I also wish to thank

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- 1 A "personal message" from bin Laden (1996: 2) to Muslims had specifically stated that:

It should not be hidden from you that the people of Islam had suffered from aggression, inequity and injustice imposed on them by the Zionist-Crusaders alliance and their collaborators; to the extent that the Muslims blood became the cheapest and their wealth as loot in the hands of the enemies. Their blood was spilled in Palestine and Iraq. The horrifying pictures of the massacre of Qana, in Lebanon are fresh in our memory. Massacres in Tajikistan, Burma, Cashmere, Assam, Philippine, Fatani, Ogadin, Somalia, Eritrea, Chechnya and in Bosnia Herzegovina took place, massacres that send shivers in the body and shake the conscience. All of this and the world watch and hear, and not only didn't respond to these atrocities, but also with a clear conspiracy between the USA and its allies and under the cover of the iniquitous United Nations, the dispossessed people were even prevented from obtaining arms to defend themselves.

(sic)

- 2 The FBI's view seems to be problematic. They define terrorism as "the unlawful use of force or violence against persons or property to intimidate or coerce a government, the civilian population, or any segment thereof, in furtherance of political goals" (Sherman Jackson 2001: 295). This has problems because it could include an army attacking the government or the military; and what is domestically "lawful" – according to state fiat – may still be terrorist, if the state legislates to allow state-terrorism.
- 3 The "terrorist multiplier" equation includes a number of variables. The first is the number of fatalities, deaths and serious injuries, such as the 3000-odd deaths associated with the 11 September attacks. And the second is the ratio of the number of persons affected by – as well as the degree of – fear and intimidation. For instance, those directly affected by the 11 September attacks, in the form of fear and intimidation, could be defined as the population of the US (280 million); and the degree of fear and intimidation could be called "relatively high" (h). The multiplier effect (m) of the terrorist activities is a ratio of the population affected (p ; 280 million), divided by the number of fatalities (f ; 3000 people), multiplied by the impact (i ; high):

$$m = \frac{p}{f}i = \frac{280m}{3000}h = 9333(h)$$

For instance, fatalities of around 3000 people from the 11 September attacks are able to instill a relatively high level of fear and intimidation into a national population of around 280 million people in the US.

- 4 Even the 3000-odd deaths from the WTC and Pentagon strikes represent a relatively low number of deaths per 100,000 population relative to car accidents, suicide and murder. For instance, per 100,000 population for the US as a whole, it represents 0.09 deaths per 100,000 population, compared with about 16 deaths per 100,000 for car accidents, 11 for suicide and 7 for murder.

- 5 Some analysts, such as Jason Pate (2001: 13), believe that the 11 September attack "is a very, very low technology incident". However this is far from being the case. The attacks were part of a wide-ranging network of systems, including sophisticated Internet communication, strategic use of multiple commercial planes, a high level of tacit knowledge and coordination, and the use of technological linkages between planes, buildings and other technologies.
- 6 As Thérèse Delpech (2001: 11) says: "Terrorism's financial backers skillfully exploit the weaknesses of the international fight against financial crime, while at the same time benefitting from the globalization and deregulation of markets".
- 7 However, as we suggest in many places, this is unlikely to lead to the inherent "clash of civilizations", posited by Samuel Huntington (1996), especially if policy and culture-response issues are handled well. Jonathon Fox's (2001) empirical research also casts doubt on the clash of civilizations thesis.
- 8 For instance, Tim Luke (2001: 131) believes that

the US slowly turned away from many larger internationalist responsibilities that befell it as the world's sole remaining superpower. Instead of continuing to stand resolutely for unshakable modern ideals, like democracy, equality, and freedom, the US . . . permitted gangster capitalism to establish itself in places as varied as Russia, Columbia, and Rumania, and [did little] as horrendous civil strife racked areas in Africa, the Middle East, and Central Asia.

- 9 Thomas Homer-Dixon, for instance, believes that

the World Trade Center was not a critical, nonredundant node. At least it wasn't critical in the way most people (including, probably, the terrorists) would have thought. Many of the financial firms in the destroyed buildings had made contingency plans for disaster by setting up alternate facilities for data, information, and computer equipment in remote locations. . . . NASDAQ officials [for instance] later claimed that their system was so robust that they could have restarted trading only a few hours after the attack.

- 10 Valery and Knights (2000) believe that Islamic extremists are unlikely to try and sabotage the Internet or other information nodules because of their "established operational style" (p. 21). However, the 11 September attacks have taught us that they are quite likely to, and capable of, taking risks and making innovatory changes in their strategies. This is also the message of the analysis done by Moorehead Kennedy (1998) and also Kelly Damphousse and Brent Smith (1998).
- 11 For instance, Islamic political economy places emphasis on the Oneness of God linked to the stock of universal knowledge that augments cognition through institutions and social systems (Choudhury and Salleh 2001: 586–587).
- 12 Sherman Jackson (2001) shows how, in classic Islamic law, the promotion of *hirabab* – particularly if murder propels fear and intimidation (whether wittingly or not) among the population – is subject to major penalties.

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Part IV

Governance issues for the future

16 Viability of national government policies in a global political economy

Phillip Anthony O'Hara

Introduction

Over the past 30 years especially, globalization has expanded throughout the world. Currencies in many nations have become more flexible, and currency movements have been growing stronger than GDP. Exports and imports have increased as a share of GDP in most nations. Tourism has expanded dramatically, even if migration has stalled relative to exports and capital movements. Currency unions and regional integration are moving ahead in all continents. Foreign direct investment has risen at a rapid pace. And national governments have become more conscious of the need to take global trends and processes into account when setting national priorities and policies. These changes raise a question about whether policy-makers, in a national context, are able to establish governance priorities so as to reflect national concerns about what governments are required to achieve.

The purpose of this paper is to examine the viability of national governance measures in an increasingly global economy. I commence with a view of the historical dynamics of the globalization trends of capitalism. The main part of the chapter then examines the role of social and public capital, followed by the role of central banking and monetary policy. A conclusion follows.

Historical pattern of the two eras of globalization

The current concern for globalization is not new. In *more recent* historical epochs there have been two main eras of globalization for capitalism. The first was during the 1880–1913 period, what one may call the “age of imperialism”. This was the heyday of capitalist development, when free movement of finance and people was rampant, the imperial powers were vying for Treasures in Africa, Asia, South America and the Middle East, and the fetters to capital were few and far between. Then came World War I (1914–1918) and depression (1929–1933) that led economies to employ “Beggary-Neighbour” policies of protectionism against the market, and the foundations of the modern welfare state were laid in embryonic form. This then led to World

War II (1939–1945), and subsequent post-war expansion (1950s–1960s), which led to a more liberal and social democratic policy framework, including a large state apparatus. As long wave downswing emerged during the 1970s, however, things started to change. Recessions became deeper, growth lower, unemployment and inflation higher; and policy changes emerged on the horizon. Through the Reagan and Thatcher revolutions and onwards, neoliberalism governments have sought to open up global money, interest rates and wages to the forces of “the market” in order to re-establish robust economic performance.

The financial system was deregulated and globalized in the 1970s and 1980s (in Asia during the 1980s and 1990s); including a decline in capital controls. Tariffs are at historically low levels at present. Exports and imports increased to somewhat higher levels. Migration levels are low compared with the 1880s–1910s, as is foreign direct investment. Overall, however, the 1980s–2000s period is similar to the 1880s–1910s: being the second great period of globalization. But how global are we at present, in absolute terms and also compared with the earlier phase of globalization?

First, Table 16.1 suggests that migration in the West was high in both eras of global capitalism, although somewhat greater in the earlier era. The previous phase of globalization (1870–1913) saw (im)migration of a high order, with the level of inflow into the US broadly balanced by outflow from Western Europe. The latest era has seen a reemergence of (im)migration, although not quite as strong as during the earlier period. Now the US continues with a strong inflow of people, and so too does Western Europe. Much of the flow represents a brain drain from underdeveloped nations, which magnifies the center-periphery dynamics of relative inequality within the global system. This has made most governance issues easier in the West, since their natural population growth has declined, and more problematic in nations that are losing skilled workers to the West, such as Africa and Latin America.

Second, on the question of trade, the current phase of global capitalism is more open than the previous one for most areas. Figure 16.1 shows that continents have increased the level of exports divided by GDP since the 1950s–1970s, as well as since the earlier phase of globalization. In most cases the increase in global reach has doubled since the early 1970s, and increased several fold since the early 1900s. This is certainly the case for Western

Table 16.1 Net migration: Western nations (millions), 1870–1998

	1870–1913	1914–1949	1950–1973	1974–1998
USA	15.82	6.22	8.26	16.72
Western Europe	–14.00*	–3.66*	9.38	10.90

Source: Adapted from Maddison (2001: 128).

Note

* Negative figure means net outflow.

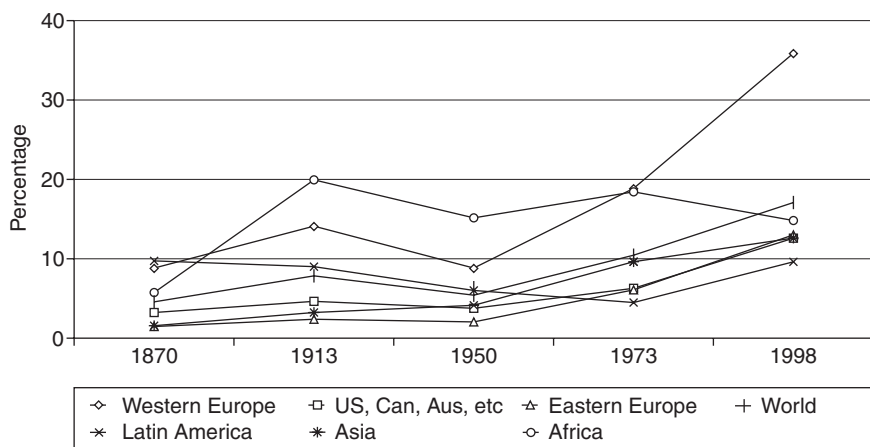


Figure 16.1 Merchandise exports percentage of GDP, various regions, 1870–1998

Source: Adapted from Maddison (2001: 127).

Europe (particularly *within* the European Community), the US, Eastern Europe, Asia and the World as a whole. However, globalization of exports has not expanded so much in Latin America, and has declined in Africa. Again, this seems to be the case of relative expansion in the center and stagnation in the periphery.

Third, what about capital movements? Figure 16.2 shows that international capital flows were strong during the late 1800s and early 1890s; then they declined during and after World War I, through the Great Depression, World War II and the post-war boom. However, capital flows started to rise with the onset of the second phase of globalization during the 1980s and 1990s (see Sachs and Warner 1995 for details of the historical record), doubling from the 1970s through to the 1990s. Foreign direct investment has expanded at a far greater rate.¹ In many nations, restrictions on capital inflow and outflow were reduced, which increased the flow of capital around the world. During the Asian boom and crisis of the 1990s, for instance, bank loans from overseas in US dollars (in particular) were subject to massive volatility, providing endogenous sources of credit during the early-mid 1990s and then enhancing uncertainty when these sources of foreign funds dried out during 1997, leading to instability and recession. The increased instability and financial crises in Mexico, Asia, Russia, Brazil and Argentina led to calls for the deepening of capital controls, perhaps along the lines of the Chilean form of prudential controls on capital inflow.

The above analysis shows that the current era of globalization is relatively unimpressive in terms of migration and general capital flows, whereas the current phase is much more global than the previous era in the area of merchandise exports. Many other areas could be introduced to illustrate a greater

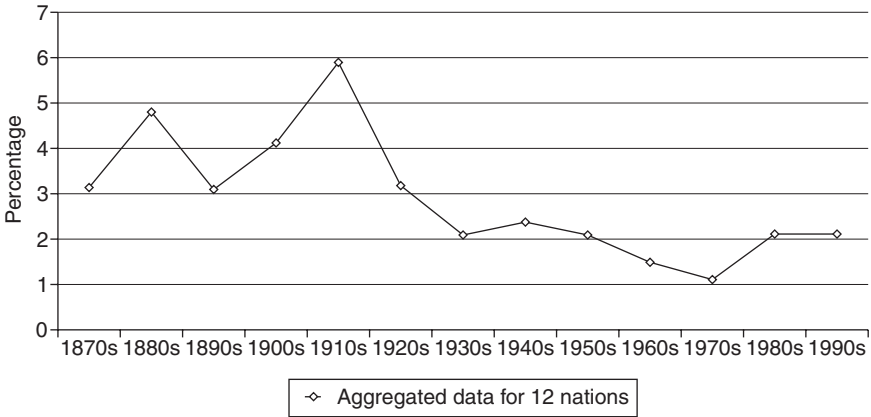


Figure 16.2 External capital flows as percentage of GDP, 12 nations, 1870s–1990s (5 year moving average)

Source: Adapted from Bordo (2002: 6). Countries include Argentina, Australia, Canada, Denmark, France, Germany, Italy, Japan, Norway, Sweden, UK, US.

degree of globalization in the current form, by including global flows of information and knowledge (see Bordo, Eichengreen and Irwin 2000). The general conclusion still holds, though, that the current global tendencies are not historically preeminent, and therefore a *prima facie* case perhaps exists for government not to be unduly constrained by the current forces of global reach. Globalization is not as dominant a trend as some authors have indicated.

