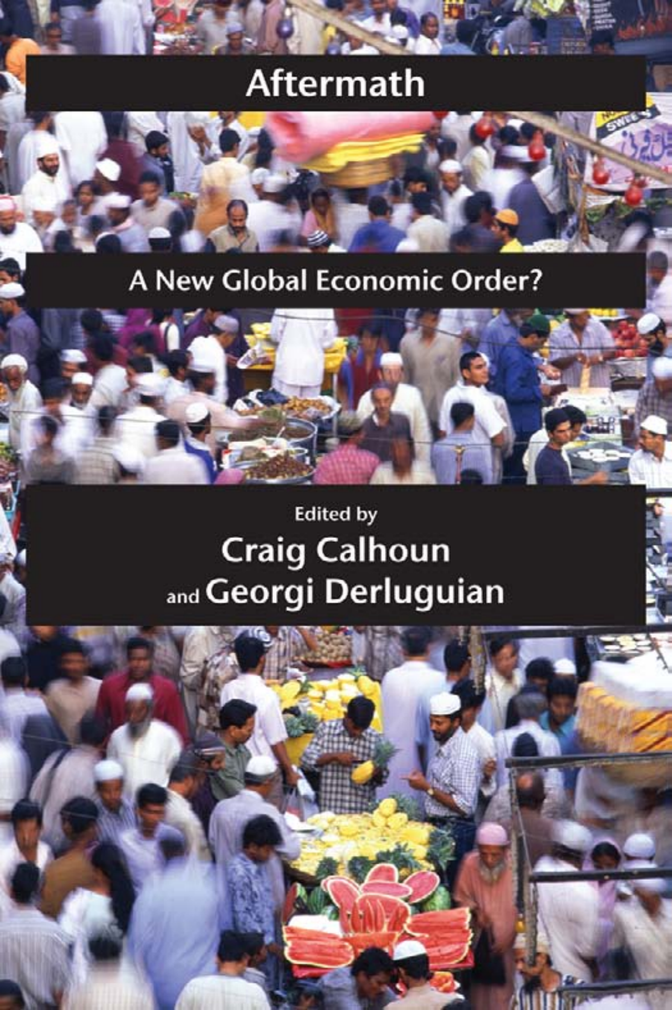
# Aftermath

## A New Global Economic Order?

Edited by

**Craig Calhoun**

and **Georgi Derluguian**



Aftermath

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*Series Editor: Craig Calhoun*

In 2008, the World Public Forum convened a group of researchers and statesmen in Vienna to take stock of major global challenges. The magnitude of the global financial crisis was only just becoming clear, but the neoliberalism and market fundamentalism of the post-Cold War years had already taken a toll of their own.

Austrian Prime Minister Alfred Gusenbauer opened the meeting with a call to make sure the urgent attention the financial crisis demanded was not just short-term and superficial but included consideration of deeper geopolitical issues and governance challenges facing the global community.

In this spirit, several of the researchers present envisioned a project to bring together the analyses of leading scholars from a range of different countries, assessing not only the financial crisis but shifts in relations among major powers, trends in political economy, and the possible futures these opened. The group sought insight into emerging issues; it did not indulge the fantasy that the future could be predicted in detail.

The World Public Forum, created to facilitate a dialogue of civilizations rather than a clash, saw value in bringing high quality research to bear on public issues and possible futures. It provided financial support to the project including opportunities for many of the researchers to gather at its annual meetings on the island of Rhodes. This initial support was crucial to inaugurating the present important series of books.

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# Contents

# Introduction

*Craig Calhoun and Georgi Derluguian*

Perhaps the most significant choices to be made in the contemporary crisis involve the future of development—not just in the core countries that produced the crisis but also in the rest of the world. There is not likely to be a simple recovery, if that means a return not only to growth but to pre-crisis political and economic relations. As Saskia Sassen suggests in the opening chapter, the crisis has sorted winners and losers in a savage way. It has revealed strength in some national trajectories and policies, weakness in what had been boom levels of development elsewhere, and fragility in much of the financial architecture of Europe, America, and the international system they have led.

Some of the relative winners have been among the world's previously less developed countries, particularly among semi-peripheral countries gaining entry to the world's economic (and political) elite. China is the obvious but not the only example. Brazil suffered less in the crisis and started to bounce back faster than almost any richer country. Several other Asian and Latin American countries have also gained in relative standing as the OECD elite stumbled. There is more development in parts of Africa than there has been since the 1970s (though not without enduring fragilities and tensions). And Turkey, which long tracked the performance of eastern European countries, has more recently outperformed most of its fellow OECD members.

At the same time, a number of middle-income countries have been hit hard, including some of those inside the EU, like Greece, Portugal, Ireland, and Spain. Several of these had enjoyed dramatic recent growth and were being touted as global models. Now huge blocks of half-built housing sit empty, and countries that had recently found themselves receiving migrants have returned to the role of sending labor abroad. The crisis has hit hard enough in Latvia to make many citizens reconsider their rush to separate themselves as sharply as they could from Russia in the 1990s. But if Russia looks a more inviting partner to some of its neighbors now, it also took a significant hit during the crisis. It benefited initially from skyrocketing prices for energy resources but went on to suffer not only from the later fall in these export commodities but from losses in Russia's financial portfolio, largely invested in the West.

In Possible Futures volume 3, contributors assess what prospects the aftermath of the crisis holds for global economic growth, specific development policies and patterns in different countries, and how much growth will bring capacities to meet social needs. These are questions about real-world political economy, but thinking seriously about them demands changing academic and practical models of how economic growth works. For decades, a "Washington Consensus" reigned that emphasized the importance of free trade across national borders, reductions in state regulation, and conservative macroeconomic policies that reduced the burden of taxation on business and protected financial markets. The consensus is now in tatters. Many of the countries most successful in achieving growth and weathering the crisis are precisely those that flouted it. But only gradually are the ideas of the economics profession adjusting to the failures of neoliberalism and the limits of neoclassical models. The long boom that preceded the 2008 crash—perhaps, better described as a "multibubble" since it was marked by recurrent crises—was not just an era when financial engineering was ascendant but also one when economic orthodoxy was strong and centered on the building of models often expressed in elegant mathematics but with little purchase on real-world problems of economic development.

This third volume gathers chapters from a strong group of internationally prominent economists (including some labeled "heterodox") as well as other social scientists who seek to revive and advance the agenda of political economy. This doesn't mean in all cases arguing for state-led development; it does mean taking states and more generally the relationships between politics and economics seriously.

Even before the crisis, the grip of orthodoxy and the onetime Washington Consensus had begun to loosen. There were, for example, more and more critics of the "structural adjustment" programs run by the World Bank and the International Monetary Fund, which demand that countries limit government spending and economic intervention in various ways in order to be eligible for loans (with IMF backing often a condition not only for access to the funds it controlled but to favorable terms from the private financial sector). Even as criticism grew, these programs continued to derive support from orthodox economic opinion (though macroeconomics became something of a backwater to academic economics during an era when new microeconomic models dominated).

In fact, macroeconomics is important, and macroeconomic reforms were important to the success of some developing countries—like Brazil—and macroeconomic failings were basic to the deep suffering of some economies, like that of Greece. But conventional approaches built a great deal of ideology into the demands made on developing countries. Ostensibly simply a call for macroeconomic prudence, structural adjustment policies were also pressure to rely more on the market and to be good clients in an era when major financial institutions in the Global North were lending to the Global South. The reforms demanded were often draconian and had direct negative impacts on the living conditions of the citizens of those countries, while long-term benefits remained a matter of faith. They involved ending food-price subsidies in many cases, for example, and in others insisting that governments not finance the provision of anti-retroviral drugs to fight HIV/AIDS. In retrospect it is odd to contemplate how much "prudence" was urged on governments in developing countries by the same professionals that threw prudence out the window when it came to the machinations of hedge funds and investment banks in London and on Wall Street. But in addition to the immediate human cost, the theory may have been wrong.

Orthodox policy advice was flouted by some developing countries, perhaps most prominently and successfully by China. Argentina decided to ignore IMF demands when it faced an earlier crisis, and there were many who thought that Greece might have done better if it had followed suit. More generally, even though flouting IMF and World Bank advice was costly in terms of access to global finance markets, it seems to have been associated with enduring prosperity for some countries. Distinguishing what actual policies helped those countries is crucial, for not every one that resisted the Washington Consensus gained rapid development. Among many factors, two stand out: the implementation by strong states of policies favoring national economic development, not just international capital, and the development of materially productive industries.

This isn't the place to try to adjudicate all these arguments. The point is that crises can encourage more open-mindedness. This is particularly true today, but it was also true earlier, for example in the response of some Asian countries to the 1997 currency crisis. Both policy organizations and academic economists began to ask new questions about how to alleviate poverty, whether overly strict macroeconomic policies could be stultifying rather than helpful, and whether protectionism might actually be productive. Of course many—not least the WTO—stuck firm to the dominant economic ideology on matters of defending private-property rights and free trade. But even while neoliberal orthodoxy reigned in most policy settings, and an extremely abstract but generally compatible economics reigned in most academic quarters, dissident voices began to gain traction.[1] Economics was at its most orthodox in the US, but even in "mainstream" American departments, new kinds of empirical research started to challenge long-held theories backed more by elegant models and ideological convictions than evidence. Not least, the importance of relatively strong states was recurrently demonstrated. Around the world, "heterodox" economics grew almost as a parallel field. As the very idea of heterodoxy suggests, this was not a field with a single voice. Neo-Schumpeterians argued with neo-Marxists, neo-Smithians, and radical Keynesians. But common to many of those debating was the notion that states could play much more helpful roles in economic development than orthodoxy was suggesting.

This was not simply an abstract advocacy of strong states. It was rooted in historical research—noting, for example, the importance of state policies, including protectionism, to the successful development of today's rich countries. Historical research also challenged orthodox ideas of how investment was related to technological innovation. Where conventional economic theory suggested this was a matter of rational action based on recognition of the market value of the new technologies, new research showed the importance of both irrational enthusiasms and long-term economic cycles that shaped how much money was available for bets on new companies or new technologies.[2] Importantly, free-market fundamentalism was challenged by those who saw problems in extreme financialization and in cognate ideas like a happy end to industrial society. The coming of post-industrial society, to borrow Daniel Bell's phrase for it, was at best an account of how some previously rich societies might fit into a global economy in which industrial production mattered a great deal, and possibly a dangerous account if read to suggest that emphasizing industry would always keep economies backward. The importance of industrial production has been manifest in the development of China, India, Brazil, and a range of other countries now moving from semi-peripheral to core status in the global economy.[3]

With the crash, such ideas found traction with new audiences. But if they helped produce a better understanding of successes in economic development, they also lent less happy insight to analysis of problems. A number of these were evident in formerly socialist economies that found themselves inserted into the modern world system as semi-peripheral players at best, with difficulty matching the low wages and labor discipline in Asia. And the combination of problematic policies and political favoritism for some investors didn't help. Perhaps the strongest of these countries, Russia has remained dependent on its (happily huge) natural resources but unable to generate self-sustaining techno-industrial growth. This is no doubt for many reasons, but at least one important one is the nature of the transition from communism imposed on Russia, one that abruptly transferred state property to private ownership. Not only was the public robbed, but also a powerful class of oligarchs was created and for the most part they were not disposed to productive investment.

All this is background to the challenge taken up in this volume, that of thinking through how to account for which countries were winners or losers in the "savage sorting" that Sassen describes in chapter 1 and what significance this has for pursuing growth and economic development in the future. Sassen herself integrates political economy with an understanding of the spatial transformations of capital accumulation on a global scale. She presents a view of the world in which governments—especially in the rich countries—support or even produce intensive privatization and mirror this in their regulatory and tariff policies. These governments (backed up often by international organizations like the IMF) typically combine advocacy for free trade with fiscal policies that make financing available for efforts to extend profit extraction into what had previously seemed unlikely domains. This can be a matter of international investment—growing flowers in Africa for shipment to Europe. But it is a link between the domestic investments and the global investments that boomed in the financial era.

The paradigm case may be selling mortgages on modest properties to buyers who cannot plausibly be expected to repay them. The profits were grand because this was done on a large scale, with government guarantees, with mechanisms like credit-default swaps to provide an element of insurance, and with the quick conversion of mortgages into securities that could be sold to others. So there is a sharp division between winners and losers within nominally national economies. But at the same time, those economies are being subjected to new sorts of globalization that both challenge the tools governments use to manage domestic affairs and literally move entire sectors of production from one country to another (sometimes while leaving it under the control of the same capitalists). In less rich countries, the expansion of capitalist investment can offer opportunities—as it has in China. There are winners even in a competition for cheaper labor prices (though they are not necessarily workers themselves). But at the same time, there are expansions with much less clearly positive consequences for poorer countries, and while one may see this as capitalist globalization, it also wears new national faces—as, for example, China buys great tracts of land and mineral rights in Africa. As Sassen suggests, we see primitive accumulation alongside, and interwoven with, the most sophisticated workings of capitalist financial markets.

Many hoped the end of the Cold War would usher in an era of thriving capitalism, ever-extended democracy, and peace. There would be open exploration of the best collaborative solutions to global problems and respect for the different conditions and civilizational histories of different regions. It would be the end of a very problematic twentieth-century history, perhaps even the end of history.

Not so much. The post–Cold War era was dominated by neoliberalism and market fundamentalism, by a wave of small and not-so-small wars and humanitarian crises, and by a securitization of international relations led by a single superpower. Stock markets, real-estate markets, and other more esoteric investments boomed repeatedly and suffered repeated crises even before the major meltdown of 2008. Russia was only one of the sites where neoliberal policies and practices wrought havoc. While fortunes were made, widespread damage was done.

Ensuing chapters in this volume focus on historical patterns, learned limitations, and possible future directions of development. An underlying theme is the question of whether and when development can mitigate or even overcome longstanding global and national inequalities. The first part of the book examines relatively general issues of economic processes and policies. The second addresses the experiences of development—and its limits—in different regional contexts.

In chapter 2, Ha-Joon Chang recounts how the economic crisis revealed the double standards that for years had informed economic policy: Keynesianism for the rich and monetarism for the poor. In other words, subsidies have been directed to capitalist enterprises and found their ways into profits and individual bonuses. At the same time, structural adjustment and similar policies justified by macroeconomic prudence impoverished the public sector and forced cuts in services to the poor. From this, Chang turns to summarize the difference between the policies rich countries (and many global organizations) recommend to the poor today and those they themselves followed in achieving their own development. In particular he stresses the importance of protection for national industries to actually become successful stories of economic development. Recalling the theories of Friedrich List, the great nineteenth-century German economist, Chang interprets the policies pressed by rich countries and the WTO as efforts to "kick away the ladder" lest others follow them up. Even when well-intentioned, development assistance has been tethered to problematic economic orthodoxies. Part of what is distinctive about the crisis centered in 2008, however, is that some of the same policies created problems for rich countries. Lack of financial regulation is an obvious case. This doesn't mean that neoliberalism will be abandoned, of course, but though it still has beneficiaries, wider confidence that it could work for the general good has been shaken.

Dani Rodrik is a leading economist who has increasingly argued for the importance of strong state policies—and strong states to carry them out. In chapter 3, his contribution here, he assesses the future of economic growth after the crisis as a matter of managing a basic tension. On the one hand, global macroeconomic stability is important; defaults and other destabilizations have serious negative effects. On the other hand, growth in poor nations depends on their being able to produce and market growing quantities of goods. Too much macroeconomic restraint can undercut productive investment. This is a matter not just of capacity to produce, of course, but also of terms of trade and the existence of markets.

For the most part, economic policymakers have focused on macroeconomic stability (and as the crisis reveals, not been able to deliver it consistently). They have often insisted in a rather doctrinaire fashion on both macroeconomic prudence and extreme commitments to free trade (and indeed developed countries have sometimes demanded more free trade from developing ones than they themselves practice despite their advantages). Rodrik calls for a shift in approach. Exchange-rate discipline and limits to external debt or other imbalances make sense if offset by industrial policies (including both subsidies and protection for nascent industries) that provide for growth and employment. We might think of this as something close to a Brazilian model. It is also a much better basis for asking China to reduce its trade imbalance with the United States and other countries than doctrinaire free-trade ideology.

The economist Jomo Kwame Sundaram and historian Felice Noelle Rodriguez take a broader and longer view of global financial architecture in chapter 4. They open their account with the 1944 creation of the Bretton Woods system of international institutions, explicitly designed to extend the success of the American New Deal to the rest of the world ravaged by the Great Depression and Second World War. The world economy was reasonably well-served by the Bretton Woods system for about three decades. This made the American dollar a de facto world reserve currency, however, which invited political abuse, notably during the Vietnam War. This led to the abandonment of the Bretton Woods system, to a substantial reduction in exchange-rate discipline, and to increased financialization of the global economy.

Tracing the story forward into the current crisis era, Jomo and Rodriguez call for a substantially rebuilt system of world financial regulation. This would mean, crucially, one that was equitably concerned with the interests of the whole world's population, not only with the interests of capital as concentrated in certain centers. They would organize this under the aegis of the United Nations, though this would require making the UN less vulnerable to the pressures from major states. Weaker institutions are subject to too much pressure from powerful political and economic actors. Even if regulation is in the long-term interest of all, manipulation will be too tempting to too many in the short run.

In chapter 5, Manuel Montes and Vladimir Popov take up the question of whether there is a plausible basis for hope that countries in all world regions and at all levels of wealth might agree to a new world order. Implicitly, the "old world order" refers to the era of more or less successful postwar development under Bretton Woods institutions and with significant assistance from some wealthy economies like the United States to some others, both in Europe and in the Third World. Montes and Popov point out that during the Cold War many economies in the Global South were able to make significant gains by means of nationalization of resource industries and/or state-led development. The end of the Cold War reduced the leverage developing countries could exert. When more stringent Washington Consensus policies were imposed after 1991, their leverage decreased even more. The countries that developed most were those, like the so-called Asian Tigers, that resisted the Washington Consensus. This makes them objects of emulation, not least because of their assertions of effective state economic roles even in the face of pressure from developed countries, the World Bank, and the IMF. It also occasions growing trade and capital investment among countries in the Global South. Much of this is regional, and regional blocs are growing stronger. Taken together, these trends allow for cautious optimism that as the grip of free-trade and other economic orthodoxies loosens, a longtime growth in inequality can be reversed.

China has become the country exerting the most fascination among global economic policymakers. Perhaps ironically, it took the current economic crisis for American economists and the American public alike to wake up to the extent to which apparent US growth during the last several decades was financed by borrowing from China. Thinking only generically in terms of deficits and debt masked the significance of specific international "imbalances" and relationships.

Though various aspects of China's success story—and its vulnerabilities—are constantly assessed, the way China looks at global political economy is less often considered. R. Bin Wong helps fill this vacuum, asking in chapter 6 how domestic, regional, and global concerns intersect in Chinese thinking and mutually affect the policy choices leaders make. Wong starts with Chinese domestic political economy and moves his analysis outward through the Asian region to the global economy. This offers a distinctive perspective not only on China but also on Europe—a region of comparable size and diversity to the single country China. This provides for an unconventional assessment of such factors as income disparities. Rather than asking whether those within China are greater than those in, say, France, we can compare Chinese disparities to those between Portugal or Greece and Germany. National diversity and competition fueled an engine of growth in Europe—though the challenges of unification are now daunting. On both sides, the comparison sheds light on China as it achieves some of the world's highest growth rates and indeed works to sustain political unity. It should be no surprise, thus, that China's leaders work to reduce income diversity and increase political cohesion, even while their capacities for growth are constrained by collapsed global demand.

If China has offered the world's most glamorous economic success story in recent years, Africa has offered many of its most disturbing failures. Ironically, the OPEC success of the 1970s that symbolized increased leverage for parts of the Global South had devastating impacts in much of Africa. Hard currency dried up; both trade and aid shrank. The interstate ambitions of pan-Africanism also shrank as both nationalism and ethnic regionalism grew. In too many cases nominally nationalist governments were in fact predators on their people. Conflicts, humanitarian crises, and then HIV/AIDS dominated news reports of Africa.

This was at least in part misleading. Africa suffered in these decades but did not simply stagnate. First and perhaps most prominently, South Africa offered the greatest late twentieth-century success in overcoming oppressive rule, a racist regime dating from colonial domination. Moreover, South Africa has continued to develop—both as a vibrant economy and as a flourishing if sometimes troubled democracy. South Africa not only threw off apartheid rule, it did so in a remarkable process of transition to a multiracial state. The South African story is not the only positive one to come out of Africa in the late twentieth and early twenty-first centuries. African musicians play an increasing role on the world music stage. African cinema is increasingly part of world cinema. African artists produce work sought after globally.

While noting that there are positive stories from Africa, we must also take some care with the negative ones. In particular, we need to recognize global complicity in many of the ills the continent has suffered. Not only did structural adjustment programs destabilize many countries, leading to conflicts outsiders would later treat as somehow distinctively African, but financial assistance came largely in the form of debt, which imposed its own burdens. And debt was provided in ways, moreover, that encouraged corruption and even kleptocratic government. It takes nothing away from the guilt of *genocidaires* in Rwanda or Burundi to note that destabilization came also from democratization programs started and then dropped and plummeting coffee prices in an economy organized (and financed) for export monoculture. And perhaps above all, there is the extent to which Africa's extraordinary wealth of natural resources has been tied in disastrous ways to global trade.

In chapter 7, Alexis Habiyaremye and Luc Soete take up precisely this question of "immiserizing wealth." In the years immediately preceding the latest financial crisis, many mainstream economists advised African countries to reap the benefits of rising prices for primary commodities. The hope was that accruing surpluses, if responsibly managed, could help to buy Africa's way out of its predicament and generate sustainable development across the continent. Such facile prescriptions ignore both political realities and the well-known negative effects of dependence on resource exports. As Habiyaremye and Soete show, the ways in which such resources were marketized contributed to state weakness when in fact only strong states could manage those resources for effective long-term growth. "Blood diamonds" that fund conflicts are only a relatively extreme case of the role played by many resources. It is worth noting that even the World Bank has recognized that strengthening and reforming resource-rich African states is the key to their development. Habiyaremye and Soete call for industrially diversified growth. This offers both wider employment and the potential for increasing-returns instead of the decreasing-returns model of "immiserizing growth" based solely on natural endowments. Here their argument dovetails with the pro-industry arguments of the heterodox economists cited earlier.

Finally what of the situation after the Cold War in the countries that were on its eastern side? Russia and eastern Europe became laboratories for liberal economic policies, somewhat as Chile had been in the 1970s.

A sudden and disruptive transition intensified corruption, concentrated wealth to an astonishing degree, abetted financialization and reliance on natural-resource sales, and undermined productive industrial investments. It also weakened governments already troubled by the discrediting of communism and the difficulties of revamping institutions and reestablishing legitimacy. Those eastern European countries that could sought membership in the European Union, not only demanding concessions that now haunt the EU in the context of crisis but forcing themselves to accept austerity programs for which the payoff is currently unclear.

Piotr Dutkiewicz and Grzegorz Gorzelak offer a broad picture, in chapter 8, of transformations in the former socialist countries passing now under the necessarily awkward rubric of Central and Eastern Europe (CEE). These countries have very different histories, and Dutkiewicz and Gorzelak show that divergence has continued since the end of communist rule (which had in fact been more or less unifying). The current crisis seems to have driven these divergences even further. Dutkiewicz and Gorzelak reveal a surprisingly rapid and deep "Europeanization" of most CEE countries, if anything accelerated by their response to the crisis, as it accentuated their dependence on the western European core. Their collective identity is thus fading. Indeed, "it might be said that Hungary is closer (in an economic sense) to Portugal, and Latvia to Greece than they are to each other." Most CEE countries were spared the worst of the crisis, however, because of the still shallow penetration of banking industries. This may be one reason why (as Rogers Brubaker noted in volume 2)[4] the crisis therefore had relatively little effect on the politics of the CEE region.

The complacent consent of the post-communist eastern Europeans to their peripheralization stands in sharp contrast, however, to Russian angst over global standing since the end of the USSR. It is much harder for Russians to experience this transformation as a matter of liberation. As Georgi Derluguian shows in chapter 9, painstakingly reconstructing the historical genealogies of Russian state and society, Russia has long pursued both geopolitical power and standing as one of the world's great societies. It has pursued these in an always uneasy relationship with the capitalist European countries flanking Russia from the west, and while the crisis of communism transformed this dynamic, it didn't bring it to an end. Derluguian explores why the long-running dialectic of regional non-capitalist might and global capitalist power mattered, why it came to a sudden end in 1991, and where this left Russia. Twenty years after the fall of communism, Russian elites, at first glance looking as provincial and politically hapless as ever, find themselves searching for a better position in the world division of labor. Merely managing a resource platform on behalf of global investors is clearly not a basis for long-term development. Yet moving beyond this semi-peripheral role requires social transformation, not just economic plans. Russia must renew its educational system, support industrial development and diversification, and provide the setting for creative new businesses to develop.

But the passing of communism was significant beyond Russia. Derluguian argues that it served as a major enabling condition for the intensification of neoliberal globalization. When neoliberal orthodoxy was embraced by Moscow itself, this seemed evidence to many that there truly was no alternative. Yet of course several countries resisting neoliberal orthodoxy, such as China and Brazil, prospered in the meantime. And Russians found their already difficult post-socialist transition made harder by much of the neoliberal inheritance.

Russia was one of the biggest losers in the "savage sorting" that Sassen describes in chapter 1. The post-communist transition accomplished with brutal speed a massive transfer of public wealth to private hands, the devaluation of assets throughout a large economy, and the subjection of a major country to global forces it was ill-prepared to resist or manage. There were beneficiaries in Russia, and there were beneficiaries among global speculators and investors. But there was no path forward by means of neoliberal economics alone. So Russia, like other countries, has given up its brief faith in the Washington Consensus. It will pursue more nationalist economic policies; these may or may not be coupled with authoritarian nationalism in domestic politics. Yet Russia remains a power and continues to occupy a central geopolitical position.[5] The course of Russian development is likely to matter globally and certain to matter regionally. Whatever Russia's path and relative success, its experience stands alongside the great crash of 2008 itself as evidence of neoliberalism's depredations.

The issues explored in this volume were not all created by the global financial crisis. Some of them were brought newly to light by it. But the role of the crisis was also to call attention to the limits of conventional economic thought and the importance of work that had previously been considered heterodox. Indeed, it made "heterodox" more of a proud label. But this was not just a matter of academic prestige, it was and is a matter of how potentially developing countries think about strategy, whose advice they seek out, and what policies they pursue. They are more likely now to pay serious attention to state-led strategies, the importance of regulatory arrangements both within and among countries, and the centrality of productive industry.

As James Galbraith contends in his closing chapter 10, learning depends on a willingness to ask new and sometimes more basic questions. Galbraith suggests that the financial crisis narrowly conceived has broad analogs. Those who made and sold unsound mortgages were like counterfeiters: they traded fake money. It was not that there was a criminal ring in the financial industry, but rather that the financial industry as a whole resembled a criminal ring. And one of Galbraith's crucial points is that the discipline of economics didn't recognize this, didn't make it clear, didn't facilitate efforts to make better policy. On the contrary, the rise of modern financial economics helped make this possible while the discipline as a whole was dominated by an orthodoxy that obscured what was going on. Galbraith is an economist, and it is perhaps easier for him to say that the "entire discipline managed to be overrun by a radical cult, its interests perfectly aligned with predatory financial power." Galbraith addresses himself to other social scientists asking for better analyses of what economists have missed. But disciplinary blinders are not unique to economists. And whatever our evaluation of each field, we ought to agree that this possibility is a basic reason why we need multiple perspectives in order to see what is going on.

Chapter 1

# A Savage Sorting of Winners and Losers, and Beyond

*Saskia Sassen*

The end of the Cold War launched one of the most brutal economic phases of the modern era. Following a period of Keynesian-led relative redistribution in developed market economies, a mix of government action and corporate economic interests led to a radical reshuffling of capitalism. Two logics organize this reshuffling. One is systemic and gets wired into most countries' economic and (de)regulatory policies, most importantly privatization and the lifting of border tariffs. We can see this in the unsettling and debordering of existing arrangements within the deep structures of capitalist economies, through the implementation of specific fiscal and monetary policies in most countries around the world, albeit with variable degrees of intensity. The effect was to open up ground for new or sharply expanded modes of profit extraction even in unlikely domains, such as subprime mortgages on modest residences, or through unlikely instruments, such as credit-default swaps, a key component of the shadow banking system.

The second logic is the actual material development of growing areas of the world into extreme zones for the enactment of that systemic logic, that is, for these new or sharply expanded modes of profit extraction. The most familiar instances are global cities and the spaces for outsourced work. These have become thick local settings for global capitalism. There are others, notably the vast purchases of land in Africa and Central Asia to grow food, mine for rare metals, and get at water.[1]

Critical to both these logics is the invention of extremely complex financial and organizational instruments to engage in what are, ultimately, new forms of extracting profit.[2] Many of the components that are part of the post-1989 global economy were already present and under development in the early 1980s. As such, just as the silent revolutions of 1989 are the iconic representation of a political process that had been building for a long time, so the corporate globalizing that took off in the late 1980s started many years earlier. But 1989 did make a major difference, most notably in giving these innovations the run of the world via the legitimating aura of market triumphalism. The outcome was the formation of a new kind of global economy, one centered in global firms using national governments to make global space for them,[3] rather than a global economy centered in international trade and capital flows governed in good part by states, no matter their unequal power to do so.

In this chapter, there is room only to examine a few aspects of the dominant economic tendencies of the past decades and how to go beyond their deeply destructive character. The first section focuses on the capacity of finance to impose its logics across economic sectors. This financializing is not just a matter of the volume of finance but, more importantly, of its logic getting wired into a growing number of economic sectors. I am particularly interested in examining the capacity of finance to invent instruments that allow it to build high financial value from modest assets, often at the cost of the owner of the latter. Next I focus on the particularity of the current crisis and what it actually reveals about a system and its limitations—more a crisis of panic than a response to subprime mortgage losses. I conclude with a number of theses as to what can be done now in order to lay the groundwork for a better, more distributive future.

## Advanced Capitalism and Its Mechanisms for Primitive Accumulation

There are few resemblances between these post-1989 economic histories and the celebration of post-1989 velvet revolutions in countries once part of the Soviet sphere of influence. Yet these economic histories spread to most of the world, including former Soviet-controlled countries. The end of the Cold War pronounced the free market victorious and neoliberalism the best growth policy for countries. All of this points to a systemic feature of advanced capitalism, one that may have been held in check by the Cold War but which rises to its full capacities for both expansion and destruction once freed from territorial restraints. This was the setting that enabled finance to enter a new phase which legitimized the financializing of growing sectors of the economy—a major effect was that "shareholder value," rather than quality of product or sales, became the leading criterion for firms. One of the ironies emerging from the growing complexity of finance was the implementation of financial forms of primitive accumulation. It is this articulation of enormously complex financial and organizational instruments with elementary forms of extraction that concerns me here.[4]

Corporate outsourcing of jobs to low-wage countries is a simpler instance of this articulation than those coming from the world of finance. There is a large literature that has documented various links in the long chains that connect outsourced jobs to shareholders' gain, firms' profits, and consumers' access to lower-cost products and services. Less attention has gone to the fact that to implement this outsourcing, global firms have had to develop complex organizational formats, using enormously expensive and talented experts. All of this complexity and talent is for the purpose of extracting more labor at lower cost than in their home countries; further, this organizational innovation encompasses the use of types of unskilled labor that would be already fairly low in these firms' home countries. To get to this simple gain it took complex reorganizations of production processes and distribution, the passing of multiple new laws or regulations in home and in destination countries, and so on.

The insidious element is that millions of saved cents per hour of labor actually translate into a particular categorical positive: gains for shareholders. They can also contribute to increases in firms' profit margins and consumers' savings. But it is the first element for which the financial sector invented the instruments to articulate the saving of a few cents per hour of labor into shareholders gain.

Similarly, the financial sector has created some of the most complicated financial instruments to extract profit from even very modest households. The aim is to secure as many credit-card holders and as many mortgage holders as possible, so that they can be bundled into investment instruments. Whether people pay the mortgage or the credit card often matters less than securing that initial number of contracts. Once these contracts are bundled into an investment instrument, it is no longer dependent on the individuals. Trillions and trillions of dollars of profits have been secured on the backs of modest-income people, and these same people have been used to dilute risk and draw investors interested in collateralized financial assets.

Thus, in the United States, which is ground zero for these forms of primitive accumulation, one example is the series of instruments developed in the 2000s that allowed investors to benefit even from subprime mortgages for modest-income households. From the investors' perspective, the key was the growing demand for asset-backed securities in a market where the outstanding value of derivatives was US$600 trillion, more than ten times the value of global GDP. To address this demand, even subprime-mortgage debt could be used as an asset. But the low quality of this debt meant cutting up each mortgage into multiple tiny slices and mixing these up with high-grade debt. The result was an enormously complex instrument that was also enormously opaque: tracing all the components of these bundled assets is difficult, and in many cases evidently impossible, as becomes clear with Lehman's assets, whose components have still not been unbundled by a team of top-level experts as part of bankruptcy proceedings.

The critical financial innovation to make subprime mortgages on mostly modest homes work for investors is to delink subprime sellers' and investors' profits from the creditworthiness of the households obtaining the subprime home mortgage. Whether the mortgage is paid matters less than securing a certain number of loans that can be bundled up into "investment products." Using complex sequences of "products," to delink creditworthiness from investors' profit and, second, selling off the instruments to pass on risk, investors have made trillions of dollars in profits on the backs of modest-income people. As with the outsourcing of labor, the insidious element is that the vast numbers of mortgage sales to modest-income individuals can actually translate into a second type of categorical positive: financial profits. The ensuing tens of millions of foreclosed homes have mostly not affected investors directly: only those who held on to these mortgages suffered from nonpayment. Most investors did not hold on, and indeed many investors also speculated against these instruments—that is to say, they speculated that crisis would hit. What investors experienced was a crisis of *confidence* as the numbers of foreclosures had grown to many millions by 2007 and as it became evident that it was impossible to trace the toxic component in their investments.

A mix of conditions, among them the fall in housing prices, led to extremely negative outcomes for households. Among the most biting of these outcomes was the sharp rise in foreclosures. In 2008, for instance, on average ten thousand households lost their home to foreclosure every day. An estimated ten to twelve million households in the United States will not be able to pay their mortgage over the next four years and, under current conditions, will lose their home. Indeed the available evidence for the first quarter of 2010 shows the highest levels of foreclosure yet of this current period that began in the early 2000s. This is a brutal form of primitive accumulation. Presented with the possibility (which turned out to be mostly a deception) of owning a house, modest-income people will put whatever few savings or future earnings they have into a down payment. Further, all the mortgage sellers were after was the contract representing the material asset (the residence). The negative effects on the household, on the neighborhood, on the city—none of that mattered. The whole process has become a reconditioning of the modest-income household sector, a more backward sector of capital, for its incorporation into a more advanced form of capitalism—high-finance.

Subprime mortgages can be valuable instruments to enable modest-income households to buy a house or even to get a second mortgage or a mortgage on a home that is already paid for. But what happened in the United States over the past few years was an abuse of the concept. The small savings or future earnings of modest-income households or the ownership of a modest house were used to enter into a contract necessary to develop a high-finance instrument that could make profits for investors even if those households defaulted and lost everything.

This has turned out to be a catastrophic and life-changing event for many of these households, and by extension, for whole neighborhoods now filled with foreclosed homes. It becomes clear in the microcosm that is New York City. Table 1.1 shows how whites, who have a far-higher average income than all the other groups in New York City, were far less likely to have subprime mortgages than all other groups, reaching just 9.1 percent in 2006, compared with 13.6 percent of Asian Americans, 28.6 percent of Hispanic Americans, and 40.7 percent of African Americans. The table also shows that all groups, regardless of incidence, had high

Table 1.1: Rate of Conventional Subprime Lending by Race in New York City, 2002 to 2006.

| | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|
| White | 4.6% | 6.2% | 7.2% | 11.2% | 9.1% |
| Black | 13.4% | 20.5% | 35.2% | 47.1% | 40.7% |
| Hispanic | 11.9% | 18.1% | 27.6% | 39.3% | 28.6% |
| Asian | 4.2% | 6.2% | 9.4% | 18.3% | 13.6% |

Source: Furman Center for Real Estate & Urban Policy, "New Housing Data Continue to Show Signs of Danger for New York City's Homeowners, Furman Center Analysis Concludes," 15 October 2007 (New York: New York University), http://furmancenter.org/files/FurmanCenterHMDA Analysis_000.pdf

growth rates in subprime lending from 2002 to 2006. If we consider the most acute period, 2002 to 2005, it more than doubled for whites, it basically tripled for Asians and Hispanics, and it quadrupled for blacks.