Indeed, as many authors have shown, the world is more international than global in operation. Ronald Dore (1996) has argued that in the major economies more than 80 percent of production is for domestic consumption and more than 80 percent of investment is undertaken by domestic businesses. Companies tend to be embedded in national home markets with national regulatory systems. Populations are much less footloose than goods, finance and information. Interest rate differentials remain substantial across different regions and also between major economies. Transnational corporations hold most of their resources in home nations. Just-in-time inventory systems and tacit knowledge reinforce the operation of national and regional systems of production and technology.

What, then, is the evidence about government spending – globally speaking – in relation to whether it has been adversely affected in magnitude by the global trend of late? Figure 16.3 presents the historical record on this.

The first era of globalization was a period of low government activity, while the second era is one of high government involvement in the economy. The record is fairly clear for the above advanced nations with a highly developed welfare sector, that there has been a gradual increase in

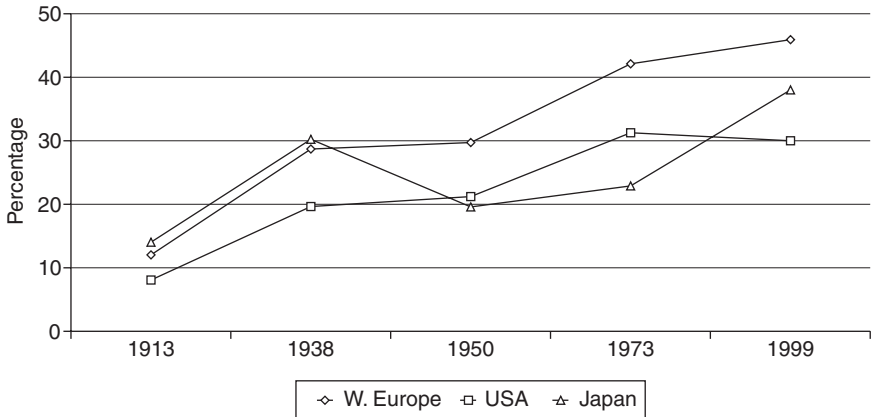


Figure 16.3 Total government spending as percentage of GDP, various regions, 1913–1999

Source: Adapted from Maddison (2001: 135).

government spending as a proportion of GDP from early in the twentieth century through to the eve of the twenty-first century. The only exception is Japan, which had a temporary expansion of government spending for war-related expenditure leading to and including World War II. Indeed, in the case of the Japan and Western Europe, the last 25 years has seen an increase in spending relative to GDP, in the Japanese case a major increase. For the US, government spending has leveled off at a relatively high 30 percent of GDP; no significant drop is evident. Since the beginnings of neoliberalism in the mid-1970s, in none of these nations has government spending dropped significantly; this perhaps provides a *prima facie* case for the argument that globalization has not adversely affected the role of government in the center.

Why has government spending increased or leveled off recently in major economies, when some globalization analysts hypothesized that it should decrease significantly as governments are forced to become more efficient in their use of “public funds”. Two hypotheses have developed. The first, “preparation thesis” (Wolfish and Smith 2000), states that governments have had to spend funds to prepare domestic businesses and citizens for greater integration into the world economy, through greater levels of human capital, enhancing language skills, and providing assistance for business. The second, the “compensation thesis” (Garrett 2001), states that governments have had to spend more to compensate for the disembedded tendencies of global integration, including more assistance for upgrading skills, periods of unemployment, and regional assistance for areas that have bared the brunt of changes.

Clearly, “preparation” and “compensation” funds often go to similar areas and have similar rationales. Hence the reason why scholars have been analyzing

the question of whether globalization has, on balance, promoted more efficiency in the use of “public funds” (hence reducing spending), or whether preparation and compensation effects have come to dominate (increasing spending). Globalization could have, on balance, either led to an expansion or a contraction of government spending based on these theses. Dozens of studies have been undertaken on the problem of which thesis has more validity. Garrett assesses most of them and then takes an independent look at the data. He believes that most of these studies have erroneously looked at *levels* of spending rather than *changes* in the level of spending which is more relevant.

Looking at changes in spending he found that there were major variations in the results across the 165 nations studied. For some nations the efficiency hypothesis seemed valid, while for others the compensation hypothesis was closer to the mark. Overall, when examined in terms of sub-continents or groups of nations, the results are shown in Table 16.2:

These results, in general, show that increases in GDP, urbanization and capital mobility are positively associated with increases in government spending. This positive link with government spending is also notable for the experience of Latin America and the OECD area. However, increases in the rate of growth of population, the dependency ratio (of imports and exports) and trade are negatively correlated with changes in spending. This negative link is also characteristic of East Asia and sub-Saharan Africa. Overall, though, none of the figures are very significant statistically, which implies that there is, in general, a weak relationship between increases in globalization and changes in government spending.

In order for the statistics to be more significant, and to favor the efficiency hypothesis somewhat, especially for the trade variable and in East Asia and sub-Saharan Africa, Garrett used central government consumption expenditure rather than the general spending variable. When the general spending variable was used the results did not support either hypothesis.

Summarizing what we have found so far, there have been two phases of globalization over the past 130 years, 1870–1913 and 1980–present. In some

Table 16.2 Changes in government spending: influence of independent variables

<i>Independent variable (factor)</i>	<i>Total central government spending coefficient</i>	<i>Independent variable (sub/ continent or group)</i>	<i>Total central government spending coefficient</i>
Δ GDP per capita	+0.058	East Asia	−0.082
Δ Population	−0.056	Latin America	+0.006
Δ Dependency ratio	−0.103	OECD	+0.062
Δ Urbanization	+0.074	Sub-Saharan Africa	−0.001
Δ Trade	−0.027		
Δ Capital mobility	+0.037		

Source: Adapted from Garrett (2001).

respects, globalization was more pronounced in the earlier phase, and in others more pronounced in the contemporary phase. In any case, globalization is nowhere near complete or all-pervasive. Government expenditure appears to be little affected by globalization, or where it has the differing trends have tended to cancel themselves out. Neither of these trends, greater efficiency and compensation, are dominant at present. However, to the extent that trends in government spending are substituting consumption for investment, problems are likely to appear as globalization expands (more on this below).

Now we move on to examine some of the more specific dimensions of government policy as it links to the current process of globalization. First, we scrutinize national government policies in the light of evidence on social and public capital.

Social and public capital and fiscal policy

Recent developments in the wealth of nations reveals that policy-makers need to take a very general view of wealth and capital. Indeed, according to the “multiple capital paradigm”, durable structures that potentially contribute flows of services through long historical time are variable and multifarious in nature. Multiple capitals range from social and cultural capitals to knowledge and communication capitals through to public and natural forms of capital as well as the usual durable fixed business capitals. This section explores the significance of this perspective for governance issues in the contemporary scene.

Recent research on the institutional foundations of growth has shown that political and social factors are critical to long-term economic performance. For instance, the social structures of accumulation approach shows that the making of accords, agreements and contracts – at the local, national and global levels – are important to the resolution of conflict between capital and labor, industry and finance, different ethnicities and nations (O’Hara 2000). Social and cultural capital research has demonstrated that the development of trust and networks of communication and participation are crucial to long-term performance (O’Hara 2001). Markets can only work effectively if they are embedded in the prevailing social and cultural fabric and where long-term structures of trust and association are in place.

These networks of association and trust are necessary at every level of the political economy. Cultural relations of experience and learning occur in family relations, which provide a basis for the intergenerational transfer of wealth and experience between family members and friends. Wider relations of trust and community may occur within civil society – between different families and communities – that help to link different local regions and markets. Network and organizational capitals develop within and between corporations and governments that help to promote efficiency and cooperation through the economy. Niches and scaled agglomerations occur in

particular regions – such as Silicon Valley – that help to promote certain regions and localities with systems of technology. And the global public goods associated with financial stability, environmental sustainability, business strategies and trade are critical to the relatively smooth operation of the global circuit of capital.

All levels of the economy require these embedded relations to promote networks of communication, participation and association. Local, provincial, national, regional and international dimension all require such social, cultural and network capitals. A proper system of governance thus represents a social economy exhibiting proper levels of human interaction. All markets require such relationships and systems of knowledge in order to reduce transaction costs, but also to resolve conflicts, ensure long-term agreement and moderate instability. Thus, a global economy necessarily grows out of smaller systems of interactions, and cannot exist without local, national and regional social and political processes.

Many nations thus have a far greater dominance of national trade and local market linkages than international trade and linkages. The domestic orientation of the US market is well known. The Canadian system also has a strong record of local and regional trade. However, the extent of the institutional dominance of local market relationships is perhaps surprising. We would expect to find greater trade flows within a nation, because of the greater distances involved between nations, especially those separated by oceans. But even the link between Canada and the US is weak compared with local relationships. For instance, consider trade between Ontario, British Columbia, Washington and California, which are approximately equidistant. According to Helliwell (2000), Ontario merchandise shipments to British Columbia were more than twice the exports to California. Ontario's exports to British Columbia were more than 12 times larger than exports to Washington.

The economic fabric of nation states has a much "tighter weave" than previously thought. For instance, a common language expands internal trade (densities) by 60 percent, whereas economic union increases trade by 40 percent. National economies are so much tighter than the international economy that arbitrage of prices among domestic city pairs shows up even in the short run (in price indices), but not across national borders. Research shows that global capital markets are more separated than integrated. Thus "inter-provincial markets for goods and services are tightly knitted together, while international ones are not" (Helliwell 2000: 51).

The evidence for Canada demonstrates not only that provincial trade linkages are far greater than global trade associations, but also that the local trade linkages grew stronger than international linkages between 1986 and 1996. Helliwell argues that, in general, national space may be an efficient method of segmenting large markets into manageable elements. The institutional and geographical operation of the real world is subject to varying levels of transaction costs, friction, potential conflict, uncertainty and knowledge. Knowledge is generally hard to acquire and evolves rapidly at times, while people

cannot always be trusted. Contracts may be incomplete and difficult to resolve in practice. Businesses often prefer to concentrate on those institutions, groups and individuals that are well known, and in close proximity, as well as being subject to a similar socio-political environment. Local and national businesses are often able to meet local and national needs cheaper and easier than global competitors. International competition often emerges from national advantages and expertise. All this depends upon factors such as economies of scale and scope, agglomeration economies, the nature of the industry and market, and so on. The global nature of business and markets is often exaggerated. As Helliwell said:

if some degree of openness is sufficient to achieve the major gains from international exchange, specialization, and the acquisition of fresh ideas, then there may be diminishing returns to openness. If so, and if there are some efficiency effects offered by the partial segmentation of global markets into national pools, then there may be some right amount of openness that may not differ much from the levels already achieved among the industrial countries.

(Helliwell 2000: 51)

This implies a form of “bounded optimality” in relation to openness, one that evolves over time; more open does not necessarily mean better. The net benefits of openness may take an inverted-U shape, increasing until diminishing returns set in, when the net costs of becoming more open increase as the transaction and adjustment costs become greater over the benefits. The costs of globalization are often hidden because the statistics associated with the stock of social, organizational and network capitals are often non-existent.

Almond and Verba (1963), for instance, found that “interpersonal trust” is a pre-requisite to the formation of secondary associations, such as businesses corporations. Interpersonal trust is thus a critical component of the complex growth equation. Helliwell and Putnam (1995) found that in Italy “there was a causal linkage running from high levels of trust and engagement to higher levels of regional government performance and in turn to higher levels of economic performance, and higher levels of upward convergence toward best practice levels of efficiency”. Later Knack and Keefer (1997) found evidence supporting the role of social institutions in economic growth, for both industrial and developing nations. What all this means is that, as Helliwell (2000: 60) says, that

there is much more scope and need for national policies than is popularly thought. This is especially true for policies of the sort needed to build institutions capable of supporting balanced and sustainable growth. This requires economic policy-makers to take a broader than usual perspective. The need for such an enlarged perspective, and the need to take institution-building seriously, is for me the most striking lesson to be drawn from the experience of the 1990s.

What are the specific implications for policy in the new millennium? First, recent research reveals the dubious validity of two of the twentieth century's dominant ideologies, namely the belief in the free market and also the belief in the merely distributive state. The free market philosophy is problematic since markets need to be imbedded in systems of institutions and relationships of trust and association. In a world of uncertainty, markets need to be infused by certain rules, norms, organizations, and informal associations of reciprocity and sentiment (Montgomery 2000). On the other hand, recent research has demonstrated the operational deficiency of the distributive state. The emphasis on transfer payments as a right to citizens when under conditions of unemployment, sickness, care and old age has its limits. One limit is that socioeconomic advancement depends upon citizens developing formal and informal networks and associations with others of a horizontal (non-hierarchical) nature. The second is that public capital has a more positive influence on growth and private investment than transfer payments.

Second, the old debate about the "size of government" (see, for example, Dalamagas 2000) failed to differentiate between different forms of public spending and activity, and needs to give way to analyses that scrutinize different types of spending and funding of governments. For instance, recent research indicates the need for government policy to become oriented more toward encouraging the development of social capital, and also to be redirected from consumption to investment in infrastructure, technological development, education, health and information-expansion so that government demand is simultaneously supply enhancing as well. Such spending not only helps to develop social and network capital itself, but also tends to crowd-in private spending.

Results along these lines have been very positive from comparative research. Miller and Tsoukis (2001), for instance, found empirical evidence for lower than optimal levels of public capital in his study of around eighty mainly low/medium-income nations. As they say, "government investment has been severely suboptimal in recent international experience and . . . scope remains for greater productive expenditures by the government sector" (p. 1125). They stress the close link between public capital and long-run economic growth, especially in the light of the reduced economic growth of the last few decades. Ahmed and Miller's (2000) results for thirty-nine developed and developing nations found considerable crowding-in effects of government spending in transport and communications capitals, especially in the formative stages of constructing a national system of roads and utilities, but a crowding-out effect for consumption spending associated with social security and welfare.

Similar results are obtained from empirical research on single nations or small numbers of countries. Ibrahim (2001), for instance, found that "development expenditures" are positively related to private investments in Malaysia. Specifically he found that capital investments in transport, telecommunications, education and health are "productive" and crowd-in private

investment, while current spending on transfer payments and general administration are “unproductive” and crowd out private investment. Laopodis (2001) supports the crowding-in of non-defense spending, especially education, transportation and housing, for Spain, Portugal, Ireland and Greece. Several studies have found similar results for advanced nations, such as the US, and in the vast majority of studies, crowding-in is enhanced by the investment being financed by bonds or money (debt) rather than taxes.

For instance, Weber (2000) found that government spending was remarkably stable in the US around a cyclical average of approximately 32 percent of GDP between 1951 and 1996, but that over the same period government purchases declined from 32 percent to 18 percent of GDP while transfer payments increased markedly. He concludes that 1970 is a watershed year in which public capital spending began to decline relative to transfer payments, and that the entire decline in the economic growth rate during the 1970s–1990s can be attributed to this shift away from public investment spending. Consistent with these results, Arthur Diamond (2000) demonstrates for the US that “science spending” on basic research tends to crowd-in private investment, due to an expansion of knowledge, which leads to an increase in long-term economic growth. And Aschaeur (2000) demonstrates considerable crowding-in of public capital spending in the US, since an expansion of public capital such as roads, buildings, energy and communications facilities raises private profit and hence investment due to the externalities and agglomeration effects. He also demonstrates that these crowding-in effects are much stronger if public capital is financed by money rather than taxes.²

The recent literature indicates a major rethinking about the role of government (relative to the 1970s and 1980s) by specifically linking crowding-in effects to government investment spending. A critical factor for the decline in long-term economic growth and productivity since the 1970s is a decrease in the public capital of education, health, communications and transport infrastructure. Thus a greater utilization and expansion of public capital is a crucial policy issue for the new millennium.

Central banks, monetary policy and interest rates

A question that needs examination is whether recent trends in the monetary transmission mechanism lead such interest rate adjustments to be effective in stabilizing the economy. There are multiple transmission mechanisms affecting the economy, from the traditional interest rate channel, to the broad credit route, to asset price mechanisms. Globalization and deregulation have promoted asset-price mechanisms, including the exchange rate and equity-price channels (Iturriaga 2000). The exchange rate channel operates (ideally) through open market operations, say, reducing interest rates (i), which leads to a net outflow of capital (K), a depreciation of the domestic currency (Dep), and presumably greater net exports (X), thus expanding gross domestic product (GDP):

Exchange rate channel of monetary policy

$$\downarrow i \Rightarrow \downarrow K \Rightarrow \downarrow \text{Dep} \Rightarrow \uparrow X \Rightarrow \uparrow \text{NY}$$

This transmission mechanism can be extended to include any process leading to a change in the exchange rate, since central banks began to concentrate on the foreign market for currency, particularly during the 1980s and 1990s. This channel helped to promote disarray and instability in emerging nations during the financial crises of the 1990s–2000s in Mexico, Asia, Russia, Brazil, Turkey and Argentina. These nations had many contracts denominated in foreign (especially US) currency, so that when initial lack of confidence led to a depreciation of their currency, this led to an increase in debt, since the domestic sum of money lost through foreign exchange contracts grew enormously. This then led to massive capital outflow, further depreciation, rising bankruptcies, and recession or worse. These destabilizing dynamics then often led authorities to think about using (if they had not already done so) capital controls or other controls to limit uncertainty, contagion and crisis. Strange policy responses were generated such as initial uncertainty leading to depreciation, capital outflow, job losses, which led authorities to increase interest rates in order to attract capital, which ironically led to an increase in debt, greater vulnerability, loss of jobs and a more intense crisis (Mishkin 2001). Thus, at least in emerging nations the exchange rate channel posed problems of instability.

The monetary authorities, especially in the industrial world, are tending to rely more on policy that centers on confidence levels in the equity market. The equity market transmission mechanism, which is becoming more critical to US policy – and other nations that follow the US lead in financial change – is described (ideally) as:

Equity market channel of monetary policy

$$\downarrow i \Rightarrow \uparrow B_p \Rightarrow B \Leftrightarrow E \Rightarrow \uparrow E_p \Rightarrow \uparrow W/P \Rightarrow \uparrow C, I \Rightarrow \uparrow \text{GDP}_{\text{[st]}}$$

Evidence demonstrates that there is a negative relationship between market interest rates and equity returns, with bank securities being more interest sensitive than securities of non-financial corporations (Madura and Schusenberg 2000). Under the “new regime”, the Federal Reserve may decide to reduce rates (*i*), which is identical to an increase in bond prices (*B_p*). If rates are perceived to be about the lowest they can go – meaning that bond prices are considered to be at or near their highest point – then bond holders will tend to sell bonds in favor of equity. This switch from bonds to equity ($B \Leftrightarrow E$) will result in an increase in equity demand, and hence an increase in equity prices (*E_p*), often financed by an increase in credit. This will raise real wealth, which will lead presumably to an increase in both consumption and invest-

ment demand (C,I), which through the multiplier and accelerator will raise GDP, at least in the short-term (st).

Evidence shows that the wealth effect of stock prices on consumption is higher in the US, because the percentage of households who hold equity (directly or indirectly) is more advanced here than elsewhere in the world; rising from 11 percent in 1985–1989 (average) to 20.9 percent in 1996, and then a sudden jump to 24.4 percent in 1997 when stock prices started to boom (IMF 2001: 98; plus a probable drop during the early 2000s due to the stock market crash). During the 1990s in the US, it has been estimated that the direct effects of equity capital gains on consumption have been considerable, with *between 5 and 15 cents in the dollar* of a share market capital gain being spent by consumers over a 2 year period (Dynan and Maki 2001: 27).

On an annual basis, the decline in the equity market in the US during 2000–2001 saw \$3.7 trillion of wealth being lost as a result of the Nasdaq crash alone (Sylvester 2001). A negative wealth effect has been in motion also through 2002, an effect compounded by the uncertainty of terrorist attacks, war and related events:

$$\downarrow E_d \rightarrow \downarrow S_p \rightarrow \downarrow W \rightarrow \downarrow C, I \rightarrow \downarrow GDP$$

As traders have come to realize that many of the high-tech and internet stocks could not live up to their potential earnings expectations, stock market confidence crashed during the period 2000 through to 2001, and again during 2002. A decline in the demand for equities led to a major drop in share prices, leading to a drop-off in wealth, and thereby reducing consumption, investment and GDP. If every dollar decline in wealth reduces consumption by approximately 7 cents (within the band of 5–15 mentioned by Dynan and Maki 2001), then the 40 percent general drop in share prices that reduced paper wealth by about \$8 trillion should result in a decline in consumption of about \$550 billion or 7.0 percent of GDP. Further multiplier and accelerator effects would magnify this in a circular and cumulative fashion.

Problems arise in the use of this equity channel when there are speculative bubbles in the stock market that have little or no direct linkage to real production activity. For instance, evidence supports the notion that a structural break occurred in the relationship between the financial and real sectors of the US economy in the late 1970s and early 1980s. Before then, in the 1950s and 1960s, there was a close link between the rate of return of financial and real activities. However, institutional changes in the 1970s led to a new relationship in the 1980s–2000s, such that there is little or no correlation between the rate of return of finance and industry.³

The changing structure and dynamics of the US financial system since the 1970s has increased the conflict between finance and industry, since the real sector has become a sideshow to the main game of capital gains in the equity market. This has had a negative impact on industry and economic growth, in the longer time horizon, by drawing funds into equity markets rather than

promoting innovation, workmanship and long-term investment in industry, broadly conceived. Lender of last resort facilities and big government may prevent depression, as Hyman Minsky (1982) recognized. But the new system of credit and increases in the power of finance over industry have increased the potential for periodic deep recession due to a lack of confidence in the structures of demand associated with real investment and consumption. Hence national economies that are similar to the US – including now a number of European nations (Arestis *et al.* 2001: 32), as well as emerging nations that are developing a neoliberal perspective on policy – have a problem with the use of monetary policy in an era of speculative bubbles and corporate fraud.⁴

This research is closely linked with recent work in finance – what Robert Haugen (1999) calls “the new finance” – that seriously calls into question the link between equity growth and real economic activity. Haugen argues that the general empirical case is for inefficient equity markets that do not reflect fundamentals. The recent trend toward shareholder value, a greater proportion of “middle class” people holding equity, and the dominance in the market of “institutional investors” lead to a short-term planning horizon on the part of corporate executives. Corporations are increasingly – especially in the 1980s, and more so in the 1990s and 2000s – under pressure to undertake projects that reap a quick return on the market. They are also under pressure to devise complicated accounting arrangements to hide their real level of debt in subsidiaries or ghost companies that are abstracted from their balance sheets and profit and loss accounts. The recent activities of ENRON, WorldCom and Global Crossing are classic examples of this practice. Thus we have the contradictory situation where if they do not operate in this fashion, their stock price will grow at a “insufficient” rate, but if they do they run the risk of being found out and charged with fraud under the corporations act, and their equity price plunging.

In any case, the widespread perception that large companies are acting in this way has been undermining confidence in business and the system of corporate governance, leading to calls for greater levels of transparency and a separation of auditing from financial advising. There are also calls for reform of managerial and directorship remuneration to be linked more specifically to long-term performance and productivity. This has implications for monetary policy, since the greater levels of uncertainty reduce the velocity of money, enhance the potential for financial crises and reduce the efficiency of the transmission mechanism in a system where finance and industry are separate to some degree. These issues of the channels of monetary policy, the state of corporate finance and the creation of speculative bubbles pose major challenges to governance in the early years of the new millennium.

Globalization and monetary-fiscal policies

It has become an element of faith among economists to believe that when capital mobility is high and exchange rates are flexible, monetary policy is

more effective than fiscal policy in affecting output, and when mobility is low fiscal policy is more effective than monetary policy. But is it? The purpose of this section is to critically evaluate this proposition in the light of the standard model and recent institutional and theoretical advances.

Generations of economics students have been informed by the Mundell-Fleming, IS-LM-BB, model of the open economy. It is a fixed-price model that analyses fiscal and monetary policies. Using this model we first examine monetary policy (Husted and Melvin 1990: 526–535), under conditions of perfect capital mobility and floating exchange rates, which is arguably the simplest model to relate to recent trends. This case starts with a domestic economy “in equilibrium”. The government has the objective of increasing output sufficiently to promote upswing in the business cycle. First it attempts to use monetary policy through buying bonds in the open market to stimulate economic activity.

The expanded money supply (simultaneously) leads to lower interest rates and therefore major capital outflow, and higher imports since GDP is increasing. These two effects would have led to a large capital account deficit (KAD, capital outflow) and a moderate current account deficit (CAD, greater imports). A large KAD and moderate CAD are not possible with flexible exchange rates; hence, there is a large depreciation of the exchange rate, which expands exports and thereby income. Monetary policy is thus very effective under conditions of flexible exchange rates and perfect capital mobility.

On the other hand, using fiscal policy the state increases government spending, or reduces taxes. This enhances income and interest rates in the short run, but because of the large capital account surplus there is (simultaneous) pressure for the exchange rate to appreciate, leading to a drop in exports and an increase in imports as they become relatively cheaper than exports. The level of GDP is thus identical to that prevailing before the expansionary fiscal policy, thus making active use of fiscal policy redundant.

However, there are a number of caveats here. First, monetary policy is more effective under full capital mobility only when the Marshall-Lerner condition holds true, i.e. when the combined elasticities of imports and exports are great than unity (one) (Pierdzioch 2002). Evidence shows that in many nations this condition often fails to hold. Second, it does not necessarily apply so strongly when there are systems of “dirty floats”, when the reserve bank or treasury controls the exchange rate through various bands of changes.⁵ Third, these examples assume that monetary and fiscal policies are independent of each other, whereas the Chartalist “taxes-drive money” theory indicates that they are interdependent and that fiscal policy is generally financed by money (Wray 1998; Kadmos and O’Hara 2000). And fourth, fiscal policy is more effective in the case of capital mobility where there are coordinated international policies:

If all nations coordinated their domestic policies and simultaneously stimulated their economies, the world interest rate would rise and the

pressure for exchange rate change and net export adjustment would fall. The problem illustrated . . . was that of a single country attempting to follow an expansionary policy while the rest of the world retained unchanged policies so that [the foreign interest rate] remained constant. If [the foreign interest rate] increased at the same time that [domestic rates] increased, the [balance of payments] curve would shift upward so that balance of payments equilibrium would be consistent with a higher interest rate.

(Husted and Melvin 1990: 531)

They go on to argue regarding the “useful” monetary policy example in a world of coordinated monetary policy to promote exchange rate stability:

Some experts argue that coordinated monetary policy, to achieve fixed exchange rates or reduced exchange rate fluctuations to within narrow “target zones”, would reduce the destabilizing aspects of international trade in goods and financial assets when currencies become “overvalued” or “undervalued”. This view emphasizes that in an increasingly integrated world economy, it seems desirable to conduct national economic policy in an international context rather than simply focusing on domestic policy goals without a view of the international implications.