The subprime mortgage instrument developed in these years is just one case that serves to illustrate the specific role of finance in developing instruments that allow financial experts to "make" major additions to financial value on even very modest assets and future losses of assets. The complexity of what it takes to have a gain in high-finance contrasts with what it takes in traditional banking. In traditional banking, the gain is on the sale of money the bank has. In finance, the gain is on the sale of money the institution does not have. As a result, finance needs to "make" capital, which means speculative instruments and financializing of nonfinancial sectors, subjects I return to later in this chapter and develop more fully elsewhere.[5]

## Crisis as Systemic Logic

Financial profit is a construction which either can be promptly materialized into a nonfinancial asset, such as an investment into building a dam or buying a telecommunications corporation, or can be used as a platform for further financial constructions, that is, speculation. The latter is what has dominated the past twenty years and generated the extremely high levels of financialization now evident especially in several major developed countries. This process has been partly facilitated by the use of electronic networks, software instruments, and the invention of many new instruments based on derivatives.[6] More generally, and to give a sense of the orders of magnitude that the financial system has created over the past two decades, the total (notional) value of outstanding derivatives, which are a form of complex debt and the most common financial instrument, stands at over US$600 trillion. Financial assets have grown far more rapidly than the overall economy of developed countries as measured by GDP.[7] In itself, this is not necessarily bad, especially if the growing financial capital is materialized in large-scale public-benefit projects—for example, a rapid transit system or the development of solar energy, to mention two attractive options. But in this current period that began in the 1980s, investing in the material economy was rare, except for some extreme cases such as the building up of Dubai. Mostly finance kept on developing more speculative and complex instruments. Historically, this process does seem to be part of the logic organizing finance—as it grows and gains power, it does not govern its power well.[8]

In the United States, the source of many of these organizational and financial innovations, the value of financial assets by 2006, right before the 2007 crisis, had reached 450 percent to US GDP.[9] In the European Union, it stood at 356 percent to GDP, and the United Kingdom at 440 percent was well above the EU average. More generally, the number of countries where financial assets exceed the value of their gross national product more than doubled from thirty-three in 1990 to seventy-two in 2006. The global value of financial assets (which means debt) in the whole world by September 2008, as the crisis was exploding, was three and half times larger (US$160 trillion) than the value of global GDP.[10]

These numbers illustrate that it is an extreme moment. But is it an anomalous moment? I argue that it is not. Further, it is not created by exogenous factors, as the notion of "crisis" suggests. Having recurrent crises is the normal way this particular type of financial system functions. And every time we have bailed out the financial system since the first crisis of this phase, the New York stock-market crash of 1987, our governments have given finance the instruments to continue its leveraging stampede. We have had five bailouts since the 1980s, the decade when the new financial phase took off. Every time, taxpayers' money was used to pump liquidity into the financial system. And every time, finance used it to leverage, aiming at more speculation and gain; it did not use it to pay off its debt because finance is about debt.

The financializing of a growing number of economic sectors since the 1980s has become both a sign of the power of this financial logic and the sign of its auto-exhaustion: insofar as finance needs to use (invade?) other economic sectors in order to grow, once it has subjected much of the economy to its logic, it reaches some type of limit. And then the downward curve is likely to set in. One acute illustration of this is the development of instruments by some financial firms that bet on growth in a sector and, simultaneously in other firms, of instruments that bet against that sector. Credit-default swaps were an illustration of this logic across firms, though they could conceivably (and illegally) also be used inside a given firm, as the recent lawsuit of the US government against Goldman Sachs makes clear. The current crisis has features which signal that financialized capitalism has reached the limits of its own logic. It has been extremely successful at extracting value from all economic sectors through their financialization. Yet when everything has become financialized, finance can no longer extract value. It needs nonfinancialized sectors to build on. In this context, one of the last potential frontiers for financial extraction is modest-income households, of which there are a billion or more worldwide. A second frontier is bailouts through taxpayers' money—which is real, old-fashioned, not financialized money.

When it comes to explaining the present financial crisis, the most common interpretation both among academics and among commentators is that the millions of subprime-mortgage foreclosures created the current financial crisis. As I explained above, this is incorrect.[11] Mass foreclosures were a crisis for home-owners and neighborhoods. For high-finance it was merely a crisis of confidence that began in August 2007. The values in play due to the actual foreclosures were relatively small for global financiers; what was alarming was not knowing what might next turn out to be a toxic asset given the impossibility of tracing the toxic component in complex investment instruments. It was the credit-default swaps, which had reached US$62 trillion by 2007, that launched the massive losses for high finance that exploded in September 2008. The millions of foreclosures alerted investors that something was wrong: those who had bought the credit-default swaps, sold as "insurance," made their claims. But those who had sold the swaps and betted on ongoing growth did not have the capital to meet the claims—because the swaps were not actually insurance but derivatives, so there was no capital backing the swaps.

The language of crisis remains ambiguous, as is evident in the following events and trends. A first point is the enormous variability of conditions that we call crisis. Since the 1980s, there have been several financial crises, some famous, such as the 1987 New York stock-market crisis and the 1997 Asian crisis, and some obscure, such as the individual country financial crises that happened in over seventy countries in the 1980s and 1990s as they deregulated their financial systems. The more obscure crises—adjustment crises—occurred under pressure from global regulators aiming at facilitating the globalization of financial markets.

We usually reserve the term *global financial crisis* for the first kind, even though the second, individual country "adjustment" crises, involved a far larger region of the globe, given the vast number of countries involved directly—it was their economies that went through the losses and crises of so-called "adjustment." The miseries these adjustment crises brought to the middle sectors in each country and the destruction of often well-functioning economic sectors are largely an invisible history to the global eye. These individual country adjustment crises only intersected with global concerns and interests when there were strong financial links with global firms and investors, as was the case with the 1994 Mexico crisis and the 2001 Argentina crisis.

A second point arises from data that present the period after the 1997 so-called Asian financial crisis as a fairly stable one—until the current crisis. One element in this representation is that after a country goes through an adjustment crisis, what follows can be measured as "stability" and even prosperity according to conventional indicators. This then produces a representation of considerable financial stability in the post-1997 period, except for a few major global crises, such as the dot-com crisis and the Argentine sovereign default.

But behind this stability lies the savage sorting of winners and losers described in the prior section. Behind this stability also lies the fact that it is easier to track winners than to track the often slow sinking into poverty of households, small firms, and government agencies (such as health and education) that are not the focus of the policy classes, partly because they are not part of the new glamour sectors (finance and trade).

The post-adjustment losers became somewhat invisible to the global eye over the past twenty years. Every now and then they became visible to the media for a few days or hours, as when members of the traditional middle class in Argentina went on food riots in Buenos Aires (and elsewhere) in the mid-1990s—after adjustment!—breaking into food shops just to get food, something that was unheard of in Argentina and that took many people by surprise. Such mostly rare events also make visible the very partial character of post-adjustment stability and the new "prosperity" so praised by global regulators and global media. Thus, we need to disaggregate the much-mentioned fact that in 2006 and 2007, most countries had a GDP growth rate of 4 percent a year or more, which is much higher than that of previous decades. Behind that measure lies the making of extreme forms of wealth and of poverty. In contrast, a 4 percent GDP growth rate in the Keynesian years described the massive growth of a middle class.

Also left out of this macrolevel picture of relative stability in the decade after the 1997 Asian financial crisis is the critical fact that "crisis" is a structural feature of deregulated, interconnected, and electronic financial markets. Two points are worth mentioning in this regard. One is the sharp growth in the extent to which nonfinancial economic sectors were financialized, leading to overall extremely high financial deepening. That is to say, if crisis is a structural feature of current financial markets, then the more financialized nonfinancial economic sectors are, the more susceptible they become to a financial crisis. The overall outcome is an extreme potential for instability even in strong and healthy economic sectors. This is a likely possibility particularly in countries with highly developed financial systems and high levels of financialization, notably the United States and the United Kingdom.

Let me illustrate with an example from the current crisis and one from the 1997 Asian crisis. When the current crisis hit the United States, many healthy firms, with good capitalization, strong demand for their goods and services, and good profit levels, were brought down. Thus, large US corporations, from Coca-Cola and Pepsi to IBM and Microsoft, were doing fine in terms of capital reserves, profits, market presence, and so on; but the financial crisis eventually hurt them, largely via consumer demand and credit access. Highly financialized sectors such as the housing market and the commercial property market suffered a direct and immediate impact. This is not the first time we see this type of impact on basically healthy non-financial firms. It happened in many countries that underwent adjustment crises: they secured the conditions for globally linked financial markets but in that process ruined non-financial firms. We saw this also in the 1997 Asian financial crisis, which destroyed thousands of healthy manufacturing firms in South Korea, whose products were in strong demand in national and foreign markets and which had the workforce and the machines to execute worldwide orders. Yet they had to close because credit dried up, preventing them from paying for up-front costs of production and causing the unemployment of over a million factory workers.[12]

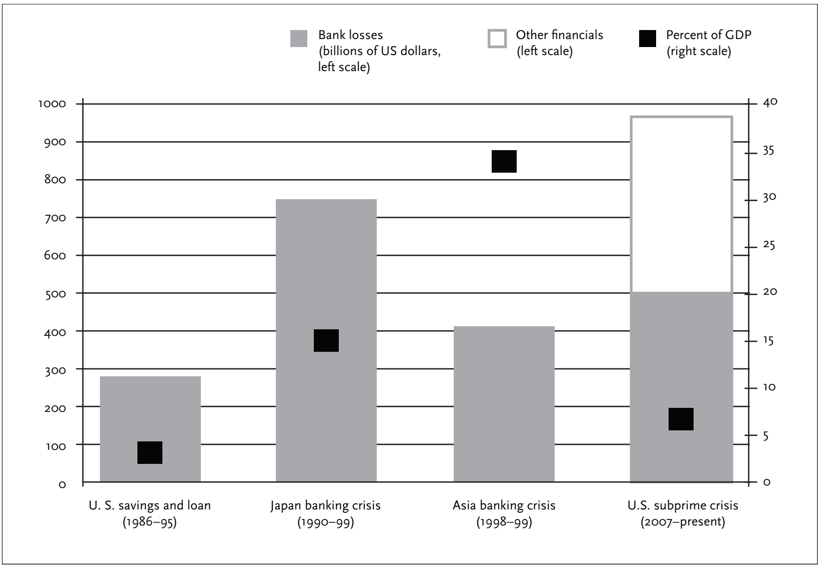
## Two Separate Crises

A comparison of the major crises since the current phase began in the 1980s shows the extent to which financial leveraging has caused the greater acuteness of the current crisis compared with the other three major crises since the 1980s. Figure 1.1 shows that financial leveraging added another 20 percent to the underlying banking crisis, thereby bringing the current financial crisis close to an equivalent of 40 percent of global GDP.

The IMF data also show the extent to which Asia was in a very different position in 2008 than the United States and Europe—and today continues to be. Its emergent crisis is economic rather than financial. But given interlinked global markets, a crisis made largely in the United States and to a lesser extent in Europe was arriving in Asia in 2008.

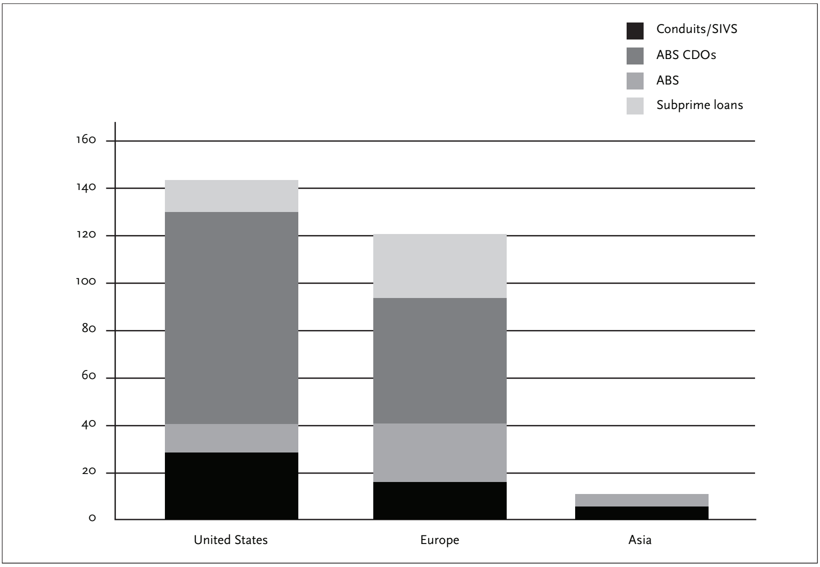
As indicated earlier, the critical component that brought the financial system to a momentary standstill was more of an old-fashioned speculation gone wrong: the US$62 trillion credit-default swap crisis that exploded on the scene in September 2008, a full year after the subprime-mortgage crisis of August 2007. Just to give a sense of orders of magnitude, this value was higher than the US$54 trillion in global GDP. Figure 1.3 shows the extremely sharp growth in the value of these swaps from 2001 to 2007. Although much attention has gone to subprime mortgages as a cause of the financial crisis, the US$800 billion value they represented could not have generated the 2008 crisis. It was the US$62 trillion in swaps in

Figure 1.1: Comparison of financial crises, 1986-2008.



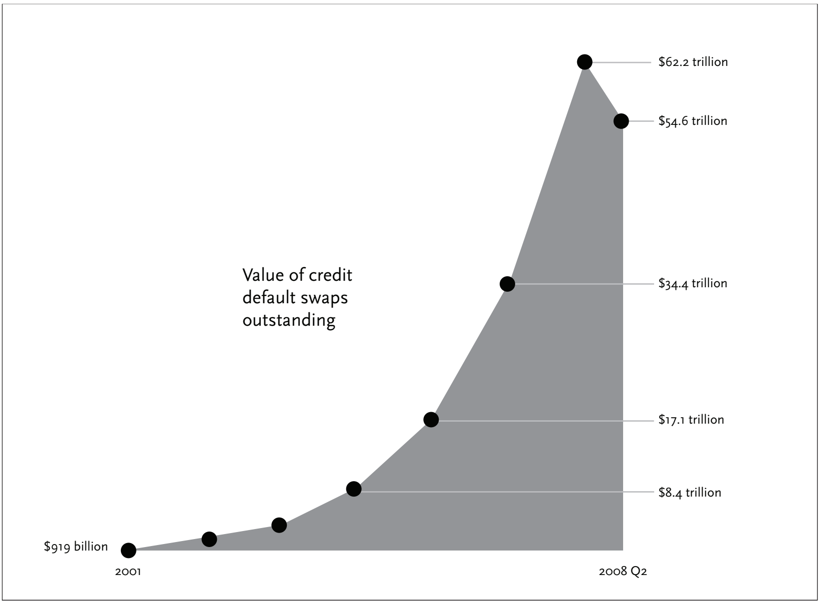

Source: See endnote 13. All costs are in real 2007 US dollars. Asia includes Indonesia, Korea, the Philippines, and Thailand.

Figure 1.2: Expected bank losses as of March 2008 (in billions of US dollars).




Source: See endnote 14. ABS = asset-backed security; CDO = collateralized debt obligation; SIV = structured investment vehicle.

Figure 1.3. Growth in the value of credit-default swaps.




Source: Based on ISDA data, N. Varchaver and K Benner, "The $55 Trillion Question: Special Report Issue 1: America's Money Crisis" (CNNMoney.com, 2008), http://money.cnn.com/2008/09/30/magazines/fortune/varchaver_derivatives_short.fortune/index.htm.

mid-2008 that really got the financial crisis going. The decline in house prices, the high rate of mortgage foreclosures, the declines in global trade, and the growth of unemployment all alerted investors that something was not right. This in turn led those who had bought credit-default swaps as a sort of "insurance" to want to cash in. But the sellers of these swaps had not expected this downturn or the demand to cash in from those whom they had sold these credit swaps. They were not ready, and this catapulted much of the financial sector into crisis. Not everybody lost: investors such as George Soros made large profits by going against the trend.

These credit-default swaps are part of what has come to be referred to as the shadow banking system. According to some analysts, this shadow banking system accounted for 70 percent of financial capital at the time that the crisis exploded. The shadow banking system is not informal, illegal, or clandestine—not at all: it is in the open, but it has thrived on the opaqueness of the investment instruments. This opaqueness has also facilitated the recoding of instruments, which, at the limit, allowed for practices that are now, after the fact, viewed as bordering on illegal. For instance, it is now clear that credit-default swaps were sold as a type of insurance, though they were not, as I explained earlier. From the perspective of the financial system, this made a significant difference: if they were being sold as insurance, the law requires they be backed by capital reserves and be subject to considerable regulation. Making them into derivatives was a de facto deregulation and eliminated the capital-reserves requirement. Credit-default swaps could not have grown so fast and reached such extreme values if those capital reserves would have had to be met, and fulfilling that requirement would have reduced much of the impact of the September 2008 crisis. None of the financial firms had the capital reserves they would have needed to back US$60 trillion in insurance. Because the swaps were recoded as derivatives, they could have an almost vertical growth curve beginning as recently as 2001.

The overall value of the subprime-mortgage losses was too small to bring this powerful financial system to a halt. But the interlinking of financial markets means that even a small market crisis, such as the subprime market, can produce ripples, which in turn can produce a crisis of confidence, as I described earlier.

There were, then, two very separate crises: the crisis of the people who had gotten these mortgages and the crisis of confidence in the investor community. The crisis of home buyers was not a direct crisis for financial investors. For finance, it was a crisis of confidence. It made visible the importance of the systems of trust that make possible the speed and orders of magnitude of this financial system. The crisis of home owners (valued at a few hundred billion dollars) was the little tail that wagged the enormous dog of trust in the financial system. In other words, this type of financial system has more of the social in it than is suggested by the technical complexity of its instruments and electronic platforms, a subject I develop elsewhere.[15]

We all need debt, whether we are a firm, a household, or a country. But do we need this level of debt? And even more important, do we need such complex instruments to finance what are mostly rather basic needs for firms and households? No. Many of these needs can be met with traditional banking loans. We need finance because it "makes" capital, and large-scale projects require vast amounts of capital: at this point, only finance can reach these orders of magnitude. The problem is that finance has entered domains—such as consumer loans and home mortgages—where traditional banking would have been a safer option for consumers. We need to expand and strengthen regulated banking and small local lending institutions and we need to make finance less invasive and aggressive.

## Changing Our Understanding of Growth and Prosperity

One important difference between the current crisis and the other post-1980 crises is the order of magnitude that speculative instruments have made possible. A second important difference is the epochal fact of a stronger recognition that we have an environmental crisis on our hands and that we need to act now. A third difference is the greater recognition that the extremes of wealth and poverty have become problematic: we now know that there is no trickle down and, more concretely, that epidemics due to poverty and inadequate health care will affect also the rich.

This combination of differences compared to prior crises creates an opening for novel economic criteria. Finance has the capacity to make capital, but we have to use that capital for needed large-scale investments—in worldwide public health, environmentally sustainable housing and transport, and so on, down a long list of needs, not luxuries. The current combination of crises is an opportunity to reorient financial capital to a broad range of other types of economies—based on material production and the meeting of needs.

An example here is the fact that the much-admired half-a-billion-strong new middle class in Asia was in good part the result of manufacturing growth. Financial capital was part of the process, but the concrete mechanisms feeding this growth were largely centered in the expansion of the material economy—manufacturing, transport, the building of whole new cities, and other material sectors. When financial capital is used for these purposes, it becomes more distributive than when it is only about the superprofits of investors. One major drawback in the case of these specific developments is the absence of a concern with environmental sustainability. This growth has also become a source of severe pollution.

In principle, a serious effort to use more financial capital than we have over the past decade to make material economic investments can be made into an opportunity to green those investments. In that sense, then, the current financial crisis, which has partly halted the further financialization of our economies, is an opportunity to make this economic development a channel for greening our economies.

This mix of conditions should also become the opportunity to upgrade vast parts of our economies worldwide. Could our financial crisis serve as one of the bridges to a new type of social order? History suggests that a market economy driven by profit maximization does not get us there. For instance, the current debate in western Europe and in the United States about rescuing the financial system seems to consider only a financial solution. Such rescues require many trillions of dollars. Growing our economies requires far fewer trillions, but this in itself is not enough to re-direct the financial logic driving investment over the last twenty years. History also shows us that some mix of well-working markets and a strong welfare state have produced the best outcomes yet, as is the case in the Scandinavian countries. Although these societies are also becoming more unequal, there is a strong ground beneath which the governments will not let people fall, unlike what is the case in the US.

In the past few decades, we have had the technology to eliminate diseases that affect millions of people and the capacity to produce enough food to feed everybody on the globe. But the opposite has happened: millions and millions die from preventable diseases, and even more go hungry. The greater our capacity to produce wealth has become over the past twenty years (and finance has played a critical role here), the more radical the condition of poverty has become. It used to be that being poor meant having a plot of land that did not produce much. Today being poor means having nothing, only one's body—no plot of land, often not even a stable shack that might be called home. We see a type of radical poverty in the Global South but also in the rich countries. And we have seen heightened inequality, with a new global class of superrich and the impoverishment of the old middle classes. Profit maximization is the dominant logic in those sectors—pharmaceuticals and corporate food producers—that might meet some of the need on these two fronts. The increased financialization of market economies over the past twenty years has further sharpened the negative effects of profit-maximization logics.

Beyond capacities, there is, then, the challenge of the logics that organize our economies. Not only do these logics often not put capacities to the aims we need met, they also divert resources. One instance is diamond mining: besides the abusive conditions under which diamonds are extracted, much of the profit from sales gets rerouted for armed warfare rather than development purposes. These logics also override old logics: in the industrial era, workers in growth sectors could gain organizing strength. This is often not an option today. For instance, some of the rare earths that are a key input for electronic components (notably cell phones) are mostly mined by workers who use their naked hands for extraction, live basically in a condition of slavery, and die too young from poisoning to have been able to pass on the news of their abuse to the wider world. Finally, there is the by now well-established fact that discovering oil in a poor country becomes the formula for even more poverty for all but a small elite of superrich.

Clearly, much of this goes well beyond finance and financial logics. But the combination of the undesirability of current financial logics and the fact of a moment of crisis does point to a window of opportunity. At the heart of this opportunity is the increasing recognition of a need to focus on the work that needs to be done to house all people, to clean our water, to green our buildings and cities and to build only zero-emission buildings, to develop sustainable agriculture, including urban agriculture, to provide health care to all, and so on. This work could employ all those who are interested in working. When we consider all the work that needs to be done, the notion of mass unemployment makes little sense. Those who are skilled in whatever the task at hand would need to train the unskilled. In short, we would all be occupied, most for pay; the work would also draw on those who do not need income but need purpose in their lives.

This would vastly expand the economic footprint beyond those who have the income to shop, and kindred market effects. Critically, it would mean a significant and substantive share of economic activity geared toward the disadvantaged. This is economic activity that would literally enter the abandoned, neglected, actively segregated, sometimes policed, and rarely governed spaces of countries—from the forgotten dying towns scattered all over the world to the brutalized hyperghettoes of major global cities. It would also enter the spaces that are now policed by private guards—malls, corporate towers, diamond mines.

The distributive character of this expanded footprint would/could begin to produce the experience that it is "our" economy, one we all work in and we work for all. This kind of experience would/could enable a sense of the collective, of being part of an economy, rather than being used by an economy. From that would/could come a greater sense of existential security and a buffer against persuasive but predatory consumer advertising—a possibility of not feeling alone and dependent on powerful economic actors. Rather than hierarchical and exclusive, there would/could be a greater weight of horizontal articulations and forms of integration, even for those who cannot wrap their minds around notions of class solidarity.[16]

The possibility of such an opening is further enhanced by the blowback of the logic of profit maximization. The extreme search for profits at all costs is becoming a boomerang. We have hints of this across our economies. Thus, the search for profit in raising cattle and in raising pigs has led to practices that are extremely abusive toward animals and that have created serious health threats to people. In the United Kingdom, feeding cattle the nonsellable parts of cattle (such as spine) is one factor linked to the dreaded so-called mad-cow disease (Kreuzfeld syndrome). The Asian flu (SARS) is linked to inadequate housing for poor people who raise birds for human consumption. And now we begin to understand that the latest "new" disease, so-called swine flu (H1N1), is linked to the extreme conditions in which pigs are raised to maximize profits. If we add to this the enormous levels of workplace injuries across the world—from the meat-packing industry in the United States to the dismantling of huge iron-clad ships by unprotected workers in India—we begin to see the vast costs to society and to economies of narrow criteria for understanding and defining profitability.

We need to change the logics through which we understand profitability and what is genuine prosperity. The triple crisis we confront should become an opportunity to regear our enormous capacities to make capital and to produce.

Chapter 2

# The 2008 World Financial Crisis and the Future of World Development

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Over the past three decades, the economic orthodoxy, both in academia and in policymaking circles, has been that free-trade, free-market policies are the best route to economic development. During this period, with the notable exception of China and India, developing countries have come to embrace this orthodoxy, sometimes voluntarily but often under external pressures. They liberalized their trade and foreign investment, privatized their state-owned enterprises (SOEs), strengthened the protection for patents and other intellectual property rights (IPRs), and implemented conservative macroeconomic policies, characterized by high interest rates and balanced budgets.

In the spread of this orthodoxy—known as neoliberalism or Washington Consensus policies—the developed countries, led by the United States, have played a critical role. They have attached conditions to their bilateral aid programs to spread neoliberal policies. They have also promoted neoliberal policies through the conditionalities attached to the loans from the International Monetary Fund (IMF), the World Bank, and other international financial institutions that they control (e.g., the Inter-American Development Bank, the Asian Development Bank). They have rewritten the rules of international trade and investment by launching the World Trade Organization (WTO). On top of that, they have signed various bilateral and regional trade and investment agreements involving developing countries. These agreements typically impose more restrictions on signatory countries than does the WTO.

It is not just the loan and aid conditionalities that make developing countries follow neoliberal policies. Often, developing-country governments refrain from using unorthodox policies that are not prohibited by any loan or aid agreements because they are afraid of being shunned by international investors based in the developed countries (e.g., banks, equity funds, transnational corporations), most of which strongly support the neoliberal policies. Sometimes, these governments voluntarily refrain from nationalistic policies because they have been totally persuaded by the "globalization" discourse promoted by the developed countries that such policies are actually harmful for the countries using them. Some developing countries have become "more Catholic than the pope," as a popular Latin American expression goes, and have implemented neoliberal policies even more aggressively than have the developed countries where those policies originated.

Individually, none of the aforementioned constraints—be they IMF loan conditionalities, WTO rules, or ideological pressures—may be decisive enough in making countries act in a certain way. Taken together, however, they form a very strong web, escaping from which is very difficult, if not impossible. Given this background, any attempt to predict the future of world development in the aftermath of the 2008 world financial crisis has to involve a prediction of what the developed countries are likely to do in relation to changing—or not changing—the current global system that defines the policy space for developing countries.

The present chapter is organized in the following way. First, I discuss how the 2008 financial crisis has shown the double standards that the developed countries have been applying in their dealings with the developing countries. When the developed countries were faced with a crisis situation, they deployed expansionary macroeconomic policies, bailout or even nationalization of key firms and banks, and increased subsidies—all policies that they have been preventing developing countries from using through their loan/aid conditionalities and the international trading rules in the past three decades. Second, I show how these double standards are, unfortunately, nothing new. I show how the developed countries used protectionism, subsidies, regulation on foreign direct investment, SOEs, and lax IPR laws—all policies that they say developing countries should not use—when they were in the earlier stages of their development and needed them. Third, I discuss how, during the age of imperialism (roughly the seventeenth century to the end of World War II), the developed countries used colonial rule and unequal treaties to ban the developing countries from using protectionism and other policies intended to promote local manufacturers. Fourth, I argue that, despite this long history of imperialism, there was a brief period between the end of World War II and the 1970s when the developed countries took a more enlightened approach to their dealings with the developing countries. During what I call the Marshall Plan era, they allowed the developing countries a relatively high degree of policy freedom. Fifth, I then go on to explain how the developed countries have reverted to the old pattern and have been reducing the policy space for developing countries continuously through aid/loan conditionalities, the WTO agreements, and bilateral and regional trade/investment agreements. In the final section of the chapter, informed by the preceding historical discussions, I try to predict the future of world development in the aftermath of the 2008 financial crisis.

## Keynesianism for the Rich, Monetarism for the Poor—Double Standards of the Developed Countries Revealed during the 2008 Crisis

Back in December 1997, having been hit by a massive currency crisis, South Korea signed an agreement with the IMF. The IMF—backed, or instructed, some would say, by the United States and other rich countries that control it—made it a condition of its loan that South Korea implement a contractionary macroeconomic policy. South Korea was required to raise its interest rate to a thumping 30 percent. It was also forced to run a budget surplus equivalent to 1 percent of GDP, despite the fact that its public finance was one of the soundest in the world (at the time, it had the second-lowest stock of public debt as a ratio of GDP among the OECD countries). It was told to get on with strict restructuring of its industrial and financial sectors—no bank or firm should be considered "too big to fail," it was told.

Given that the South Korean firms were at the time famously highly leveraged by international standards, raising interest rates to 30 percent was a death sentence to many of them. On top of that, with the IMF proscriptions against bank bailout, South Korea ended up closing down nearly a quarter of its financial institutions following the 1997 crisis.

Closure of so many financial institutions predictably led to a massive contraction of bank loans, pushing even more nonfinancial firms into bankruptcy. Trying to run a budget surplus in the face of falling tax revenue (due to the recession), the South Korean government had to cut its spending aggressively, which resulted in a further fall in demand.

Predictably, the South Korean economy took a nosedive for the next five months, with over one hundred enterprises going bankrupt *a day*. Not until May 1998 did the IMF accept that its policy was not working and allow the South Korean government to run a budget deficit—but only what is equivalent to 0.8 percent of GDP. In the following months, even that proved insufficient, so the IMF started easing the fiscal conditions further. However, the fiscal relief came too little too late. South Korea's economy contracted by nearly 6 percent in 1998.

The IMF conditions imposed on South Korea were actually not as harsh as those it imposed on most other countries. Indonesia, which signed an IMF agreement a little before South Korea did, was forced to raise its interest rate to the usurious level of 80 percent. With requirements of massive budget-deficit reduction, it had to make massive cuts in government spending, especially food subsidies, sparking off popular riots. It was made to close down sixteen large banks all at the same time in the middle of the crisis, causing a major financial panic. Indonesia's economy contracted by 16 percent in 1998. And all this was done despite the fact that the IMF, and the rich countries that control it, had been repeatedly criticized—to no avail, apparently—for imposing "pro-cyclical" policies on crisis-hit countries that reduce demand in the middle of a recession.

Fast-forward to the aftermath of the 2008 global financial crisis: the governments of the crisis-hit economies of the United States, Britain, and other developed countries have been doing the exact opposite of what was imposed on South Korea and Indonesia. These countries are running huge budget deficits in order to counter the dramatic fall in private-sector demand. In the United States, Britain, and Ireland, the budget deficits reached 12–15 percent in 2009. They have slashed interest rates practically down to zero and, finding even that is not enough, flushed the economy with liquidity through "quantitative easing"—to the extent that there is a growing concern that the excess liquidity is inflating another asset bubble. They have bailed out—sometimes even nationalized—their large banks in order to prevent the collapse of the financial system.

Once the famous American writer Gore Vidal argued that the American economic system is socialism for the rich and capitalism for the poor. Macroeconomic policy on a global scale is a bit like that: it is Keynesianism for the rich and monetarism for the poor. When the developing countries experience a fall in demand due to a financial crisis, they are forced to use monetarist policies (à la Chicago School) that reduce, rather than prop up, demand. The result is a deepening of the downturn, which often results in economic and social collapses, as we saw in the case of Indonesia in 1998 and Argentina in 2001. In contrast, when the developed countries experience similar crises, the response is the opposite. Monetarist orthodoxy that recommends "pro-cyclical" policies is swiftly forgotten, and all possible measures are deployed to prop up demand. Interest rates are lowered, and monetary supply is increased. Government spending is maintained, or even increased, despite a fall in tax revenue. Tax rates are cut to boost spending.

It is not just in macroeconomic policy that the current crisis has revealed the double standards that the developed countries are deploying. For example, the US government took over the bankrupt automakers General Motors and Chrysler and reorganized them into new business entities, unburdened by previous debts. Demands for automobiles were propped up by government "green" subsidies for those who scrap their old cars for newer ones (known as "cash for clunkers"). However, only a couple years ago, in 2007, the same government had proposed in the WTO a new subsidies rule, in which government lending to "uncreditworthy" companies (such as—GM?) and government investments in "unequity-worthy" companies (such as—the US banks?) are all to be classified as "illegal" subsidies.

The United States was not alone in subsidizing, bailing out, and nationalizing failing private-sector firms. Britain also announced a £2.5 billion rescue package for its auto industry. France, Germany, and Italy also have propped up their auto industries through "green" subsidies for consumers trading in their old cars. For another example, Britain had been preaching to the world the virtues of privatization since the days of Margaret Thatcher, but it was the first developed country to nationalize a number of banks, in order to prevent the collapse of the banking system.

## Kicking Away the Ladder—
## What Did the Developed Countries Do in Order to Develop?

The way the governments of the developed countries have managed the 2008 world financial crisis vividly reveals the double standards that they apply in their dealings with the developing countries. What is interesting is that this double standard has a long history.

Let us start with Britain—the country that is supposed to have become the first hegemon of the world economy by adopting free-trade, free-market policy before others. Contrary to this popular myth, Britain had been an aggressive user, and in many areas a pioneer, of interventionist industrial and trade policies intended to promote its "infant industries," before it became the world's leading industrial nation. As is well known, the logic of infant-industry protection is that the government of a relatively backward economy needs to protect and nurture the country's young producers against competition from superior producers abroad, until they can stand on their own feet—in the same way in which we need to protect and nurture our children before they grow up.

Until the seventeenth century, Britain was a relatively backward economy, dependent on raw-material exports. At the time, woolen manufacturing was the high-tech industry of Europe, and its center was the Low Countries (or what are the Netherlands and Belgium today). Britain was the main supplier of the raw material for the industry—raw wool. In order to overcome the country's status as a raw-material producer, some British kings—notably Edward III and Henry VII—implemented various schemes to promote "import substitution" in woolen manufacturing, establishing the industry as an engine of British export earnings.

In 1721, Robert Walpole, the so-called first British prime minister, introduced a trade and industrial policy reform that was intended to expand infant-industry protection to the rest of the economy. The policies thus implemented were reminiscent of what later came to be known as "East Asian–style" industrial policies: protection of infant industries, export subsidies, the lowering of tariffs on industrial inputs, import tariff rebates on inputs used for exporting (a good way of promoting exports), export quality control by the state. Between Walpole's reform and the repeal of the Corn Law in 1846, Britain implemented a most aggressive program of infant-industry promotion, boasting one of the highest average industrial tariff rates in the world (see table 2.1). Britain adopted free trade only in the 1860s, when its industrial superiority became unquestionable and thus its industries did not need protection anymore.