(Husted and Melvin, 1990: 531)

Hence, in a global economy, fiscal policy (at least) may be quite effective when there is a successful system of coordinated policies and when the government tends to control exchange rates within certain bands. Also, fiscal policy would be more effective if a fiscal expansion was – in the normal course of things – financed by money as the modern Chartal theory indicates. Thus, the present age of globalization does not necessarily mean that fiscal policy is redundant, if policies are coordinated, Chartalism has validity, and public capital is expanded rather than transfer payments.

Conclusion

The current trends of globalization and neoliberalism result in a deficiency of global aggregate effective demand. This is due to limits to all four components of demand. Long-term consumption by workers will be lower due to lower wages and conditions. ICT is still not a dominant sector in terms of GDP share and productivity effect, and hence investment is limited. Government spending by neoliberal governments have been minimal due to their desire to cut spending and moderate monetary policy. And exports are lower because of low global demand due to the neoliberal policies. In the long-term this has a major negative effect in terms of circular and cumulation causation.

However, as argued above, there is no reason why government policies

should not be effective in a global economy if they are well formulated and activated. But what is needed seems to be the recognition that productive state spending needs to be enhanced relative to unproductive spending. The requirements for social capital may be different from business fixed capital, and hence policies need to adequately recognize the need for an expansion of trust and association. And monetary policy needs to be redirected from the share market to industrial and social capitals.⁶

Notes

- 1 For instance, Amitava Dutt (2004) shows that the World foreign direct investment/GDP ratio has increased threefold during the 1990s. However, with the onset of fairly widespread recession and the terrorism threat during the early 2000s, there has been a dramatic drop in FDI levels worldwide of just over 50 percent (UNCTAD 2002: 3). The distribution of FDI is dominated by developed nations; hardly any goes to Africa; the share of Asian FDI has not changed much during the 1990s; but more is now going to Latin America than during the 1980s (UNCTAD 2002: 7).
- 2 The question of the financing of public capital is very important. According to the Chartal, taxes-drives-money approach, debt financing is likely to crowd-in private investment spending because of the subsequent expansion of liquidity. Tax-financing, on the other hand, reduces liquidity and thus tends to crowd-out private investment spending by reducing the level of reserves. Taxation, accordingly, should only be used to reduce demand during times of potentially high inflation when caused by demand factors.
- 3 This has led to three main developments, according to Binswanger (1999). First, there has been a marked drop in the causal link between money/credit and inflation during the 1980s and 1990s. Much of the credit has been used for buying equity, and therefore credit expansion has propelled higher equity prices more than higher prices for investment or consumer goods. This has had an apparently positive effect on the economy by dampening inflationary forces. Second, however, by reducing inflationary pressures, and thereby limiting interest rate rises, this has led to a rapid expansion in the demand for equity, propelling successive speculative bubbles in the economy. These bubbles are not sustainable because fundamental variables, such as dividends and expected profitability of industry, fundamentally condition stock prices in a long-time horizon. Thus, the use of derivatives such as options, swaps and futures has reduced the cost of diversification and leverage, and also increased the relative return for equity relative to industry.
- 4 Thus, "economists had no trouble in explaining the [1949–1965] persistent bull market by standard valuation models according to which stock prices are determined by market fundamentals. But the present [1984–1995] period is more troublesome" as stock returns have no relationship to fundamentals, according to Binswanger (2000: 380). Binswanger scrutinized hypothesis H_0 , that "Stock returns do not Granger cause production growth". He found, through the "F statistic", that there was a temporal link between the two variables leading from stock prices to production for the 1953–1965 period, but not for the 1984–1995 period. The probability that there was no link was very low during 1953–1965 and high during 1984–1995. R^2 , the squared correlation between observed and fitted values, was 0.11 for 1953–1965 and 0.00 for 1984–1995. Hence his conclusion that, over the past 20 years, "current stock returns do not seem to contain significant information about future real activity as before" (2000: 386).
- 5 There is some controversy in the literature over the use of interest rates under the

system of high capital mobility. Peter Kriesler and John Neville (2003), for instance, argue that under these conditions there is less scope of having an interest rate that is different from the average (taking into account expected changes in currency value and other factors). Marc Lavoie (2000), on the other hand, argues that even with high capital mobility there is scope for differential interest rates from the norm, due to interest differentials varying according to the risk premium, with the central bank being able to manipulate the level of debt to influence risk.

- 6 A further area of analysis is the question of the power of corporations to influence government taxation rates on corporate profits. Some, for instance, have argued that the power of transnational capital is leading to the "race to the bottom". James Crotty *et al.* (1998) argue persuasively that there are major limits to government on this score. On the broader question of the feasibility of "progressive" policies in a global political economy, see Dean Baker *et al.* (1998).

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17 Viable policies, programs and institutions for the future*

Hassan Bougrine

Introduction

The relative dominance of the neoliberal agenda is partly due to the shortcomings of traditional Keynesian policies. Even though the neoliberal agenda does not constitute a viable long-term social project, it has been embraced by a majority of policy makers who see no alternatives to free, unfettered, markets worldwide. However, the increased flow of information, commodities and capital has not improved the welfare of the majority of people and the gap between the rich and the poor is now wider. There is a need for alternative policies and programs that can generate prosperity, eliminate poverty and ensure full employment and a sustainable growth. The challenge then is to devise institutions that are compatible with this objective and which are capable of dealing with the new environment.

Several studies indicate that, historically, advanced industrialized countries of Western Europe and North America have typically relied on heavy state intervention for their development over the past 300 years (see Dutt 1992; Thurow 1992; Fallows 1993). Other studies also demonstrate that recent success stories of the East Asian “miracle” economies have not been based on free-market ideology but rather on the implementation of carefully designed trade and investment policies (see Amsden 1993, 1996, 1997; Amsden *et al.* 1994; Wade 1995). However, with the recent wave of globalization, there has been a drastic policy shift since the 1970s, which led to the gradual abandonment of the “interventionist strategy” that had prevailed in the past. Even though the social project being offered by this new “neoliberal” strategy is fraught with contradictions (see O’Hara 2000), it has been quickly embraced by a majority of governments.

The economic and social policies being implemented by the engineers of the neoliberal strategy threaten to destroy the social fabric and foundations of the very system they claim to want to fix. Indeed, one of the most damaging policies (the balanced-budget or surplus policy) has now become the norm and is used by credit-rating agencies and some international organizations to assess the creditworthiness of governments. Some of these governments have ceased to be sovereign since they have voluntarily surrendered their prerogative to

conduct independent fiscal and monetary policies (e.g. members of the European Monetary Union), thus placing themselves under binding financial constraints.

As will be shown later, the neoliberal strategy is not viable in the long run because its policies lead to high unemployment and poverty, lower growth, and ultimately reduce private sector wealth. The context in which these policies are being implemented (i.e. globalization) calls for increasing liberalization, privatization and further weakening of the State, which reinforces the philosophy of individualism. According to this philosophy, there is no need for planning the economy. It is often argued that, in any case, all planning attempts will necessarily fail because no planning agency could ever have a better understanding of how things “are really going” than those who are directly involved, i.e. the individual entrepreneur and consumer.¹

However, many scholars maintain that government policies are very powerful tools that shape the economic and social environment within which human activity is carried out. In the absence of government regulation, history shows that market failures are too frequent to be dismissed as accidental and that private enterprise has caused a great deal of damage to the environment and the well-being of poor and powerless communities. Moreover, reliance on pure market forces invariably results in unequal distribution of income and wealth and leads to polarization and injustice, thus further exacerbating the social tensions. This chapter will propose alternative economic and social policies to managing globalization, with the aim of avoiding these problems. Consequently, the remainder of the chapter is divided into four sections. In the next section, we define the goals that must be set for the future agenda. The means of achieving them are discussed in the third section. The fourth section discusses the scope for policy coordination within this framework. Some concluding remarks are given in the last section.

Defining the goals

The most noble goals of human existence can be conveniently summarized by the following statement by a shepherd from the Atlas mountains of Morocco: “a life with dignity, in harmony with nature”. This could be translated by saying that modern societies should strive to eliminate poverty, achieve social justice and protect the environment. Although these objectives are best dealt with through national policies, it must be emphasized that there is also need for international policy coordination. This is essential because otherwise some countries, for whatever reason, may lag behind in dealing with one or the other issue, thus allowing, for instance, poverty to persist or environmental damage to continue.

Eradication of poverty

Poverty is considered by many as the greatest social evil. In simple terms, poverty can be defined as the lack of access to the means that allow indi-

viduals to satisfy their human needs and develop their physical and mental faculties. In extreme cases, poverty means homelessness, malnutrition and hunger, illness and illiteracy, and many other forms of social alienation.² One of the most urgent problems on the agenda of the United Nations Millennium Summit (New York 2000) was the widespread poverty in Africa and other developing countries. A review of the reports of previous conferences sponsored by the United Nations (UN) reveals that poverty reduction has been a concern at least since 1990. Throughout their modern history, most industrialized countries have implemented various programs (unemployment insurance benefits, welfare payments, and so on) to alleviate the impact of poverty on the most vulnerable members of society. The fight against poverty is the *raison-d'être* of many international organizations. The IMF considers poverty reduction as part of its new mandate and has recently created a new facility called "Poverty Reduction and Growth Facility" (PRGF). The dream and motto of the World Bank (WB) is "A World Free of Poverty". Yet, poverty continues to be a major problem in most developing countries and, in some parts of the world, it is rising (see World Bank 2001).

Given the enormous costs (psychological, social, economic, and so on) associated with poverty, it is plausible to argue that eliminating poverty and achieving high standards of living *for everyone* must be a priority on the agenda of any future social policy. However, the "universal" character of this goal is not supported by all policy makers. In fact, the dominant political and intellectual discourse is quite hostile to an overall strategy that seeks to *eradicate* poverty. This is why international organizations (UN, WTO, IMF, WB, etc.) are only advocating "targeted" programs that focus on certain categories of the poor (children, the elderly, single women, and so on). Despite the success and popularity of some anti-poverty "targeted" programs in several OECD countries during the last 50 years or so, targeting cannot be a viable solution to poverty.³ Indeed, even if targeting helps to improve the well-being of certain groups, it does not question why some people are extremely poor while others are stupendously rich, nor does it offer tangible opportunities to break the vicious circle of poverty through social mobility. Targeting is not concerned with the distribution of wealth and the related issue of social justice.

Democratization of wealth

The distribution of wealth has always been at the centre of the debate on social issues. The essence of the debate revolves around the issue of equal opportunities to acquire wealth. The general conclusion that emanates from the literature on this subject is that wealth is more equally distributed in democratic societies and that unequal distribution is widely considered a symptom of social injustice. Most democratic societies have indeed attempted to lessen the impacts of social polarization and wealth inequality by relying on some redistributive measures, which have been integrated into their legal

systems.⁴ By contrast, in aristocracies and less democratic societies, wealth is highly concentrated in the hands of a few and routinely passed on to their heirs and descendants without impediments, since the state does not care about redistribution of wealth.

This general characterization over-simplifies reality and misleads one to believe that social mobility in democratic capitalist societies has increased dramatically over the past century or so. Advocates of free-market economy often tend to exaggerate this increase by invoking Tocqueville's (1835: 611) statement according to which, in democracies, "the rich daily rise out of the crowd and constantly return thither" or the famous saying according to which "wealth never survives three generations". However, several studies have shown that wealth in democratic societies is not only earned, it is also inherited; and in the case of the USA, some estimates indicate that up to 46 per cent of household wealth is inherited (Kotlikoff and Summers 1981; Kopczuk and Lupton 2000). The recent trends and current state of income and wealth distribution worldwide indicate that it is highly unequal (Galbraith 1998; Levy Institute 1999). The same studies also show that an equitable distribution of wealth cannot be achieved through market forces. Therefore, if we want to prevent wealth from being concentrated in the hands of a few and make it *truly democratic*, it would be necessary to consider redistribution through government intervention.

Clean and healthy environment

It is generally agreed that the long struggle by human beings to understand and dominate the forces of nature has been largely motivated by the desire to create conditions for a better life. This goal has been partly achieved thanks to various scientific discoveries. Unfortunately, the industrial development and technological advances of the last two centuries have also been accompanied by some detrimental "side-effects", which greatly reduced the quality of life (air, water, and noise pollution, ozone destruction, drastic climate changes, and so on). It is true that the present state of the limited human knowledge does not permit the elimination or prevention of these side-effects. However, it is also true that lack of progress in this area can be blamed, at least partly, on how modern societies have chosen to deal with environmental issues. For instance, there has been a lack of regulations and laws that protect nature. There has also been a rampant commercialization of nature and careless pursuit of profit, parallel with the promotion of individual property rights over communal and social well being (see Conca 2000; Barker and Mander 1999).

Indeed, the standard approach to dealing with the "side-effects" falls within the common practice of cost externalization, which consists of disposing of (toxic) waste "somewhere else", usually areas where environmental laws are lax or nonexistent. Wallerstein (2000: 260) likens this approach to relocation of production to low-wage areas in an effort to cutting costs and concludes that

[i]t works as long as there previously unutilized areas in which to dump waste. But eventually there are no more streams to pollute, or trees to cut down – or, at least, there are no more without serious immediate consequences for the health of the biosphere. This is the situation in which we find ourselves today after 500 years of such practices, which is why today we have an ecology movement that has been growing rapidly throughout the world.

In the same vein, Conca (2000: 486) argues that

the threat to relocate can be an important tool to weaken environmental standards, just as it provides leverage in labour negotiations. To some extent the problem . . . is endemic to a world of trade-based economic competition. But WTO rules and procedures clearly exacerbate the problem: to date, the WTO has handed down an anti-environmental decision in every major dispute case where a national environmental regulation has been challenged.

If this trend continues, humanity would have defeated the purpose behind its efforts in the scientific field. It follows that any viable social policy must include ways to protect nature and the environment and prevent the race to a “polluted bottom”. In this regard, what is needed is a global strategy that incorporates the various agreements dealing with specific environmental problems (the Montreal Protocol on stratospheric ozone, the Basel Convention on trade in hazardous waste, the Convention on International Trade in Engendered Species, The Kyoto Climate Accord, etc.). However, one must be aware of the fact that the exploitation of nature and its resources obeys first and foremost the laws of the market. Hence, there is a strong resistance and opposition, particularly from transnational corporations, to measures (e.g. eco-taxes, agreements to reduce gas emissions, etc.) that may hinder profitability (Görg and Brand 2000).

The means

In this section, we discuss alternative policies and programs that can be implemented in order to achieve each of the goals mentioned above. Our approach follows a political economy view of policy. The set of policies proposed here derive from non-orthodox views of economic theory and, therefore, depart significantly from commonly held views regarding, for instance, the meaning and nature of money, public finance and the role of the state in a market economy.

A full-employment strategy

Concerning the first objective, we start by noting that international organizations such as the World Bank and the World Trade Organization maintain

that economic growth, which can be fostered by globalization and free trade, is the key to tackling unemployment and alleviating poverty (for an excellent account, see Wade 2001, and references therein). However, a closer look at this suggestion reveals that economic growth *per se* does not necessarily benefit the unemployed nor does it ensure that the jobs created provide workers with a minimum acceptable standard of living. Moreover, it is important to realize that, although economic growth can generate employment, it does not mean that enough jobs are being created to absorb new entrants to the labour force and to reduce existing unemployment. In fact, some studies have shown that employment growth does not follow the same pattern as GDP growth and that labour intensity of GDP growth has been declining in developing countries (Muqtada and Basu 1994; Singh 1991). Focussing on GDP growth as the point of departure for reducing unemployment and poverty is too narrow, to say the least.

Therefore, the main argument in this essay is that full employment, not simply economic growth, must be the primary objective of economic policy of national governments as well as international organizations.⁵ The reason for this shift of focus is simple. The expansion of employment appears to be a major contributor to economic growth at least for two reasons: i) employment of idle labour resources adds directly to the production of goods and services, and ii) the incomes thus generated serve to support increased consumption and greater demand, therefore giving incentives to producers to expand and hire more workers to meet the increased demand.

The question, then, is how can we create the jobs in which to employ the idle labour resources? The strategy proposed here is based on two pillars: i) promote employment creation in the private sector through the expansion of credit to small and micro-enterprises, and ii) hire all surplus labour by the government through a massive infrastructure-building program. The two parts of the strategy are highly complementary in the sense that one sector would create demand for the other and promote further expansion through cumulative effects. The second part of the strategy has been described by others as a means that relies on the government as an Employer of Last Resort (ELR). Several studies have demonstrated the benefits of economic policies based on such a strategy (see, among others, Mosler 1998; Wray 1998; Forstater 2000). The idea can also be traced back to Keynes (1936) who strongly advocated the expansion of aggregate demand through public-works programs.

The first pillar

A major problem faced by poor people and owners of small businesses in developing countries is access to credit. The problem is even greater for potential start-ups because of lack of experience and collateral, so that a large number of prospective borrowers are *excluded* due to current banking practices which discriminate against certain groups for rational economic reasons

or other grounds such as gender, age and so on. As a result, many employment opportunities are lost, often permanently. The expansion of credit to the poor, small and micro-enterprises at very low or zero interest rates can be an effective policy instrument in the generation of employment, as shown by the experiences of some countries in Latin America and Asia (see Morisson *et al.* 1994; ILO 1990).

As suggested by the United Nations (1999): "Many [poor people] are, and can become, entrepreneurs, as either farmers or traders or as producers of goods [and services]. For this they need credit to purchase [materials and] inputs" (United Nations 1999: 183). These small enterprises can easily specialize and fill the gap in several niches in all major sectors of the economy (agriculture, services and manufacturing). To increase the chances of success of these enterprises, the strategy should be accompanied by training programs to strengthen the productive and managerial skills of those starting new businesses. Education and skill upgrading are essential also in order to ensure that the goods and services produced by these enterprises are of high quality with competitive prices so that they can be exported to international markets.

In most developing countries, extending credit to those who are unable to have access to formal finance is often arranged through informal financial institutions. However, experience has shown that the success of this type of finance is limited for many reasons. For instance, moneylenders are notorious for charging high interest rates; pawnbrokers require tangible property (e.g. jewellery) as collateral for loans; group-based institutions (self-help and mutual assistance groups such as the Rotating Savings and Credit Associations) are limited by the amount of savings they can collect from the group or the community they serve; and in most cases, the loans are small and only for short terms.

Some semi-formal financial institutions (e.g. Grameen Bank) operated by non-governmental organizations have had some success in helping the poor by providing them with micro-loans. However, the role of micro-lending schemes in alleviating poverty is limited (see Hulme and Mosley 1996; Khandker 1998) and recently, following financial liberalization trends, some micro-finance institutions have been under increasing pressure from governments and donors to become financially sustainable and adopt market-based techniques.⁶ Although these institutions continue to provide loans to the poor and small entrepreneurs, lending on commercial terms is not the solution to eradicating poverty. Financial exclusion of the poor can only be addressed adequately by government-sponsored not-for-profit institutions. Providing the poor with credit and the skills, training and education needed to make a productive use of such credit is a *public responsibility*.

Therefore, it is the responsibility of every sovereign government to ensure, through its central bank, that demand for credit is satisfied and that total spending in the country does not fall below the level of the full utilization of its productive capacity because otherwise, as Abba Lerner (1943) argued, it would permit the existence of unemployment. In order to achieve this

objective, the sovereign government must set up a “National Credit Bank” with branches all over the country to dispense credit to all those who demand it, with a particular focus on the poor. This is not charity or “welfare madness” as neo-conservative critics would argue. This is good business for the government and for society as whole for three reasons. First, because the loans are likely to be repaid since the government has more power than the informal and semi-formal financial institutions to enforce repayment. Second, because the poor and unemployed reduce their poverty, improve their standard of living and participate in building healthier communities, which gives them a sense of personal fulfilment and social belonging. And third, the government will spend less resources on social assistance and the problems associated with poverty and unemployment.

Neoliberal ideologues and proponents of “sound finance” are quick to dismiss this strategy as irresponsible and inflationary because, in their view, it puts a strain on fiscal resources and injects more money into the economy. However, as Lerner (1943: 47) has shown, “there is no risk of inflation from this, *because if there were such a risk a greater amount [of money] would have to be collected in taxes*” [emphasis added]. Therefore, unemployment, not inflation, should be the primary concern. This means that the population has the right to demand and expect from their governments and the international community a set of measures that seek to achieve full employment, eradicate poverty and eliminate social injustice in order to build an inclusive society.

The second pillar

The second pillar of the strategy is based on the basic principle according to which the government will absorb all the surplus labour by creating jobs for all those who are able and willing to work. In this respect, two questions are often asked: What jobs will these workers do? Where will the government get the money to pay them? First, we must recognize that in developing countries where poverty rates are the highest, there is a serious lack of basic public infrastructure: limited and congested road-networks, lack of water and sewerage systems in some communities, lack of waste collection and management programs, lack of paved streets and sidewalks, lack of other public amenities such as recreation parks, street-lights, telephone networks, and so on. To build and maintain this infrastructure would require the employment of a large number of workers and, therefore, substantially reduce unemployment and alleviate poverty.

As noted above, the incomes earned by the workers who participate in the building and maintenance of such public infrastructure and/or in the provision of other socially useful jobs raise aggregate demand and, therefore, contribute to stimulating economic growth. In addition, building such infrastructure is not a luxury but rather an economic necessity. Poor and underdeveloped infrastructure has long been recognized as a major impediment to growth and expansion of private enterprises, both small and large,

including transnational corporations. It is also important to realize that the resources allocated to public infrastructure are not a simple expenditure. Rather, they constitute an investment which has high social returns: creation of jobs, improvement in skills and education, reduction of poverty, and a healthier and more productive labour force, which all contribute to the social and economic development of the country.⁷

However, if the issue of job creation can be settled relatively easily as it appears from the above discussion, the financing issue remains controversial, mainly due to the fact that the principles of classical economics are still well ingrained in the minds of the political elite (including those on the Left and its academic advisers). Indeed, the basic thinking in these circles is that taxes are the *only legitimate* source of government revenue and that public spending must not exceed the limited “revenues collected from taxes”.⁸

The Chartalist school and the Circuit Theory fundamentally disagree with this view of taxes. Lerner (1943, 1947), Bell (1998, 2001) and Wray (1998) argue that taxes cannot be used to finance government spending. Rather, they are used to give value and acceptance to money and to control the aggregate spending in the economy. Bougrine and Seccareccia (2001: 9) maintain that taxes cannot finance government activity because

at the beginning of the fiscal year when the budget is decided and the government starts making actual disbursements, taxes are not yet collected. Moreover, taxes cannot be collected at the beginning of the period because incomes on which they are levied have not yet been earned. Therefore, if taxes are to be considered as government income in any sense at all, then it must be said that they are an income contingent on the realization of private agents' income and therefore can only be determined *ex post*. The question that should be asked then is how can we claim that an *ex-post* income is used to finance an *ex-ante* economic activity? This is clearly not possible. In a sense, in accordance with Chartalist theory, money must first be spent before it can be collected in taxes.

If taxes are only collected *ex post* and, therefore, cannot be used to fund an *ex ante* economic activity, how does the government then pay for its expenditures? Bougrine and Seccareccia (2001: 10) answered the question by stating that

in order for government operations to proceed and incomes to be earned in the public sector, all that is required is that the banking arm of government accepts to honour the cheques issued by its fiscal arm, the Treasury. Since these cheques will then be deposited by the public within the commercial banking system, the government's account at the central bank will be debited whereas private agents' accounts at commercial banks will be credited by the same amount.

This is what corresponds to the creation of money and it is in this sense that Lerner (1947) and the Chartalist School speak of money as a “creature of the state”. The state can start collecting taxes only after it has injected money into the system and only after private incomes have been generated. It should be clear that the operation of levying taxes is the inverse of government spending, which means that, at this stage, private agents’ accounts at commercial banks are debited and the government’s account is credited. Therefore, government spending adds to money while taxes subtract from it. Taxes destroy money and in this sense they cannot be considered as a source of revenue for the government. Hence, the answer to the question “where will the government get the money?” becomes evident once we realize that sovereign governments are capable of creating money at will.

Public debt and the creation of wealth and prosperity

A major conclusion that follows from the analysis presented in the previous section is that, in order for the private sector to have a positive amount of money, the state must spend more than it collects in taxes, i.e. it must run a deficit. Therefore, public deficits are a source of money creation (wealth) for the private sector. Indeed, the counterpart of a public deficit is a surplus in the private sector, which corresponds to an increase in firms’ profits and, therefore, in their net wealth (for more details see Mosler 1998; Bougrine 2000; Halevi and Kriesler 2000). By the same token, public surpluses ($G - T < 0$) amount to a net withdrawal of funds from the private sector, thus lowering profits and net wealth. Fiscal and monetary restraints are rightly associated with austerity programs that have almost invariably resulted in slow growth and recessions (Wray 1998). The dominant trend in policy making is to “balance the books” and pay off the public debt. The objectives of balancing budgets and reaching surpluses are nowadays considered the norm and used by various international organizations (the IMF, in particular) as characteristics of “good economic management”. Nothing can be further from “the truth”. A policy based on budget surplus – as its fundamental core – has detrimental consequences on the national economy because it hampers growth and forces millions of people into unemployment and poverty.

To see this, let us analyse what happens when the government is running a deficit, perhaps because it needs to upgrade or renovate the infrastructure of the country, but chooses not to levy taxes for the reasons discussed above. When private (individual and corporate) citizens participating in this project receive their income from the government and deposit the cheques (drawn on the central bank) into their accounts with commercial banks, the balance sheet of the latter is increased by an equal amount on the liabilities side (to the depositors) and on the assets side (since commercial banks now hold government money). This means that commercial banks’ reserves with the central bank will increase. It is well known from the literature on money and banking that such reserves (government money) do not pay interest whereas

government bonds do. Since commercial banks are profit-maximizers, they do not wish to hold funds that generate no income. Hence, the demand by commercial banks for government bonds increases. However, as explained by Parguez (2000), if the government, via its central bank, decides not to issue any new bonds, the price of the latter would increase and their yield, the interest rate, would fall. The same result would also occur when commercial banks with excess reserves attempt to lend these in the funds market (see Mosler 1998; Wray 1998). The central bank can therefore control the interest rate by controlling the issue of bonds, the demand for which can be manipulated by controlling the size of the deficit. The larger the deficit is, the more excess reserves will be in the system and the lower the interest rate will be.