If Britain was the first country to have succeeded by infant-industry protection, the first country to have theorized it is the United States. Even more surprising is the fact that the theory was invented by none other than the first finance minister (Treasury secretary) of the country, Alexander Hamilton. Hamilton developed this theory (and even coined the name) in his 1791 report to Congress, called *The Report on the Subject of Manufactures*. The report was not simply about tariffs. In fact, it was probably the world's first comprehensive development-planning document—arguing for not just tariffs and subsidies for infant industries but a whole range of policy interventions to promote economic development, including the developments of the banking industry, the government bond market, and the patent system. And what impudence! In recommending infant-industry protection for his young country, this thirty-five-year-old finance minister with only a liberal arts degree from what then was considered a second-rate college (King's College of New York, now Columbia University) was going against the advice from the leading economists of the day, such as Adam Smith, who openly advised the Americans not to "artificially" develop industries:

> Were the Americans, either by combination or by any other sort of violence, to stop the importation of European manufactures, and, by thus giving a monopoly to such of their own countrymen as could manufacture the like goods, divert any considerable part of their capital into this employment, they would retard instead of accelerating the further increase in the value of their annual produce, and would obstruct instead of promoting the progress of their country towards real wealth and greatness.[1]

Naturally, in the beginning, few Americans were convinced by Hamilton's argument. Especially against it were the southern agrarian interests, led by Thomas Jefferson, Hamilton's political archenemy and then secretary of state. They (very rationally) argued that it was madness to subsidize inefficient Yankee manufacturers, when the country could import better and cheaper manufactured goods from Europe. The US Congress rejected Hamilton's proposal and granted only a small rise in

Table 2.1: Average Tariff Rates on Manufactured Products for Selected Developed Countries in Their Early Stages of Development (weighted average; in percentages of value)[a]

| | 1820[b] | 1875[b] | 1913 | 1925 | 1931 | 1950 |
|---|---|---|---|---|---|---|
| Austria[c] | R | 15–20 | 18 | 16 | 24 | 18 |
| Belgium[d] | 6–8 | 9–10 | 9 | 15 | 14 | 11 |
| Canada[e] | 5 | 15 | n.a. | 23 | 28 | 17 |
| Denmark | 25–35 | 15–20 | 14 | 10 | n.a. | 3 |
| France | R | 12–15 | 20 | 21 | 30 | 18 |
| Germany[f] | 8–12 | 4–6 | 13 | 20 | 21 | 26 |
| Italy | n.a. | 8–10 | 18 | 22 | 46 | 25 |
| Japan[g] | R | 5 | 30 | n.a. | n.a. | n.a. |
| Netherlands[d] | 6–8 | 3–5 | 4 | 6 | n.a. | 11 |
| Russia | R | 15–20 | 84 | R | R | R |
| Spain | R | 15–20 | 41 | 41 | 63 | n.a. |
| Sweden | R | 3–5 | 20 | 16 | 21 | 9 |
| Switzerland | 8–12 | 4–6 | 9 | 14 | 19 | n.a. |
| United Kingdom | 45–55 | 0 | 0 | 5 | n.a. | 23 |
| United States | 35–45 | 40–50 | 44 | 37 | 48 | 14 |

Source: H.-J. Chang, *Kicking Away the Ladder* (New York: Anthem, 2002), 17, table 2.1, largely based on P. Bairoch, *Economics and World History: Myths and Paradoxes* (Brighton, UK: Wheatsheaf, 1993), 40, table 3.3.

R = Numerous and important restrictions on manufactured imports existed, and therefore average tariff rates are not meaningful.

a World Bank, World Development Report 1991, 97, box table 5.2, provides a similar table, partly drawing on Bairoch's own studies that form the basis of this table. However, the World Bank figures, although in most cases very similar to Bairoch's figures, are unweighted averages, which are obviously less preferable to the weighted average figures that Bairoch provides.

b These are very approximate rates and give a range of average rates, not extremes.

c Austria-Hungary before 1925.

d In 1820, Belgium was united with the Netherlands.

e Source: K. W. Taylor, "Tariffs," in *The Encyclopedia of Canada*, ed. W. Stewart Wallace, vol. 6 (Toronto: University Associates of Canada, 1948), 102–108, 398.

f The 1820 figure is for Prussia only.

g Before 1911, Japan was obliged to keep low tariff rates (up to 5 percent) through a series of "unequal treaties" with the European countries and the United States. The World Bank table cited in note a gives Japan's unweighted average tariff rate for all goods (and not just manufactured goods) for the years 1925, 1930, and 1950 as 13 percent, 19 percent, 4 percent, respectively.

tariffs, in order to placate this influential politician (a rise in the average industrial tariff rate from 5 percent to around 12.5 percent).

Hamilton was killed in a pistol duel in 1804, so he did not live to see the day when his idea became popular. Over time, however, other Americans began to see sense in his argument, and the United States shifted toward protectionism after the end of the Anglo-American War in 1816. From the 1830s until World War II, the United States was literally the most protectionist country in the world, except for brief periods in the early twentieth century, when Russia and Spain raised their tariffs to very high levels (see table 2.1). Even the infamous Smoot-Hawley tariff of 1930, which is supposed to have destroyed the world trading system by raising tariffs to unprecedented levels and sparking off a tariff war, was not such an aberration from the trade policy regime that had prevailed for the previous century. It raised the United States' average industrial tariff rate from 37 percent (1925) to 48 percent (1931). Forty-eight percent is high, but the point is that it was well within the historical range of US tariffs since the 1830s (between 35 percent and 55 percent). It was only after World War II, with the United States' industrial supremacy unchallenged, that it liberalized its trade.

Britain and the United States—the supposed homes of free trade in what I call the "official history of capitalism"—may be particularly shocking cases, but the fact is that all of today's developed countries used protectionism at least for some periods of their early development history, with few exceptions, such as Switzerland (but only until World War I) and the Netherlands (see table 2.1).[2] Interestingly, countries such as France, Germany, and Japan—countries that are normally thought to be the homes of protectionism—did not use infant-industry protection as vigorously as Britain or the United States did (see table 2.1; see table 2.2 for a comparison between British and French protectionism). Japan could not use tariff protection until 1911 due to the unequal treaties that it had been forced to sign upon opening its markets in 1853. Even in the post–World War II period, protection was quite high in these countries until the 1960s (see table 2.3).

So, contrary to today's orthodoxy, and in accordance with Hamilton's infant-industry argument, trade protection and other measures to support infant industries were key elements in the earlier stages of economic development in most of today's developed countries. Of course, this is not

Table 2.2: Protectionism in Britain and France, 1821–1913 (measured by net customs revenue as a percentage of net import values)

| | BRITAIN | FRANCE |
|---|---|---|
| 1821–1825 | 53.1 | 20.3 |
| 1826–1830 | 47.2 | 22.6 |
| 1831–1835 | 40.5 | 21.5 |
| 1836–1840 | 30.9 | 18.0 |
| 1841–1845 | 32.2 | 17.9 |
| 1846–1850 | 25.3 | 17.2 |
| 1851–1855 | 19.5 | 13.2 |
| 1856–1860 | 15.0 | 10.0 |
| 1861–1865 | 11.5 | 5.9 |
| 1866–1870 | 8.9 | 3.8 |
| 1871–1875 | 6.7 | 5.3 |
| 1876–1880 | 6.1 | 6.6 |
| 1881–1885 | 5.9 | 7.5 |
| 1886–1890 | 6.1 | 8.3 |
| 1891–1895 | 5.5 | 10.6 |
| 1896–1900 | 5.3 | 10.2 |
| 1901–1905 | 7.0 | 8.8 |
| 1906–1910 | 5.9 | 8.0 |
| 1911–1913 | 5.4 | 8.8 |

Source: J. Nye, "The Myth of Free Trade Britain and Fortress France: Tariffs and Trade in the Nineteenth Century," *Journal of Economic History*, no. 51 (1991): 26, table 1.

Table 2.3: Average Tariff Rates on Manufactured Products for Selected Developed Countries in the Early Post–World War II Period (%)

| | 1950 | 1959 | 1962 | 1973 | 1979 |
|---|---|---|---|---|---|
| Europe | | | | | |
| Belgium | 11 | 14 | | | |
| France | 18 | 30 | | | |
| West Germany | 26 | 7 | | | |
| Italy | 25 | 18 | | | |
| Netherlands | 11 | 7 | | | |
| EEC average[a] | | 15 | 13 | 8 | 6 |
| Austria | 18 | | 20[b] | 11 | 8 |
| Denmark | 3 | | | | |
| Finland | | | 20-plus[c] | 13 | 11 |
| Sweden | 9 | | 8 | 6 | 5 |
| Japan | n.a. | | 18 | 10 | 6 |
| United Kingdom | 23 | | 16 | | |
| United States | 14 | | 13 | 12 | 7 |

Source: H-J. Chang, *Why Developing Countries Need Tariffs: How WTO NAMA Negotiations Could Deny Developing Countries' Right to a Future* (Geneva: Oxfam, Oxford, and South Centre, 2005), table 5.

a EEC average after 1973 includes Denmark and the United Kingdom.

b 1960

c Estimate by the author. The data on Finland's tariff rates are not readily available, but in 1965, tariff revenue as a percentage of all imports in Finland was 9.97 percent, which was considerably higher than that of Japan (7.55 percent), which had an 18 percent average industrial tariff rate, or that of Austria (8.57 percent), which had a 20 percent average industrial tariff rate, according to data reported in M. Panić, *National Management of the International Economy* (New York: Macmillan; London: St. Martin's Press,1988), 151, table 8.2. Given these data, it would not be unreasonable to estimate that Finland's average industrial tariff rate in the mid-1960s was well over 20 percent.

to say that all protectionist measures that existed in those countries were beneficial. There can be, and have been, instances of poorly conceived protectionism that does not help development (e.g., protecting industries that are too far beyond a country's reach or prolonging protection beyond usefulness). However, even though infant-industry protection is not a sufficient condition for economic development, historical evidence suggests that some measure of it is a necessary condition.

Trade policy is not the only area in which today's developed countries used "heretical" policies that they tell today's developing countries not to adopt. Similar pictures hold in all other major policy areas. Today, the developed countries regularly tell the developing countries not to regulate foreign direct investment (FDI), but many of them heavily regulated FDI when they were on the receiving end.[3] In the nineteenth century, Britain, France, and Germany had few regulations on FDI, as they were the investing countries. However, being the largest net recipient of FDI at the time, the United States severely regulated FDI. FDI in coastal shipping was totally banned, while there were many restrictions on FDI in mining and logging, especially on publicly owned land. In banking, only American citizens could become directors in a national (as opposed to state) bank, and foreign shareholders could not vote in shareholder meetings. Some state laws openly discriminated against FDI—the 1887 Indiana law withdrawing court protection to foreign firms being the most notorious example. Japan virtually banned FDI until the 1980s. South Korea and Taiwan also heavily restricted FDI outside the export processing zones, where FDI was encouraged. Between the 1930s and the 1980s, Finland classified all firms with more than 20 percent foreign ownership as "dangerous enterprises."

The picture is similar in relation to state-owned enterprises.[4] Today, developing countries are strongly encouraged, if not forced, to privatize their SOEs on the ground that they only breed inefficiency and lack of dynamism. However, many (although not all) of today's developed countries actively used SOEs when they were deemed necessary. Germany (especially in textile and steel) and Japan (especially in steel for shipbuilding) used SOEs to kick-start their industrialization in the early nineteenth century and the late nineteenth century, respectively. In the post–World War II period, SOEs were extensively used in France, Finland, Austria, Norway, Taiwan, and Singapore, in order not only to provide universal access to essential social services but also to upgrade their economies through more aggressive investments in riskier, high-tech industries than what the private-sector firms would undertake. Between the end of World War II and the 1980s, Austria had one of the largest SOE sectors in the world but grew even faster than West Germany (in per-capita terms). Most famous French firms—Renault, Thales, St. Gobain, Thomson, Elf-Aquitaine, Rhone-Poulenc, you name it—are either still state owned or were so until recently. Although Singapore may be a free-trade economy, it produces 22 percent of its GDP through SOEs (the international average is around 10 percent). Taiwan, another East Asian "miracle" economy, has also relied heavily on SOEs. The ratio used to be much higher in the 1950s and the 1960s, but even after some privatization in the past couple decades, SOEs still produce 16 percent of Taiwan's GDP.

We see the same pattern in the area of intellectual property rights (IPRs).[5] With the WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) in 1995, developing countries have been compelled to provide strong protection to IPRs, especially foreigners' IPRs. However, when today's developed countries themselves needed to "borrow" other people's ideas, they did not respect foreigners' IPRs very well. During the nineteenth century, many of them—including Britain, the Netherlands, the United States, France, and Austria—explicitly allowed patenting of foreigners' inventions. In the nineteenth century, the Germans mass produced fake "Made in England" products, so much so that the British Parliament was compelled to revise the trademark law (then called the Merchandise Act) in 1862, to require that the trademark description include the country of manufacture. Naturally, the Germans came up with all sorts of ingenious ways to get around this requirement, and the counterfeiting continued. Switzerland (until 1907) and the Netherlands (until 1912) refused to protect patents—mainly on the ground that they were free-trading nations (which they were) and therefore could not possibly endorse artificial monopolies such as patents.[6] The United States refused to protect foreigners' copyrights until 1891, and it refused to protect copyrights for materials printed abroad until 1988. Because of this, Charles Dickens apparently sold more books in America than in England, but he never saw a penny of the sales proceeds.

The picture is clear. It is not simply that the developed countries are recommending to the developing countries policies that they are not using themselves today (e.g., pro-cyclical macroeconomic policies). They are also denying to the developing countries the use of policies that helped them become rich (e.g., protection, regulation on FDI, lax IPRs).

The sad thing is that there is nothing new about this practice. Friedrich List, the nineteenth-century German economist who is today commonly—but mistakenly—known as the father of the argument for infant-industry protection, condemned the British advocacy of free trade in the nineteenth century as an act equivalent to "kicking away the ladder," with which it had climbed up to the top.

> It is a very common clever device that when anyone has attained the summit of greatness, he *kicks away the ladder* by which he has climbed up, in order to deprive others of the means of climbing up after him. In this lies the secret of the cosmopolitical doctrine of Adam Smith, and of the cosmopolitical tendencies of his great contemporary William Pitt, and of all his successors in the British Government administrations.
>
> Any nation which by means of protective duties and restrictions on navigation has raised her manufacturing power and her navigation to such a degree of development that no other nation can sustain free competition with her, can do nothing wiser than *to throw away these ladders* of her greatness, to preach to other nations the benefits of free trade, and to declare in penitent tones that she has hitherto wandered in the paths of error, and has now for the first time succeeded in discovering the truth [italics added].[7]

## Imperialism vs. Marshall Plan: How Have the Developed Countries Helped (or Not) the Developing Countries in Their Development Effort?

Even though historically the leader countries have always been kicking away the ladder for the follower countries, the form that takes has varied according to who is at the receiving end of that ladder-kicking. For the relatively developed economies, such as Germany and the United States vis-à-vis Britain in List's time, ladder-kicking took the more subtle form of ideological persuasion. However, when it came to countries in significantly weaker positions, it has taken more vicious and intrusive forms, exercised not just through ideological dominance but also through financial power and even military force. Let us see how these forms have evolved in the past, in anticipation for our speculation about the future of world development later in the chapter.

### *The Age of Imperialism*

During what I call the "age of imperialism," that is, between the seventeenth century and the end of World War II, many of the weaker countries were colonized and forced to implement policies that were in the interests of the colonizers and detrimental for their own development. Typical measures included the following.[8]

First of all, high value-added manufacturing industries were outlawed in the colonies. Some people in the imperialist countries wanted to ban manufacturing in colonies altogether—for example, Pitt the Elder is reported to have said that the American colonies should not be allowed to manufacture even a horseshoe nail. Few went that far, but colonies were only allowed to engage in low value-added manufacturing activities. For example, under Robert Walpole, the construction of new rolling and slitting steel mills in America was outlawed, which forced the American colonies to specialize in the low value-added pig and bar iron, rather than high value-added steel products.

Second, exports from the colonies that competed with the colonizer's products were banned. For example, the cotton textile industry of India was dealt a heavy blow in the eighteenth century by the British ban on cotton textile imports from India (known as calicoes), which were then superior to the British ones. For another example, in 1699 Britain banned the export of woolen cloth from its colonies to other countries (the Wool Act), essentially destroying the Irish woolen industry. This act also stifled the emergence of the woolen manufacturing industry in the American colonies.

Third, policies were deployed to encourage primary production in the colonies. For example, in the 1720s, Walpole provided export subsidies ("bounties") and abolished import duties on raw materials produced in the American colonies (such as hemp, wood, and timber). This was done in the belief that encouraging the production of raw material would "divert them from carrying on manufactures which interfered with those of England."[9]

Last but not least, the use of tariffs by colonial authorities was banned. If tariffs were considered necessary for revenue reasons, measures were deployed to minimize their impacts on the colonizing country's exports. When in 1859 the British colonial government in India imposed small import duties on textile goods (3–10 percent)—for purely fiscal reasons—the Indian producers were taxed to the same magnitude in order to provide a "level playing field" for the British exporters.[10] Even with this "compensation," the British cotton manufacturers put constant pressure on the government for the repeal of the duties, which they finally got in 1882. In the 1890s, when the colonial government in India once again tried to impose tariffs on cotton products—this time in order to promote the Indian cotton industry, rather than for revenue reasons—the cotton-textile pressure groups thwarted the attempt. Until 1917, there was no tariff on cotton-goods imports into India.

Even during the age of imperialism, not all weaker countries were colonies. However, those weaker countries that escaped the fate of colonial occupation were forced into unequal treaties that deprived them of tariff autonomy and their jurisdiction over foreigners on the ground that their governments were not reliable enough. Deprived of their ability to set their own tariffs, these countries were required to have a uniform, low rate of tariff (typically 3–5 percent).

Britain first used unequal treaties in Latin America, starting with Brazil in 1810, as the countries on the continent acquired political independence. Starting with the Nanking Treaty (1842), which followed the Opium War (1839–42), China was forced to sign a series of unequal treaties over the next couple of decades. These eventually resulted in a complete loss of tariff autonomy and, very symbolically, a Briton being the head of customs for fifty-five years—from 1863 to 1908. From 1824 onward, Thailand (then Siam) signed various unequal treaties, which ended with the most comprehensive one in 1855. Persia signed unequal treaties in 1836 and 1857, and the Ottoman Empire in 1838 and 1861.

As mentioned earlier, Japan lost its tariff autonomy following the unequal treaties signed after its opening up in 1853 (see table 2.1). It was eventually able to end the unequal treaties, but that did not happen until 1911.[11] In this context, it is also interesting to note that when Japan forcefully opened up Korea in 1876, it exactly imitated the Western imperialist countries and forced Korea to sign an unequal treaty that deprived the latter of its tariff autonomy—despite the fact that Japan still did not have tariff autonomy itself.

The larger Latin American countries were able to regain tariff autonomy starting in the 1880s, before Japan did. Many other countries regained it after World War I, but Turkey had to wait for its tariff autonomy until 1923, although it came into effect only in 1929 (the unequal treaty had been signed as early as 1838!), and China had to wait until 1929.

It is extremely disconcerting to note that the binding of tariff at a low, uniform level in the unequal treaties is exactly what modern day free-trade economists recommend to developing countries. The classic work by Little et al. argues that the appropriate level of protection is at most 20 percent for the poorest countries and virtually zero for the more advanced developing countries.[12] The World Bank argues that "evidence suggests the merits of phasing out quantitative restrictions rapidly, and reducing tariffs to reasonably *low and uniform* levels, such as a range of 15–25 percent [emphasis added]."[13]

### *The "Marshall Plan" Period*

Between the end of World War II and the Second Oil Shock in 1979, ladder-kicking by the developed countries was at its lowest ebb. During this period, the developing countries were allowed quite a lot of policy freedom—or "policy space," to use a currently popular jargon.

Between the inception of the World Bank and the IMF in 1944 and the 1970s, the institutions operated with fairly restricted mandates. The World Bank mainly financed infrastructural development, while the IMF provided liquidity in times of short-term balance-of-payments crises. They attached relatively few conditions on policies outside these narrow areas. The ideologies of the World Bank and the IMF themselves were not as promarket and not as intolerant as they have been in the past three decades. While the developed countries were whittling down many of their tariffs through various rounds of the GATT (General Agreement on Trade and Tariffs) negotiations, the developing countries were left to do what they saw fit in terms of tariffs and other trade policy matters. There was no "single undertaking" in the GATT, as is the case with its successor, the WTO, so countries could opt out of some GATT agreements that they were not happy with.

Why was there such a sea change in the developed countries' attitude toward the developing countries, compared to the age of imperialism?

Colonial guilt certainly played a part in it. Moreover, given the Cold War, the developed countries had to treat the developing countries nicely, lest they become too friendly with the Soviet bloc. However, credit should be given to the United States, the new world hegemon. In the immediate post–World War II years, the United States tried to deliberately deindustrialize Germany and let the other European countries—even those that fought on the Allied side—deal with their own economic difficulties. Realizing, however, that this strategy was turning into a disaster, the United States quickly came to accept that it was in its long-term self-interest to help Europe to rebuild its economy. A more prosperous Europe would mean bigger export markets and a more politically stable world, where the US corporations could invest with less risk. This shift in outlook was manifested in the Marshall Plan in 1948, in which the United States provided substantial financial aid to the European countries and helped them kick-start reconstruction. (Erik Reinert provides a fascinating discussion of the political backgrounds and the ideological foundations of the Marshall Plan.[14])

Even though the Marshall Plan itself concerned only the other developed (if war-torn) European countries, the same spirit ruled in the US dealings with the developing countries in the next three decades, as described earlier. To be sure, the Marshall Plan period between the late 1940s until the late 1970s should not be idealized as some sort of innocent golden age. Aid often came with strings, and there were still a lot of informal influences by the former colonial masters on many developing countries. The talk of "neocolonialism" was not simply radical propaganda. However, compared to the previous and the subsequent periods, there was much less ladder-kicking during the Marshall Plan period.

### *The Neoliberal Era*

Toward the end of the Marshall Plan period, during the 1970s, the attitudes of the developed countries vis-à-vis the developing countries started to change. With the relative decline in economic dominance (as exemplified by the end of unlimited dollar-gold convertibility in the early 1970s), the United States became increasingly less generous in its attitude toward the rest of the world. The 1970s debate surrounding the New International Economic Order (NIEO), where a more equal relationship between the developed and the developing nations was called for by the developing countries, galvanized many developed countries into putting the developing countries "back into their places," so to speak. This tendency became quite serious with the election of right-wing governments in the key developed countries since the late 1970s, starting with the Thatcher government in 1979 in the United Kingdom. In the 1980s, following the election of the Reagan government, the United States became quite aggressive in its dealings with all trading partners, believing that "unfair" practices by its trading partners (e.g., tariff and nontariff barriers to trade, lax intellectual property rights laws) were largely to blame for its relative economic decline.

The World Bank and the IMF, reflecting these changes in the political moods of the developed countries that control them, shifted significantly to the right. In the 1980s, not only did they become more right-wing, but they also became much less tolerant of dissenters among their employees. Many employees who did not agree with the newly dominant neoliberal doctrine were pushed out or marginalized. Moreover, under the Structural Adjustment Programs (SAPs), started in the late 1970s and widely implemented following the Third World Debt Crisis of 1982, the World Bank and the IMF started to intervene in areas that used to be outside their mandates. Previously confined largely to project financing (especially in infrastructure) in the case of the World Bank and balance-of-payments support in the case of the IMF, they were now forcing the borrowing countries to implement policies such as trade liberalization, abolition of controls over foreign capital inflow, and privatization of SOEs.

With the end of the Cold War in the early 1990s, and the potential threat of a developing country going over to the "other side" gone, the developed countries became even more aggressive in their push for neoliberal policies on the developing countries. It was declared that there is only one game in town now—free-market capitalism—and that countries refuse to join it at their own peril.

It was in this atmosphere of neoliberal triumphalism that the Uruguay Round of the GATT talks was concluded and the NAFTA (North American Free Trade Agreement) was signed (both in 1994). The conclusion of the Uruguay Round led to the birth of the WTO, while NAFTA heralded the advent of a new generation of bilateral and regional trade and investment agreements involving both developed and developing countries. As a result, the policy options for the developing countries have been radically diminished.

Under the new regime, quantitative restrictions on international trade (such as import quotas) are banned. The WTO has made its member countries "bind" their tariffs at levels significantly lower than what they had before 1995. The poorest countries were allowed not to bind tariffs, but these are countries that already had lowered their tariffs significantly through the SAPs. The use of subsidies has become very constrained. Export subsidies are banned outright, except for the poorest countries. All other subsidies, other than environmental and agricultural subsidies, are potentially subject to challenge. Moreover, the WTO rules cover areas that were not covered by international trade agreements before—such as restrictions on what countries can do in terms of regulating FDI and IPR regimes—each area respectively being covered by the Agreement on Trade-Related Investment Measures (TRIMs) and TRIPS.

What is notable is that the WTO rules are much more binding for developing countries, even though in theory they apply to all member countries and not just the developing countries. This is because the rules are stricter when it comes to policy tools that the developing countries need more (e.g., tariffs, quantitative restrictions, export subsidies, regulations on foreign investment, lax intellectual property rights), while they are more generous when it comes to policies that the developed countries use more extensively. For example, the subsidies that can be used with no formal restriction (e.g., agriculture, environment) or the subsidies that are de facto allowed (i.e., they can in theory be challenged but never have been; these include subsidies for research and development and regional equality) are basically subsidies that the developed countries need and often use.

On top of the WTO, there has been an increase in the number of bilateral and regional trade agreements in the mold of NAFTA. Most of these are "WTO-plus," in the sense that they put even more constraints on the policy freedom of the signatory countries than does the WTO. Their rules are considered even more biased than the WTO ones (e.g., the notorious provision for direct lawsuit by foreign investors, first introduced by NAFTA). Moreover, if the developed countries have their way in the currently stalled Doha Round of WTO negotiations, the industrial tariffs of the developing countries will be brought down to the lowest level (5–7 percent average) since the end of colonialism and unequal treaties.[15] Given that tariffs are now the only main developmental policy tool left for the developing countries, such an outcome may make their economic development all but impossible.

## Possible Futures

What does the preceding historical overview tell us about possible futures for world development in the aftermath of the 2008 world financial crisis? One obvious thing is that the future prospects for the developing countries depend a lot on what happens in the developed countries as a result of the crisis. If these countries abandon, or at least significantly tone down, their neoliberal policies, they are more likely (although not guaranteed) to rewrite the global rules in a way that gives the developing countries a greater policy space. Naturally, a greater policy space does not guarantee development. A greater policy space is only a necessary and not a sufficient condition for development. Some countries will use it well, while others will not. However, without this change, the prospect for economic development in those countries is bleak. In contrast, if neoliberalism survives this crisis in the developed countries, the policy space for the developing countries will remain constrained, or even be reduced further, and that will be detrimental to the development prospects of the developing countries.

Which way things will go depends quite a lot on how the crisis evolves. Until the Greek debt crisis blew up in the spring of 2010, there had been a growing opinion that the crisis was more or less over and that the world could go back to "business as usual." Many countries had started growing again, albeit sluggishly, while there were signs that the unemployment problem was beginning to ease at least in some countries. Above all, share prices and other financial-market indicators had been moving up for over a year, recouping all the losses made since the collapse of Lehman Brothers. While there were tough talks among politicians on the strengthening of financial regulation and bank taxes, few concrete actions had been taken, not least because of the enormous resistance from the financial industry. It seemed that the financial industry could, yet again, talk their way out of the potential regulatory onslaught, as it did in the late 1990s, following the Asian, Brazilian, and Russian crises.

However, the Greek debt crisis has rudely reminded us that this crisis is far from over and that its future course is very unpredictable.

One obvious issue is the budget deficit. A sovereign-debt crisis is an immediate possibility for Spain and Portugal, and it is also a real possibility for Italy and Ireland. The talk of sovereign-debt crisis in the United Kingdom may be somewhat premature, but it is not implausible. The United States, being a country of reserve currency and military dominance, may be relatively safe, but it is not totally impossible that there may be a run on the US dollar. Whether or not these countries actually experience a sovereign-debt crisis, they will have to impose savage cuts in public spending in order to deal with their budget-deficit problems in the coming years. When this happens, popular discontent will mount. If these resistances are effective, the result may be a further destabilization, rather than a stabilization, of the economy. Of course, at this point it is impossible to predict which countries will experience a sovereign-debt crisis and when, how many cuts each country will make in case of (or in the absence of) such a crisis, and how strong and how effective the popular resistance to those cuts will be in each country. This makes it very difficult to predict the future evolution of the crisis.

Another issue that is potentially more important than that of budget deficit is the huge financial bubbles that have been built up over the past year or so. The unprecedentedly lax fiscal and monetary policies, as well as state bailout and even nationalization of troubled financial institutions, may have been necessary in order to pull the world economy back from the brink. However, in the absence of a strengthening of financial regulations, these policies have allowed financial investors to behave in the same old way, resulting in the inflation of huge financial bubbles. These bubbles may burst before we can deflate them in an orderly manner through a mixture of regulatory reforms and careful macroeconomic tightening. If the bubbles burst, the world economy may experience another severe downturn. Once again, the timing and the manner of the bubble bursting is very difficult to predict (as we just saw with the 2008 crisis), so how the future will exactly unfold is difficult to know.

On top of these two major problems, there are still many smaller time bombs ticking in the world economy. If unemployment does not fall quickly, there will be an increase in defaults in credit-card debts and house mortgages. This will be a particularly serious problem for countries such as the United States and the United Kingdom, where household debts are large. There are worries about oversupply of commercial real estates, especially in the United States, the United Kingdom, Spain, and Ireland, whose financing problems are predicted to reach their peaks in the next couple of years. There are serious doubts about the quality of public investments that China made in the immediate aftermath of the 2008 crisis. If too many of these projects turn sour, China may experience a significant economic problem. None of these alone may be sufficient to push the world economy into another recession, but they can all act as a trigger for a negative chain reaction, leading to a recession or at least contributing to the further weakening of the major economies.

With all these potential problems, the 2008 recession could turn out to be what is called a "double-dip" or "W-shaped" recession—with the economy picking up and then falling into a recession again. Or we could end up with something similar to Japan's "lost decade," with the economy not quite going into recession in a technical sense but showing anemic growth, spiked by bouts of negative growth.

Now, even if the crisis worsens in the ways just described, this does not necessarily mean that neoliberalism will be abandoned. To put it bluntly, there is simply too much money, too much power, and too much intellectual prestige at stake for the neoliberal regimes to go quietly. The extent to which the financial industry has been able to resist reforms so far is the best evidence of this. In many countries, right-wing parties have been able to reclaim power largely because the crisis happened during the watch of a left-wing government, which often had bought partially into the neoliberal orthodoxy (Britain being the best example of this). Among mainstream promarket economists, there is hardly any critical reflection on the failures of their theories.

This is not to say that the forces of reform—not just the traditional critics of free-market capitalism but some of the believers in the old system who have come to accept its shortcomings—will never be able to overcome these resistances. With a prolonged recession, there will be a higher chance of those forces coalescing and overcoming the resistances to reform. However, it should be borne in mind that a longer or a more severe recession is not necessarily going to increase the chance of reform. Japan's shift to the right during the so-called lost decade and beyond is a good example of that.

As for the impact of the 2008 crisis on the developed countries' dealings with the developing countries, the early signs have not been good. The IMF has professed to have seen its errors with its traditional pro-cyclical adjustment programs, but its practice has changed little. Between September 2008 and January 2009, the IMF signed nine stand-by agreements (SBAs) with countries in financial crises. According to a report by the Third World Network (TWN), a prominent South-based nongovernmental organization, in all these agreements, except the one with Iceland, a developed country, the IMF stuck to its traditional formula. It made the other eight countries reduce, not increase, their budget deficits and tighten, not loosen, their monetary policies.[16] According to a later study by the Washington-based think tank Center for Economic and Policy Research (CEPR), of the forty-one agreements that the IMF signed between the outbreak of the 2008 crisis and October 2009, thirty-one demanded pro-cyclical macroeconomic policies.[17]

Despite great expectations, the establishment of the G20, which includes some major developing countries, has changed the way the global economy is run only a little. For example, the G20 decided to strengthen the IMF (which has been acting as its de facto secretariat, which itself is a cause for worry) without reforming its policies and governance structure. Because the key developing countries are involved, the G20 may even be used as a means to give greater legitimacy to the policies of the IMF.

Some developed-country trade negotiators are even trying to use this crisis as an opportunity to strengthen the free-trade agenda and push through their positions in the Doha Round negotiations. They argue that we should conclude the Doha Round quickly so that we do not succumb to the temptation of protectionism. They argue that increased protectionism in the early years of the Great Depression destroyed the world trading system, even when evidence shows that the destruction was mainly due to the lack of demand and the drying up of trade credit and was not due to higher tariffs.[18]

It is undeniable that the 2008 crisis has shaken the confidence of the developed countries in neoliberalism and has also dramatically exposed their double standards. Despite the magnitude of the crisis, it is unclear at the time of this writing (May 2010) whether it will lead to a fundamental reform of the global economic system. Much will depend on how the crisis evolves and how proreform forces organize themselves. However, if we cannot rethink and reform the global system now, when else can we do it? History has shown that although the strong tend to engage in ladder-kicking, it is also possible for them to act in their enlightened self-interest, as shown by the Marshall Plan period, rather than in narrow, myopic self-interests.

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CHAPTER 3

# Growth after the Crisis

*Dani Rodrik*

## I. Introduction

The past fifty years were a remarkable period in world economic history. Not only did we experience unprecedented rates of technological advance and economic growth in this period, but an increasing number of hitherto poor countries—those in the periphery of the North Atlantic economic core—were able to participate in this progress. The current crisis presages a new era, one which may be significantly less hospitable to the growth of poor countries. It is too early to know how long it will take for financial stability to be restored in the advanced countries and for recovery to set in. But even with the worst of the crisis over, it is likely that we will enter a period in which world trade will grow at a slower pace, there will less external finance, and the appetite of the United States and other rich nations to run large current account balances will be significantly diminished.

This chapter focuses on the implications of this scenario for the growth prospects of developing nations. In particular, it asks whether we can reconcile two apparently conflicting demands on the world economic system. On the one hand, global macroeconomic stability requires that we avoid large current account imbalances of the type that the world economy experienced in the run-up to the crisis. Epitomized by the US–China bilateral trade relationship, these imbalances played at the very least an important supporting role in bringing on the financial crisis. In the next stage of the world economy, there will be much greater pressure on countries with large deficits or surpluses to reduce these imbalances through adjustments in their currency and macroeconomic policies.

But on the other hand, a return to high growth in the developing countries requires that these countries resume their push into tradable goods and services. Countries that grew rapidly in the postwar period were those that were able to capture a growing share of the world market for manufactures and other nonprimary products. Prior to the crisis of 2008, this push was accommodated by the willingness of the Unites States and a few other developed nations to run large trade deficits. This seems no longer a feasible strategy for large or middle-income developing nations.

So are the requirements of global macro stability and of economic convergence at odds with each other? Will the developing nations' need to generate large increases in the supply of tradables inevitably clash with the world's intolerance of trade imbalances? No, not necessarily. There is in fact no inherent conflict, once we understand that what matters for growth in developing nations is not the size of their trade surplus or even the volume of their exports. What matters for growth is their *output* of nontraditional tradables, which can expand without limit as long as domestic demand expands at the same time. Maintaining an undervalued currency has the upside that it subsidizes the production of tradables; but it also has the downside that it taxes the domestic consumption of tradables—which is why it generates a trade surplus. It is possible to have the upside without the downside, by encouraging tradables production directly. A large part of this chapter is devoted to making this rather simple, if important and overlooked, point.