A surplus would obviously lead to higher interest rates and increase rentier wealth. In addition, higher interest rates negatively impact on private wealth because they lower the value of assets held by households and firms; they increase the costs paid out by firms and consequently lower their profits, which, in turn, lowers opportunities for expansion and job creation through new investments; and they discourage households from borrowing funds to start new businesses and, therefore, limit the opportunities for them to improve their wealth and well being.

This leads us to conclude that a government that pursues a high interest-rate policy (via budget surpluses) must be attempting to favour and protect the *interests* of the rentiers against all other groups of society. Since low interest rates have the opposite effects, we presume that a democratic society would prefer lower interest rates and, therefore, would prefer to pursue a public policy that is based on budget deficits, not surpluses. Low interest rates allow ordinary citizens to have access to credit and give them the opportunity to borrow in order to purchase homes and acquire other valuable assets. In this manner, low interest rates contribute to spreading wealth to a larger portion of society and, therefore, to creating “democratic wealth”. In Tocqueville’s terminology, we might say that a low-interest rate policy is the distinctive characteristic of democracies since it offers the people “equal opportunities” to have access to wealth. The dominant trend of fiscal orthodoxy, which is based on budget surpluses serves the immediate interests of the rentier class, thus conferring power onto an “entrenched elite”.

Taxes, wealth, and the global environment

The layman’s understanding of taxes is that they reduce private consumption. Our analysis of the role of taxes in the national economy indicates that this is indeed the case since taxes are part of the reflux phase of the monetary circuit. Taxes destroy money and as such they cannot pay for the provision of public goods nor can they redistribute wealth across social groups. The talk about the need for high taxes to pay for more social programs and redistribute income and wealth in favour of the poor is highly misleading, and the layman’s view turns out to be much more accurate than that of many

“sophisticated” economists. As emphasized by Parguez (2000: 12), economists’ misunderstanding of the role of taxes has resulted in what he calls a “tax squeeze” that seriously depressed aggregate demand and led to slow growth and unemployment:

The deflationary effect of taxes explains why in the long run tax hikes have a destabilizing impact in a modern economy by generating a long-run decrease in consumption expenditures which determines a fall in expected profits, leading to a fall in private investment. The tax-squeeze effect can be the underlying cause of the so-called “crisis” of the old Robin Hood welfare State.

(Parguez 2000: 12)

Based on this view, the viable policy would be to have lower taxes on the general population and increase them only if there are inflationary pressures in the economy, as suggested by Lerner (1943). However, as Bougrine and Seccareccia (2001) have shown, a progressive taxation system can play a positive role in creating a more equitable distribution in the sense that higher taxes on the rich prevent them from accumulating so much wealth whereas less taxes (or no taxes at all) would allow the poor to accumulate more wealth. In this sense, taxes can contribute to creating a more equitable society but not in the sense that they would transfer wealth from the rich to the poor as emphasized by the traditional view. High taxes can also be an effective tool to discourage environmentally unfriendly consumption habits and production techniques. For instance, the production and use of alternative sources of energy (wind, sun, etc.) should receive tax credits whereas polluting industries must be penalized by incurring high taxes. In this manner, society can create a safer and healthier environment for present and future generations.

However, since the degradation of the ecosystem is a global problem, national policies are not enough even though they are useful. Taxes can, and should, be extended beyond the national borders and imposed, for instance, on imports and exports of certain products, either because they are harmful or because they threaten the biodiversity of the ecosystem. The implementation and success of this policy calls for the political will and cooperation at the international level to adopt trade regimes that can protect “the natural capital” and develop into a global strategy of environmental protection. Such strategy clearly contradicts the principles of trade liberalization advocated by GATT and WTO.⁹ This contradiction is at the heart of the problem and questions arising from discussions about the need for environmental protection. It also explains why present environmental regimes reflect the interests of the powerful players in the process of (capitalist) globalization. The underlying argument behind the strategy of the WTO and its powerful players is that “the complete privatization and commercialization of biological diversity, would ensure its preservation even without regulatory state intervention” (Görg and Brand 2000: 380). Privatization is proposed as a means of

preventing the destruction of the natural capital (or “global commons”) because of “the assumption *that* biodiversity in fact *does not belong to anybody*; and . . . the allegation that it is being destroyed *because* it does not belong to anybody” (Görg and Brand 2000: 381, emphasis in original).

These assumptions are also used in the negotiations over reductions of greenhouse gases, such as in the Kyoto Protocol on climate change. Indeed, a major obstacle threatening the Kyoto Protocol is that some governments are arguing that they should be allowed to “count emissions reductions outside their borders as part of their treaty obligations to reduce greenhouse gases” (Conca 2000: 490), thus claiming their rights over emissions reductions realized elsewhere. It is argued that, through a market mechanism (called cooperative mechanism), countries that reduce their emissions by more than their treaty obligations should be able to sell the extra credits to countries where such reductions prove to be costly. The end result of this neoliberal logic is that, as (Conca 2000: 491) put it,

climate commodification allows powerful, globally minded actors to buy a slice of pollution control wherever the badly distorted and heavily externalized “market” says that it happens to be cheapest at the moment, with no regard for the local communities whose environmental quality is being bought and sold. Trading schemes also invite abuse, in that what is being traded is not a traceable good or service but an alleged change in emissions, based on national data of often dubious quality.

Opponents of the neoliberal model question the ability of the market to solve environmental problems and maintain that the proper management of the “global commons” must be the responsibility of states, working together in an effort to protect the environment as a common good. This raises the issue of whether or not global environmental problems lead to greater international cooperation. As can be seen from the above discussion, reasons for optimism are very few unless the objectives of policy making, both at the national and the international levels, are clearly defined to include the socio-economic and environmental questions raised in the previous sections.

The scope for international policy coordination

Public policies are always designed and implemented to achieve specific goals. They represent a conscious effort to solve given social and economic problems. For this reason, policy choices must reflect the needs and aspirations of the community. However, societies are not homogenous and it must be recognized that specific policies are often introduced as a response to group pressures seeking to serve their own interests and objectives. Policy making in the era of globalization clearly reflects the interests and objectives of the dominant class as represented by the rentiers and global capital. This is apparent in the statements and declarations following, for instance, the

various summits of the Group of Seven, which make frequent reference to open markets, deregulation, privatization, and monetary and fiscal restraint.

In this context, the scope for international policy coordination is reduced to the management of some "key" variables such as exchange rates and inflation, with a flagrant neglect of issues relating to unemployment, wealth distribution and the environment. This neglect, however, is consistent with the dominant view of the economy and the model on which it is based. According to the neoclassical model (summarized in Mussa 1979), there is no need for international policy coordination. If governments do not intervene, for instance, in foreign exchange markets, floating exchange rates would insulate employment from foreign economic disturbances and ensure balanced payments, or at least short-lived imbalances. Fixed exchange rates, on the other hand, were seen as obstacles to the automatic adjustment of the balance of payments, and as such, some would argue, they precipitated the collapse of the Bretton Woods system.

However, the reality shows that domestic economies are not, and cannot be, insulated from the effects of macroeconomic policies of the rest of the world. Policies leading to a recession in the European Union (EU) will undoubtedly impact on the economies of EU's trading partners. Economic policies of one country affect the prospects of growth and expansion in the others because the structures of their economies are intertwined through trade and financial flows. Such structural interdependencies have increased over the last 50 years, thus making the need for policy coordination even more relevant. The problem is that there is no point talking about international policy coordination if there is no agreement over the objectives of public policies at the domestic level.¹⁰ Moreover, policy coordination can have only limited results if the objective is limited to reducing the externalities arising out of the structural interdependencies.

If policy makers are concerned with reducing world unemployment, poverty and hunger, and the damage done to the environment, then one might say that their objectives are interdependent (Horne and Masson 1988). Policy coordination in this context can help to alleviate these problems given that the objectives are similar. In fact, it can be argued that coordination of policies can help in the pursuit of national policy goals since these are compatible with the ones determined at the international level. The Kyoto protocol on environmental policy is a good example to illustrate this convergence of objectives even though the USA has refused to ratify it. The objections of the USA to ratifying the protocol are essentially justified by the fact that developing countries have no targets for reducing the emissions of greenhouse gases. Since much of the emission reduction can be achieved through modern technology, it would be sensible for developing countries to adopt emission limits and insist on technology transfer. These issues, however, involve the question of devising policies and measures for funding and financing sustainable development, a question that is at the core of the North-South debate.

The alternative framework for national policies proposed above can serve as a basis of guidelines for these negotiations and the role played by international organizations such as the IMF and the WB. These institutions should reverse their policy recommendations of fiscal and monetary restraint and encourage central banks to finance development projects, including those that target environmental protection ("green projects"). As mentioned earlier, some form of global-warming tax should be imposed on activities that have negative effects on the environment. At the same time, such policy reversal would result in low interest rates, which are essential for the promotion of private initiative. High interest rates and the removal of restrictions on international capital encouraged the growth of financial markets, which in turn increased macroeconomic instability worldwide and contributed to the fragility of financial systems. The pursuit of high returns on capital has led to rapid over-expansions and subsequent contractions of the financial sector, thus making financial crises quite frequent in the 1990s–2000s. The return on financial instruments (particularly short-term securities and loans) depends on real rates of interest, that is on inflation rates, but generally not on the growth of output and employment. It is for this reason that recent policy coordination within the Group of Seven, for instance, has been excessively focussed on the fight against inflation without any real concerns for unemployment.

Indeed, as noted by Pollin (1998: 439) financial market participants have developed various ways to circumvent existing laws, which enabled them to

exert significant pressure against governments that pursue policies contrary to their perceived interests. Anything resembling an expansionary/full employment strategy is frequently regarded as suspect because of its anticipated negative effects on the real incomes of nonfinancial and especially financial capitalists, the returns on whose assets are fixed in nominal terms.

It is evident that in the absence of international policy coordination, such pressures (or external constraints) can jeopardize the success of any national full-employment strategy. For this reason, Eatwell (1994: 280, quoted in Pollin 1998) argues that

the pursuit of a full employment policy must involve either withdrawing from the international pressures which create unemployment . . . or the creation of an international environment which replicates the expansionary framework of Bretton Woods. . . . However, there is no intrinsic reason why the Group of Seven should not be able to create a new international regime which would underwrite national full employment policies.

To curb speculation and reduce the effects caused by fleeing "hot money", proponents of stability in financial markets, following Tobin (1982) and

others, are calling for a global tax on foreign exchange conversions in the hope of mitigating the speculative dimension of international capital flows. Wachtel (2000: 340), for instance, believes that “such a tax would restore a degree of control over monetary policy for central banks that today have lost some monetary autonomy and have become passive reactors to private financial markets”. Those concerned with poverty reduction argue that the Tobin tax receipts could be used to finance sustainable development projects in the South or fund low-income recipients in developed countries.

Conclusion

Policy making in the age of globalization is dominated by the principles of neoclassical economics, which advocate increased liberalization and deregulation of all markets. The constraints placed on government intervention have reduced the power of the state to conduct expansionary policies to deal with rising unemployment and poverty. The pressure from powerful actors on the international scene has also weakened the political will to design and implement policies to protect the environment. The present study proposed alternative means to deal with each of these issues. The implementation and success of the proposed policies hinge on the role played by a sovereign government, with its own central bank. To those who see no alternative to globalization and free markets, a proposal that seeks to bring the state back in may sound like swimming against the current. However, one should not forget that it is only through the organized political will of the state that poverty and other forms of social injustice can be corrected. Governments that have surrendered their right to conduct independent monetary and fiscal policies have, at the same time, given up the means that would allow them to achieve these goals because, like provincial governments, they can only rely on taxes and borrowing to finance their expenditures. It is true that the current process of globalization has weakened the power of the nation state, as it did in the case of the EMU and perhaps soon in North America and elsewhere. However, not all is lost if the necessary institutions are re-created at the supra-national level, that is, for instance, parallel to the European Central Bank or the proposed “North American Federal Reserve Bank”, one should also have a European government and a North American government, each with its own Treasury department conducting the policies proposed above and relying on its own central bank to finance its spending. And perhaps in the long-run the myriad of international governance institutions will merge into some form of World Government.

Notes

- * I would like to thank, without implicating, Phil O'Hara, Alain Parguez, Mario Seccareccia, John Smithin, for their helpful comments on earlier versions of this chapter.

- 1 Wallerstein (2000: 250) argues that

[t]his discourse is in fact a gigantic misreading of current reality – a deception imposed on us by powerful groups and an even worse one that we have imposed upon ourselves, often despairingly. It is a discourse that leads to ignore the real issues before us, and to misunderstand the historical crisis within which we find ourselves. We do indeed stand at a moment of transformation. But this is not that of an already established, newly globalized world with clear rules. Rather we are located in age of transition, transition not merely of a few backward countries who need to catch up with the spirit of globalization, but a transition in which the entire capitalist world-system will be transformed into something else. The future, far from being inevitable and one to which there is no alternative, is being determined in this transition that has an extremely uncertain outcome.

- 2 Some estimates of the World Bank indicate that over one-fifth of the world's population is living on less than a dollar a day, one quarter of the world's adults are illiterate, and about 11 million children die every year of preventable diseases (see World Development Indicators and World Development Report, various years).
- 3 By definition, targeting seeks to improve the living standard of some people, for instance, by increasing the benefits allocated to them, but leaves out others who do not belong to the targeted group. In addition, targeting does not permanently remove people from poverty since it does not intend to eliminate the root causes (unemployment, underemployment, etc.), as would be the case in a full-employment strategy.
- 4 Since the 1980s and with the advent of the European Union and other free trade arrangements, there is a tendency towards abandoning the welfare state in most OECD countries. The general argument in support of this tendency is that transfer payments (social security, welfare, unemployment insurance, etc.) are no longer affordable, unfair, and/or cause great inefficiencies in the economic system.
- 5 The United Nation reports of conferences on poverty reduction generally point to the lack of access to employment opportunities as the primary cause of poverty. It is also worth noting that most developed countries have in the past adopted economic policies aiming at achieving full, or at least high, levels of employment. Moreover, the right to employment is one of the economic and social rights emphasized by the Universal Declaration of Human Rights. The same right is also provided for in the International Covenant on Economic, Social and Cultural Rights, which has been signed or ratified by most countries. According to this article, governments of States which are parties to the Covenant have the responsibility to provide all their citizens with "technical and vocational guidance and training programs, policies and techniques to achieve steady economic, social and cultural development and *full and productive employment* under conditions safeguarding fundamental political and economic freedoms to the individual".
- 6 For instance, the Banco Solidario in Bolivia transformed itself from a non-governmental organization to a commercial bank, and the Grameen Bank in Bangladesh became a chartered bank by government ordinance. For further details, see United Nations (1999).
- 7 One might still wonder where will these workers be employed once the infrastructure is taken care of? How can society find new jobs for them? The answer given by Keynes (1936: 128–129) to similar questions is illuminating: "If the Treasury were to fill old bottles with banknotes, bury them at suitable depths in disused coalmines which are then filled up to the surface with town rubbish, and

leave it to private enterprise on well-trying principles of *laissez-faire* to dig the notes up again (the right to do so being obtained, of course, by tendering for leases of the note-bearing territory), there need be no unemployment, and with the help of the repercussions, the real income of the community, and its capital wealth also would probably become a good deal greater than it actually is" Keynes (1936: 128–129). Of course, Keynes was not advocating that the government should follow these actions as a guiding principle for public policy. Rather, his argument was clearly intended to show that it is not, or should not, be difficult for a society to create jobs for its unemployed. In doing so, Keynes obviously favoured socially useful jobs, since he maintained that "It would, indeed, be more sensible to build houses and the like; but if there are political and practical difficulties in the way of this, the above would be better than nothing" Keynes (1936: 129).

- 8 This belief has convinced policy makers on the political Left to lead the fight against tax cuts because supposedly taxes are needed to "fund" social programs. In this respect, there is no difference between the Left and the Right since they both agree that taxes are used to finance public spending. Pushing the argument further, Toye (2000: 36) concluded that the existence of the welfare state and its social programs in developed countries is due to their success in "establishing the institutions necessary for the direct taxation of the majority of adult population during the first half of the twentieth century". Commenting on the situation in developing countries, he noted that "[t]he absence of direct personal taxation on the revenue side of the budget is matched by the absence, on the expenditure side, of much spending on social security, education and health services" (Toye 2000: 36). Note, however, that over one half of a century ago, Lerner had expressed a completely different point of view concerning the role of taxes when he argued that: "taxing is *never* to be undertaken merely because the government needs to make money payments. Taxation should therefore be imposed only when it is desirable that the taxpayers shall have less money to spend, for example, when they would otherwise spend enough to bring about inflation" (Lerner 1943: 40).

- 9 Conca (2000: 489) writes:

Article XI of GATT, which prohibits quantitative import or export restrictions, has been cited as the basis for a WTO challenge on round-log export bans. A "tree logging" agreement that would relegitimize the trade was one of the failed deals that Seattle was meant to seal, and still looms as a dangerous addition to the WTO family of agreements.

- 10 Pollin (1998: 440) writes:

Indeed, the only conditions under which these types of cooperative relationships could form would be through progressive national governments that are attempting to implement egalitarian growth policies within their domestic economies. But such governments are not likely to form if they require an environment of global cooperation as a precondition to attempting a domestic growth agenda.

He goes on to add that "in short, the initial impetus for building a new international framework that can support full employment and egalitarian policies will have to begin within domestic settings".

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18 Development policies for the twenty-first century

B.N. Ghosh

Introduction

In Lewis Carroll's novel, *Alice in Wonderland*, Alice runs and runs only to find herself confined to the same place. The achievements of development in many of the developing countries, including Africa (especially), much of Latin America, and the South Asian nations since the 1950s, have not been much different from the experience of Alice in Wonderland. In many important respects, development policies of the last 50 years have not been suitable for the basic desiderata of human and sustainable development. Some successes have been achieved, particularly in the areas of reducing absolute poverty, increasing longevity and literacy. But the failures have left us standing still or even going backwards. Relative poverty has increased, trust diminished to low levels, AIDS and other diseases have sapped the potential of (especially) Africa, and financial crises along with money laundering and terrorism have increased the instabilities of the system.

It is necessary at the outset to carefully formulate the basic outlines of the development policy of the new millennium. The chapter is organized in the following manner. First, as a necessary background, I discuss the failures of development policies in the last half of the twentieth century. Second, the changing concept of development will be examined vis-à-vis the milieu of development policy in the twenty-first century. And last, the chapter will present a new development framework in the context of neoliberalism and globalization.

Development policies in the twentieth century: a critical appraisal

Ever since its inception as a new subject in the 1950s, development economics has been pursuing the basic objectives of ameliorating poverty, increasing employment and income, plus eliminating diseases and reducing malnutrition and under-nutrition from the Third World, in particular, by means of growth and development. In the 1960s, it was realized that, despite concerted efforts for over a decade, and the realization of around 5 percent

rate of growth by less-developed countries (LDCs), the basic problem of poverty and income inequality could not be perceptively reduced. On the other hand, the economic distance between developed (DCs) and less developed countries widened. The optimism with which the decade started off could not be sustained, and a sense of pessimism entered the arena of development economics.¹

The 1970s can be looked upon as a decade of reappraisal. The achievement of a 5 percent rate of growth was not sustainable, and poverty and inequality intensified in most of the poor countries.² Economic growth as the basic desideratum of development economics was challenged by many economists, and it was thought that the blind application of Western growth models was not only inappropriate but also harmful, for these caused enormous mal-development in LDCs. All this called for limits to growth. On the other end of the spectrum, one could discern growing economic domination of the DCs through trade and aid. The debt burden of LDCs started increasing in the late 1970s, and it was realized that trade was no longer the engine of growth, rather it was a mechanism of immiserizing growth.³ The negative externalities of large industrial projects in terms of ecological costs looked conspicuously overwhelming.

Education, health, employment and the like were regarded as the correct components of development, reflected in the formulation of the *basic needs approach*, popularized by the World Bank and the UN Research Institute for Social Development.⁴ The most significant achievement of this decade was the realization that it was *fairer distribution* rather than production *per se* that is necessary for ensuring basic needs. The 1980s was characterized as a "lost decade" in policy making for development for many obvious reasons. First, many contradictions became evident in the simplistic economic paradigm of development (Wignaraja 1997: 81–83). Development became unstable and volatile in many countries (Esteva *et al.* 1998: 46) and there was an apparent failure of conventional theories of development. Many of the structural adjustment policies advanced by the World Bank in the 1980s came to adversely affect those who previously depended on such employment and income sources, which also impacted negatively on growth (Barrett 2001).

Second, the Keynesian-welfare state theory no longer brought any hope for solving the problems of underdevelopment and poverty. At the other end of the continuum, there was a smoldering discontent both against capitalism and socialism for their failure to show a viable road to growth and development in poor countries. Third, while the countries in the South were trying to find alternative forces for socioeconomic change, they castigated the North as being responsible for their sad plight: the North–South debate thus became more vociferous and vitriolic. Fourth, the new international economic order lost its momentum, and could be dubbed a system of new international economic disorder. Contrary to expectations, less capital and less technology flowed to the LDCs from DCs; and there was also the *reverse transfer of technology* from the poor to the rich countries.⁵ And fifth, there was an apparent

disillusionment with aid and trade as mechanisms for helping the desired process of development, as they became means of surplus extraction from poor countries. Many nations experienced negative development through being exposed to the debt crises of the 1980s, which reduced funds for social and economic improvement. There were indeed many debates, conflicts, issues and questions during the decade. But there was no synthesis and solutions in the offing, and neither was there any new consensus on the feasible strategic action and direction. In the words of W.A. Lewis, development economics was “in the doldrums”.

The 1990s will go down in the annals of development economics as the decade of new vision and direction. The decade witnessed attempts at re-development after years of mal-development in the Third World. The entire development process so far, based on state planning and patronage, came in for serious criticism, and more reliance was placed on the market as an organizing mechanism for global relations (Harcourt 1997: 5–8). Privatization – which was already on the agenda in many developing countries – occupied the front seat in terms of priority. During the 1990s–2000s, the limitations of the free market mechanism came to the surface with the financial crises in Mexico, Japan, East Asia, Russia, Brazil, Argentina, the US and elsewhere. New perceptions emerged. The economic underpinnings of development came once again under critical scrutiny, especially by feminists and social capital theorists. For instance, at the Beijing conference of 1995, a whole gamut of issues concerning gender was recast, and the earlier notion of women in development was replaced by the more comprehensive issue of gender and development (O’Connell 1997: 119–120). Also, questions of trust, sociality and *human* development began to dominate the agenda, through a more holistic approach.

Be that as it may, there has been mounting pressure from the Third World to reform the UN, to democratize the WTO, and to make the international institutions more accountable and transparent. It was realized that old institutions like the IMF and the World Bank need structural changes to effectively deal with financial crises and unforeseen economic turmoil that occurs from time to time. The civil society movement that was prominent in the early 1990s became very positive and innovative in its agenda for action on all-round policy changes both within and without. Globalization was the most publicized slogan in this decade. It reminds one of the exploitative globalization of the nineteenth century, and many well-informed groups have been trying to spin away from it because the corporate-led globalization may unleash a regime of unequal competition between DCs and LDCs, which may be destructive to economic and social development. These groups are engaged in achieving self-sufficiency and autonomy while recognizing limits to competition in the globalized world. The human and social dimensions of development, which were emphasized in international conferences during the 1990s, are getting the upper-hand, and are likely to be the basic theme song of development policy in the new millennium.

The changing concept of development

Since the 1950s, the concept of development has undergone substantial changes. Initially in the 1950s, development was basically understood in the sense of economic development. The emphasis was gross and materialistic, which put a premium on the rate of growth of GNP, subsequently modified as real GNP per capita for facilitating an international comparison of development performance. However, it was later realized that the GNP concept of development could not reveal the whole purpose and objectives of development. Hence, in the late 1960s and early 1970s, attempts were made to introduce the concept of *basic human needs*, including the physical quality of life index. The materialistic concept of development, thus, was gradually replaced by the human-centered approach. This concept takes note of human values and relations. According to this view, development is a more qualitative enrichment of health, skills and lifestyle.

The human-centered concept of development has many dimensions. First, it can be interpreted in terms of human achievements and failures at different operational levels. One way to appreciate this is to formulate a composite index of human development, or what is called the *Human Development Index* (HDI), by incorporating various essential factors such as literacy, life expectancy, infant mortality, population per doctor, population per television, population per telephone, and so forth (UN 2002).

However, some of the factors affecting the quality of life which cannot be easily quantified and brought under the measuring yardstick are not generally considered in the human development index. These factors include freedom, power relations, the pattern of income distribution, trust, and many other types of social relations. Thus, the human development index, as prepared by the UNDP, does not give a perfect picture of human development in a country. However, it can be regarded as a reasonable approximation to reality in the absence of a better measure, especially if it is supplemented with other indicators.

Another direction in the study of human development includes a study of *human degradation*. This is a negative way of appreciating human achievement and failure. Here, one can make a composite index of human degradation by taking into account the factors that degrade human life, such as illiteracy, unemployment, poverty, malnutrition and serious diseases (such as HIV/AIDS). Such an index can be prepared by incorporating some basic human degradation indicators (BHDI), or be extended by incorporating many other related indicators. It should be noted that the higher the value of BHDI, the higher is the level of human degradation, and consequently, the lower is the level of human development.

The measurement of human development, which is a pro-people concept, has been constrained by many factors. First, including income as a proxy of welfare leaves scope for criticism. Second, the indicators cannot be made universal. They should be specific and contextual. And third, the same indicators

cannot always be used for both DCs and LDCs. Thus, distinct approaches to measurement are necessary. But there are, indeed, many conceptual and methodological problems. For instance, it is difficult to compare the acquisition of knowledge by people of different countries.

HDI is a significant step forward in the computation of development or progress in recent years. The most important dimension in this regard is the treatment of ethical issues relating to poverty, deprivation, empowerment and entitlement. HDI, however, cannot explain many interrelations among agents, principles and their relations, and it cannot also explain many socio-economic, institutional and political forces that ride the crest of the globalization process in the modern world. Human development that incorporates ethical issues should focus on the normative and positive nature of interactions in the grass-root planning process. The United Nations (UN 1998) has pointed out that, while the fortunate rich countries have gained from globalization in terms of increasing consumption, the poor people have gained only marginally.