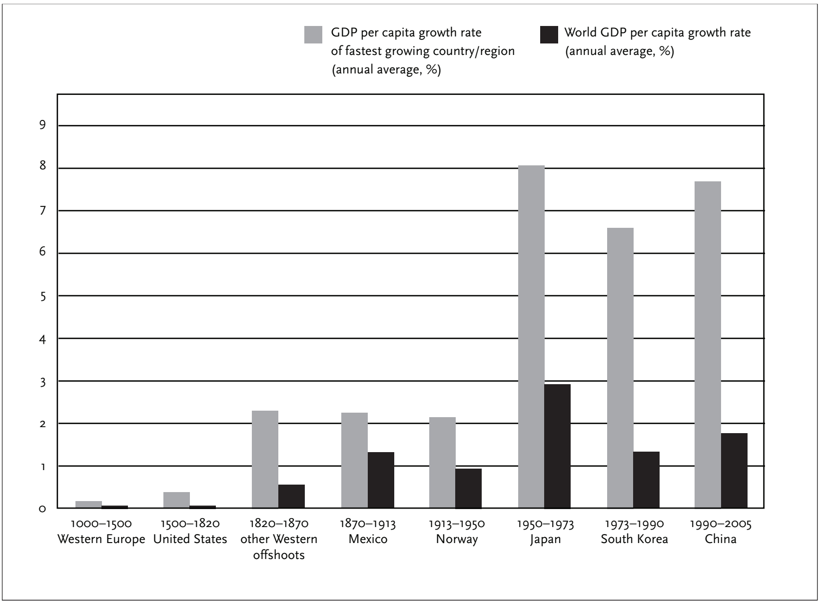
There are many ways in which the profitability of tradables can be enhanced, including reducing the cost of nontraded inputs and services through appropriately targeted investments in infrastructure. But it is reasonable to expect that industrial policies will be part of the arsenal. So the external policy environment will have to be more tolerant of such policies, including explicit subsidies on tradables (as long as the effects on the trade balance are neutralized through appropriate adjustments in the real exchange rate). Permissiveness on industrial policies in the developing world is the "price" to be paid by deficit countries for greater discipline on exchange rates and external imbalances. The bottom line is that the growth potential of developing nations need not be severely affected as long as the implications of this new world for domestic and international policies are well understood.

To trace out the likely effect of the crisis on growth, we need to have a good fix on the drivers of growth. So I begin the chapter by providing an interpretation of growth performance in the world economy since the end of the Second World War. I argue that the engine of growth has been rapid structural change in the developing nations—from traditional, primary products to nontraditional, mostly industrial products. This structural transformation was facilitated by what I call productivist policies in successful countries. I then ask how the contours of the world economy postcrisis are likely to affect this process. Slow growth in the developed world and reduced appetite for international lending do not directly threaten growth prospects in developing nations. The threat is that lower demand for (or acceptance of) imports from developing countries will make it harder for these countries to engage in rapid structural change. This threat can be averted by developing nations' employing more balanced growth strategies which allow consumption of tradables to expand alongside production. I present the simple analytics of subsidies on tradables to show how it is possible to engineer structural change in the direction of tradables without generating trade surpluses along the way. I also provide some illustrations of the kind of policies that can be used.

## II. The Miracle Years

The period since 1950 has been quite unique in terms of economic growth. As figure 3.1 reveals, what is truly remarkable about this era is not that the *overall* rate of economic growth has been high by historical standards. In fact, taken as a whole, the post-1950 period did not greatly outperform the gold-standard era during 1870–1913. What stands out after 1950 is the stupendously high rates of growth achieved by the *best performing* countries. Japan, South Korea, and China were the growth champions during the three subperiods 1950–1973, 1973–1990, and 1990–2005, respectively, with annual per-capita growth rates between 6 and 8 percent. These rates are historically unprecedented and greatly

Figure 3.1: The expanding growth frontier




Source: Angus Maddison, *The World Economy: A Millennial Perspective* (Paris: OECD, 2001) and World Bank, *World Development Indicators.*

exceed those experienced by the growth champions of earlier eras. For example, the most rapidly growing country under the classical gold standard, Norway, registered a per-capita annual growth rate barely above 2 percent.

So something happened in the world economy after about 1950 which allowed it to support much more rapid economic convergence in the lower-income countries. What was this change? Commodity-price-led booms and capital-inflow cycles can explain short-term changes in economic performance, and these clearly had something to do with the high growth we have seen throughout the developing world in the most recent decade prior to the crash of 2008. But the longer-term nature of the expansion of the growth frontier suggests that something more fundamental, and much more of a secular nature, changed as well.

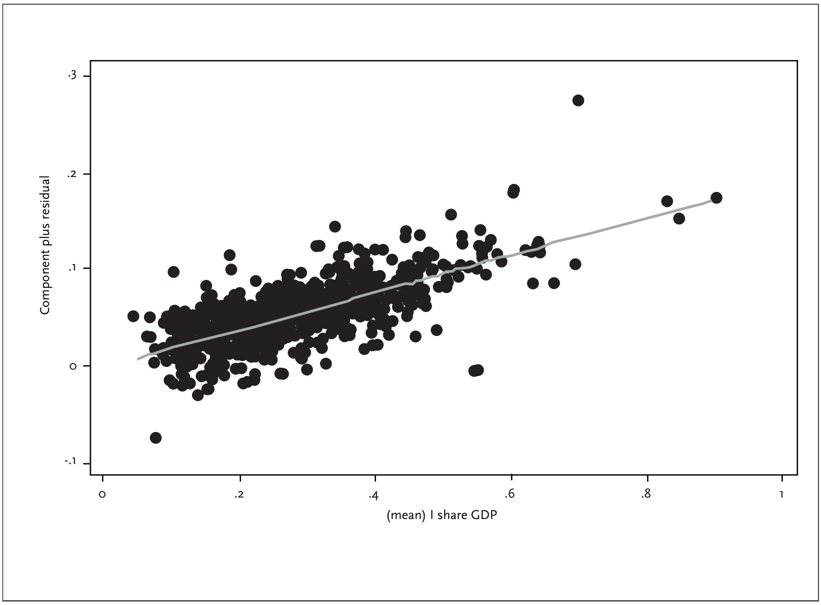
Conventional accounts, heavily influenced by the Chinese miracle of the past quarter century, emphasize the enabling role of globalization. This too provides a poor explanation. The international integration of markets in goods and assets gathered speed slowly and reached its apogee only after the 1990s, whereas economic convergence on the part of successful countries was as rapid in the couple of decades after 1950 as it has been more recently. China was preceded by South Korea, which was in turn preceded by Japan. There was, if anything, a greater number of developing countries in Asia, Latin America, and Africa that experienced rapid convergence in the initial decades after the Second World War than there has been in more recent decades.[1]

What is common about Japan, South Korea, and China (and indeed about many of the rapidly growing import-substituting countries during 1950–1980) is that they based their growth strategies on developing industrial capabilities, rather than on specializing according to their (static) comparative advantages. They each became manufacturing superpowers in short order—and much more rapidly than one would have expected based on their resource endowments. China's export bundle was built up using strategic industrial policies that forced foreign companies to transfer technology and, as a result, resembles one for a country that is three or four times as rich.[2] South Korea started out with very little manufacturing capability and quickly moved from simple manufactures (in the 1960s) to more complex products (in the 1970s). Japan, unlike the other two countries, had developed an industrial base (prior to the Second World War), but this base was totally destroyed in the war and was restored thanks to trade and industrial policies that protected domestic producers.

The general lesson to be drawn from the experience of these postwar growth champions is this: high-growth countries are those that are able to undertake rapid structural transformation from low-productivity ("traditional") to high-productivity ("modern") activities. These modern activities are largely tradable products, and within tradables, they are mostly industrial ones (although tradable services are clearly becoming important as well).[3] In other words, poor countries become rich by producing what rich countries produce.

This experience is quite different from the nineteenth-century pattern of growth, where success in the periphery was based on specialization in commodities and primary products. It explains why high performers in the postwar period have been able to grow so much faster than the growth champions of earlier eras (e.g., Mexico in 1870–1913 or Norway in 1913–1950; see figure 3.1).

Figure 3.2: Relationship between industrial share in GDP (horizontal axis) and economic growth (vertical axis).



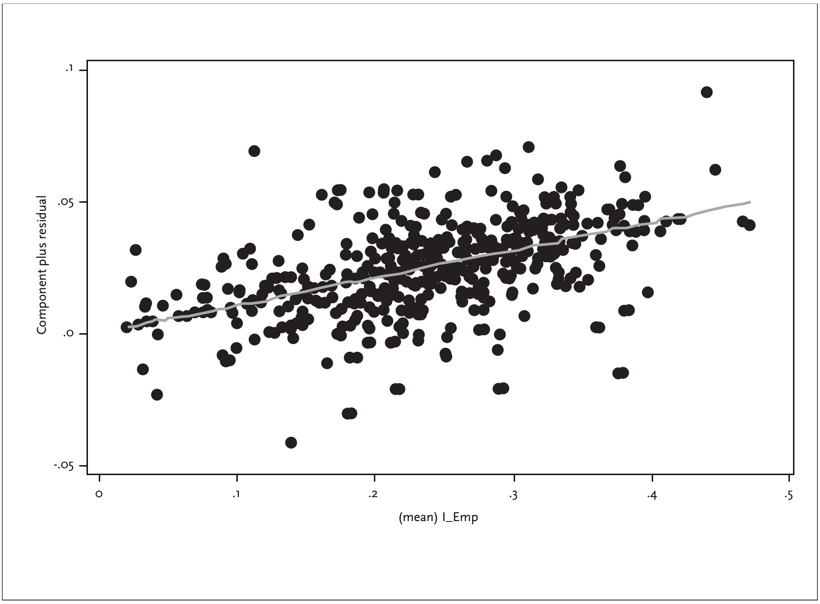

Source: Author's calculations using data from World Bank, World Development Indicators and Penn World Tables.

Note: Each point in the chart corresponds to a 5-year subperiod during 1960-2004 for a specific country. The growth rates control for initial income levels and country and period fixed effects.

The close association between movement into industry and high growth is evident in the postwar data. This is shown in figures 3.2 and 3.3 for two measures of industrial activity, the share of industrial value added in GDP and the share of industrial employment in total employment, respectively. I have regressed five-year averages for economic growth on corresponding averages for industrial activity, controlling for initial income levels as well as fixed effects for countries and time periods. Note that the economically relevant distinction here is between modern and traditional, not between industry and the rest of the economy. There are modern, tradable activities in agriculture (e.g., horticulture) and services (e.g., call centers) as well. But in the absence of data for a large enough sample of countries, I use "industry" as my proxy for nontraditional activities.

The scatter plots show what happens to growth when the shares of industrial output or employment change over time within a country. (Note

Figure 3.3: Relationship between industrial employment shares (horizontal axis) and economic growth (vertical axis).




Source: Author's calculations using data from World Bank, World Development Indicators and Penn World Tables.

Note: Each point in the chart corresponds to a 5-year subperiod during 1960-2004 for a specific country. The growth rates control for initial income levels and country and period fixed effects.

that country fixed effects absorb time-invariant factors specific to individual economies.) In each case, the message is loud and clear. An expansion of industrial activity is closely associated with faster economic growth. Moreover, unlike what a simple comparative-advantage story would suggest, this relationship is not any weaker in lower-income countries. The slope coefficient changes very little over different income ranges.

Why is transition into modern industrial activities an engine of economic growth? As I discuss elsewhere and in line with a long tradition of dual-economy models,[4] the answer seems to be that there exist significant gaps between the social marginal productivities in traditional and modern parts of developing economies. Even very poor economies have economic activities—horticulture in Ethiopia, auto assembly in India, consumer electronics in China—whose productivity levels are not too far off from what we observe in the advanced economies.[5] As resources move from traditional activities toward these activities, economy-wide productivity increases. These gaps can be due to a wide range of features that are specific to underdevelopment, which I discuss in two broad categories.[6] One has to do with institutional weaknesses—such as poor protection of property rights and weak contract enforcement—which make themselves felt more intensively in tradable activities. The second are various market failures and externalities—for example, learning spillovers and coordination failures—associated with modern activities. In both cases, industrial activity and investment are underprovided in the absence of proactive policies that stimulate them. Anything that speeds up structural transformation in the requisite direction will speed up the rate of economic growth.

What is the secret for achieving this structural transformation? Even though actual policies have differed significantly across successful countries, one can still identify some important common elements. First, it is clear that sound "fundamentals" have played a role, as long as we interpret the term quite broadly and not associate it with any specific laundry list of policies (such as the "Washington Consensus" or the governance reforms that are in fashion currently). Thus, all successful countries have had governments that have prioritized economic growth, followed market-friendly policies, and maintained macroeconomic stability. It is probably true to say that these are the sine qua non of economic growth. But the ways in which these principles can be put into practice are so numerous and context specific that enunciating them hardly provides a guide to action.[7]

Second, all successful countries have followed what one might call productivist policies. These are activist policies aimed at enhancing the profitability of modern industrial activities and accelerating the movement of resources toward modern industrial activities. They go considerably beyond the conventional recommendation to reduce red tape, corruption, and the cost of doing business. They entail in addition (and sometimes instead)

- explicit *industrial policies* in support of new economic activities (trade protection, subsidies, tax and credit incentives, special government attention);
- *undervalued currencies* to promote tradables; and
- a certain degree of *repression of finance,* to enable subsidized credit, development banking, and currency undervaluation.

It is true that industrial policies have often failed. But it is also true that it is virtually impossible to identify countries, whether in Asia (South Korea, Taiwan) or in Latin America (Chile), that have done well without them. Just as is the case with fiscal policy, say, or education policy, what distinguishes good performers from bad performers is not the presence or absence of the policy but the skill with which it has been implemented.

The reason that undervaluation of the currency works as a powerful force for economic growth is that it acts as a kind of industrial policy. By raising the domestic relative price of tradable economic activities, it increases the profitability of such activities and spurs capacity and employment generation in the modern industrial sectors that are key to growth. Table 3.1 shows the mechanism at work.[8] Columns (1) and (2) are fixed-effects panel regressions which establish that high levels of the real exchange rates (undervalued currencies) are associated with larger industrial sectors, measured by either output or employment. Columns (3) and (4) are in turn the second stage of two-stage least squares (TSLS) regressions, which show that undervalued currencies result in higher growth, *through* their effects on the size of industry. As I discuss in detail elsewhere,[9] this association between undervalued currencies and high growth is a very robust feature of the postwar data, particularly for lower-income countries.[10]

Undervaluation has the practical advantage, compared to explicit industrial policies, of being an across-the-board policy not requiring selectivity and therefore entailing fewer agency problems (rent-seeking and corruption). Perhaps this accounts for its widespread success in promoting development, as just documented. But it also has several disadvantages. First, it requires that the macroeconomic policy framework be sufficiently flexible and adaptable to the needs of undervaluation: a real exchange rate depreciation is possible only if the economy can generate an increase in saving relative to investment, which has obvious implications for fiscal and other policies.[11] Second, undervaluation does an imperfect job of targeting modern economic activities: traditional primary products receive a boost in profits alongside new industrial activities. And third, undervaluation is not just a subsidy on the production of tradables; it acts also as a domestic tax on their consumption (it raises the relative price of imported goods). That is why it produces an excess supply of tradables—a trade surplus. The last point is of special relevance to the subject of this chapter, and I return to it later.

Table 3.1: How undervaluation drives growth through its impact on industrial activity (panel of 5-year sub-periods, 1960-2004)

| | (1) | (2) | (3) | (4) |
|---|---|---|---|---|
| DEPENDENT VARIABLE: | INDUSTRY SHARE IN GDP | INDUSTRY SHARE IN EMPLOYMENT | GROWTH — TSLS | GROWTH — TSLS |
| ln current income | 0.079* (9.99) | 0.025 (1.51) | | |
| ln initial income | | | -0.134* (-8.33) | -0.071* (-4.39) |
| ln UNDERVAL | 0.024* (3.62) | 0.042* (4.87) | | |
| Share of industry in GDP | | | 1.716* (7.59) | |
| Share of industry in employment | | | | 1.076* (6.15) |
| Time dummies | yes | yes | yes | yes |
| Country dummies | yes | yes | yes | yes |
| Observations | 985 | 469 | 938 | 459 |

Notes: Industry and agriculture shares in GDP are in constant local currency units. In columns (3) and (4), industry shares are regressed on ln UNDERVAL, ln income, and lagged ln income in the first stage.

* significant at 1% level

Source: Adapted from Rodrik, "The Real Exchange Rate and Economic Growth," in *Brookings Papers on Economic Activity: Fall 2008*, ed. D.W. Elmendorf, et al. (Washington, DC: Brookings Institution, 2009).

Finally, there was an important *external* element that enabled the postwar growth miracles to take place. The advanced nations of the world, and the United States in particular, essentially had an attitude of benign neglect toward the policies in the developing world that made the industrial transformation possible. The GATT system placed very few restrictions on developing countries. The disciplines were few and far between on trade policies and nonexistent on subsidies and other industrial policies. The IMF could be tough when it came to conditionality on monetary and fiscal policies—but only in instances when countries faced external deficits (and had *over*valued currencies). There was no presumption in favor of financial liberalization or capital-account opening, since many of the advanced economies themselves retained financial controls well into the 1970s. Consumers in the United States were happy to absorb the excess supply of tradables on the world market, even at the cost of rising borrowing from abroad.

The global environment became less permissive over time. The World Trade Organization (WTO), unlike its predecessor, placed severe restrictions on the conduct of industrial policies in middle-income developing countries. Financial liberalization and capital mobility became the norm, with developing countries expected to converge toward "best practice" in these areas (although, it became recognized, in the aftermath of the Asian financial crisis, that too rapid liberalization may be undesirable). Finally, the US trade deficit with China and the undervaluation of the renminbi became serious issues, with the IMF charged to carry out surveillance over "currency manipulation" (although in practice the effort led nowhere).

Despite these changes, until the present crisis the global context remained largely benign with respect to developing countries' need to diversify into industrial products in order to accelerate their growth. It is much less clear that we will be able to say the same about the environment going forward.

## III. What Will Be Different after the Crisis?

Financial stability has been restored in the United States and in most other advanced countries, even though concerns remain about the weaker countries of the European Union. But even with the financial crisis behind us, given the magnitude of the crisis, its residue is likely to linger for quite a while. In particular, the developed world may not recover quickly, and its growth may remain low or nonexistent for some years to come. Japan's stagnation following its crisis in the early 1990s—after a period of very high growth—provides one worrisome antecedent. It is difficult to know whether the United States and Europe will replicate this experience, but it is certainly impossible to rule the possibility out. At this writing, growth remains exceptionally fragile in Europe (with the possible exception of Germany), and the odds seem even that the United States is in for a double-dip recession.

While slower growth in the advanced countries would be bad news, its implications on the developing world would be largely indirect. When rich nations grow more slowly (or not at all), the stock of knowledge and technology which is available to firms in poor countries is not reduced. The potential for productivity enhancement and catch-up remains fully in place. From an economic standpoint, the rate of growth of developing countries depends not on the speed at which rich countries grow but on the difference between developing and rich nations' income *levels*—that is, the "convergence gap." The first does affect the second, but only slowly and over time.

The indirect effects operate through the channels of international trade and finance. Remittances are important too for many countries, but I shall set them aside. Three likely developments here are of potential concern: (1) reduced appetite for cross-border lending, (2) slower growth in world trade, and (3) less tolerance for large external trade imbalances. I discuss each in turn.

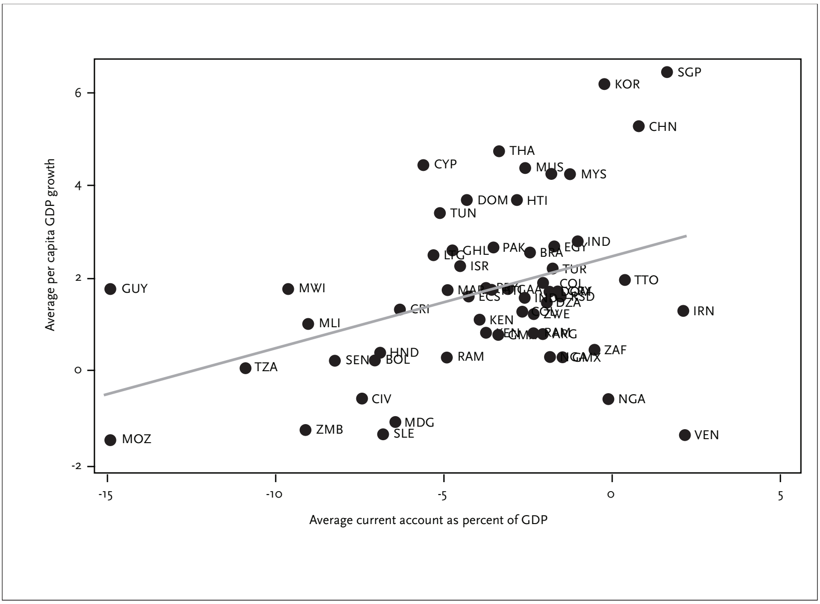
### *1. Reduction in Cross-Border Lending*

Weaknesses in the financial markets of developing nations had little to do with the emergence of the financial crisis of 2008. Nevertheless, the trend toward deleveraging and flight to safety during the crisis was felt strongly in developing countries, and there were strong, negative effects on capital flows to developing countries. By now this process seems to have played itself out, and emerging markets are again receiving substantial inflows. But going forward, and especially as new Basle capital requirements are phased in, developing nations may find that external finance is not as plentiful as it was prior to 2008.

Whether one thinks this is a big deal depends on one's views about the growth process in developing nations. If we believe that the binding constraint to growth lies on the saving side, then we would conclude that a reduction in net inflows comes with a significant growth penalty. This would be the conventional inference drawn from the neoclassical growth model and the presumption that private returns to investment are higher in poor nations than in rich nations. But the experience of the past few decades gives us ample reason to take this view with a heavy grain of salt. The presumption that the saving constraint binds in most poor nations is contradicted by one important stylized fact: high growth and net capital inflows are negatively (rather than positively) correlated across developing countries. This was demonstrated in an important paper by Prasad, Rajan, and Subramanian,[12] whose central finding is shown in figure 3.4. China, of course, is the best-known case of a high-growth country with a trade surplus, but as the Prasad et al. evidence shows, China's experience is not an anomaly. Rapidly growing countries are more likely to be net exporters of capital than net importers (and this is true even when aid flows, which tend to go disproportionately to the worse-off countries, are taken out). This should not be surprise in light of the growth story I laid out in the previous section. The binding constraint in that interpretation is not the supply of loanable funds but investment demand in tradables. What limits growth is not access to finance but the low (private) profitability of modern tradables. Accordingly, the key to growth is not more finance but enhanced private profitability in tradables. Moreover, in typical second-best fashion, more finance can result in lower growth if it exacerbates the more significant constraint. How? Through the effect of capital inflows on the real exchange rate. As shown by Prasad et al. and by me elsewhere,[13] countries with larger net capital inflows and more open capital accounts tend to have more overvalued currencies. This mechanism goes a long way to explain why financial globalization has proved so disappointing for the vast majority of developing nations.[14]

No doubt there are some countries for which low domestic saving is indeed a binding constraint. This constraint can be relaxed, in principle at least, through access to foreign finance. Brazil, for example, has built a diversified agricultural and industrial base (thanks in large part to industrial policies in earlier decades), but all indications are that investment levels in modern economic activities are currently constrained primarily

Figure 3.4: Net capital outflows and growth




Source: E. Prasad, et al., "Foreign Capital and Economic Growth," *Brookings Paper on Economic Activity* 1 (2007).

by the high cost of capital driven by low domestic saving.[15] Turkey represents a similar case. So growth and investment in Brazil and Turkey go up and down with net capital inflows. However, since capital flows are highly volatile and subject to "sudden stops," neither Brazil nor Turkey has been able to generate consistently high growth since the end of the 1980s. So even in saving-constrained cases such as these, the appropriate remedy lies not in resuscitating financial globalization but in domestic policies (such as reductions in fiscal deficits and encouragement of private saving).

Neither is there much cause for concern regarding a reduction in global risk sharing. In principle, higher levels of gross (two-way) flows allow countries to insure themselves against idiosyncratic risks. But here, too, the evidence cuts the other way. Kose, Prasad, and Terrones find that consumption risk sharing has actually gone down in the developing world since the 1990s (while it has improved in the rich countries).[16] One reason of course is the greatest prevalence of financial crises in a financially globalized world.

The bottom line is that developing nations should not shed too many tears if the world economy experiences some financial deglobalization. Countries that have been recipients of large capital inflows may even end up seeing their growth prospects improved, since they will now experience less pressure for real exchange rate appreciation. And fewer financial crises is nothing to lose sleep over.

*2. Less Buoyant World Trade*

Lower growth in the advanced countries also implies a lower rate of expansion of their import demand, which has implications for both prices and quantities in world trade. On the price side, there are two relative prices that matter to developing nations—the terms of trade and the relative price of industrial goods—and they are likely to move in opposite directions. Consider first the terms of trade. The developed and developing worlds share one terms of trade, which are the inverse of each other. As long as domestic demand is slower to pick up in the developed world than in the developing world, which is my baseline assumption here, the terms of trade are likely to move in the rich countries' favor. This will constitute a net loss of real income to the developing countries, but it is unlikely to have much of a perceptible effect on their growth *rates*. To the extent that developing countries are able to continue to diversify into new products (of the type produced in the rich countries), they can avoid large terms-of-trade declines—as rapidly growing countries have in fact managed to do to date.

The second relative price of consequence is the price of industrial goods relative to primary goods on world markets. This is of independent interest to the developing countries, because it affects the relative profitability of their modern tradable sectors and, hence, the speed at which structural change and economic growth take place through the mechanisms I have already discussed. This relative price is not exactly the inverse of the rich countries' terms of trade, but it is likely to be negatively correlated with it (since developed countries are net industrial exporters and net commodity importers). Consequently, this particular channel presents some good news for the growth prospects of developing countries. Slower growth in the North reduces the prospects of a Dutch disease in the South.

What about the quantity effects? We normally associate a slower pace in export volumes with lower economic growth, but upon closer look, the causal effect from the former to the latter is not at all clear. In the very short run, there may be positive Keynesian effects from export demand. But it is hard to believe that exports can act as an engine of growth for Keynesian, excess-capacity reasons over the medium to longer run. And if they could, developing nations could simply substitute fiscal stimulus and get growth that way.

For export quantities to matter over the longer run, one must believe either in learning or other spillovers from exports, which have been hard to document, or in the story I laid out earlier, in which tradables are special because that is where the higher-productivity activities are. The two accounts differ on the importance they attach to the act of exporting per se. The "spillovers-from-exporting" story relies on the technological or marketing externalities that are created when a tradable good crosses an international boundary. The "tradables-are-special" story is indifferent to whether international trade actually takes place.

In table 3.2, I report the results of regressions where the two hypotheses are allowed to compete against each other. Each column is a regression estimated with fixed effects for countries and time periods, using a panel of five-year subperiods. The regressors, in addition to the fixed effects, are lagged income (to account for convergence), the share of industrial value added in GDP, and the share of exports in GDP. In order to allow comparison of the estimated coefficients on the industry and export shares, I have standardized these indicators. So the coefficient tells us the estimated effect of a single standard-deviation change in the relevant variable.

The first column runs the regression on the entire post-1960 sample for which there is data. Industry and export shares are both statistically significant, but the estimated impact of industrial activity is more than twice as powerful: a one standard-deviation increase in industrial shares is estimated to increase growth by 1.6 percentage points, while the corresponding increase in export shares boosts growth only by 0.7 percentage points. Moreover, it turns out that the result with export shares is not robust. When the sample is restricted to post-1990 data (column 2), the estimated coefficient on exports becomes insignificant. And the difference in the magnitudes of the effects rises to a factor of between four and five (0.028 versus 0.006). When a few observations corresponding to countries with very high export shares (e.g., Luxemburg and Hong Kong) are excluded, the significance of the export variable is reduced further (column 3). Perhaps most importantly, when we restrict the sample to developing

Table 3.2: Exports and industrial output as determinants of growth (panel of 5-year sub-periods, 1960–2004)

| DEPENDENT VARIABLE: GROWTH IN PER-CAPITA GDP | (1) FULL SAMPLE | (2) POST-1990 SAMPLE | (3) POST-1990 SAMPLE, EXPORT OUTLIERS REMOVED | (4) DEVELOPING COUNTRY SAMPLE |
|---|---|---|---|---|
| ln initial income | -0.043* | -0.125* | -0.125* | -0.045* |
| | (-7.98) | (-8.56) | (-8.32) | (-5.57) |
| Share of industry in GDP | 0.016* | 0.028* | 0.028* | 0.021* |
| | (4.54) | (3.57) | (3.53) | (4.06) |
| Share of exports in GDP | 0.007* | 0.006 | 0.006 | -0.001 |
| | (2.67) | (1.69) | (1.49) | (-0.34) |
| Time dummies | yes | yes | yes | yes |
| Country dummies | yes | yes | yes | yes |
| Observations | 850 | 417 | 410 | 527 |

Notes: Industry and export shares are standardized variables. Column (3) excludes observations where exports shares exceed 100%. Column (4) excludes observations with per-capita GDP > US$6,000.

* significant at 1% level

countries, the coefficient on the export share turns slightly negative (and is statistically insignificant), while the coefficient on the industry share rises (to 0.020) and remains strongly significant (column 4). The horse race between industrial activity and export orientation has a clear winner.

As long as what matters is industrial (and other nontraditional) output, an increase in world trade can in fact even be a mixed blessing for many developing countries. Leaving aside the presence of large trade imbalances, to which I turn in the next section, growth in exports implies growth in imports. If the former add to demand for domestically produced tradables, the latter subtract from it. A *balanced* increase in international trade creates no additional net demand for domestic tradables.

If imports are dominated by industrial products, as is the case in many developing nations, a large expansion of trade can even be bad for domestic industrial output.

The experiences of various groups of developing countries have differed in this respect. For countries such as China and many other low-cost suppliers of manufactures, which were rapidly diversifying into industrial products and became large importers of primary commodities, the expansion of global trade was an unambiguous benefit for their industrial sectors. But many other countries found their industrial sectors coming under severe competition from precisely these low-cost sources. Countries ranging from Ethiopia to Mexico found their manufacturing firms getting squeezed by imports.

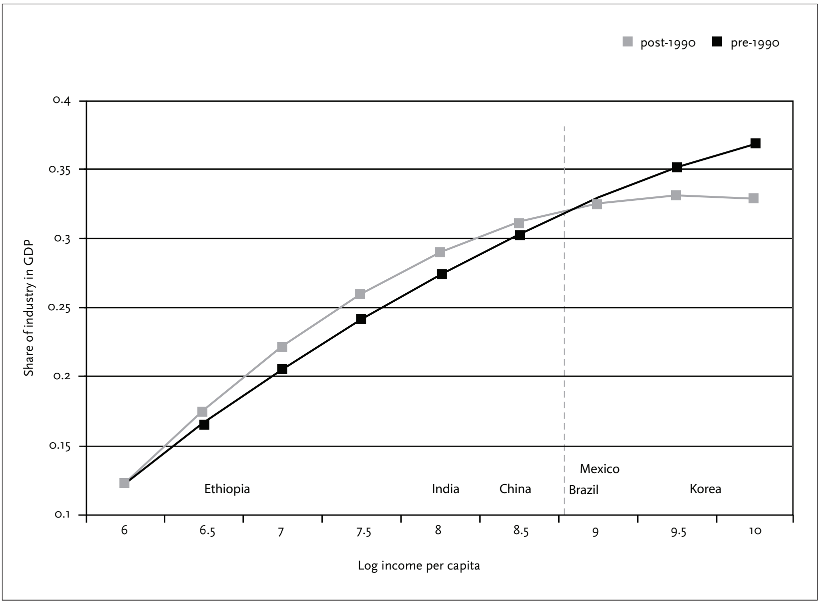
Whether the depressed returns to import substitution were more than offset by the higher returns from exporting (and thus industrial activity was affected positively on net on account of trade) depended very much on the nature of other economic policies in place. The evidence seems to indicate that the large-scale entry of China and other low-cost producers in world markets affected middle-income countries particularly adversely. This is shown in figure 3.5, which displays the relationship between income levels and industrial activity in the periods before and after 1990. This relationship is quite (log-) linear in the earlier period but becomes visibly concave after 1990. What the picture makes clear is that countries at low income levels were able to support much higher levels of industrial activity after 1990 compared to earlier periods, while the opposite was true for countries at a medium and higher level of incomes. What was an enabling environment for China and India was not nearly as hospitable to Mexico or Brazil.

The bottom line is that reduced buoyancy in world trade is of smaller consequence to the growth of developing nations than is usually imagined. What matters for growth is the ability to expand industrial economic activities, not trade per se. Industrial activity can increase without increasing trade, if domestic demand for tradables rises alongside. I discuss the kind of policy changes needed to achieve this outcome later.

### *3. Smaller Current Account Imbalances*

Industrial nations are likely to tolerate smaller current account imbalances going forward, both as a consequence of lower growth and because of

Figure 3.5: The income gradient of industrial shares in GDP




Note: Relationship is based on a quadratic fit.

the lesson from the crash of 2008 that large imbalances portend trouble down the road. So countries with large trade surpluses—anything around or over 5 percent of GDP—are likely to come under pressure to adjust their currency and macroeconomic policies, especially if these countries are large and systemically important.

As a matter of accounting, a trade surplus is a source of net demand for a country's tradables. So we do expect trade surpluses and growth to go together, especially in countries which are diversifying into modern tradables such as industrial products. This is an important reason behind the negative, rather than positive, association between net capital inflows (= current account deficits) and growth, noted earlier. So might the lower tolerance of current account surpluses from larger developing countries act as a serious constraint on their growth potential in years ahead? Once again, we need to remember that the key to growth is the domestic output of modern tradables and not the excess supply thereof. Systematic evidence on this is provided in table 3.3, which presents the results of another horse race, this time between industry shares and trade surpluses.

Table 3.3: Trade surpluses and industrial output as determinants of growth (panel of 5-year sub-periods, 1960–2004)

| DEPENDENT VARIABLE: GROWTH IN PER-CAPITA GDP | (1) FULL SAMPLE | (2) POST-1990 SAMPLE | (3) POST-1990 SAMPLE, TRADE SURPLUS OUTLIERS REMOVED | (4) DEVELOPING COUNTRY SAMPLE |
|---|---|---|---|---|
| ln initial income | -0.041* | -0.126* | -0.122* | -0.045* |
| | (-7.89) | (-8.90) | (-8.32) | (-5.58) |
| Share of industry in GDP | 0.018* | 0.029* | 0.041* | 0.021* |
| | (4.79) | (3.75) | (4.39) | (3.97) |
| Trade surplus as percent of GDP | -0.002** | 0.003 | -0.007 | -0.002 |
| | (-1.25) | (1.02) | (-1.19) | (-1.17) |
| Time dummies | yes | yes | yes | yes |
| Country dummies | yes | yes | yes | yes |
| Observations | 850 | 417 | 359 | 527 |

Notes: Industry and export shares are standardized variables. Column (3) excludes observations where the absolute value of the trade surplus exceeds 20% of GDP. Column (4) excludes observations with per-capita GDP > US$6,000.

* significant at 1% level

The main result is that, once industry shares in GDP are controlled for, trade surpluses exert no additional positive effect on economic growth. This is true for the full sample (column 1), for post-1990 data (column 2), for samples in which large trade deficits or surpluses have been removed (column 3), and for samples restricted to developing countries (column 4). In each one of these runs, the industry variable is highly significant, while the trade surplus is not.

The implication for developing nations that have gotten hooked on trade surpluses as their "engines of growth" should be clear: there is no need to sacrifice growth as long as domestic demand for tradables can be increased alongside the domestic supply. Undervaluation of the currency may be out. But there are other policy options, as I discuss in the next section, which can spur both the consumption and production of tradables.

## IV. Promoting Industrialization without Trade Surpluses

Let us return to the interpretation underlying the growth dynamics that I sketched out earlier. In this model, poor countries are poor because too few of their resources are in modern, high-productivity activities. Fast growth happens when there is rapid structural transformation from low-productivity traditional sectors to high-productivity modern activities. The reason this transformation is not an automatic, market-led process is that there are severe market or institutional failures whose costs are borne disproportionately by the modern sectors. Sometimes transformation is blocked because of low domestic saving and high cost of capital, which keep investment and structural change sluggish. But more typically the problem is a large wedge between private and social returns in modern sectors. These sectors are subject both to learning spillovers and coordination failures and to high costs imposed by weaknesses in legal and regulatory institutions. These weaknesses are hard to remove in short order, and the experience of advanced economies is that they are addressed only through the long course of decades, if not centuries.[17]

So while it would be desirable to address these shortcomings *directly* by removing market failures and fixing institutions, as a practical matter such an agenda is too broad and ambitious and hence too unrealistic in the short to medium run as a growth strategy. As noted previously, successful countries have pursued growth strategies that alleviate these constraints *indirectly,* by raising the relative profitability of modern activities through other means. What all these strategies have in common is that they act as *subsidies* on tradables.

Once we strip these strategies to their essence, it becomes easier to understand what is central and what is incidental to their working. In particular, we can see that a strategy of subsidizing tradables need not be associated with undervalued exchange rates and trade surpluses. The point can be made with the help of figures 3.6a, b, and c, which show the equilibrium in the market for tradables. The supply of tradables is increasing in the relative price of tradables ($R$, the real exchange rate), while the demand is decreasing. Start from an initial equilibrium ($R^0$, $Q^0$), where there is no excess supply of tradables and therefore the trade balance is zero (figure 3.6a). Now suppose the government imposes a production subsidy on tradables. This shifts the supply schedule for tradables out, since for any level of *R*, producers of tradables are now willing to supply a larger amount (figure 3.6b). Where will the new equilibrium be? If we assume that the real exchange rate remains at $R^0$, the subsidy would produce not only an increase in the output of tradables but also a trade surplus (an excess supply of tradables).

But as is shown in figure 3.6c, this is not necessarily the final equilibrium. Unless the government adopts additional macroeconomic policies to maintain the real exchange rate unchanged, there will be an endogenous appreciation of the real exchange rate to $R^2$, which spurs domestic consumption of tradables and brings the trade balance back to zero (figure 3.6c). Note that in this final equilibrium, the output of tradables still ends up being higher even though the real exchange rate has appreciated and trade balance has been reestablished. That is because the real exchange rate appreciation needed to bring the trade balance back to zero is (proportionately) less than the magnitude of the initial subsidy since, unlike the subsidy, it affects both the consumption and production margins. Therefore it does not fully undo the effect of the subsidy on the supply side. The full details are worked out in an explicitly general-equilibrium framework in the appendix to this chapter.

As this analysis demonstrates, it is possible to enhance production incentives for tradables, and to do so by as wide a margin as is necessary, without creating spillovers to the rest of the world in terms of trade imbalances. Unlike currency undervaluation (which taxes domestic consumption of tradables), a policy of explicitly subsidizing tradables (combined with macroeconomic policies that maintain external balance) boosts the domestic consumption of tradables.

What form should this subsidy take in practice? In the rest of this section, I discuss three approaches for increasing the effective producer price of tradables: (1) industrial policies, (2) reducing input costs for tradables, and (3) incomes policies. All of these pose practical problems in implementation, so the appropriate mix will depend on the circumstances of each country.

Figure 3.6a

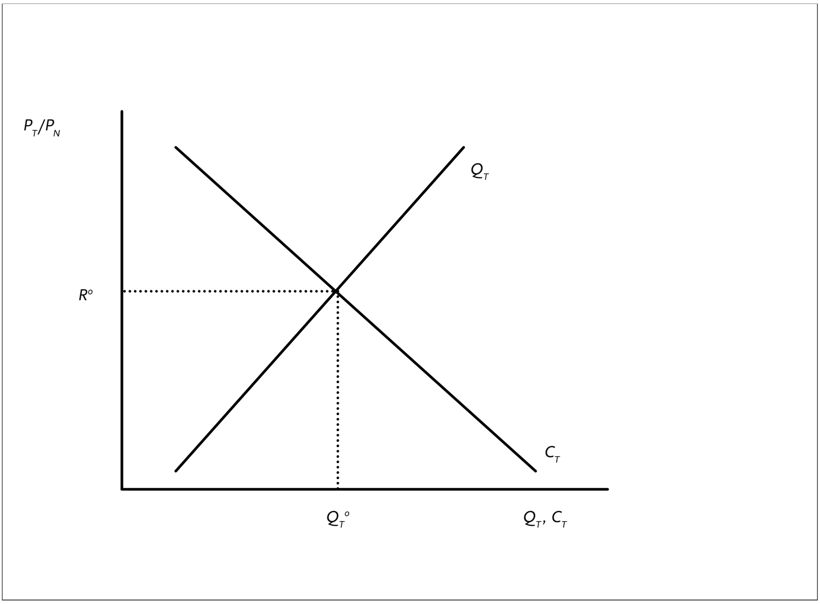



Figure 3.6b

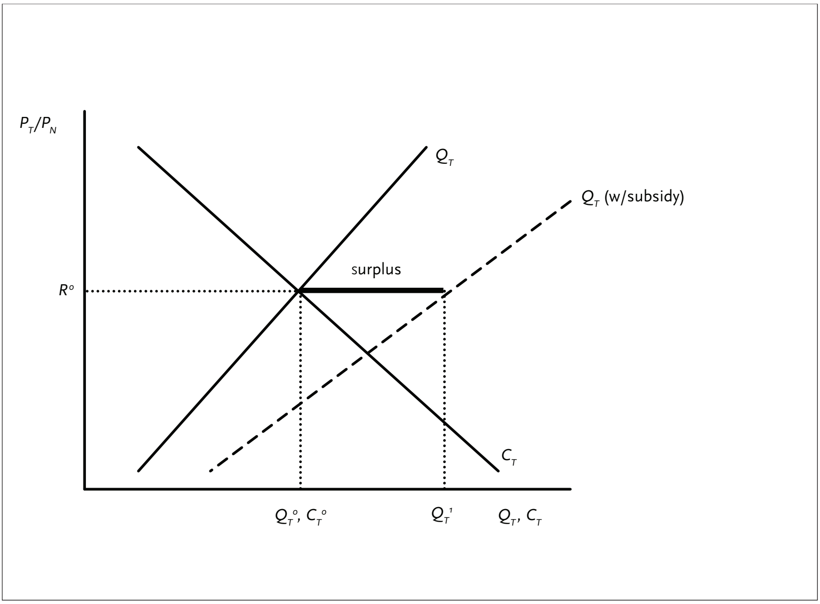
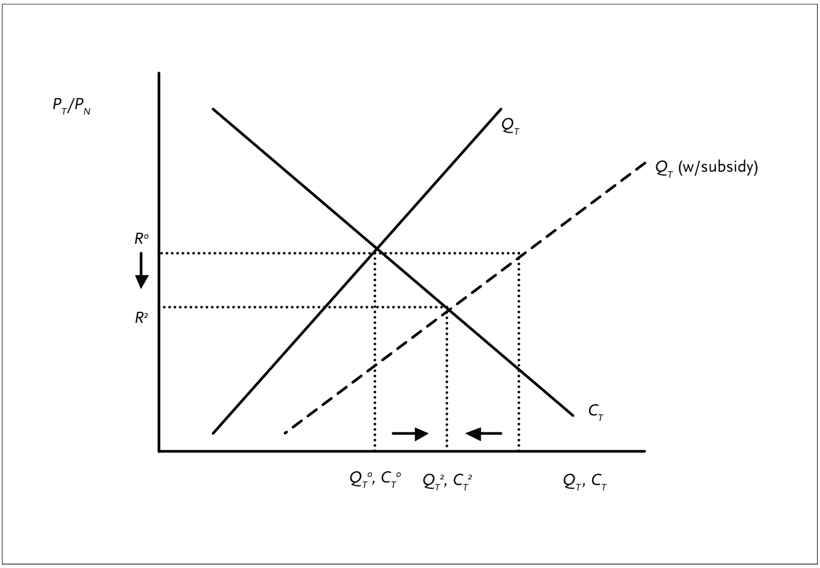


Figure 3.6c




*1. Industrial Policy*

In principle, industrial policy is ideally suited to the problem at hand. What needs to be done is to enhance the relative profitability of nontraditional products that face large information externalities or coordination failures or which suffer particularly strongly from the poor institutional environment. That is what good industrial policy attempts to do. Tax exemptions, directed credit, payroll subsidies, investment subsidies, and export processing zones are some of the forms through which industrial policy gets implemented. What is distinctive about these policies is that they target specific firms or sectors and therefore privilege some at the expense of others. That is what makes industrial policy controversial, of course. But as long as the targeting is done broadly well—as long as it focuses on new activities at the outer margins of a country's underlying competence—the potential upside is large. The advantage of industrial policy relative to currency undervaluation is precisely that it allows greater fine-tuning and discrimination: traditional tradables (such as primary products and industrial products in which a country has already established itself) need not be subsidized, and the consumption of tradables need not be taxed (as explained previously).

There is still a sense in which subsidies on modern tradables can spill across borders. Even if the net supply of tradables does not increase *in aggregate,* the net supply of those that are targeted for promotion will. Other developing countries will be on the receiving end of this, and if they remain passive, their own industrialization incentives will be blunted. But the right way of expressing this problem is to say that the use of "optimal" industrial policies in some countries increases the costs of not using such policies in others. As some countries alleviate their market imperfections, the costs of not dealing with these imperfections get exacerbated elsewhere. So as long as all countries are following industrial policies that are optimal from their perspective, there are no spillovers to contend with. The spillovers in question can be effectively neutralized as long as other developing countries are following appropriate industrial policies as well. It is desirable for policies in *all* developing countries to promote the production of tradables since it is economically efficient for a larger share of the world's tradables to be produced in those nations.

The two chief arguments against industrial policy have to do with state capacity: governments can never do the requisite targeting properly, it is argued, since they lack sufficient information, and even if they could, the process would become rife with rent-seeking and corruption. There are good counterarguments to both objections.[18] First, it makes little sense to hold the conduct of industrial policy to the unrealistic standard that governments always be able to pick the winners. In view of the uncertainties involved, mistakes are not only unavoidable; they are part and parcel of optimal program design: if the government never makes any mistakes, it is as good an indicator as any that it is not ambitious enough. The much more meaningful and desirable requirement is that governments be able to recognize their mistakes and change course when needed. That is obviously a much weaker desideratum than omniscience. And it can be achieved through appropriate institutional design.[19]

With respect to corruption, that is a real danger, of course. But industrial policy is hardly the only area of government policy which is susceptible to corruption. Education policy and tax policy, to name just a couple other areas, are equally at risk. Yet we never advise governments that they should give up on collecting taxes or that they should not finance education and build schools. Instead, we try to think of ways in which these systems can be rendered less susceptible to corruption and rent-seeking. There is no reason why industrial policy should be any different. There are various safeguards—professional and independent management, sunset clauses, close monitoring, explicit success benchmarks, reporting requirements—that would discipline the process and make public programs operate more like private venture capital. Once again appropriate institutional design holds the key to better implementation.

Can government capacity be built where it is lacking? The answer is yes, as long as industrial policy is made a priority. Monetary and fiscal policies, for example, were areas of rampant failure in much of the developing world until recently. Yet fiscal and monetary institutions have become remarkably stronger in the developing world during the past fifteen years or so. As the importance of macroeconomic stability became better understood and institutional innovations (such as central-bank independence) came into play, areas of weakness were turned into areas of strength. The same can happen with industrial policy as well. The remedy for government failure is not always a prohibition on government action. It can just as well be better rules and better policy guidance.

The main *external* obstacle to the wider use of industrial policies by the larger developing countries is the WTO's Agreement on Subsidies. This agreement prohibits the use of subsidies which take the form of fiscal expenditures conditioned on export performance. More seriously, it also renders "actionable" the use of subsidies that have the effect of increasing exports, even if they are not directly conditioned on exports. (Least developed countries are exempt from these rules.) A literal application of this standard would rule out many kinds of industrial policies, the objective of which is precisely to increase the domestic supply of tradables. Only subsidies that encouraged import substitution would remain exempt.

In practice, of course, there are many loopholes, and one can debate the extent to which this and other WTO agreements actually restrict the space for industrial policies.[20] But it is also the case that the restrictiveness of the Agreement on Subsidies has not been put to a real test. As long as countries were free to use currency policies to encourage industrialization, the WTO constraint did not bind all that much. So China could hugely subsidize its tradables through an undervalued renminbi while abiding (barely) by WTO rules on subsidies or local content.

In a world where economic growth requires the encouragement of modern economic activities in developing nations, the Agreement on Subsidies makes little economic sense for them.[21] It rules out a desirable second-best policy for promoting economic diversification and structural change. It has the unintended consequence of inducing governments to favor an inferior policy (in view of its spillovers into trade imbalances), namely, undervalued currencies. Worse still, it may encourage trade protection as a defensive measure against industrial imports. If we want greater international oversight on currency practices, as I think we should, we will need to substantially relax discipline over industrial subsidies.[22]

*2. Reducing Input Costs for Tradables*

A second type of government policy which can shift relative incentives in favor of tradables is to reduce the costs of inputs which are used intensively by modern economic activities. Certain types of specialized industrial or professional skills (e.g., machinists or call-center operators) fit the bill well. Government investment in training in such areas will have the effect of incentivizing modern tradables (and will do so in most cases without threatening conflict with the WTO). While straightforward in theory, however, this approach also faces some practical obstacles. The difficulty is that many of the most obvious strategies one can think of produce asymmetric effects across different groups of tradables.

So consider, for example, what is perhaps the most immediate policy that comes to mind: reducing trade costs in the form of transport and logistics costs. Such costs can be a significant deterrent to trade, which is why many governments are so keen to invest in trade infrastructure (modernization of ports and improving transport). But the effects of this on industrial incentives are ambiguous, for the same reason that trade liberalization yields uncertain dynamic gains. A reduction in trade costs helps export activities; but it also hurts import-substitution activities, because it takes some "natural protection" away from them. The net result depends on whether more new, dynamic activities are crowded in than are crowded out. It cannot be determined a priori without some careful prospective analysis.

Or consider reducing tariffs on intermediate inputs. This will be good for all final-goods producers but not so good for competing intermediate-good producers at home. The net effect is once again indeterminate.

### *3. Wage Restraint*

The single most important nontraded input in the modern sector is labor. Developing countries typically have segmented labor markets, where formal-sector wages may differ significantly from wages in informal activities and the rural sector. In such settings, the institutional and regulatory setting exerts a large influence on the determination of the wages most relevant to modern-sector firms. Consequently, changes in these arrangements can have a correspondingly significant effect on the relative profitability of modern tradable activities.

In societies where there exists a habit of cooperation among social partners, it may be possible to negotiate wage restraint in the formal parts of the economy in return for the expectation of continued job creation. Unions which are able to think long term and internalize the interests of their future as well as present membership may be persuaded to moderate wage demands.

Unfortunately, such social pacts are more common in advanced economies with centralized wage bargaining (such as Sweden, Austria, or Ireland) than in developing ones (e.g., Mauritius). When they are set up, it is typically as a temporary arrangement to deal with a severe macroeconomic crisis (e.g., Mexico in 1987, South Korea in 1997). Institutions of conflict management are weak in developing countries, along with all other institutions. For the vast majority of developing nations, therefore, this is no easy alternative to explicit industrial policy.

## V. Concluding Remarks

How hospitable will the global environment be for economic growth in the developing world as we come out of the present financial crisis? The answer depends, I have argued, on how well we manage the following tension. On the one hand, global macro stability requires that we prevent external imbalances from getting too large. On the other hand, growth in poor nations requires that the world economy be able to absorb a rapid increase in the supply of tradables produced in the developing world.

For many small developing countries, undervaluation of their currency remains a viable industrialization strategy, although it is not even second best, for reasons I have discussed. Given their small footprint in world trade, it is unlikely that they will make a large appearance on the radar screen of surveillance over "currency manipulation practices." But middle-income and large developing nations do have to transition into alternative strategies. They will have to contemplate—and the rest of the world will have to allow them—the use of various explicit industrial promotion measures for nontraditional tradables, including subsidies. Combined with real exchange rate appreciation, such subsidies would boost the supply of nontraditional goods but would be neutral with respect to the trade balance. In effect, industrial policy can be assigned to the structural transformation target while the exchange rate is assigned to the external balance.

Removing the real exchange rate as a tool for development does represent a cost to the larger developing countries. But failure to realize that there are alternative approaches that can be used as substitutes would greatly magnify the adverse effects on growth. If the need for such a strategy is not recognized and trade rules on subsidies are enforced blindly, we are likely to find ourselves in a period of great tension in international economic relations. This tension will exhibit itself not only as a North-South divide but also as a cleavage within the developing world. As the relative size of advanced economies and their markets shrinks, manufactured exports from low-cost suppliers will spill over into the markets of middle-income countries with greater force. If the latter do not have their own industrial promotion and diversification strategies, they will come under strong pressure from domestic industry to react in a defensive manner, by erecting protectionist barriers against imports from other developing countries. Restricting the policy space on industrial policies will have the unintended consequence of fostering trade protection.

So there is room for guarded optimism with regard to the prospects for developing nations. The good news is that developing countries can continue to grow rapidly even if there is some slowdown in world trade and there is reduced appetite for capital flows and trade imbalances. The bad news is that the favorable outcome will not happen on its own, as a result of the magic of market forces. As we reform global rules and redesign domestic strategies, we need to ensure that the environment in the future will be as conducive to structural transformation in the developing world as it has been during the past fifty years.

Appendix: Production Subsidies on Tradables in General Equilibrium

We divide the economy into two sectors, producing tradable and nontradable goods respectively. Let us take the price of nontraded goods to be the numeraire and fix it to *1*. The demand side of the economy is represented with the expenditure function $E(R, 1, u)$, where $u$ stands for aggregate utility and $R$ is the (relative) price of tradables and the real exchange rate. The supply side of the economy is represented by a GDP or revenue function given by $G(R, 1)$, where I have repressed the factor endowments of the economy since they will be taken to be in fixed supply throughout.

We are interested in the effects of a production subsidy on tradables, $s$. The direct effect of such a subsidy is to increase the supply price of tradables, so the GDP function is rewritten as $G(R+s, 1)$ while the expenditure function remains unchanged.

Equilibrium in this economy can be expressed using three equations. Note first that the partial derivative of $G(.)$ with respect to the price of tradables (expressed as $G_1(R+s, 1)$) gives us the supply of tradables, $Q_T$.

$$(1) \quad Q_T = G_1(R+s, 1)$$

The second relationship is an expenditure equals income identity:

$$(2) \quad E(R, 1, u) = G(R+s, 1) - s\, G_1(R+s, 1)$$

We assume that the subsidy is financed through lump-sum taxes, so the income available for private-sector consumption is GDP minus the tax revenue needed to finance the subsidy. The last term in equation (2) is the corresponding tax revenue. Finally, we express equilibrium in the market for tradable goods:

$$(3) \quad E_1(R, 1, u) = G_1(R+s, 1)\ ,$$

where $E_1(.)$ is the (Hicksian) demand for the tradable good. By Walras' Law, (2) and (3) guarantee that the market equilibrium for nontraded goods holds as well. These three equations determine the three endogenous variables in the system, $Q_T$, $R$, and $u$.

From (1), it is evident that the output of the tradable good depends exclusively on what happens to its supply price, *R+s*. If this price increases in response to an increase in the subsidy, the supply response will be positive.

Performing the comparative statics of the system yields the following result:

$$\frac{d(R+s)}{ds} = \left[\frac{E_{11}(.)}{E_{11}(.) - R_{11}(.)}\right]\left[1 - sR_{11}(.)\ \frac{E_{1u}(.)}{E_{u}(.)}\right]^{-1}$$

To interpret this expression, focus first on the case where the subsidy is "small," and we evaluate the expression at $s$=0. Since $E_{11}(.) < 0$ and $R_{11}(.) > 0$ from the properties of expenditure and revenue functions, *d(R+s)/ds* is unambiguously positive in this case, which is to say that the appreciation of the real exchange rate does not fully undo the incentive effects of the subsidy.

In the case where *s* is not zero or very small to begin with, income effects come into play, as captured by the last term in the expression.

Since $R_{11}(.)\frac{E_{1u}(.)}{E_{u}(.)}$ is positive, the second bracketed term cannot be signed in general. But it is conventional to assume, as part of a stability requirement, that this term is not larger than 1, so that *d(R+s)/ds* remains positive.

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Chapter 4

# Structural Causes and Consequences of the 2008–2009 Financial Crisis

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The international monetary and financial system created at Bretton Woods (BW) in 1944 was supposed to address the international dimensions of the financial crisis associated with the US Crash of 1929 and the ensuing Great Depression of the 1930s. The gold standard of the prewar period was replaced by dollar-gold parity, effectively making the dollar the international reserve currency since the 1940s. The growing US current account deficit of the 1960s and other problems contributed to the crises of the early 1970s and to subsequent global economic transformations associated with economic liberalization and globalization.

Consequent global economic asymmetries have shaped and been shaped by such global international economic integration. Economic performance has become increasingly hostage to growing financialization, with economic booms based on bubbles and in turn contributing to growing financial fragility. Various factors shaped vulnerability to and the impact of the financial crisis and its recessionary consequences, as well as policy responses. Despite the rhetorical invocation of Keynes since this crisis began, the level of ambition in response has been modest compared to President Franklin D. Roosevelt's New Deal and its international counterpart at Bretton Woods. This is reflected in the nature of social dimensions of recovery measures as well as the official reform proposals at both national and international levels. With the New Deal and sustained countercyclical measures, President Roosevelt created about two million jobs through what was called the Citizens Conservation Corps (CCC), equivalent to five million jobs with the larger US population and labor force today.[1] This is especially important because there is great interest today in sustainable development and the need to try to promote renewable energy, which is likely to create three to five times as many jobs as the generation of fossil-fuel energy.[2]

This chapter aims to highlight some structural or systemic causes of the crisis and its consequences. Although the Bretton Woods system served the world economy reasonably well for about three decades, this chapter traces the root cause of the crisis in the flaws of the original Bretton Woods system and the failure to design a new international financial architecture following its breakdown in the early 1970s. It then argues for more inclusive efforts under the auspices of the United Nations to design a new international financial architecture.

## The Significance of Bretton Woods

The experience of events leading to the Great Depression of the 1930s and World War II convinced world leaders that economic cooperation was the only way to achieve both peace and prosperity, at home and abroad. Thus, with this vision, leaders and experts, representing forty-four states or governments, including the Soviet Union, met for three long weeks (July 1–22, 1944) at Bretton Woods, New Hampshire, to make financial arrangements for the postwar world. It was very clear to everyone attending the Bretton Woods conference that the world's economies were intricately linked and that economic crisis in one nation could quickly cascade to affect the entire world. Hence, they agreed to tight restrictions, in an attempt to stave off any future global catastrophe. In addition to creating the rules to govern the global economy, the Western powers also agreed to take on responsibility for the global economy themselves by lowering trade barriers and allowing capital to flow freely from their countries.[3]

President Roosevelt opened the conference by stating, "The economic health of every country is a proper matter of concern to all its neighbors, near and far." The agreements reached on large and complex matters are without precedent in the history of international economic relations. The conference drew up a project for the International Bank for Reconstruction and Development (IBRD)[4] to make long-term capital available to states urgently needing such foreign aid, and a project for the International Monetary Fund (IMF) to finance short-term imbalances in international payments in order to stabilize exchange rates.

Two other very important institutions were proposed at the Bretton Woods conference but were never agreed upon. One was the International Trade Organization (ITO), which would have set up rules to mediate international trade. The other was the International Clearing Union (ICU), which would have acted essentially as a strictly regulated international bank. The ICU was proposed by the noted British economist John Maynard Keynes but was firmly opposed by the United States, largely to preserve its national interests. The ICU was replaced with the IMF, which gave enormous powers to the United States and gave developed nations access to unlimited credit. It also gave the US dollar a position of privilege to ensure the United States would never face an economic collapse as a result of debt. Nevertheless, the Bretton Woods conference largely marked the end of economic nationalism.

The official name of the 1944 Bretton Woods conference was the United Nations Conference on Monetary and Financial Affairs. The United Nations organization did not even exist in 1944 and was only set up a year later in San Francisco. The League of Nations had been set up after the end of World War I but had not prevented the outbreak of World War II. Calling it a United Nations conference was a deliberate statement by President Roosevelt underlining the failure of the League of Nations, a statement which also envisaged an *inclusive postcolonial multilateralism including economic governance issues.*

President Roosevelt had another option, favored by the UK prime minister Winston Churchill, who had communicated to the US president that he did not want a multilateral conference but preferred a bilateral conference, between the (rising) power, the United States, and the (declining) power, the United Kingdom; such a bilateral meeting would certainly have been more convenient, as the world was at war. Thus, President Roosevelt's commitment to an inclusive multilateralism continues to distinguish United Nations processes from other more exclusive processes.

As noted, Bretton Woods was not just about restoring monetary and financial stability but also about creating a new system of postwar economic governance, to create the conditions for sustained growth and employment creation. (This is also in the mandate of the US Federal Reserve, but unfortunately, the purpose of reforms has been forgotten in most contemporary discussions of monetary and financial affairs.) A third element, no less important, is captured by the original name of the World Bank—the International Bank for Reconstruction and Development, expressing a clear commitment to postwar reconstruction and also postcolonial development. President Roosevelt was anticipating a postcolonial world, demonstrated by the granting of independence to the Philippines, the first country to get independence after the war. Of the forty-four countries which participated in Bretton Woods, twenty-eight would be classified as developing countries today, including nineteen from Latin America, but there were countries from Africa as well as Asia, including India and the Philippines, then still under colonial rule. Hence, in a very profound sense, the Bretton Woods conference was a redefining moment, in terms of a postwar order, of a new postcolonial, postwar world economic order, and one in which economic governance would be principally committed to sustained growth, employment creation, and economic development.

In sum, the month-long Bretton Woods conference sought to create the conditions for international monetary and financial stability, not for its own sake but in conjunction with creating an economic and trading system to support economic and job growth. It was also agreed that the liberal international economic system required governmental intervention. As the official name of the World Bank implies, it also sought to create the conditions for (postwar) reconstruction and (postcolonial) development. But the key ICU proposal by Keynes, the Liberal peer who led the UK delegation to Bretton Woods, was rejected by the United States, with ominous consequences decades later. Keynes anticipated the likely problems emanating from the use of national (or regional) currencies as the international reserve currency.

Despite its flaws, the Bretton Woods system contributed crucially to the postwar conditions for what many economists term the postwar "golden age" through the 1950s and the 1960s, which saw sustained recovery and economic growth, especially in Europe but also in many other parts of the world. In those countries which secured independence early, mainly in Asia, there were relatively high rates of economic growth. There was a lag of almost two decades before African countries got independence in the 1960s. They, too, enjoyed relatively high economic growth until hit by the first oil-price shock and the subsequent global stagflation in the 1970s.[5]

## The End of the Bretton Woods System

The postwar international economic order predicated on the Bretton Woods system eventually came unstuck because of the problematic arrangement of the global reserve currency. The dollar's role as the principal international reserve currency since Bretton Woods has subsequently encouraged major US current account deficits. This has, in turn, undermined its credibility and role as the international reserve currency, leading to crises and major attempts at exchange-rate adjustments in 1971, 1985, and 2008.

The dollar's ability to play its stabilizing role as a reserve currency began to decline during the 1960s when President Lyndon Johnson decided not raise taxes to finance the Vietnam War. The financing of the Vietnam War by creating dollars was hugely problematic. To begin with, it caused inflationary pressure, and the US inflation rate was significantly higher than that of its European and other trading partners. As a result, the United States began running trade deficits. The crucial turning point was 1970, when the US gold coverage deteriorated from 55 percent to 22 percent. In the first six months of 1971, assets worth US$22 billion fled the United States. Increasing European pressures on the United States finally resulted in President Richard Nixon's unilaterally abrogating in September 1971 the commitment to dollar-gold parity made in 1944, marking the end of the Bretton Woods system.[6] That opened a new era of flexible exchange rates, financial globalization, and what was later dubbed a "nonsystem" in international finance.[7]

President Bill Clinton's mid-1998 call for a new international financial architecture after the 1990s Asian crisis thus came over a quarter century after the end of the old one, and the failure to adequately respond to that call can be said to be part of the problem. At the IMF, this absence of a system was presided over by what was called the Interim Committee, which lasted for almost three decades and has since been replaced by the International Monetary and Financial Committee (IMFC).

The IMF's handling of the Asian crisis came under severe criticisms,[8] even by its own independent evaluation office, set up in 2001 to look into its policies and activities. Many of the IMF's big clients, such as Argentina, Indonesia, and Brazil, left its programs during 2002–5, and developing countries in increasing numbers demanded reforms of the IMF—its governance structure, handling of sovereign debts, and lending practices. The IMF's second building in Washington, DC, was often jokingly called the Turkey building, as it was erected when the Turkish government was its main client. After that, the IMF was without significant paying clients, which resulted several years ago in significant diminution of its staff, by several hundred.

At the second G20 Summit in London in early April 2009, UK prime minister Gordon Brown, previously chair of the IMFC while Chancellor of the Exchequer, or finance minister, succeeded in injecting three-quarters of a trillion dollars into the IMF without requiring any of the major reforms long sought by the developing countries. While additional IMF resources have helped meet some external financing requirements, especially of some developed and emerging-market economies, it remains unclear whether the onerous conditionalities previously associated with such credit will be permanently reduced to facilitate sustained recovery and longer-term development.

One relationship which Simon Johnson suggests is benign, but which Joseph Stiglitz has referred to more critically for over a decade, is the relationship between the US Treasury and the IMF.[9] This relationship is not unimportant. The only country which has a veto power in the IMF is the United States, which holds a 17 percent share there—15 percent gives a member an effective veto power in the IMF. Article 6 of the IMF's Articles of Agreement, for example, specifies that sovereign states have the right to control their capital account, but in reality, the contrary—capital account liberalization—has been actively promoted by IMF staff, leading to the 1997–98 Asian crisis and again more recently in the past half decade. IMF research has shown how financial globalization has undermined growth and stability,[10] but nonetheless, the IMF has continued to promote these policies.

The end of the Bretton Woods system coincided with the first oil-price shock, which led to stagflation (high unemployment coupled with high inflation) in major industrial countries. Most developing countries, faced with high import costs due to rising oil prices, experienced severe balance-of-payments problems. This saw the rise of a conservative economic philosophy that championed the free-market system and deregulation of the economy.[11] As an increasing number of developing countries sought support from the IMF to deal with their balance-of-payments problems, the process of wholesale liberalization accelerated under the conditionalities of the IMF's and the World Bank's adjustment programs.

A hallmark of three decades of liberalization and globalization has been growing international specialization. A new international division of labor evolved, which has involved significant deindustrialization in the rich or industrialized countries as well as in many developing countries and transition economies, while some other parts of the world have industrialized rapidly on the basis of economies of scale and learning. These rich countries are less and less industrial, while many of these economies subsidize agriculture for reasons of social welfare and food security. The squeeze on industry and the subsidization of agriculture has been accompanied by the growth of services, especially the rise of finance, and significant corresponding changes in the nature of capital.

A second important outcome of liberalization or deregulation has been the ascendance of financial interests. The dominant ideology of market fundamentalism, or neoliberalism, of the past three decades or so, with the emergence of Thatcherism and Reaganism, has favored finance for various reasons.[12] One important element in this is what Simon Johnson, the former chief economist of the IMF, refers to as the nexus between Wall Street (finance capital) and the US Treasury Department, which shapes financial policy.[13] This is also true of the United Kingdom, where Prime Minister Brown very successfully served as Chancellor of the Exchequer for a decade. This relationship was recognized by economist Jagdish Bhagwati over a decade ago, when commenting on the Asian crisis.[14]

An important consequence of these developments is the greater capture of financial rents,[15] a term used by Keynes more than seven decades ago. Financial rents, as the term implies, come out of oligopolistic or quasi-monopolistic situations. This suggests not just the rise of finance but of oligopolistic finance, with profound implications. Profits are, in fact, increasingly composed of rents, or what other classical economists preferred to refer to as the surplus. Although finance constitutes 12 percent of the US economy in terms of corporate wealth, it captured 40 percent of profits in 2007. This, of course, reflects the ability of the financial sector to capture significant total "superprofits," or rents, when they are able to influence public policy and public regulation in ways favorable to them.

During the second Reagan administration (1985–88), US secretary of state George Shultz greatly expanded the international enforcement of intellectual property rights for extracting rents, often understood as superprofits. This eventually resulted in Schumpeterian rents,[16] ostensibly to reward innovation, secured by enforcing intellectual property rights, becoming the second source of rents next to finance, according to some estimates. All this suggests that the major sources of US corporate income are essentially rents in nature, very far from any kind of liberal capitalist model. Besides financial and Schumpeterian rents, the increasingly oligopolistic nature of international markets points to the concentrated nature of the commanding heights of the global economy.

## Financial Globalization

The international monetary and financial "nonsystem" from the early 1970s resulted in what management guru Peter Drucker referred to as the "new world economy" when he noted that 89 percent of cross-border currency transactions in 1985 did not involve the real economy, that is, the international trade in goods and services.[17] At the time that the Asian crisis broke out in 1997, this figure had gone up to 97 percent. And despite the understanding at Bretton Woods that the capital account is subject to sovereign management (see article 6 of the IMF's Articles of Agreement), there has been considerable pressure during recent decades to encourage countries to liberalize their capital account. This has been very problematic for middle-income developing countries and other emerging markets. Instead of a net flow of capital from the capital rich to the capital poor, the reverse has been true, with the emergence of the United States in the past decade as the world's single largest debtor. Ironically, these flows of capital constitute the world's largest foreign-aid program to the richest economy in the world. The Nobel laureate Robert Lucas has highlighted this as a paradox from the perspective of (neoclassical) economic theory.[18]

All this has resulted in what has been called financial globalization.[19] And at least two recent chief economists found, much to their surprise, that financial globalization has not brought about the beneficial effects for development which they had presumed. Also, contrary to the claims of the proponents of financial liberalization and globalization, the cost of funds did not really go down with financial deepening. Instead, greater intermediation with financial deepening, greater financial rent capture (noted earlier), and other factors have contributed to the cost of funds not going down except due to US Federal Reserve policy on interest rates. In addition, financial globalization—involving financial liberalization at the global level, giving rise to financial deepening, and so on—was expected to reduce volatility and increase stability, but the contrary has happened. While financial volatility and instability have increased with reduced fetters on cyclical booms and busts, exaggerated by debt financing, the frequency of financial crises has also grown in recent decades. Owing to Western-prescribed "shock therapy" and greater enthusiasm for market reforms, popularly seen as the repudiation of the command economies, the so-called transition economies of eastern Europe and the former Soviet Union moved much faster in the direction in which developing countries were being encouraged to move. Many transition economies enthusiastically embraced the antithesis of what they considered to be socialist central planning, starting almost from scratch, thus hastening the pace of financial liberalization. And so the transition economies became exaggerated caricatures of the other so-called emerging markets. In contrast, many developing countries had to be induced with either carrots or sticks. Conditionalities had to be imposed, and governments often had to be pushed to adopt such reforms. Not surprisingly, the transition economies have experienced the most adverse consequences of the recent crisis.[20]

In developing countries and transition economies, foreign direct investment has been favored in recent decades. With deindustrialization in the transition economies and in many developing economies, domestic wealth accumulation and entrepreneurship have moved increasingly from the real economy to the world of finance. The possibilities of financial arbitrage thus become extremely profitable and attractive. All this was reinforced by greater emphasis on business school and other types of financial education and training which promoted greater short-termism in business and the efficient market hypothesis that works through arbitrage. All this, in turn, enhanced the financialization of the economy and increased the volatility of exchange rates and the frequency of asset-price bubbles.

Not surprisingly, capital inflows to these emerging-market economies were largely short term in nature. These flows nevertheless contributed to asset-price bubbles—in stock markets and property markets—and sometimes resulted in construction booms. Often, they helped finance consumer binges—usually of imported luxury products. In some cases, the availability of cheap credit resulted in overinvestment, with very important consequences for prospects of recovery from the current crisis.[21]

## From Financial Fragility to Crisis

This crisis was very specifically foretold, not just in the broad sense that theories of currency crisis or financial crisis have anticipated crises. This crisis was anticipated by the UN system (UNCTAD and UNDESA) as well as by the Bank of International Settlements. The G24, a caucus of developing countries in the Bretton Woods institutions, actually published work which warned of the likely consequence of what was happening in the US subprime-mortgage market in the second quarter of 2007, at least one quarter before the subprime-mortgage market burst at the end of the summer of 2007. Also, there were warnings from academics such as Joseph Stiglitz, Robert Shiller, Nouriel Roubini, and others that the bubble and the imbalances were unsustainable. But their warnings were ignored by most market players and by the international financial institutions. The world was lulled into complacency by the very institutions with the responsibility to warn the world and to try to counter this unsustainable pattern. In fact, both the IMF and the World Bank were optimistic about the continuation of the boom, and if there were any slowdown, they predicted it to be a soft landing and localized.[22] Thus, not surprisingly, many observers now hold the Bretton Woods institutions (BWIs) culpable for the human tragedy and other adverse consequences the crisis has caused.