The poorest 20 per cent of the world's people and more have been left out of the consumption explosion. Well over a billion people are deprived of basic consumption needs. Of the 4.4 billion people in developing countries, nearly three-fifths lack basic sanitation. Almost a third have no access to clean water. A quarter do not have adequate housing. A fifth have no access to modern health services. One fifth of children do not attend school to grade 5, and so on in the list of deprivation.

(Ghosh 2003: 835–839)

In the situation of uncertainty and moral hazard that dependency generates, human development and basic human rights cannot be ensured through empowerment and entitlement. The issue of human rights without the guarantee of basic human needs and development becomes an empty issue indeed. For instance, the Vienna (1999) Conference on Human Rights was unable to take stock of the global political economy vis-à-vis human rights problems. The global political economy is based on an unfair and unjust system. World organizations such as the IMF, World Bank and the WTO are dominated by the Group of Seven (G-7). The global system is unequal in many respects.

Human development which should form a part of general development policy must include a measure for *human capability expansion*; otherwise there would be capability failure, and development would not be possible. For human capability expansion, an atmosphere of socioeconomic and political equality and freedom becomes an essential pre-requisite. Also, the philosophy of democratization in all important walks of human life needs to be institutionalized as a policy parameter. It is in this context that freedom derives its real meaning. When development is interpreted as freedom, as Sen (1999) argues, some caveats become imperative. First, the concept of freedom must not be partial, it has to be all-permeating. For instance, polit-

ical freedom becomes meaningless without economic freedom, and economic freedom does not carry much sense without the freedom of choice. Second, freedom should be consistent with obligations, duties and social rationality. What, then, is necessary is *bounded freedom* rather than absolute freedom. Third, all types of freedom, such as the freedom to choose, to compete, freedom for capability expansion and so forth must aim at maximizing social welfare. It must not lead to the situation of a zero-sum game.

The basic purpose of freedom is to endow the people with the power of capability expansion. Development as freedom encompasses freedom to pursue one's own goals without domination or dependency. Development policy which considers human development as its primary aim, should give priorities to human entitlement and endowment as the main focus of action. But more important than human capability is the concept of human contestability. All contestability includes capability but all capability may not include contestability, which is a broader concept. *Contestability* is capability *plus command over resources to apply the capability*. The resources that are needed include not only financial resources but also information and knowledge.

Development policy in the twenty-first century should not only aim at improving human capability but also human contestability to be consistent with the concept of international humanity in the global environment. Development policy in the new millennium must also take care of environmental and ecological sustainability. Thus, it is not simply growth that is important but in particular the attainment of a rate of growth that is sustainable with ecological balance.

Since excessive population growth puts pressure on the environment, a policy of controlled population growth should form an integral part of new development policy. The issue of population control is also linked with the question of poverty which still remains an important problem to be tackled in the twenty-first century. The Earth Summit in South Africa in September 2002 made it abundantly clear that poverty and environmental degradation are the two basic problems of the present century.

The sustainability of development is also linked to human disease and life processes. As the discussion in the Summit revealed, some 9000 people die of AIDS every day in the world, and most of these people are in the productive age-group. One part of the solution to the problem is the supply of cheap drugs but the cheapest drug (costing one dollar a day), is often beyond the reach of the HIV-affected poor people. A critical agreement was made in 2002 whereby countries affected by HIV/AIDS can use the drugs cheaply from multinational producers. For many of the problems affecting the poor countries and people, a sustained rise in real income can be helpful in many ways, but such a course of action needs a long-term strategy of economic development. It is pertinent in this connection to note that Western models of development used in many of the developing countries need to be changed and more indigenous models incorporating appropriate technology that suit the local situation introduced in their place.

Development in the age of neoliberalism and globalization

Two of the main influences on governance over the two past decades have been neoliberalism and globalization. Neoliberalism has led to the belief that public fiscal deficits are a problem and should be rectified. Indeed, many developing nations, in particular, seem to be confronted with the “problem” of heavy fiscal deficits. In order to reduce fiscal deficits, many countries now practice what is called *fiscal retrenchment*. A reduction in spending is thought necessary to keep the budget in balance. If there is a large deficit, the government is assumed not to be able to carry out its development functions with efficiency. Growth and employment weaknesses may arise.

However, this concern for the public deficit may be misguided. The real problems may be low levels of effective demand, and the switch from public investment to transfer payments and other unproductive forms of government spending. For instance, recently a whole series of studies – for both developing and developed nations – have found that productive government spending (especially through the use of deficits rather than tax-financing) have exerted a crowding-in impact on private spending. For instance, a study by Ahmed and Miller (2000: 124–133) for thirty-nine countries (twenty-three developing and sixteen developed) came to the conclusion that, in the case of deficit-financed public spending, transport and communication, economic affairs and services resulted in crowding-in effects, whereas social security and welfare expenditure led to moderate crowding-out (worse if financed by taxation). Ramirez (1998), in a study for Mexico, found that public capital spending generally complements private investment spending, and that “indiscriminate reductions in public expenditures could undermine the long-term efficiency gains and growth prospects promised by liberalization and privatization enthusiasts” (p. 79). For four nations lower down the list of developed nations – Greece, Spain, Portugal and Ireland – Lapodis (2001: 1563–1577) came to the conclusions that (i) if the economy is operating below full employment and if the increase in debt is monetized, then it is likely that government spending will crowd-in or have no net impact on private investment, and (ii) if the government expenditure is not in the form of transfer payments but on education, public works and infrastructure, public housing, health, communication and information, then there is likely to be a positive crowding-in effect.

These studies are consistent with recent views that development should be concerned with the essential human dimensions of the problem, and also that a critical challenge is to formulate policies to reduce corruption and the unproductive use of government finances. The state sector can help the development process by contributing to the social infrastructure of health, education, communications and transportation. If this strategy is successful, private investment and consumption will expand and thus sustainable human development may be possible. Productive investments that enhance innova-

tion and skill-formation are thus critical to the problems of the twenty-first century. But the need for productive investments must be seen against the backdrop of current wastage in the form of corruption, money laundering and bureaucratic sclerosis that reduces growth and development.

Development policies in the twenty-first century are more likely to be influenced by global events and circumstances. In an open economy, for instance, the inflow of capital, particularly hot money, may accentuate domestic macroeconomic vulnerabilities in many ways. Capital inflow may cause, in the absence of proper sterilization policy, monetary and fiscal expansion, export reduction, balance of payments problems, speculative attack and currency crisis. Unrestricted capital inflow is very likely, in the long-run, to cause an appreciation in the real exchange rate, leading to a decline in exports, economic contraction and a series of development – retarding situations (Ghosh 2000). There may arise many types of macro vulnerabilities in a globalized world, such as rising debt-equity ratios (leverage), appreciation of the real exchange rate, rising unemployment and inflation rates, soaring current account deficits, increasing non-performing loans, dwindling international reserves, rising capital-output ratios, and so on. Needless to say, all these factors are likely to affect the tempo of domestic development. Thus, a proper policy of development must take note of the macroeconomic fundamentals of a domestic economy and make policy changes accordingly.

One of the most pernicious effects of globalization is its discriminatory attitude to labor. While capital mobility is permitted, labor mobility is not allowed. The imposition of many types of labor clauses and immigration restrictions by the DCs inhibit labor mobility. A suitable policy of development at the global level must, therefore, address the issue of labor immobility in the context of higher labor demand in some countries and labor surplus in others. Labor markets also experience the flight of high quality manpower (HQM) from the developing countries. This problem of *brain drain* deserves the special attention of policy makers. If a country constantly loses such manpower, the quality of its development, the growth of R&D and leadership will be negatively affected. As the supply curve of HQM is more or less inelastic in LDCs, development policy in the new millennium must properly tackle this crucial issue.

Connected with the problem of labor, is the issue of increasing domestic income inequality that is often intensified by globalization. Some researchers like Feenstra and Hanson (1997) and Mah (2002) maintain that globalization does increase income inequality in LDCs. In the same way, Spilimbergo *et al.* (1999) came to the conclusion that neoliberal governments have more liberal trade policies but less liberal redistribution policies, which may lead to more income inequality.

For a particular country, if any micro study reveals the adverse impact of globalization on income inequality, it will necessitate many types of integrated policy reforms. In a broad perspective, the development policy of our

times must consider certain types of reforms as the necessary precondition for smooth economic development. These reforms mainly pertain to the financial sector, technology, capital account convertibility, information technology, and the like. The first principle of sequencing the reform is that macro stabilization policy must precede the financial reform. Domestic financial reform must precede capital account liberalization. The opening of the capital account before trade liberalization is not desirable because if the system is liberalized prior to the removal of capital controls, there may be massive capital inflow, monetary expansion, inflation and a sustained rise in the real exchange rate.

To a significant extent, development policy and investment–income–expenditure policies are mutually interrelated. But the nexus, more often than not, is not so easy to comprehend due to a number of missing links and also due to different behavioral patterns of complex variables. Thus, it is very difficult to say whether a cheap money policy or a dear money policy would be the most appropriate one in the twenty-first century. However, since recession is going to be a more likely phenomenon than inflation in the early years of the new century, a cheap money policy seems to be a more desirable form of monetary policy. But a change in the interest policy to influence income, output and employment may work in an entirely different way than what is generally expected (Kindleberger 1996).

In order to prevent policy failures, some of these policies need to be formulated in coordination with international policies framed by world organizations. This may especially help the developing countries in at least two ways. First, the implementation may be logistically and financially assisted by influential world economies and organizations. And second, the chance of policy or implementation failure may indeed be significantly reduced. In the case of coordinated policy in which the developing countries have equal participation, a better success rate can hopefully be achieved. It is also imperative to have better cooperation among the developing countries themselves. This will give them an opportunity to solve many of their problems relating to trade, aid and development, and also provide a better countervailing power for the LDCs.

Conclusion

The major thrust of the development policies of the twenty-first century can be summarized in terms of a number of conclusions. A critical one is the provision of the *basic needs* of life to the people, including food security, employment, shelter, clothing, education and pure drinking water. The most important priority would be to eradicate poverty and unemployment. It is necessary to prevent child labor in many of the developing countries and to make provision for free food and education to such labor. Recent development perspectives have also emphasized the need for *freedom* in all walks of life on the basis of democratic choice and participation for optimal human

development, contestability and capability expansion. Also critical to governance in the new millennium is to reduce the degree of both market failure and government failure. One of the critical market failures involves the emergence of financial crises, which were the outcome of a deregulation process that provided insufficient prudential functions and an explosion of hot money flows. Establishing a viable and strong financial system as well as a proper regulatory environment should moderate these instabilities. Government failure involved such things as a high level of corruption and the unproductive use of state spending. These problems can be moderated through the development of checks and balances, effective democratic procedures, and an expansion of productive state spending.

It is also necessary to ensure *sustainable development and growth*. Emphasis should be given to the development of new products, new resources, new technology and new methods of production. Innovation rather than imitation must be encouraged through better R&D. It is necessary to provide ways and means for *technology-based growth* rather than simply investment-led growth. Qualitatively better education and skills would be necessary for new ventures and higher total factor productivity. The technology should, however, be appropriate for the country and consistent with its resources endowments. A critical challenge for the twenty-first century is for the formulation of *globalization policy*. A case can be made at the international level for a freer cross-country movement of labor. However, developing countries need to be cautious in opening their economies to hot capitals and introducing capital account convertibility. Related to this, it would be necessary to repair the damage done to the *ecological environment*. What is needed is to have an environmental policy coordinated with the policy of development, and the trade off between the two has to be arrived at on the basis of priority, needs and costs. In addition, some of the negative *international externalities* such as terrorism, recession, and deadly viruses need to be tackled for the sake of better human life and smooth development. These should be controlled both at the internal and international levels, and a meaningful development policy in the twenty-first century must incorporate measures to deal with these negative externalities.

Development policy in the twenty-first century, first of all, must try to correct the policy failures of the last century. There are many areas of such policy failure, and these are very obvious to students and practitioners of development economics. Whereas the development policy of the last century was grossly materialistic in orientation, the policy focus of the present century is going to be more human-centered, environmentally conscious, and technology- and community-based with more emphasis on *social capital* formation. Trust and association are critical co-requisites for “capacity” and “contestability”, through the development of social networks and relationships that are the essence of development.⁶

Notes

- 1 The major achievements and failures of development economics have been elaborated by many academic journals, see *Development*, March 1977 and *Development Practice*, August 1998, among others.
- 2 For instance, poverty intensified in India and China. In India, poverty increased from 30 percent in 1960–1961 to 52 percent in 1972–1973. Jan Myrdal's study showed that poverty increased in China since the end of the 1960s (Jan Myrdal 1966).
- 3 For an elaboration of the idea of immiserizing growth, see Bhagwati (1958).
- 4 Basic needs included physical and cultural needs. The basic needs approach can be regarded as social indicators of development. Initially, the following six basic indicators were considered: nutrition, basic education, health, sanitation, water supply, housing and related infrastructure (Norman Hicks and Paul Streeten 1979).
- 5 The UNCTAD Report (1974) observed that US foreign aid to LDCs amounted to \$3.1 billion in 1970, but the income gain by the United States through brain drain, the seed-corn technology, and so on, amounted to \$3.7 billion in the same year. The study makes it quite clear that it is really the poor countries that are on balance aiding the rich developed countries, and not the other way round (see Ghosh 1999: 46).
- 6 Social capital has been defined as comprising many dimensions (see O'Hara 2001), such as trust, association and sympathy. Also, social capital may be differentiated from sectional trust and association of vested interests and elites. Pure social capital is engrained in the whole society.

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