First, there was the problem of growing financial fragility, exacerbated by the pressures for and trends toward financial liberalization, at both national and international levels, with the latter involving financial globalization. Second, the problem of unsustainable global imbalances had been growing over the previous half decade. The failure to create an independent international currency reserve system as part of the postwar BW system and to address other related problems resulted in President Nixon's ending of the BW system in 1971. In 1985, the Plaza Hotel accord responded to another manifestation of this recurring problem, then involving Japan—rather than western Europe, as in the late 1960s and early 1970s—while China figures more prominently this time around.

On all three occasions, the dollar's role as the world's reserve currency allowed the United States to run huge current account deficits with the rest of the world, undermining confidence in the dollar and the willingness of others to continue to accumulate dollar assets. Ending the BW system in 1971 and moving to flexible exchange rates allowed the dollar to depreciate after the mid-1970s. Similarly, the Plaza Hotel accord was followed by the decade-long *endaka* (high yen period), characterized by the depreciation of the greenback against the yen and other currencies. Holding three trillion in dollar assets, including over a trillion in US Treasury bills, the Chinese government and many state-related enterprises stand to lose a great deal from another US dollar depreciation against the renminbi, which is the basis of the current Chinese dilemma with regard to this inevitability. US denial of the problem by portraying the United States as doing a favor to the world, especially the East Asians and particularly the Chinese, by absorbing their "excessive savings," served to sustain the mid-2000s boom based on a bubble made possible by US Federal Reserve–enabled "cheap credit" sustained throughout the decade.

## Impacts on Developing Countries

The current crisis has had many impacts on developing countries. In the financial sector, one especially problematic consequence has been the higher cost and reduced availability of credit, particularly problematic for financing trade because much trade finance is short term in nature. The rise in the cost of trade finance is especially serious because one major consequence of the past three decades of structural adjustment and other economic reforms has been far more integration into the world economy and far more trade orientation than ever before.

Another major consequence has been a reverse "wealth effect," exacerbated by the high levels of inequality associated with the concentration of greater financial power and its ability to dictate public policy. This has exacerbated world inequality, including wealth inequality in recent years.[23] A third effect of the crisis in the real economy has been a significant reduction of demand. This has meant that for developing countries, which have become much more export oriented, there is less of a market for their exports, resulting in a tremendous collapse in commodity prices. In the past three decades, sub-Saharan Africa as a region particularly has done badly, except for the half decade before the crisis. During 2003–8, over half the countries of sub-Saharan Africa were able to grow by over 6 percent, largely due to increased commodity, especially mineral, prices and investments associated with producing them. Now, all that has come to an end very abruptly.

In a sense, the world economy has slowed down altogether, very different from the situation in the late 1970s. The late 1970s in the Western economies were characterized by stagflation, slow economic growth and high inflation. This provided the pretext for the academic, ideological, and policy counterrevolution against Keynesian economics—and against development economics. But despite this stagflation in the West, there was high economic growth in much of Latin America and Asia, although sub-Saharan Africa was most adversely affected by the oil-price increases.

The late 1970s contrast in economic performance in different parts of the world economy has not been as significant during this crisis, as all economies have been adversely affected in a far more integrated world economy after three decades of globalization, or international financial and trade integration. Of course, the impacts of the crisis have been uneven, with some countries perhaps less affected than others. This has led to the thought of decoupling in some large developing countries, with larger domestic markets, such as India and Brazil. Ironically, on the one hand, it is claimed that these economies had successfully integrated into the world economy, but at the same time, it is claimed that they had decoupled. This decoupling thesis seemed to have some basis in the evidence of their economic performance, but by the end of 2008, as the crisis spread, nobody really believed in decoupling anymore.[24] Nonetheless, the existence of a large domestic market has meant that these economies could resort to domestic demand instead of relying on the previously favored export-oriented economic growth strategy. Hence, it has been possible for countries such as India and China to counter some of the worst adverse consequences of what was happening in the world economy through domestic measures.

## Social Impacts

In 2010 the political setback experienced by President Obama's Democratic Party seems to have drawn greater attention to the continuing rise of unemployment despite some indications of economic recovery since more than half a year earlier. There is also greater acknowledgment of the seemingly growing lag between output recovery and job recovery, as highlighted by the International Labour Organization's International Institute of Labour Studies. In the United States, there is growing recognition that recovery measures have mainly favored politically influential large corporations deemed "too big to fail," while those commanding less political influence have received less attention. In Europe and elsewhere, there are growing fears that the time-bound nature of most "automatic stabilizers" will soon expire, reducing the social protection from which many of the vulnerable have so far benefited.[25] With the decline in social provisioning in transition economies and middle-income developing countries over recent decades, there is a heightened sense of vulnerability widely felt in such economies, especially those most adversely affected by the economic crisis. In the poorer economies, the impact of the global financial and economic crisis comes on top of a series of catastrophes including those associated with higher food prices, more extreme weather conditions, greater market vulnerability, lower commodity prices, the decades-long development crisis, and, often, civil conflict and violence fed by these very conditions.

In 2009, the ILO forecast that at least two hundred million working people would slip below the poverty line due to the crisis; these working poor are quite different from those who are poor because they are unemployed or underemployed. The ILO also projected that unemployment would rise by over fifty million due to the crisis. These ILO projections were based on the IMF projections of November 2008. The ILO did not revise these forecasts, although subsequent IMF projections became increasingly dire before the September 2009 projections suggested a tentative recovery from the second quarter of 2009. The latest estimates by the World Bank in its *Global Economic Prospects 2010* show that there would be at least sixty-four million more extreme poor due to the crisis. According to the United Nations' *World Economic Situation and Prospects 2010,* between forty-seven and eighty-four million more people are estimated to remain poor or to have fallen into extreme poverty in developing countries than would have been the case had the crisis not occurred.

Social spending is at risk. Slower growth, reduced export earnings, fiscal constraints, and other deflationary tendencies will all adversely affect the internationally agreed development goals, including the Millennium Development Goals (MDGs). There has been increased social—and political—unrest, and in early 2009, the diverse US intelligence community agreed that the single greatest threat to world as well as US security comes from the crisis.

The social impacts of all these developments have been quite different and are likely to be very uneven depending on context and over time. Livelihoods are being threatened in important ways, with unemployment and incomes hit for a variety of reasons. Social spending will be badly affected by old and new fiscal constraints. Social spending is already relatively low in developing countries, averaging 11 percent of total public expenditure. Government spending on social services is likely to contract, despite greater need for it, with important human welfare consequences. The ability to respond to the H1N1 pandemic may be worse than the inadequate response to the avian-flu pandemic before that. Likewise, this reduction in government spending will compromise our ability to respond to a whole host of economic security threats as well as other social problems.

## Responses to the Crisis

Policymakers initially responded in piecemeal fashion to the turmoil, failing to see the systemic risk and the global ramifications of which the symptoms were already being felt in 2007. The initial approach included massive liquidity injections into the financial system and the bailout of some major financial institutions. As the crisis intensified in September 2008, crisis management became more comprehensive and better coordinated. The measures have reshaped the previously deregulated financial landscape. Globally, government-guaranteed funding for rescuing financial-sector operations is estimated at about US$20 trillion, or some 30 percent of world gross product (WGP). Fiscal stimulus packages totaled about US$2.6 trillion (or 4.3 percent of WGP) during 2008–10. Furthermore, there have been drastic cuts in policy interest rates and massive liquidity injections.

In some developing countries, there was a tendency to deny the impact of the crisis by claiming "decoupling," effectively denying the consequences of globalization and international economic integration. Incredibly, those who once celebrated globalization have also claimed that decoupling had taken place. Since the origins of the crisis are external, the vulnerability of the system itself is sometimes said to have been exaggerated.

In different contexts, various social groups have different influences on budgetary processes. The fiscal process is, of course, fundamentally redistributive on the taxation side as well as on the expenditure side. Broadly speaking, direct taxes tend to be more progressive than indirect taxes. Generally, developing countries and transition economies have poorer populations as well as lower rates of tax-revenue capture. Developing countries and transition economies have far less fiscal space.[26]

Reduced fiscal capacity basically undermines most state capacities as well as policy space, whether for development or for reflation in the context of the current crisis. All this has also meant the weaker ability of many governments to deal with social conflict. The consequence of this, in extreme circumstances in some places, is what are called fragile and failed states. But this prior weakening of state capacity is partly due to this manufactured fiscal crisis, a consequence of policies required or expected of governments under the liberalization and globalization drives and exacerbated by the current crisis.

Nationalization is said not to be an option because the United States has eschewed this option despite making available considerable public resources for financial-sector rescues. In the United States especially, nationalization has rarely been seriously considered because private ownership is deemed better in all circumstances. Hence, despite the US government's undertaking early measures to reflate the economy and to bail out financial institutions and automobile manufacturers, such lifelines were provided with few requirements, for example, to allow government a voice in management, to change executive remuneration, or to agree to stricter regulation in the case of financial institutions, or to accelerate the transition to the widespread use of electric cars as a contribution to reducing fossil-fuel use in the case of the car industry, let alone government ownership. Some Europeans have claimed that almost any recovery measure—fiscal or monetary—is potentially inflationary, and they have basically argued for not doing anything more than what has already been provided for in the form of preexisting "automatic stabilizers." These were first developed in the "social market" economies of the Continent in the early postwar period referred to as the "golden age" and are now considered more than adequate to deal with the new situation. The debate over appropriate policy responses reflects, but also influences, the character of the social interests involved.

The trends associated with financialization have ensured the dominance of finance over the real economy. Meanwhile, a growing lobby opposing deficit-financed reflationary efforts has been gaining influence, mainly by invoking the prospect of inflation due to debt-financed recovery measures; they invoke evidence of "green shoots" of recovery since mid-2009 to oppose further monetary and fiscal reflationary efforts and already argue for winding down the reflationary measures undertaken thus far, for fear of the dangers they pose, especially that of inflation. They insist that the recovery is sustainable, despite many doubts to the contrary.

## The Prospects for Recovery and the Significance of Delays

Although the worst seems to be over, the recovery is uneven, and conditions for sustained growth remain fragile.[27] As the positive contribution of fiscal stimulus and the restocking of inventories by industries wanes, growth will slow. This is in part because spending by households and the banking sector will be less buoyant as they repair their balance sheets. Credit conditions are still tight in major developed economies, where many major financial institutions need to be restructured. Consumption and investment demand will also remain weak due to a continued rise in unemployment and underemployment rates as output gaps remain wide in most countries. Global economic recovery is therefore expected to remain sluggish—projected to grow by only 2.4 percent in 2010. However, the level of world economic activity will be around 7 percent below where it might have been had precrisis growth continued.

Three problems for economic recovery demand attention. First, delay in adopting stimulus measures in many economies has resulted in even greater delays in recovery. There is evidence of this from the last two major downturns in 1991 and 2001. Second, there is often a big lag between output recovery and job recovery; in 1991, the lag was about two and a half years, but for 2001, the lag was about four years.[28] This is important because the only way to eradicate poverty is through job creation. Third, the availability of cheap credit before the crisis encouraged overinvestment, which has resulted in excess capacity in many sectors and, consequently, a greater reluctance to invest currently. This reluctance to invest is going to delay recovery in important ways.

## From G7 to G20

More recently, there has been a coup d'état of sorts in the global coordination of the recovery process. When President Nicolas Sarkozy of France recognized, in October 2008, that turning back to the G7 was not going to achieve much, he met with the United Nations secretary-general and then-president George W. Bush, who immediately agreed to host in Washington, DC, in mid-November, a G20 Summit, or more accurately, the first meeting of G20 members at the leaders', rather than at the finance ministers' level.

The G20 had already existed for a decade before that: Paul Martin, the finance minister of Canada, had created the G20 after the 1997–98 Asian crisis. But nobody paid any serious attention to the G20 in that decade. Suddenly, the G20 was given new significance and was no longer meeting at the finance ministers' level but at the leaders' level. Of course, everybody who was invited was happy to be invited, and Spain and Holland insisted on getting invited and succeeded; a number of other countries tried to get invited but were kept out.

Some commentators have described the September 2009 G20 Pittsburgh summit as a coup by the G7, capturing the G20 by reverse takeover. The earlier G8+5 arrangements were clumsy and even insulting to the five, so that they were not viable anymore and basically needed something which was more inclusive and hence more likely to enjoy greater legitimacy than the G7. The G20 is likely to be institutionalized in some important ways in the near future—for example, there is still no permanent secretariat of the G20. Already, there are latent tensions with the Bretton Woods institutions where representatives of smaller European countries not in the G20 have not appreciated the expectation that their boards will merely rubber-stamp G20 decisions. Also, the ad hoc character of the G20 has meant that much depends on the initiative, preferences, and efforts of the host government, as evident when comparing the outcome of the April 2, 2009, London summit with the Washington and Pittsburgh summits.

One alternative is a Global Economic Council (GEC) or Global Economic Coordinating Council (GECC). Chancellor Angela Merkel of Germany, for example, has also spoken of some such arrangements, while Kemal Dervish, then UNDP administrator, has suggested the idea of an L27, half the size of the United Nations Economic and Social Council (ECOSOC), with a degree of representativeness and accountability. Here, the UN system can learn from the Bretton Woods system, where the representative for a constituency is held accountable in important ways by all members of that constituency. Of course, the G20—in effect, the L22 now, although if you removed the EU, it is 21—can always meet as a policy forum, but an effective alternative at the leaders' level in the form of the GECC is more likely to enjoy greater legitimacy, as it would be more inclusive and accountable. This would most certainly strengthen the broader commitment to inclusive multilateralism which has been increasingly threatened in recent years by decisions imposed on the international community by exclusive groupings of powerful countries as well as other plurilateral arrangements.

## Prospects for Systemic Reforms

The near-term prospects for recovery turned better since late 2009 than they were earlier in the year. However, the discourse on addressing the crisis has focused on restoring financial stability and improving risk management, with very little attention to the more ambitious types of reforms President Roosevelt tried to bring about at Bretton Woods. As mentioned earlier, even though the United Nations did not formally exist in 1944, the BW conference was officially called the United Nations Conference on Monetary and Financial Affairs—forty-four countries attended, of which twenty-eight were developing countries. And with the support of other countries such as the then Soviet Union, a postwar reconstruction and postcolonial development agenda was successfully advanced at BW.

That is missing in the more recent discourse, including that initiated by the G20. There is also no mention of trying to develop a much more inclusive financial system. The current discussion has also failed to address other challenges of this era, including the challenge of sustaining growth and employment creation as well as postconflict reconstruction. It does not even rise to the challenge of BW or the reality that we have been living with what the late Robert Triffin called a "nonsystem," as the BW system was destroyed but not really replaced in 1971. The ad hoc nature of subsequent international monetary and financial reforms has largely been in response to the concerns of the most powerful economies and do not amount to a system with potential for self-correction.

## Summary

The original promise of Bretton Woods—to create an international economic and trading system with monetary and financial stability conducive to sustained economic growth and employment creation, postwar reconstruction, and postcolonial development—has been undermined by a flaw in its creation, namely, the use of national (or regional) currencies as the international reserve currency. The dollar's role as the international reserve currency since the 1940s has encouraged major US current account deficits, which have subsequently undermined its role as the international reserve currency and contributed to the crises in 1971, 1985, and 2008. Of course, a range of other problems have also contributed to these crises, and the failure to develop an international financial architecture since 1971 has served to exacerbate the problems.

Most important, the transformation of the world economy over the past three decades has served to compound the problems. Economic globalization has involved much greater international financial and trade integration. Financial globalization has worsened volatility and instability besides draining scarce financial resources from most developing countries and neither contributing to economic growth nor lowering the cost of funds. Capital account liberalization has been particularly disruptive, encouraging short-term cross-border flows, which in turn undermine the availability of long-term investment finance and thus contribute to consumer binges and even disruptive overinvestment.

The asymmetries of global economic power have allowed a few powerful governments to undertake debt-financed recovery measures, while the vast majority of governments have not been allowed to do so. Economic recovery has come earlier and stronger in those countries which have undertaken such steps, but there is growing pressure—invoking the threat of inflation due to deficit financing of recovery measures—to reverse them following the tentative recovery since mid-2009. Although the complacent claims of "decoupling" in the larger developing countries such as India and Brazil wrongly denied prior economic integration, their surviving capital account management practices as well as larger domestic markets undoubtedly served to reduce the adverse impacts of the crisis on their economic performance.

The global financial and economic crisis has had devastating social consequences all over the world. In the United States, millions of jobs have been lost and incomes reduced, while the values of financial and real property assets have shrunk drastically, exacerbating a host of social problems in a society offering less social protection than that in most other developed economies. Although social provisioning can play an important countercyclical role, these measures are far more pronounced in other developed economies. Economic recovery measures have mainly benefited large financial and automobile corporations, with relatively little going for social provisioning or toward economic recovery on a more sustainable basis, for example, promoting renewable-energy use or public transportation. Developing countries able to undertake economic recovery measures have generally emphasized social protection and long-term economic development measures, thus slightly reversing the growing external market orientation of economic reforms over the previous three decades.

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Chapter 5

# Bridging the Gap: A New World Economic Order for Development?

*Manuel Montes and Vladimir Popov*

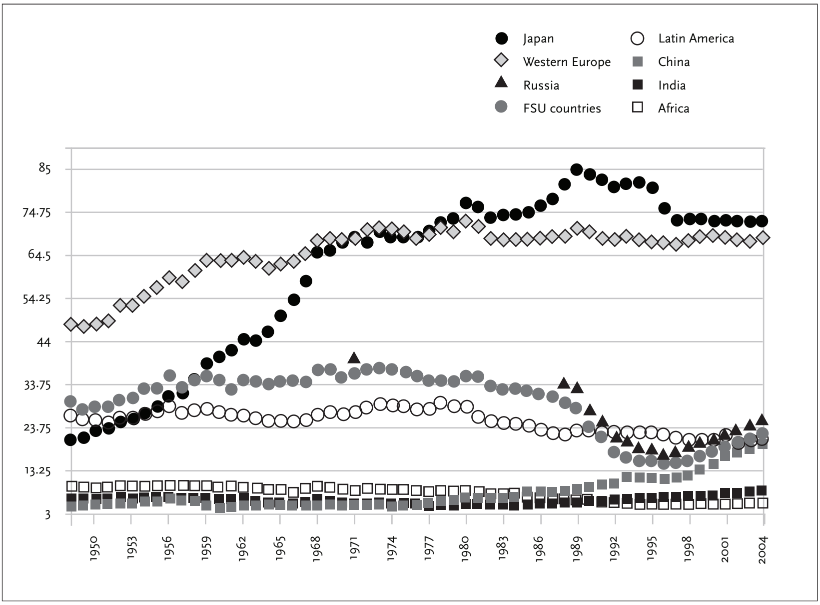
## Introduction: Trends in North-South Economic Relations

In 1500, the ratio of average per-capita income in the North to that in the South was approximately 1:1; in 1900, it increased to 6:1 and stayed at this level for the next one hundred years (if China is excluded, the ratio actually increased). It may well be that at the end of the twentieth century we reached a tipping point and that in the twenty-first century the gap between the North and the South is going to narrow (figure 5.1).

After World War II, the colonial empires collapsed, and many developing countries started to assert their economic independence (nationalization of resource industries). Since the first oil-price shock in 1973 and before the collapse of the USSR in 1991, the South on balance was able to bend the rules of the international economic game in its favor. True, after the collapse of the USSR and before the 9/11 terrorist attacks, "Washington Consensus" policies became important conditions for access to external finance for many developing countries. But after 9/11, it appears that developing countries once again have managed to enjoy improved terms of trade (through the increase in resource prices), and some of them have been able to pursue many growth-conducive policies in spite of pressure from the West.

The USSR in the 1930s–'60s was the first major non-Western country to experience successful catch-up development and to narrow the

Figure 5.1: PPP GDP per capita (in 1990 International Geary-Khamis dollars) as a % of the US level




Source: A. Maddison, "Statistics on World Population, GDP and Per Capita GDP, 1–2006, http://www.ggdc.net/maddison/historical_statistics/horizontal-file_09-2008.xls

gap with the West, although afterward (1970–'80s) the gap stopped narrowing, and later (1990s) it widened. Japan, South Korea, Taiwan, Hong Kong, and Singapore in the 1950–'80s were the only states that successfully caught up with the West and became developed countries. In the past several decades, a similar process has been under way in Southeast Asia and in China. Together with the recent acceleration of growth of India and in some other developing countries, it could mean that we have reached a tipping point in the Great Divergence and that from now on the world will experience a gradual global convergence in the level of income.

An unexpected consequence of China's rise is the creation of favorable conditions for the catch-up development of all countries of the South. The result may be the bridging of the gap between the world rich and the world poor, between the West and developing countries. Even in the last two decades of the twentieth century, this gap in fact was widening for all developing countries as a group, if China is excluded.[1] Now, in the twenty-first century, the rise of China is making the dirigisme-based model of catch-up development not only attractive but also legitimate and is creating a new international economic climate favoring such a catch-up.

New export-oriented growth model à la East Asian Tigers seems to be successful, and it is not based on the "Washington Consensus." It includes, but is not limited to, the following:

- Building strong state institutions capable of delivering public goods (law and order, education, infrastructure, health care) needed for development
- Gradual market-type reforms
- Export-oriented industrial policy, including such tools as tariff protectionism and subsidies
- Prudent macroeconomic policy—not only in the traditional sense (fiscal and monetary policy) but also exchange-rate policy: undervaluation of the exchange rate via rapid accumulation of foreign exchange reserves

This model is now an object of imitation by many developing countries, conscious or unconscious, depending on their national political arrangements. We may well witness the triumphal march of the Chinese model in the South. If so, it would also become increasingly obvious in the process of successful catch-up development that the previous policy that the West recommended and prescribed to the South (deregulation, downsizing the state, privatization, free trade, and capital movements) was in fact hindering rather than promoting development in those countries. As the strength of the South increases, it can and will push for changes in international economic relations that are more conducive to its catch-up development.

The creation of a new world economic order, a popular demand of the South in the 1970s–1980s, after the first and the second oil-price shocks, may be back on the agenda of North-South negotiations with the rise of China. "Democratization" of international economic relations—that is, the adoption of rules of the game that are favorable for the development of the South—together with the proliferation of the new Chinese growth model in the developing world, has the potential to make globalization good for the poor.

A large body of literature has emerged in recent years questioning the universality of recipes for economic reform. It states that what may be good for developed countries is not necessarily good for countries that are further away from the technological frontier and are catching up with developed nations. A simple enumeration of the areas where market-type reforms are found to be detrimental for less developed countries is quite impressive: free international trade and migration of skilled labor, elimination of subsidies to producers and promotion of competition, liberalization of capital flows and deregulation of domestic financial markets. The general conclusion of such studies is that developing countries should not embark blindly on market-friendly policies and reforms, even if they have proved to be beneficial in more advanced countries. On the contrary, in other areas, such as the protection of intellectual property rights, Western regulatory requirements are perceived to be too constricting for poorer countries.

In addition, there are studies that question the fairness of applying the Western pattern of tradeoffs between different development goals (wealth, education, life expectancy, equality, environmental standards, human rights, etc.) to less developed countries. Policies that prohibit child labor, for instance, may be an unaffordable luxury for developing countries, where the choice is not between putting a child to school or into a factory shop but between allowing the child to work or letting the child die from hunger. The marginal cost of adopting stricter government regulations in such areas as environment and human rights (reproductive rights, work conditions and safety standards, children's and prisoners' rights, and even political rights) in developing countries, in terms of deterioration of other developmental indicators (life expectancy), may be prohibitively high.

The argument in both cases is that most Western countries one hundred years ago did not have either laissez-faire markets or today's strict standards of protection of environmental and human rights. By advocating these standards in less wealthy parts of the world, and even threatening developing countries with economic sanctions if they refuse to accept such standards, the West, whatever its good intentions may be, de facto undermines the competitiveness of poorer countries and preserves their backwardness. There are even accusations of a double standard (when the West was industrializing, it was not maintaining these standards) and "kicking away the ladder" (after the West got rich through exploitation of colonies and child labor, it does everything to slow down the growth of "the other world").[2]

Below we examine several major areas in which the economic interests of the West and the South diverge.

## Industrial Policy and Protectionism

Fast-growing countries are usually more involved in international trade—they have higher and faster-growing trade-to-GDP ratios. In addition, there is a correlation between the share of investment in GDP and the share of export in GDP—countries which export more invest more as well. However, fast-growing and more intensively trading nations are not always and were not always more open to trade (with low tariff and non-tariff barriers) than their less globalized competitors.

The debates on whether free trade or protectionism is more conducive to growth are as old as economic research itself. In the nineteenth century, although detailed statistics do not exist, there are some powerful examples suggesting that the growth-promoting nature of free trade is not obvious: China after the Opium Wars had to open its economy to international trade completely, but GDP per capita in 1949, when the Communists took power, was at the same level as in 1850; one hundred years were lost for growth despite pervasive openness. Recent empirical studies have found that there is no conclusive evidence that free trade is always good for growth:[3] whereas protectionist countries grew more rapidly before World War I, they exhibited lower-than-average growth after World War II.

It appears that the impact of trade protectionism on growth depends on the level of development (distance to technological frontier) and on the quality of institutions. Cross-country regressions identify the thresholds in per-capita GDP and institutional indicators that separate the positive and negative influence of trade protection on growth.[4]

Two recent papers propose some theoretical explanations for these stylized facts,[5] arguing that the impact of particular policies on economic performance depends on the distance from the technological frontier—the larger the productivity gap between the country in question and the most advanced (Western) economies, the more likely that interventionist policy, by encouraging investment into a catch-up pattern of development, would be beneficial. The authors actually extend these principles to a number of policy areas (promotion of vertical integration and imitation of technology versus indigenous research and development—the larger the distance to the frontier, the greater the returns from vertically integrated companies and from reliance on imported technology), but the principle can be extended to protectionism as well.

The debate, in fact, is even more general—it is about the impact of industrial policy in a developing economy, not only about trade protectionism, which is no more than just one tool of industrial policy.[6] Whereas for developed countries industrial policy may be of little use, for countries that are catching up, appropriate (often export-oriented) industrial policy promises high returns. With respect to rapidly growing countries of East Asia, this argument was made in the World Bank development report *East Asian Miracle,*[7] but the issue is by no means settled, and the controversies continue. There were only five countries that managed to transform themselves in the second half of the twentieth century from developing into developed (Japan and the four Asian Tigers—Hong Kong, Singapore, South Korea, Taiwan); all these countries relied heavily on various industrial policy instruments, including protectionism.

World Trade Organization (WTO) rules limiting increases in protection of domestic markets, except for special circumstances, may thus actually be destructive for developing countries, even setting aside for the moment the most damaging cases, such as WTO recognition of agricultural subsidies in Western countries.

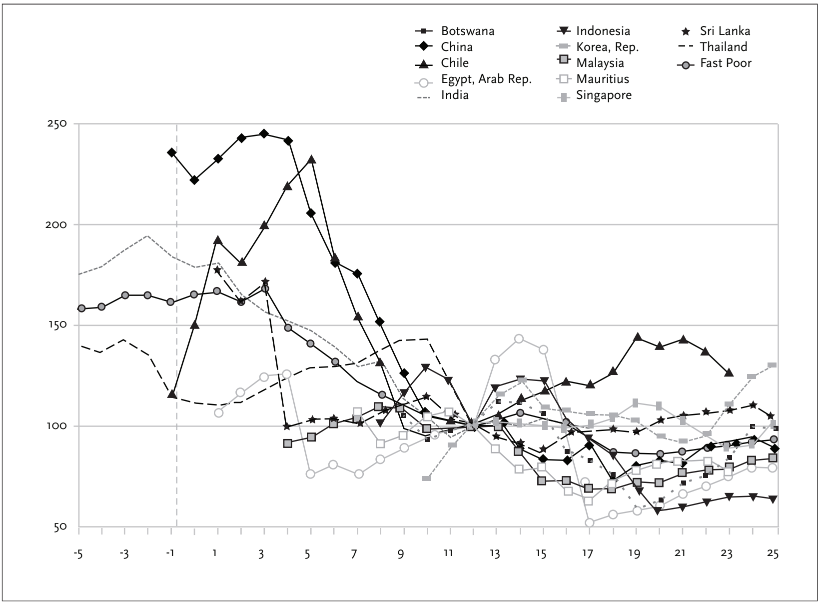
## Foreign Exchange Reserve Accumulation

Fast-growing countries often have undervalued exchange-rates of currencies (that is, ceteris paribus, a lower ratio of domestic to US prices), which is often achieved through a rapid accumulation of foreign exchange reserves (FER) (figure 5.2). As a result, there is a positive correlation between the accumulation of reserves, the share of investment in GDP, and economic growth. It has been shown that for developing countries an overvaluation of the exchange rate is detrimental to economic growth (as indicated by the positive impact of exchange-rate undervaluation in standard growth regressions).[8] Dani Rodrik believes that large real exchange rate devaluations have played a big role in some of the more recent growth accelerations, notably in Chile and Botswana, although not in East Asia.[9] As a UN policy note suggests,

> Exchange rate policy, then, is not simply a tactical matter of getting-prices-right, but may turn out to be a strategic matter of a deliberately undervalued exchange rate, maintained over a period of time, to provide an entry into the world market for differentiated manufactured goods. Several Asian countries have used such strategic exchange rate policy to promote manufactured exports. Similarly, the build-up of the Chilean boom of the 1990s was clearly preceded by a weak exchange rate policy in the late 1980s and early 1990s.
>
> A competitive exchange rate is seen today as an essential ingredient of dynamic growth and employment in developing countries. It allows domestic firms to benefit from rapid growth in international trade and attracts international firms searching for the best location for their worldwide sourcing of their goods. This may also have positive spillovers for domestic technological development, and lead to a process of learning how to produce with the best technologies available, and with the best marketing tools for the global economy. Furthermore, a competitive exchange rate means that spillovers of export production on other domestic sectors are enhanced, as exporters find it more attractive to buy the inputs and services they need domestically. In a world of reduced trade barriers, import-competing sectors see a competitive exchange rate as their major (and perhaps only) source of protection.[10]

Empirical evidence suggests that the accumulation of foreign exchange reserves contributes to economic growth of a developing economy by increasing both the investment-to-GDP ratio and capital productivity.[11] First, FER accumulation causes real exchange rate undervaluation that is expansionary in the short run and may have long-term effects, if devaluations are carried out periodically and unexpectedly. Second, real exchange rate undervaluation permits taking full advantages of the export externality

Figure 5.2: Average real exchange rate versus the US $ (Year 12 = 100%) in fast growing developing economies, year "0" denotes the point of take-off

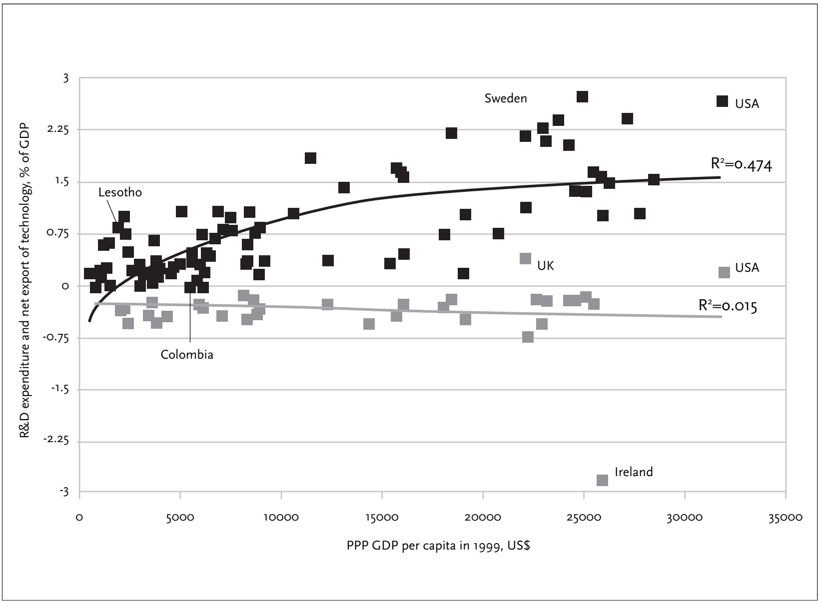



Source: Victor Polterovich and Vladimir Popov, "Accumulation of Foreign Exchange Reserves and Long Term Economic Growth," in *Slavic Eurasia's Integration into the World Economy*, ed. S. Tabata and A. Iwashita (Sapporo: Slavic Research Center, Hokkaido University, 2004; updated 2006).

and triggers export-led growth. This is sometimes called "exchange rate protectionism" and quantitatively is considerably more important than conventional trade barriers.[12] Third, an FER buildup attracts foreign direct investment (FDI) because it increases the credibility of the government of a recipient country and lowers the dollar price of real assets. This third mechanism can operate even with exchange rate overvaluation, if benefits from FDI inflows exceed costs of not fully utilizing the export externality.

In practical terms, there are no formal limits for the accumulation of reserves by developing countries, but exchange rate protectionism can result in beggar-thy-neighbor policies—obviously all countries cannot exercise these policies at the same time. China did not devalue the yuan versus the dollar after the 1997 Southeast Asian currency crises, mostly on political grounds. China bore an economic cost, since its exports were competing with ASEAN exports in Western markets, for the sake of preventing further collapses in the exchange rates of its neighbors and

Figure 5.3: R&D expenditure and net export of technology (receipts of licence fees and royalties minus payments of licence fees and royalties) in 1980-99, % of GDP, and PPP GDP per capita in 1999, US$




Source: World Economic Development Indicator database, World Bank.

promoting East Asian solidarity. If China devalued its currency, it is possible that exchange rate protectionism of developing countries might have provoked conventional protectionism in the West. The Plaza Accord of 1985 involved the coordinated efforts of major Western countries to appreciate their currencies against the dollar in order to reduce the US trade deficit; as a result, the Japanese currency appreciated from 240 yen to the dollar in 1985 to below 100 yen in 1995—a major reason for the slowdown of Japanese growth in the 1990s, as many economists acknowledge.

## Imitation versus Innovation and Protection of Intellectual Property

To what extent should a developing country rely on technology transfer from the West, and what should be its own innovation efforts? Is there an optimal strategy to shorten the distance in technological levels from more developed countries? What should be the regime of technology transfers that maximizes welfare? As Figure 5.3 suggests, research and development (R&D) expenditure as a percentage of GDP appears to increase with the growth of GDP per capita, but there is no apparent link between the level of development and net transfer of technology.

The current dominant wisdom is that intellectual property rights have to be protected to support private innovation. TRIPS (trade-related intellectual property) rules that resulted from WTO agreements require the protection of patents for no less than twenty years and the protection of copyrights for no less than fifty years. There are several reasons why these rules impede growth in developing countries.

First, stricter protection of intellectual property rights is a double-edged sword: it stimulates innovations by rewarding the inventor only at the price of inhibiting the dissemination, application, and adaptation of the invention. Many authors have cast serious doubt on the usefulness of stricter protection of intellectual property rights.[13] Mariko Sakakibara and Lee Branstetter studied the 1998 Japanese patent-law reforms and did not find any evidence of its positive impact.[14] These and a number of other results "raise the possibility that strengthened intellectual property rights have led to the socially wasteful accumulation of defensive patent portfolios."[15]

There are many alternative approaches to achieving the social purpose of encouraging private innovation, beyond the prevailing method of granting monopoly use to the inventor. One can imagine, for example, the following alternative regime of intellectual property rights. All inventions are registered by the state but enter the public domain not in twenty years, as it is the case today, but immediately. The inventor is rewarded by the state, with the reward being proportionate to the volume of output created in the first twenty years from the use of the patented technology. The reward to the inventor is paid either from the government budget or from a separate nonbudgetary fund. Resident firms can use the technology free of charge, whereas nonresidents pay for the patent to the state. The inventor in this case is rewarded, but not at the expense of slowing down the dissemination of his or her innovation.

Second, even if there is a need to protect intellectual property rights, there is no reason to force developing countries to protect them as strictly as developed countries do. In countless global pronouncements, the accelerated development of poor countries is an accepted priority for the world and for the rich countries in particular (since it reduces the threat of terrorism, for example). There seems to be a consensus among economists and policymakers that the transfer of technology to poor countries is the most efficient way of assistance. Yet the TRIPS disciplines are undoubtedly limiting the transfer of technology to the South.

It has been suggested that trade negotiators are "captured" by industry and that intellectual property policies can become overprotective even if trade-policy negotiators are equally concerned with all domestic interests, those of both consumers and producers, because intellectual property is the only available tool by which cross-border externalities can be recaptured by the innovating country. To a trade-policy negotiator, profit earned abroad is unambiguously a good thing, and the consumers' surplus conferred on foreign consumers does not count at all.[16] Whatever the reasons, the TRIPS regime is making it more difficult for poor countries to develop not only economically but also socially. Copyrights hinder the dissemination of information, knowledge, and culture, whereas patents on pharmaceutical products limit the ability of poor countries to fight diseases and decrease mortality. It is only in cases of national emergency, such as the AIDS epidemic in South Africa, that drugs can be purchased or produced with no regard to patent protection.

Third, even if there is a need for protection of intellectual property rights in developing countries, there is no reason to link it to the trade-liberalization agenda, as is currently happening within the WTO. The activities of the World Intellectual Property Organization (WIPO), which was founded at the end of the nineteenth century, have come under the domination of developed countries, undertaking technical assistance in implementing Western approaches to intellectual property protection, though recently the development agenda has been reintroduced through the efforts of developing countries. However, the enforcement of intellectual property protection is undertaken and introduced within the WTO framework through TRIPS. Whereas Western countries are in the minority and have less leverage over developing countries in the WIPO, in the WTO developing countries' access to Western markets is linked to the protection of intellectual property rights.

Developing countries thus find themselves between a rock and a hard place: either retain access to Western markets with little or expensive transfer of technology or use the technology with no access to Western markets. Meanwhile, to the extent that trade expansion has an intrinsic value for developed and developing countries, holding it hostage to the protection of intellectual property does not seem to be a rational policy.

Total losses of Western companies from piracy were estimated by the IIPA (International Intellectual Property Alliance) at US$16.4 billion in 2007 ($2.9 billion, China; $2.7 billion, Russia).[17] However, losses of developing countries from the implementation of TRIPS are several times higher; that is, piracy compensates only for a fraction of what developing countries are losing from TRIPS. Michael Finger, former chief of trade-policy research at the World Bank, estimates that through the TRIPS agreement, developing countries have taken on as a legal obligation a cost of $60 billion per year, but there is no legal obligation in the agreement for any member to provide anything in exchange.[18] A World Bank report estimates that the net annual increase in patent rents resulting from TRIPS for the top-six developed countries in this field will be US$40 billion (with the top beneficiaries being the United States with $19 billion, Germany with $6.8 billion, Japan with $5.7 billion, France with $3.3 billion, the United Kingdom with $3 billion, and Switzerland with $2 billion).[19] Developing countries that will incur major annual net costs include South Korea ($15.3 billion), China ($5.1 billion), Mexico ($2.6 billion), India ($903 million), and Brazil ($530 million). In addition, there are financial and human-resource costs for administering and enforcing intellectual property laws and policies—requiring legal reform, enforcement agencies, and legal expertise—that have to be borne by developing countries. By way of comparison, official development assistance (ODA) of Western countries to developing countries is only a little more than US$100 billion.

The costs of TRIPS for the Global South are high because developing countries are mostly importers/users of intellectual property. Out of 120,000 patent applications in 2004 (WIPO statistics), US residents accounted for 35 percent; Japan, 17 percent; Germany, 12 percent; and France and the United Kingdom, 4 percent, whereas all developing countries accounted for only 6.3 percent.[20]

Though in recent decades, the two kinds of systems of corporate financing and control—the Anglo-American (market based) and German-Japanese (institution or bank based)—were converging rather than diverging, substantial differences still persist.[21] First, in Japan, Germany, and other continental European countries, several major shareholders, normally banks, typically hold a substantial portion of total equity, whereas in Britain, the United States, and Canada stock ownership is much more dispersed. In a sense, large shareholders, that is, stakeholders, in the German-Japanese system have a more secure and stronger control over companies: hostile takeovers and leveraged buyouts reflect the absence of insiders' control on management and are common in the United States but not in continental Europe and Japan. Second, in the Anglo-American system, corporations rely more on internal sources of funds (undistributed profits plus depreciation) and hence are more independent from large banks: in 1970–85, these sources accounted for over three-fourths of total investment financing in the United States, Canada, and the United Kingdom, as compared to 52–71 percent in France, Germany, Italy, and Japan. A third difference between the two types of financial system is that the share of external financing provided by banks is usually greater in continental Europe and Japan, whereas American companies derive more funds from sales of securities. In the United States and Canada, bonds, short-term securities, and shares provide funds the equivalent of 50–75 percent of sums borrowed from banks; in Japan and continental Europe, less than 30 percent. Finally, the banking system in the United States is much less concentrated than it is in all other Western countries, which are dominated by the "big three" or "big five" largest banks.[22]

Overall, in market economies, bank credits and equity financing complement rather than substitute for each other: normally, the larger the bank credits, the higher the market capitalization. It has been shown that both greater stock-market liquidity and a deeper banking system contribute to higher rates of capital accumulation and economic growth independently of each other.[23] Moreover, in developing countries, greater stock-market liquidity is linked to a rise in the amount of capital raised through bonds and bank loans, so that corporate debt-equity ratios rise with market liquidity.[24] Nevertheless, it is meaningful that in Japan and in most western European countries, market capitalization is two or more times lower than total bank credits, whereas in the United States, the United Kingdom, the Netherlands, and Switzerland, as well as in some developing countries (Malaysia, Singapore, South Africa, Chile, Philippines), market capitalization is roughly comparable with total domestic credit provided by the banking sector.

Normally a financial system based on a strong securities market is considered to be more flexible and better suited for risky projects. Banks do not enjoy the position of strength vis-à-vis nonfinancial corporations, which rely mostly on internal sources of financing, whereas external sources are less important and include mostly sales of securities, not bank credits. The result is that there is no bank monopoly on financing: even when banks refuse to finance a particular project, it may still be carried out through other means. In the United States at least, as amply demonstrated by the ongoing financial crisis, even when bank financing is provided, the location of risk moves decisively outside of the banks, through vastly expanded securitization of bank loans.

In contrast, the Japanese (European) model implies that banks and financial institutions are in a position to influence investment decisions of nonfinancial companies. Both models have their advantages and limitations: the American model is usually perceived as a more competitive one, whereas the Euro-Japanese model is perceived as the one that allows for a reduction of risk, bankruptcies, and instability (but at a price of not undertaking too many risky projects).

Basically the difference between bank-based and securities-based financial systems is the difference between centralized and decentralized systems. The centralized institution-based system is superior for mobilizing financing for large-scale long-term projects that will yield results only some time in the future, but it is not so well suited for the evaluation and financing of millions of short- and medium-term risky projects. The decentralized securities-based system puts a price tag on every project (pricing them in the stock and securities markets),[25] but the risk is being borne by investors themselves, not by intermediaries (banks).

Many emerging-market economies took special measures to promote the development of stock markets, and some of them even tried to limit the credit expansion of banks by putting an emphasis on equity financing. Thus, the principal transactions bank and credit control systems introduced in South Korea in 1974 sought to encourage direct financing of large corporations through public offerings of shares while holding down borrowing from financial institutions.[26]

But differences in capital markets and financial systems across countries reflect not only economic outcomes—the competition between institutions, in which the most efficient institutions survive—but, at least in part, politics, history, and path-dependent evolution.[27] In emerging-market economies, the share of external financing is typically very high—over 50 percent, much higher than in mature market economies. The share of equity financing in total external financing is also high—over half of external financing, or over one-third of the total financing, which again is much higher than in Western countries. For instance, in Jordan, South Korea, Mexico, Thailand, and Turkey, the share of equity financing alone in 1980–88 was in the range of 40 to 70 percent, and in India, Malaysia, Pakistan, and Zimbabwe, it is in the range of 14 to 35 percent.

A high share of external and equity financing in developing countries is probably associated with the transformation of traditional business entities into joint-stock companies ("corporatization"). When this happens, the original owners can retain control of the company even after selling as much as half of its shares to outsiders; in practice, this provides them the unique opportunity to finance the bulk of their new investment from external sources for a number of years. Similarly, in the United States and other Western countries, equity financing was also very high at the end of the past century and the beginning of this century, when the same kind of transformation occurred.[28] In British industry in the interwar period, new issues of debt and equity were generally comparable with capital investment in tangible assets for most of the time, and the share of equity exceeded that of debt in total external financing (50 to 90 percent).[29]

It has been argued that stock markets and the Anglo-Saxon-type market for corporate control are too heavy a burden to bear in developing countries, since share prices are very volatile and encourage speculation rather than long-term investment.[30] Other scholars claim that at early developmental stages, it was typical for equity financing to play an important role in developed countries (beginning of the twentieth century) as well as in developing countries (now).[31] To obtain equity capital, a company should not necessarily possess an equivalent base of assets as security or a history of past dividend payment. Hence, newly emerging enterprises and industries tend to rely to a greater extent on equity financing than on debt. As W. A. Thomas shows, in Britain in between the two world wars, new industries, such as oil, vehicles, and aviation, tended to use equity finance, whereas traditional heavy industries, such as iron and steel and shipbuilding, relied more heavily on debt borrowing.[32]

Once again, here as in other areas, institutional arrangements that are appropriate for one stage of development may hinder growth at another stage and in different circumstances. It may also be the case that due to the path-dependent nature of development, replacing less efficient (but functioning and leading basically to the same outcomes) institutional arrangements with more efficient ones is not justified because of adjustment costs.

Moreover, it is often the case that the policy to increase reliance on equity and bond finance has been motivated by the intention of mobilizing private external finance and accompanied by policies to remove capital account controls. The resulting surges in capital flows, independent of external trade in goods and services, have often induced exchange-rate movements that disrupt domestic real-sector production and export development in emerging markets. The unstable and short-term nature of such financing often does not justify the cost to the real sector of removing capital controls.

## Liberalization of Capital Flows

Fast-growing developing countries often, but not always, experience significant net inflows of foreign direct investment. However, there are important exceptions: Japan and South Korea during their rapid growth. It is widely accepted that the inflows of foreign direct investment that are not volatile and that are often the most efficient channels for the new technology transfers are good for developing countries.

As Victor Polterovich and Vladimir Popov show, FDI inflows into countries with a poor investment climate do actually more harm than good.[33] First, there is the damage caused by self-selection: if the investment climate is bad, foreign investors come mostly for short-term profit and/or super-profitable resource projects, in which the transfer of technology, the main benefit of FDI, is at best limited. Second, foreign investors do not reinvest profits in countries with poor investment climates, so that the outflow of profits immediately outweighs the inflow of FDI. Third, purchases of companies in countries with bad investment conditions do not necessarily lead to an increase in total investment because the inflow of FDI is often completely absorbed by an outflow of short-term capital.[34] The worse the investment climate of a country, the larger may be losses from FDI and, hence, the greater the regulation of FDI by the state is required.

With respect to portfolio and especially to short-term capital flows, the balance of costs and benefits is even less encouraging. There is no evidence that the free movement of short-term capital promotes economic growth.[35] Whereas the conventional wisdom before the 1997 Asian currency crises recommended full liberalization of capital accounts, today's consensus, if any, leans toward the understanding that costs associated with free short-term capital flows (volatility) are too high, while benefits are not obvious.[36] The IMF has admitted that forcing developing countries to open their markets to foreign investors could increase the risk of financial crises. "The process of capital account liberalization appears to have been accompanied in some cases by increased vulnerability to crises," the IMF said in a report prepared by a group including its then chief economist, Kenneth Rogoff.[37]

## Migration

The most significant remaining restrictions and barriers in the world economy today are not those on international trade and capital flows but on the movement of people across national borders. "If international policy makers were really interested in maximizing worldwide efficiency, they would spend little of their energies on a new trade round or on the international financial architecture. They would all be busy at work liberalizing immigration restrictions."[38]

Compared to one hundred years ago, the world economy is much less globalized today in terms of the free flow of labor. From 1850 to 1914, migration from Europe to North America (arguably a North-to-North movement) involved about sixty million people, whereas the

South-to-South migration may have been even larger.[39] This means that annual migration flows in the early twentieth century, right before World War I—about two million people a year—were actually no less significant than they are now in absolute terms and were about four times more intense (as a proportion of the population) than they are now. Suffice it is to say that the US population in the nineteenth century was growing at about 1 percent a year due to the net inflow of migrants, whereas in the 1990s the population growth caused by this inflow amounted only to 0.3 percent. The pressure for migration, however, has not decreased; differences in wage levels in 2000 ranged from thirty-two dollars per hour in Germany to twenty-five cents per hour in India, whereas the progress in the means of transportation and communications obviously has reduced the costs of migration dramatically. To put it differently, the decrease in the international migration in the past hundred years is due primarily to the tightening of immigration control by Western countries.

In the neoclassical Heckscher-Ohlin framework, the free movement of labor, capital, and goods are substitutes, in the sense that the each of the three can lead to the reduction of wage differentials between the North and the South. There is really no purely theoretical argument which can justify free trade without at the same time justifying free migration.[40] To explain why it is to the benefit of Western countries to support free trade and to oppose the free movement of labor at the same time, one has to look at the gains from selective immigration of skilled workers ("brain gain") or at the cost of public goods and redistributive policies in the rich countries.[41]

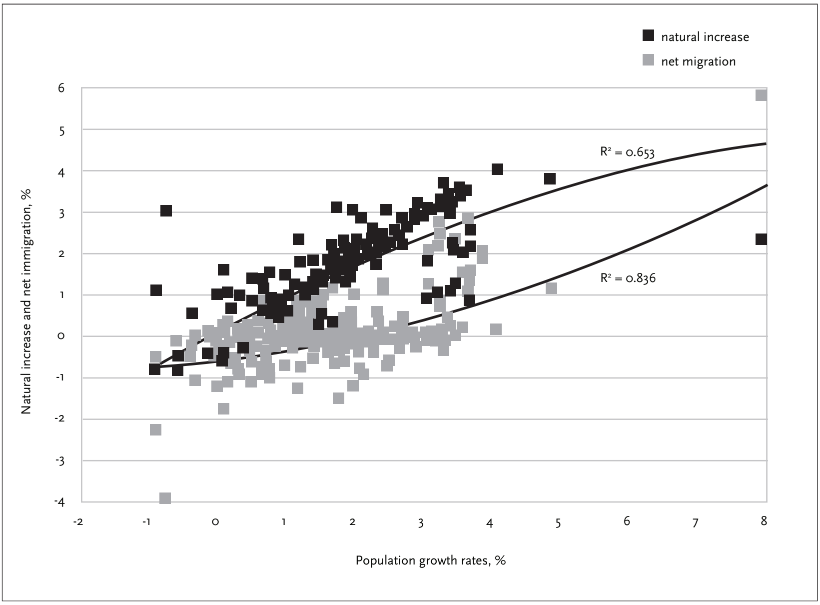
In a dynamic framework, high rates of labor-force (population) growth can slow down the growth rate of GDP per capita in a modern growth regime, as suggested by the Solow model; at a given savings/investment rate, higher labor-force growth requires more investment into the creation of jobs for the new entrants, meaning less investment into the deepening of the capital-to-labor ratio. Mass migration in the pre-World War I years from Europe to the New World explains totally the convergence in wages that has occurred; in the absence of mass migration, wage gaps between Europe and the New World would have risen from 108 percent to something like 128 percent, when in fact they declined to 85 percent.[42]

It may well be that mass emigration from Europe played a crucial role in the transition to the modern growth regime from a Malthusian regime. The latter was characterized by a growth of population that was "eating up" all the potential increases in income per capita resulting from technological change.[43] When technological progress accelerated in the nineteenth century, but the population-growth rates still remained high and growing (0.6 percent in 1820–70) because the demographic transition had not yet occurred, mass migration to North America helped to alleviate pressure on the scarce resource—land—and to avoid diminishing returns.[44] The other, more traditional explanation of the economic success of the West[45] also assigns a nontrivial role to emigration; the early elimination of serfdom in Europe made free labor more expensive, which in turn stimulated the development of labor-saving technologies. Without mass emigration to America and other offshoots, labor in the Old World would have remained less expensive. Today the inability of developing countries to "export" unskilled labor to the West may be keeping them in a demographic trap where all available investment is spent on creating new jobs for the rapidly growing population.

There is a negative relationship between growth rates of per-capita output and population-growth rates, as predicted by the Solow model. Nevertheless, some East Asian countries (Hong Kong, Malaysia, Singapore, Thailand) were able to increase output per capita by over 4 percent annually in 1960–99 with very high population-growth rates (2 to 3 percent a year). High population-growth rates are due to both high rates of natural increase and high net immigration (Figure 5.4). Thus, international migration does not help to equalize population-growth rates by countries; there is no link between rates of natural increase and rates of migration inflows.

In short, the North and the South may have conflicting migration objectives: the North is interested in attracting migrants who are highly endowed with human and other forms of capital and in restricting entry of migrants with limited endowments; the South would like to stem the flight of human and other forms of capital and would prefer free emigration of unskilled labor as a partial solution to poverty.[46] Jagdish Bhagwati and Koichi Hamada proposed a tax on emigrants, with that tax levied by the receiving (developed) country and transmitted in one form or another to the sending (developing) country.[47] This tax cannot be levied by developing countries unilaterally without violating freedom of movement, so there is not much they can do without the cooperation of the West. A

Figure 5.4: Growth rates of population in 2000–natural increase and net immigration, % of total population



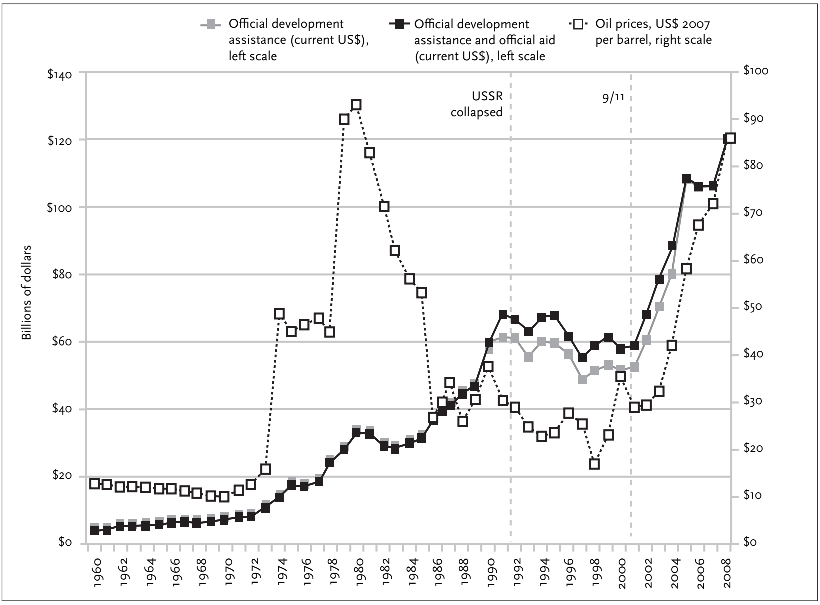

Source: World Economic Development Indicators database, World Bank.

number of international organizations that deal with migration issues (the non-UN International Organization for Migration, the World Trade Organization, the United Nations' International Labour Organization, the United Nations High Commissioner for Refugees, the Population Division of the UN Department of Economic and Social Affairs) have made no progress toward a North-South multilateral arrangement to promote freer movements of people and compensation for brain drain.

## Aid

One measure of the willingness and readiness of the West to accommodate demands of developing countries is perhaps the amount of Western assistance (aid) provided for development. While significant proportions of the populations in Western countries have been known to express their support for contributing to poverty reduction in the developing countries,

Figure 5.5: ODA and official aid to developing countries and oil prices per barrel in 2007 US$

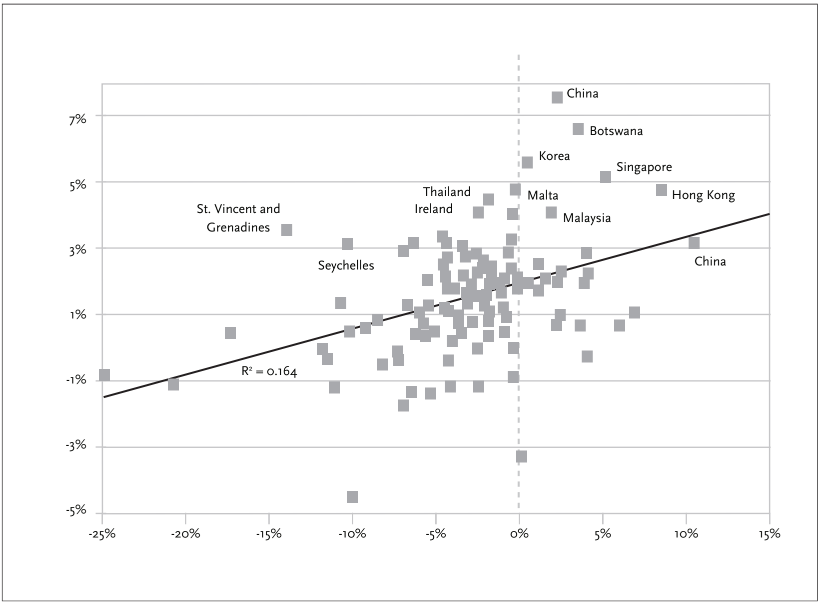



Source: World Economic Development Indicators database, World Bank.

official development assistance flows are more directly explained by geopolitical trends. Figure 5.5 indicates, among other things, the long-term rising trend in ODA through the Cold War, and the clear leveling off between 1990 and 2002, after the collapse of the Soviet Union and the end of East-West competition; as a proportion of GDP, ODA collapses with the end of the Cold War, then begins to recover coincident with the 9/11 terrorist attack in 2001 and a renewed commitment to achieve the historical target of 0.7 percent of GDP, set mostly by European countries after the International Conference on Financing for Development in Monterrey in 2002.

Figure 5.5 utilizes oil prices as an indicator of the political strength of the South, as the significant source of raw materials required by industry, relative to the North. The original discussion of a New International Economic Order (NIEO) emerged in the 1970s when commodity prices tilted the relative power temporarily in favor of the South. Figure 5.5 also marks the fall of the Soviet Union as a turning point in the relative

Figure 5.6: Average current account as a % of GDP and growth of GDP per capita, %, in 1970-2007




Source: World Economic Development Indicators database, World Bank.

ability of non-Western countries to have their voices heard in global economic governance. The increase in the growth rate of ODA in the NIEO period ends with the collapse of the Soviet Union and resumes after the September 11 attacks in the United States.

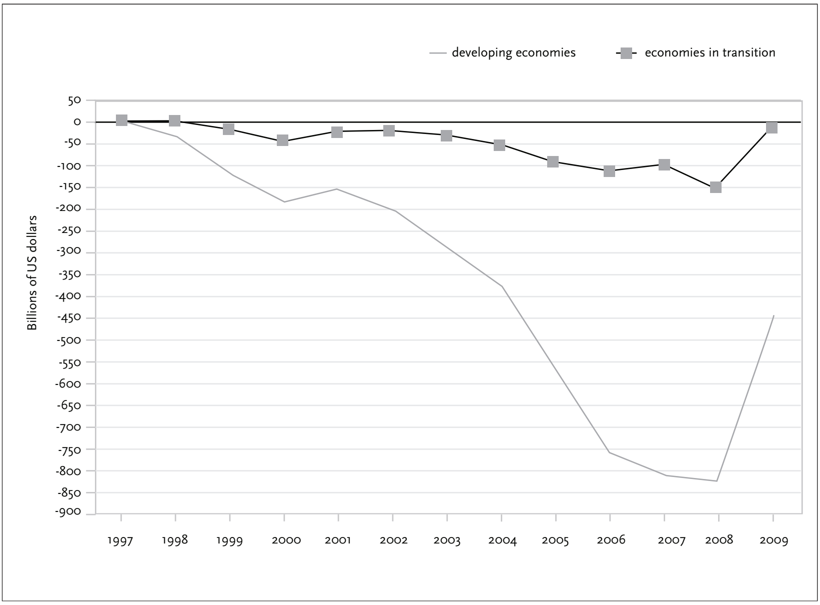
Aid is an overresearched issue, recently impelled by William Easterly's pessimism, drawing on numerous studies that do not find a correlation between aid and growth and development.[48] Foreign assistance may reflect the attitude of the West toward developing countries and in turn their relative power, but it does not seem to be an important factor promoting development. Arguably, ODA is less important than possible gains from any of the following reforms: elimination of Western agricultural subsidies; a more benevolent attitude of the West toward trade and exchange-rate protectionism of the South; loosening of the IPR regime for the South; allowing freer international migration of low-skilled labor and making efforts to stop brain drain from the South; control over the capital account and over FDI; recognition that the reduction of pollution should be done primarily by the West and that per-capita pollution in the South can be as high as in the North; understanding that labor, environmental, and human-rights standards in the South could differ from those in the North. In fact, there is no instance of a country which permanently overcame underdevelopment due to foreign assistance. Moreover, countries that managed to achieve high growth rates were mostly net creditors, not net borrowers; their current accounts were positive—that is, they were saving more than they were investing (Figure 5.6).[49]

## Global Imbalances (Capital Flowing Upstream)

The liberalization of capital accounts spread rapidly through the developing world in the 1990s, punctuated only briefly by the Asian financial crisis in the latter years of the decade. In the context of the Feldstein-Horioka puzzle—a puzzle because contrary to theory, domestic savings have been the main source of domestic investment even among countries with relatively open capital accounts—the developing-country policy choice of a determined attempt to rely on external financing is ironic. Open capital accounts do not naturally increase the probability of external funding for domestic investment. In fact, the international flow of funds has been going in the opposite direction, away from developing and transition economies.

In the wake of the Asian crisis, which had demonstrated particularly to East Asian countries the inadequacies of the multilateral reserve system and its inequitable procedures in resolving imbalances in capital flows, developing countries as a group have been providing net financing to the global economy, reflecting a situation in which capital was flowing from the poor to the rich countries (Figure 5.7). Many countries, particularly in East Asia, accumulated international reserves to be able to service external obligations in the event of another crisis without having to resort to IMF adjustment methods, which had proven to impose all the adjustment on developing countries' public authorities, with very little of the burden falling on developed countries and the international private sector, in a crisis whose roots lay in the often foolish search for investment destinations of large financial companies in the major financial centers.[50]

Figure 5.7: Net financial flows to the developing and transition countries, billion US dollars

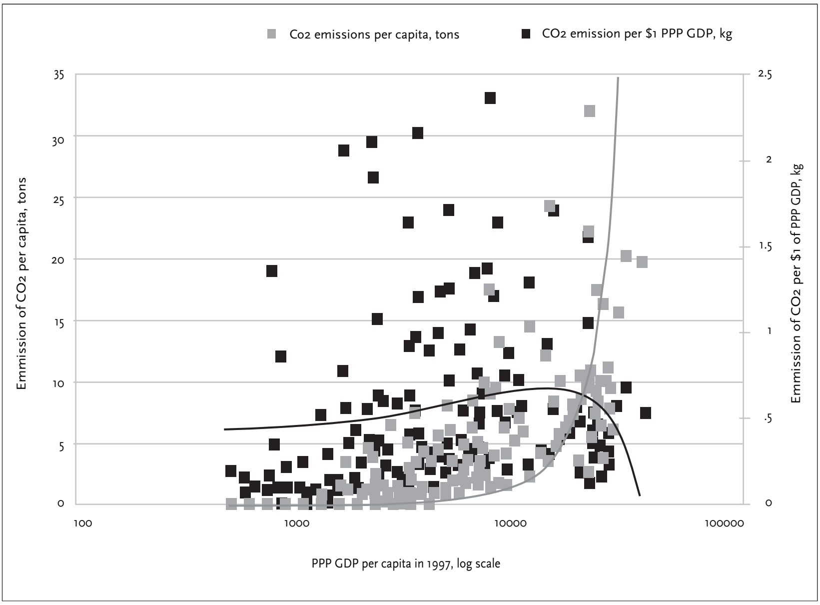



Source: UN DESA, *World Economic Situation and Prospects, 2007* (New York: UN Department of Economic and Social Affairs, 2007).

## Stabilization of Resource Prices

The period of strong growth in developing countries,[51] particularly in Africa, in the past decade, characterized by high commodity prices, is sufficient proof that the stabilization of international prices is a key element of a development-friendly international economic system. Discussions and initial efforts in commodity-price stabilization in the 1970s within the rubric of the New International Economic Order were not successful, though there was a revival of interest in 2008, before the global financial crisis and in the wake of the global food crisis.[52] Attention has once again shifted away from this issue, but significant exporters of gas and crude oil, especially in the context of international discussions on climate change, might be able to restart efforts in this area.

Figure 5.8: Emissions of CO2 per capita (left scale, tons) and per US$1 of PPP GDP (right scale, kg) in 1997




Source: World Economic Development Indicators database, World Bank.

## Environmental and Labor Standards, Human Rights

According to the Kyoto Protocol, quotas for pollution would be allocated to particular countries proportionately to 1990 levels of emission of polluting gases, not in proportion to the population. The implicit assumption is that rich countries, just because of their higher productivity, are entitled to produce fifty times more pollutants per capita than, say, African countries, even though rich countries have already produced a disproportionately high share of total pollution during the past two centuries.

In addition, there appears to be an Environmental Kuznets Curve (EKC), an inverted U-shaped relationship between income and $CO_2$ emissions;[53] according to this view, in early stages of development, capital accumulation results in rising emissions; its contribution to emissions rises as the country industrializes but falls and becomes negative in the postindustrial age (Figure 5.8). This may be due to the use of cleaner technologies in all industries of Western countries, but it also may result from the "pollution-haven" effect, in which the downward-sloping part of the EKC is due to the spinning off of polluting products to developing countries through trade and foreign investment. Present-day industrial countries were experiencing a more-than-proportional increase in $CO_2$ emissions as income was increasing during 1870–1910, just as do many developing countries today (Figure 5.8). During 1910–50, almost all industrial countries had made the environmental transition to less-than-proportional growth in emissions.

What is clear is that developing and developed countries find themselves at different sides of the EKC. Developing countries are still at the stage when income growth, structural change, capital accumulation, and trade all contribute to rapidly increasing $CO_2$ emissions.[54] Hence, the requirement that emissions be limited to a certain percentage of their level in 1990 imposes a particularly heavy burden on developing countries. Even the requirement to cut emissions per one dollar of GDP to the level of developed countries should be considered unfair because it deprives the developing countries of a chance to follow the same industrialization path that was once followed by the West. Paying a greater share of their GDPs for the environmental cleanup than the Western countries once did, less developed countries would have to sacrifice other developmental objectives, such as growth, health, life expectancy, and literacy of the population.

Similar arguments can be made with respect to labor standards (safety, child labor, etc.) and human-rights protection in general.[55] No matter how noble the goal of eliminating child labor is, not all the means are good to achieve the ends. Increases in mortality due to the reduction of income resulting from the prohibition on using child labor may be too high a price to pay. A proper evaluation of the tradeoffs between developmental goals requires self-awareness of the historical origins of the very norms by which such evaluations are made.[56]

## Is the NIEO Coming? Possible Scenarios

What will be the future trends in North-South relations? The total GDP of the South is already higher than that of the North; direct military intervention into large developing countries today is hardly possible;

some countries (East Asia) do pursue policies that allow them to change the rules of the international economic order in their favor and to narrow the gap with the West.

The rise of China, if it continues, would become the turning point for the world economy because for the first time in history successful economic development on a major scale is based on an indigenous, not a Western-type, economic model. Because the Chinese growth model became so successful in ensuring catch-up development, there is no surprise that it is becoming extremely appealing in the developing world. The attractiveness of the Chinese model of economic growth today could be compared with the popularity of the Soviet model of catch-up development in the "third world" in the 1960s. With the collapse of the Soviet model, the Chinese model became the logical and natural heir to that model—not a centrally planned economy but by no means a model of a liberalized market economy that is recommended by the advocates of the Washington Consensus and even post–Washington Consensus.

In addition, the rise of China has the potential to provoke a profound reform of the thinking (the "software") underpinning the world economic order and international relations. Trade protectionism, industrial policy, undervaluation of the exchange rate via accumulation of foreign exchange reserves (also, as argued, a variety of export-oriented industrial policies), and control over the international capital flows (not only short term but FDI as well) can become legitimate tools for catch-up development. There may be a new regime of protection of intellectual property rights and technology transfer, new regulations for international trade in energy and resources, new rules for international migration, new agreements about cutting emissions of pollutants (reconsideration of the Kyoto Protocol), and so on.

Moreover, the principles of international relations can change radically as well. Although "Beijing Consensus" may not yet be a rigorous term,[57] it is clear that the Chinese approach to international politics (no interference into domestic affairs, no military interventions, no trade embargoes) provides the developing world with a real alternative for building relations with other countries. China rejects the use of force, embargoes, and sanctions in international politics nearly as a matter of principle. Even in its relations with Taiwan, China has always been pushing for wider economic and cultural exchanges, which Taiwanese authorities have resisted. The new rules of international relations may (1) explicitly limit the use of force only to cases of severe violations of nonpolitical rights (e.g., mass repressions, hunger, ethnic violence) and prohibit the use of force against liberal authoritarian regimes (just for the sake of "establishing democracy") and (2) prohibit unilateral military interventions (without the authorization of the United Nations). The new world security system would most probably imply the reform of the United Nations, including reforming the Security Council (giving larger voting rights to countries of the South), developing R2P (responsibility to protect) interventions, and extending the mandate of international courts, among other things.

As a rising economic power, China could bide its time to take its rightful place in an unreformed global governance system, a particularly feasible strategy if China transforms itself fairly rapidly into a developed capitalist country, joining the side of the North in the debate on the new world order. Or China could still revive the Southern position on the reform of international economic relations after it catches up with the West, which would strengthen the bargaining position of the South. If Chinese growth slows down and China stays a developing country for a long time, it will have all reasons to take a Southern side in the North-South dialogue; the Global South in this case has a good chance to unite itself in order to get better conditions in relations with the North, but it may not have the necessary economic weight to push its agenda forward.

China would be an important, but not the only, player in skirmishes over reforming the world economic system, which the global financial crisis has intensified. In June 2009, for example, Russia convened the first summit of the "BRIC" group of countries (Brazil, Russian Federation, India, and China) in Yekaterinburg, where the question of an alternative reserve system was famously discussed, among other things. Trade and investment flows among the South have been growing faster than North-South trade, though until the current crisis, Northern markets for final consumer demand were indispensable. Southern markets can only replace Northern markets with faster growth in their domestic demand, which would require a decisive redirection from the low-wage, export-driven strategies of the faster-growing developing countries.

The feasibility therefore of a new world economic order is not only contingent on the outcomes of North-South engagements but depends very heavily on the ability of the South to self-organize in creating new structures and funding the accompanying secretariat functions to support them, to expand East-West economic and political interaction unhindered by Northern limitation, and to seize the initiative in undertaking less export-dependent growth strategies so that they can pursue their industrial upgrading and replace dependence on Northern markets and technology. A key agenda of such self-organization is the expansion of efforts, in the United Nations, in the Bretton Woods institutions, and in others, to reform international rules and arrangements so that the world order facilitates, instead of obstructs, national development efforts.

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Chapter 6

# Chinese Political Economy and the International Economy: Linking Global, Regional, and Domestic Possibilities

*R. Bin Wong*

As economies across the globe work through a recovery from the contraction of economic activity occasioned by the financial-market crisis beginning in 2007, historians are fond of reminding us that this is hardly the first time that economies have been thrown into confusion and turmoil by a rapid change in perception of the financial value of certain economic assets. But it is the first time such a crisis has affected such large numbers of people across so many economies. The spatial and demographic impacts of this financial-market crisis are only possible for two basic reasons. First, far more of the world has experienced economic development since the Great Depression of the 1930s than had before. Second, this economic development, especially in parts of Asia, has taken place through an expansion of production for foreign markets. The global character of the economic order that has emerged since the 1980s was the object of both self-confident celebration and anxious critique in the 1990s and early 2000s. Now that faith in the strength and sensibility of unfettered markets has waned without the expression of clear and coherent alternatives to the global order we have lost, policymakers, business people, and scholars ponder where we might be headed. Many of the immediate short-run challenges are clear and have been the object of national monetary and fiscal policies across the world. The future dimensions of the global economy over the long run are difficult to predict.

One obvious and important set of actors in the decades to come will be Chinese. Most commentaries on the Chinese role in the international economy view matters from the perspective of actors already in the institutional order of the international economy and ponder how the Chinese might fit in. In this chapter, I consider what we might learn by starting from Chinese domestic political economy and moving outward through the Asian region to the global economy. This is a vantage point no doubt more familiar to Chinese actors than to American or European ones. Yet the issue is not simply one of taking account of different positions in the international economy from which different parties begin. Rather, the challenge I pose, though hardly answer fully here, is how to understand the ways that domestic, regional, and global concerns intersect and mutually affect the policy choices toward the international economy that actors in any particular country make. I use the example of China because of its growing global importance and the particular challenges of analysis and interpretation that grappling with China's situation offers. The ongoing growth of China's economy, the increased visibility of Chinese political leaders and policymakers, and the startling changes in Chinese society together suggest the need to consider the ways in which China's growing presence in the global economy and international politics is linked to its domestic political economy and social challenges. Foreign policies are linked to domestic concerns in all countries, but the ways in which the two broad spheres of decision making interact reflect particular priorities and challenges in each country. Since Chinese domestic concerns are grounded in a set of developmental issues politically defined across a large country with great regional differences, the ways in which domestic and international issues are related politically need not closely resemble formulations found elsewhere. Some of the different ways in which China's domestic transformations are linked to its plausible future economic and political roles on international stages are considered later in this chapter.

## China as a Domestic and a Regional Unit: A Different View on Europe

As a sovereign national state, China is often misleadingly compared with other national states. A recent example would be the critical statements made within and beyond China about the tremendous Chinese income inequality that grew during much of the first decade of the twenty-first century, a scale of inequality greater than that of any other country. Since observers often associate the quality of a government with its ability to reduce domestic inequalities, Chinese leaders can be easily criticized and the negative features of their country's remarkable economic growth highlighted. Yet, if we were to look at a transnational European region of comparable spatial scale and closer to the demographic size of China in 1960, we would no doubt find dramatic disparities in income levels from rich to poor as we moved from western Europe to the east. But few would expect Europe not to have economic differences between west and east in the 1950s and 1960s, since the region was unevenly developed before the war and recovery and economic change took place under very different political regimes after the war. Fixated on national political units, we do not think of comparing economic features of spatial units more similar in geographic and demographic scale but think of economies as national. Yet spatial scale clearly matters for what we can expect to find in terms of economic disparities as economies grow, since development always starts in specific places, and the ways in which it spreads depend on the institutional structures that encourage emulation of successful practices and market integration. State policies can support or obstruct economic integration across larger spaces. A basic difference of China's being a single national government and Europe's having multiple sovereign states makes the economic possibilities of their respective regions differ in political terms. But it does us little good to make the contrast a simple one of domestic versus international when looking at the two cases.

The growth of the European Union gives us a plausible political unit to compare with China in terms of geographical scale and demographic size, though in both respects the EU is still smaller than China. If we ask how effectively financial markets can be regulated in the EU, we discover there are political impediments to coordination across EU member states that do not exist between Chinese provinces. Not surprisingly, one finds that the Chinese central government has far greater capacities in general to articulate and implement policies in a coordinated fashion than can the EU, which has multiple levels of political authority making economic policy. This simple contrast makes an important point that is at once self-obvious and yet rarely recognized. The nature of European political institutions hinders the development of effective financial regulation across their increasingly integrated markets in ways that do not exist in China. This contrast is useful for several reasons.

First, it gives us a different kind of example regarding the relationship between political institutions and effective economic policies from those we often ponder. For instance, we are comfortable considering how domestic political concerns shape international trade policies—US President Obama's September 2009 decision to impose high tariffs on Chinese tires is an obvious recent example. Economists preach the virtues of free trade to all parties as a scientific truth. Achieving effective free trade is often then seen as a technical issue that is complicated and indeed compromised by political interests and concerns. In fact, the identification and separation of political and technical issues is more complex than we realize. We are ill equipped to cope with these complexities because we assume that technically sensible policies are produced by particular kinds of political and economic institutions and that these institutions are ones created in North America and western Europe. If, however, effective financial regulation is politically more difficult to achieve in the EU than in China, we can appreciate more clearly that what is technically possible is defined by political institutions. European (or for that matter American) institutions are not necessarily the most enabling for effective economic policies. Taking seriously this possibility means that the standard assumption that advanced industrial societies offer the models from which institution building in developing economies should draw is an incomplete approach to considering institutional changes in politics and policy innovations.

We do not naturally consider this kind of analytical possibility because we assume that developing economies can only improve through selecting from strategies and practices pioneered in advanced industrial settings. We also see clear constraints on political capacities and limitations to economic institutions in much of Asia and Africa, judged by standards of what is successful in western Europe and North America. Chinese institutional capacities in particular often suffer from inadequate organizational development. Within a situation of greater political opportunities to create effective policies of financial regulation, the Chinese are hampered by infrastructural limitations. As a result of these conditions and the ways in which we conventionally view them, policymakers in advanced economies, such as those in the EU, can more easily see what the Chinese can learn from technical abilities in Europe than they can imagine what an appreciation of the Chinese political system's policy capacities can suggest about what may or may not be reasonable aspirations in a European context.

Second, the contrasting political capacities of Chinese and EU government leaders to formulate policies for financial-market regulation remind us that institutions are developed through historical processes. Differences in the current institutional arrangements in China and the EU are the products of the distinct political histories of these two polities. Those very different political histories have not surprisingly created two very different kinds of government today. It may well be therefore implausible for Europeans to learn all that much from how Chinese political institutions enable centralized decisions about financial-market regulation, because little of that learning is applicable in a European setting. Yet, obvious as this no doubt would seem to many if not most European policymakers presented this contrast, the symmetric observation that European political capacities may not be easily emulated in a Chinese context for the same reasons of historical differences is far less likely to be persuasive to them. Why?

For many Western observers, the reasons for their beliefs may rest on assumptions implicitly held but never questioned, namely, that European history has supplied the narratives of successful political and economic development. It is from those experiences that we can distill the guidelines and goals relevant to other parts of the world. This is the line of reasoning that was consciously promoted by nineteenth-century Westerners and made into basic parts of the social sciences after World War II. Moreover, these perspectives were embraced by many Asian political and economic leaders throughout the twentieth century, at the same time as the choice of which practices to adapt or adopt was often a subject of debate. Formulated within the categories of national states seeking political power and their subjects chasing wealth and prosperity, the political and economic variations among different parts of the world are perceived according to either national political units or regional aggregations of national units. The EU has become a model unit for thinking about other regions composed of contiguous sovereign states. Through this approach, the fundamental importance of the national state is affirmed for policy purposes, and the success of Europeans in transcending the limitations of policymaking at national levels can become a model for other regions composed of sovereign states. What cannot be seen when we only look at the world from the vantage point of European political practices at their national and regional levels is that their "national" is only "provincial" in China, and their "regional" is not quite the geographic and demographic scale of the Chinese "national." This means that the economic problems affecting comparable populations over comparable spaces are conceived politically as regional in Europe and national in China. To compare how policymakers act in these two parts of the world it therefore makes sense to augment our perspectives with one that allows comparison of a Chinese national unit with a European regional unit. This then allows us to consider how China as a national unit entering international discussions is also coping domestically with issues that in Europe are themselves already beyond a simple domestic location.

Armed with such a perspective, we can follow China from its domestic challenges and policies to the roles that the country plays internationally. These roles will be made possible by the ongoing economic development within China and the relationships of this growth to economies within Asia and those in Africa, the Americas, and Europe. The character of domestic Chinese growth will in turn be shaped by government policies, which are grounded in a set of politically defined priorities currently stressing economic growth, the benefits of which are shared more equally across a society. Chinese public-finance policies in particular have responded to the challenges of stimulating growth through the difficult period of falling exports brought on by the global financial crisis. The next section of this chapter looks at Chinese public finance—its goals and challenges. Both the challenges faced by Chinese public finance and the structural capacities of Chinese public finance are far greater than those encountered in more developed economies.

## Chinese Public-Finance Goals and the Global Financial Crisis: Putting Global Crisis in Domestic Contexts

During the fall of 2008, Chinese leaders reacted to the collapse of global economic demand with a massive domestic stimulus package. To understand the logic, problems, possibilities, and significance of these public-finance policies, Chinese fiscal capacities and priorities need to be contextualized and explained historically and comparatively. Chinese success at using fiscal stimuli to stabilize their economy and to support economic growth not only matters to the Chinese but has implications for others both in Asia and across the world.

The Chinese government implemented a far-reaching set of public-finance reforms in 1994 which raised government revenues as a percentage of GDP and the proportion of revenues that were under central government control. As a result, the central government was better able to decide on the distribution of public resources across the country. At the same time, the central government aimed to incentivize lower levels of government to develop the economy as a means to generate more income for local-level public-finance projects. Local governments received transfer payments from the center to help pay for locally provided social services and public goods. The demands to increase public spending since the mid-1990s have become ever more intense in the past fifteen years. Economic reforms have created two distinct kinds of challenges for public finance. First, some social services, such as public health and primary education, previously provided at the local level have been reduced. Local officials have prized economic growth ahead of other criteria of government effort and success. Second, growth has created dramatic regional inequalities as well as inequalities between urban and rural areas.

The global financial crisis and decline in Chinese exports that followed from the collapse of demand in foreign markets created conditions under which a stimulus package could respond to these domestic economic and social concerns. China's stimulus package formulated in the fall of 2008 includes some four hundred billion RMB, or a sum approaching sixty billion US dollars. Several purposes were targeted. Some covered public goods provided in many countries, including public infrastructure and housing, railroad and road investments, and water and electricity in rural areas, as well as education and public health. Other public expenditures met specific challenges, in particular earthquake relief for the areas devastated by the May 12, 2008, Sichuan earthquake. Sustainable economic development goals have been pursued through stimulus investments in the development of new technologies and environmental protection.

A key feature of the stimulus spending has been the continued affirmation of economic policy goals that had been formulated before the collapse of credit markets led to the dramatic reductions in foreign demand for Chinese goods. These goals reflect the desire to spread the benefits of economic growth to people who have been least favorably affected by the previous decades of economic reform. They are political goals premised on an understanding that the state's legitimacy and the viability of society both depend on bringing the benefits of economic growth to more and more people in more equal and thus equitable ways. Given that the people whose incomes have reached the highest levels are those living in eastern cities most closely connected to global markets, it is hardly surprising that those who have benefited the least include people in the western half of the country and rural people in all parts of the country. The stimulus package has aimed to raise incomes of rural people directly with various projects to develop the diversity of their economic pursuits. The twin challenges of reducing urban-rural differences and those between the eastern and western halves of the country mean that public spending has stressed both the western interior over the eastern coastal region and projects benefiting rural residents over those benefiting only urban dwellers. By reducing the gap between urban and rural public expenditures, officials in fact are helping to support continued urbanization, as more rural areas are transformed into urban ones by a shift of land use from agriculture to industry.

The relationship between fiscal and monetary policies in China's stimulus response to the financial crisis highlights some of the economy's key features as a developing economy. Direct government investments in both western and rural parts of the country make particular sense not only because these areas are poorer but also because the financial system serves these areas less effectively than it does richer places in eastern China. This is hardly surprising since financial institutions in general tend to develop in tandem with economic growth; China has been no exception. While the government continues to push the expansion of the financial system into less developed regions and rural areas, it can achieve a more immediate impact on economic growth by direct investment. Economists disagree over the relative virtues of fiscal and monetary policy levers to stimulate growth in economically advanced societies. The Chinese choices suggest that, in developing countries at least, fiscal policies can reasonably be considered superior to monetary policies as levers to promote growth, especially in poorer areas, and these can work most effectively when financial opportunities and pressures from international financial markets are reduced.

While any particular fiscal and monetary policies can be considered to be either complements or substitutes for developing western and poorer regions of the country, fiscal and monetary policies more generally address different kinds of issues. Monetary policies, in contrast to fiscal policies, have international as well as domestic dimensions. To continue with fiscal policies specifically, public spending has a domestic focus. Thus, a choice between fiscal and monetary policies as the key ways to respond to a global crisis and its domestic impacts has implications for the tradeoffs between infrastructural investment and investment directly related to production. China's use of fiscal policies has meant provincial governments have decided how they think public investment can best improve possibilities for subsequent economic development. Shanghai has favored road investment, Zhejiang province has invested heavily in railroad construction, while Shandong province has put large sums into natural resources, including construction projects and water control for agricultural land and forest management. Jiangsu province has invested in housing at the same time that Henan province has chosen to complement its housing construction with public-health and education projects.

Efforts to overcome the financial crisis's impacts on the Chinese economy affirm the policy priorities that officials identified before the global downturn in production caused by the collapse of credit markets. Indeed, one might even argue that the global downturn has made it easier for Chinese policymakers to reduce the gap between richer and poorer parts of the country. Richer parts of the country had grown through ties to the international economy. Their abilities to grow in this manner have been necessarily constrained by the fall in global demand. Poorer parts of the country, where growth has been based on domestic development, respond more effectively to investment, both direct public investment and private capital infusions.

Since much of China's fiscal stimulus package has in fact been infrastructural expenditures in line with what had been identified as developmental priorities before the global financial crisis unfolded, viewing Chinese government spending as a countercyclical strategy to pull an economy out of an economic downturn tells only part of the story. China's fiscal and monetary responses to the financial crisis have been embedded in a larger program of economic development. We can appreciate some of the parallels and similarities, as well as certain types of differences, by moving beyond China. The major differences among American and European policy preferences between monetary and fiscal measures are only one important axis of variation to observe. Brief reflection on the contrasts between American and Chinese fiscal-stimulus policy implementation makes clear that the political economies of the two countries are structured in fundamentally different ways.

The Chinese fiscal-spending package has a combination of central-government and provincial-level-government spending. The center is able both to allocate funds across the country differentially and to work with provincial officials regarding their targeted uses of fiscal expenditures. In the United States, the division of authority between the federal and state governments and the presence of separate constitutions for each mean that economic policies can be difficult to implement; federal systems promote the autonomy of different levels of government without necessarily encouraging coordination between them in the ways possible when central-provincial relations can be more flexibly negotiated. The balanced-budget provision of many US state constitutions means that they have to cut state-government expenditures at exactly the time when countercyclical fiscal expenditures are called for. The contraction of state-level spending thus exacerbates the economic downturn already set in motion by market adjustments. Coordination and implementation of expenditure policies according to macroeconomic policy goals between central and provincial levels of government can be more easily achieved in China than in the United States. This observation parallels the comparison of policies to regulate financial markets in China and in the EU made in the previous section of this chapter. In both cases, the delineation of authorities and responsibilities between levels of government has constitutional definition and thus basic constraints on flexibility and coordination in formulating policy responses at different levels of government, constraints that do not exist in the Chinese case.

The robustness of Chinese responses to the contraction of international demand for its products and services also suggests the potential utility of studying more closely the institutions of Chinese political economy that have made its policy implementation effective. Using American and European perspectives in a manner not commonly deployed, what is striking about Chinese fiscal relations between center and province is the absence of the constitutional limitations presented in either the United States or the European Union. Might these latter two cases be better able to respond to financial crises if they had institutional capacities more similar to the Chinese? Of course, we are very unlikely to see any basic change in constitutional relations between Washington, DC, and the states to make public-finance responses to economic crises more effective, but thinking of the constraints faced in the American case become clearer when contrasted with Chinese conditions. Although constitutional changes are not in the offing, we could imagine better coordination of financial policies for the banking sector in the EU that would start moving toward the norms possible in China, where there is only one central bank.

To suggest that we take seriously that what is possible in public and private financial sectors in China is more difficult in the United States or the EU does not of course mean that China is done with its own much-needed institutional reforms. Nor does it mean that the greater room for negotiation between center and province in China does not also allow for considerable variation in the ways that interests at different levels of the political system gain or lose voice. It does, however, suggest that the capacity to find the common or shared and mutual interests across the institutional divide of center and province may be easier without constitutional constructions of distinct rights and responsibilities. What the contrast should in any case pose is the possibility that the naturalized assumption that Western institutions always outperform non-Western ones may have become a bit outdated and inconsistent with at least some of the evidence that is accumulating in our early twenty-first-century world. It may often turn out, again, as suggested in the previous section for financial-market regulation, that the reasons for more effective policy possibilities in China than in Europe or the United States may be historically produced and that the particular institutions and techniques utilized in China cannot be transported into American or European settings. But unless we explicitly conceive the possibility that Chinese policy experiences might be relevant to what Americans and Europeans should consider, it may well be more difficult to transform the political structures of the global economic order in ways that take into account the growing prominence of the Chinese economy.

The last major financial crisis to affect East Asia occurred in the summer of 1997. China was not much affected because its financial markets were segregated from the markets of highly liquid investments that could be pulled out swiftly. As China continues to open its financial markets to foreign institutions, the need for greater understanding of complex credit instruments and the construction of a more diversified credit structure become ever more important. Integration into international financial markets challenges Chinese policymakers to develop better domestic regulations and protections. It also gives the Chinese government an ever-larger stake in seeing that the governance structures of the international economy protect its interests.

In 1997, Tokyo floated the idea of making the yen a more important currency for trade in East Asia. Washington was not too keen on the idea and was able to discourage such changes. But central banks in East Asia did agree after the 1997 crisis to currency swaps to stabilize capital flows into and out of the region and among the countries within the region. Today, the Chinese have made the renminbi a more important currency by allowing it to be used to pay for cross-border trade in East Asia. At the same time, Tokyo has been growing as a financial center. How financial markets evolve in East Asia and the roles of the Chinese and Japanese in these markets is an open question. How Shanghai, Hong Kong, Tokyo, and Singapore all find their financial-market niches remains to be seen. Politics of course matter. For instance, Shanghai banking leaders still travel weekly to Beijing to report on and discuss their decisions and activities. But this much is clear: Washington is no longer in a position to limit the ways in which Chinese and Japanese develop financial markets in East Asia.

What is unclear is how the growing importance of East Asian financial markets will be fit into larger global financial networks. This depends in part on the voice that East Asian policymakers get within international bodies such as the IMF and the World Bank. Already Chinese are being more assertive about making financial policy suggestions, and some European leaders call on the Chinese to take a more visible lead. If China and Europe agree on reforms of financial-market regulation, Americans may well have to accept some practices that are no longer the product of policy discussions they lead. Americans' abilities to hear Chinese voices will depend on their willingness and capacity to recognize that Chinese policymakers have rights to their voices being heard. This will become more likely if domestic Chinese challenges and successes are better understood and considered, at least potentially, as relevant data for those coping with challenges in other parts of the world. If and when academics and policymakers begin to see more clearly that concrete comparisons of fiscal and monetary policies across countries may reveal occasions when Chinese practices outperform either American or European ones, the abilities of Western governments to accord the Chinese greater voice becomes more natural and sensible.

Changes to international financial-market policies and growing roles in both markets and policymaking for the Chinese specifically and East Asia more generally cannot by themselves solve imbalances in the real economy. The tremendous levels of debt reached by American consumers and their federal government make possible the very large capital reserves in China and Japan. None of this imbalance is tenable in the long run. These challenges, much like the domestic challenges of reducing the gaps between urban and rural locales and between the more developed eastern half of the country and the western half, predate the financial crisis.

Just as China's economic successes of the past thirty years are unprecedented in world history, and as analysts both within the country and abroad have had much to study in order to make sense of so many dramatic changes, so too China's more recent visible vaulting into a prominent position regarding defining the architecture of the global economic system after the 2007 financial crisis would have been hard to foresee based on the country's position in the 1997 Asian financial crisis barely a decade ago. Exacerbating real estate price rises notwithstanding, China's policy response to the 2007 financial crisis stimulated the domestic economy more swiftly than did policy efforts in the US or Europe; in part, this simply reflects the fact that the fundamentals of the Chinese economy, despite areas of continued weak institutions, promise far more growth than do the fundamentals of the US and European economies. The financial crisis and consequent questioning of the global economic system should not lead us astray into thinking that the longer-term trends that preceded this crisis are not continuing unabated. In the short run, the world is facing a cyclical collapse, but in the longer run, we are witnessing the revision of the global economic order in which Asia has become, as it once was several centuries ago, the most dynamic economic region of the world. Far different from the distant past, however, are the successive stages of political and economic integration that make Asia's economic rise a challenge and opportunity for people throughout the world.

The character of the postcrisis global economic order will depend on the choices made by political and economic leaders in both the East and the West. Their views of the global situation will be affected by their perceptions of both domestic and regional conditions and by the kinds of organizations and interests that have political voice in their varied contexts. In the short run, China and the Association of Southeast Asian Nations especially are becoming more integrated economically, and this in turn has important potential consequences for regional economic development within China itself. But the short-run challenge of the massive trade imbalances and China's capital account surplus remains unresolved.

In China, as in other parts of the world, there is no simple uniformity of perception or unanimity of opinion on how to move forward. But many analysts within and beyond the government suggest the need for broader and deeper financial markets, which will help move capital within and beyond China more efficiently; capital surpluses will also be reduced with the continued growth of urban populations and their higher capacities for consumption; improving Chinese financial-market institutions and continuing to use urbanization to address urban-rural disparities are two ways policymakers can strive to achieve what they consider harmonious and equitable growth. Will leaders in other major developed and developing economies reach comparable clarity and consensus on what they wish and need to achieve for both their own citizens and for the future of the global economic order?

## *Further Readings*

China's policy response to the recent financial crisis is not yet the subject of a significant academic literature in English. Much of the relevant data has circulated only in Chinese, though it has been covered in the international media. The *Financial Times,* for instance, has provided basic data and interpretation. For initial overview of response, see Geoff Dyer, "China Authorises 'Massive' Stimulus Package," *Financial*

*Times,* November 9, 2008, http://www.ft.com/cms/s/0/6e89710e-ae91-11dd-b621-000077b07658.html; for subsequent critique of the policy response's successes and difficulties, see Yu Yongding, "China's Stimulus Shows the Problems of Success," *Financial Times,* August 25, 2009, http://www.ft.com/cms/s/0/94314bde-91a3-11de-879d-00144feabdc0.html. More comprehensive evaluations of Chinese policy responses to the financial crisis can be found in Chinese: Wu Zhenxing and YuanYe, *Weiji yu zhuanji: Jingrong fengbao, jingji weijixia zhongguo jingji de wenti, zhengce fenxi yu chulu* [Crisis and Turning Point: In Financial and Economic Crisis, Chinese Economic Problems, Policy Analysis and Path Forward] (New World, 2009); Pang Zhengbo, *Zhongguo zemo ban dang jingrong weiji gaibian shijie* [What Should China Do as the Financial Crisis Changes the World?] (China Economic Publishing House, 2009).

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CHAPTER 7

# The Global Financial Crisis and Africa's "Immiserizing Wealth"

*Alexis Habiyaremye and Luc Soete*

Before the onset of the current financial crisis, some African countries richly endowed with natural resources were recording unprecedented rates of economic growth, as a result of a price boom generated by the growing demand for raw materials and fossil energy by, amongst others, China and India. Almost immediately after the crisis spread to the real economy, the prices of oil and many other primary commodity items fell sharply and reverted to their pre-boom levels. The prices of most mineral ores declined considerably in response to the sluggish demand in international markets. The optimism that had started to emerge about Africa's growth prospects evaporated, and the usual worries about Africa's poor performance in the global economic system reclaimed their place. As a consequence, Africa's economic future has never been so uncertain as in this period of global financial crisis, as can be inferred from the contrast between the weak and fluctuating growth rates in the period 1980-2001 and the pre-crisis boom in the period 2002–2007. This uncertainty is reflected, on the one hand, in media outcries like "Africa reels as financial crisis hits late but hard" (*International Herald Tribune*, August 3rd, 2009), and, on the other, in beliefs and hopes that the continent, with its huge reserves of mineral and fossil resources, will finally succeed in getting an endogenous growth and development process under way.

Although some observers would still affirm today that, with its considerable mineral wealth Africa is a rich continent, numerous communities in mineral- or oil-rich regions remain mired in misery and see little prospect of improving their livelihoods in the foreseeable future. Available evidence on the way mineral and fossil resources have been exploited so far shows that this exploitation has hindered development by preventing economic diversification and by delaying the accumulation of adequate human-capital stocks needed to put the countries in question on the innovation-driven growth path. As pointed out by Collier, the exploitation of natural resources in many African countries has tended to generate situations of conflicts and civil wars after the colonial period, which has impeded capital accumulation and left these countries in a self-reinforcing mechanism of dependence on the export of raw materials.[1] This raises the question of whether natural resources are not the very root of the misery that African populations continue to experience. If such proved to be the case, Africa's endowment in natural resources might be termed "immiserizing wealth," by analogy to the well known phenomenon of "immiserizing growth" in the theory of international trade.

## Africa: A Wealthy Continent with a Poor Population

As surprising as it might look, at the aggregate level of the African continent, national income per capita has been substantially higher than that of other developing regions. In fact, until as recently as 2005, the average African per capita income was no less than 25% higher than that of India and only marginally below that of China, the two natural resource-poor countries which witnessed impressive growth rates over the last twenty years.[2] However, the stronger and more sustained growth rates recorded by Asian countries in comparison to the corresponding pre-boom rates for African countries illustrate the advantage of Asian dynamic productive forces over African wealth deposits in the form of natural resources. Today, the two most populous Asian countries appear to have succeeded in catching up in their "delayed" industrialization process: China in manufacturing, thanks to an active industrial policy based on its large-scale potential work force, which can be moved out of the informal rural sector; and India in services, thanks to a huge English-literate population capable of utilizing digital opportunities that allow for long-distance work and the increased international trading opportunities of such services. Compared to those success stories, Africa seems stuck in its natural resource and income wealth, as if, in a purely mercantilist way, the availability of this wealth *immiserizes* its development; as if the prodigious availability of such a natural wealth had become a major source for economic and political instability, for foreign private and public envy, for rent-seeking behavior in vulnerable states, with all its accompanying features of attempts at illegal extraction and corruption. In this sense, it seems that natural resources, rather than being "the wealth of nations," are more likely to undermine a country's endogenous economic dynamism—its desire to innovate, to exploit more efficiently the available resources, to structurally transform and diversify the economy, to climb the ladder. This process is, of course, well-described in the context of developed economies in economic literature as the Dutch disease, a process which, within the context of developing countries with relatively young political histories, takes on a much more direct meaning (the term comes from the phenomenon observed in the Netherlands following the discovery of large gas reserves in the north of the country).

Ever since the end of the decolonization process, the contrast between Africa's tremendous "endowment" in natural resources of all kinds (for example, mineral ores, fossil fuels, or the wide bevy of its fauna and flora) and its relatively weak economic performance and poor human development track record has been striking. Whereas in the period of colonization, the basis of Africa's poor economic performance could be framed in terms of a politically-imposed, unequal exchange with the colonial power extracting Africa's mineral wealth to the benefit of the colonial power's citizens and industry, today, nearly half a century later, it is clear that independent Africa's development barely benefits from the gift of nature. The significance of that generosity of nature can hardly be overstated and is absolutely striking. In some regions of Africa, like the Katanga province in the Democratic Republic of the Congo (DRC), the mineral wealth is so prodigiously abundant that it has sometimes been referred to as "a geological miracle." Despite this exceptional generosity of nature, the continent, and in particular the Sub-Saharan region, has systematically witnessed the lowest growth at the world level, with a majority of countries remaining stuck in the group of least developed countries. In various parts of the continent, entire populations have witnessed generation after generation of violence, experiencing only civil wars and social disruption rather than any long-term economic benefit from the presence of natural resources in their region.

## The Elusive Resource Boom and the Financial Crisis

The price boom in natural resources and other raw materials that preceded the current financial crisis had reinforced in the minds of many Africans the belief that raw materials were a source of sustainable prosperity. When the crisis hit developed countries, the collapse of major raw material prices became ineluctable, reflecting the slowdown in demand for manufactured goods and services that these raw materials were used to produce. Furthermore, whereas most analysts expected that the crisis would impact Africa only after a long period of time had passed (as its economies were not tightly integrated into the global financial system), Africa's economy became directly and significantly hit by the decline in foreign direct investment, the contraction in credit flows, and the shortfall in international remittances from its own foreign migrants. As a result, the impact of the financial crisis on African investment was much more significant and immediate than generally expected. This abrupt weakening of African economies, while experiencing a boom, exposed once more the vulnerability of countries that rely mainly on the export of raw materials and other primary commodities in their international trade. In short, the discussion of how Africa will find its way out of the current crisis inevitably reopens debates surrounding the place of natural resources in the innovation and development processes of developing countries and the long-run implications for the terms of trade of African economies as exporters of raw materials, versus emerging countries in Asia and industrialized economies as exporters of manufactured products.

Before the financial crisis, the high prices of natural resources and other primary commodities in international markets had prompted many analysts to suggest that resource-rich developing countries in Africa or Latin America had reached a unique opportunity to jump on a high-growth industrialization and development path. This was said to be possible if these countries succeeded in managing the revenues from their natural resources in a long-term sustainable manner by,[3] amongst other things, investing in the creation and acquisition of new knowledge.[4] More specifically, in the period that directly preceded the crisis, a number of economists (amongst others, Kaplinsky[5]) viewed the price boom of raw materials as a potentially strong counterargument to challenge the old Prebisch hypothesis of the long-run terms-of-trade disadvantage for underdeveloped countries dependent on the export of raw materials.[6] The potentially positive role of natural resources for future African growth had become a new positive development feature, as optimistic expectations based on the buoyant demand seemed to turn upside down the resource-curse debate and reverse the perception of a terms-of-trade advantage of manufactures versus raw materials. Indeed, before the financial crisis broke out, raw material exporters were said to possess an enhanced comparative advantage and to face a favourable evolution of terms-of trade *vis à vis* exporters of manufactured products. Innovation and diversification into finished products were viewed as counterproductive since raw materials were predicted to become the scarcest economic resource in the future, as the fast-growing Asian giants were expected to drive up the demand for such commodities for several decades.[7]

## Resource Abundance, Disruptive Forces and Dependence

There exists, however, a historically well-documented literature, describing in detail, on a case-by-case basis, the many disruptive features of natural resource specialization within a developing country context. Across the African continent, cases of dire poverty and misery attributable to the presence of natural resources are innumerable. To name just a couple of cases for illustration, given its oil resources, Nigeria should be one of the wealthiest countries in Africa, but mismanagement of its oil revenues has instead led it to become one of the poorest and lowest ranking in terms of human development indicators. The Niger Delta is the country's richest area of biodiversity, but due to regular oil spills, the blatant dumping of industrial waste, and unfulfilled promises of development projects, local environmental degradation and health problems have led to a significant deterioration of economic living conditions of local communities. Foreign oil companies have often played a nefarious role in this situation. In a report published in January 2000, the US-based Essential Action and Global Exchange noted that "far from being a positive force, the oil companies act as a destabilizing force, pitting one community against another, and acting as a catalyst (together with the military with whom they work closely) to some of the violence racking the region."[8]

Similarly, the abundance of natural resources in the eastern provinces of DRC, instead of benefiting the Congolese population, has been one of the major sources of its misery. By igniting and fueling the crippling wars that have plagued the country, these resources have so far cost the lives of more than five million people and have destroyed wildlife and the environment. Indeed, the huge deposits of natural resources in this nation have attracted various foreign powers, as well as internal forces that have sought to gain an easy advantage by tapping and using mineral revenues to finance armed conflicts. A number of major human rights groups have documented how individuals and foreign corporations have made enormous profits from the war and have developed networks of key political, military, and business elites to organize the plundering of Congo's natural resources. In October 2002, a UN expert panel accused eighty-five foreign companies of breaching OECD standards through their business activities connected to the rape, murder, torture and other human rights abuses that followed the scramble to exploit Congo's wealth after war broke out in 1998.

The most notorious is the trade in coltan (the ore from which tantalum, a rare mineral used in video game consoles, lap-top computers, and mobile phones is extracted), which, according to the aforementioned 2002 UN panel, produced devastating social dynamics akin to slavery. In 1999 and 2000, a sharp increase in the world prices of tantalum led to a large increase in coltan production in eastern DRC. Part of that increased production was conducted by rebel groups and unscrupulous business people who forced farmers and their families to leave their land or chased people off land where coltan was found and obligated them to work in artisanal mines where they were exposed to hazardous radiation. The resulting widespread destruction of agriculture and the hunger that it produced have profoundly disrupted the social fabric of entire communities in the region. The coltan trade and battles over other resources have also affected DRC's wildlife and environment, as the national parks that house endangered gorillas and other animals are often overrun to exploit minerals and hunt wildlife. Similar examples of the harmful effects that can be caused by an endowment in natural resources can be found in many other corners of the African continent, to say nothing of the "blood diamonds" in places such as Sierra Leone. The heightened risk of civil war in natural resource-endowed countries has been extensively documented by Paul Collier and Anke Hoeffler.[9]

In many instances, the presence of foreign productive powers in the exploitation and exportation of natural resources is made acceptable to the local population by promises of aid for local development, either directly by the involved foreign companies or indirectly by the governments of their home countries. When such development aid is directly channeled through the government budget, it often serves to legitimize political elites and to reinforce their dependence on the exploitation of resources. In such cases, greed and iniquity are never far from the driver's seat, while the invisible hand often provides an alibi for lack of accountability. Even in the best case scenario in which aid is targeted to local development projects, it often comes along with partnership agreements whereby the aid provider sometimes inadvertently or unconsciously destroys the local agricultural productive power, flooding the local markets with heavily subsidized food items. All of this forces the country in question into an even higher dependence on natural resources, with the ensuing disruptive forces that usually accompany it.

Even if one assumes away the devastating effects of violent conflicts and civil wars that arise from the scramble for the control of natural resources revenues, the abundance of these "fortuitous gifts of nature" (as they were referred to by Nobel Prize laureate Simon Kuznets) can hardly be perceived as contributing to economic development within a context where the resource-endowed countries merely exploit their natural wealth to export it as raw materials. Numerous cross-country analyses of the impact of natural resource abundance on economic performance have unveiled the fact that the economic performance of resource-rich countries has been poor relative to that of countries without such abundance.[10] In this sense, resource endowments are not complementary to the typical endowment of developing countries, i.e., large human resources; on the contrary, natural-resource specialization implies a capital intensive rather than labor intensive industrialization process.

The historical colonization process was thus not just politically but also economically coherent: it was to the benefit of powerful foreign nations well-endowed with technical knowledge to conquer natural-resource rich regions, deploying their technical knowledge to use these resources as raw materials for the production of more valuable goods. Yet, the political independence process most African countries experienced in the 1960s hasn't changed anything: the underlying economic dependency principles have remained in place, and instead of innovating to emancipate themselves from economic dependence, African countries continue to rely on the export of mineral resources to their former colonial rulers.

While this dependency situation was characteristic during the colonial period, similar examples existed even in ancient times, when Nubia served as a gold repository for the Egyptian pharaohs or when merchants from Cornwall and Spain sold tin and silver to Phoenician and Carthagian merchants at very low prices, because, as attested to by historians such as Herodotus and Diodorus Siculus, the indigenous population ignored any potential use of these minerals. Similarly, when the Roman legions first crossed the Channel in 55 BC, they were, according to Suetonius and Cicero, mainly attracted by the prospect of controlling the rich tin mines and the trade in tin that had been in the hands of Celtic Britons. In short, so far back as our memories can reach, we see the dominance and supremacy of technologically advanced nations over those dependent on the selling of natural resources.

In addition to these well-known, historically disruptive political dynamics, there are many other, more traditional economic forces that have the potential to make resource endowments a hindrance to the long-term economic growth of a nation. These include the volatility in export revenues, which hampers effective economic planning and investment; the exchange rate appreciation in periods of price booms, which harms trade in others sectors; the crowding out effects of investment capital; the underinvestment in human capital; and the lack of an employment-intensive, inclusive growth and development pattern. In general, high shares of natural resources in the economy of a country tend to be associated with the crowding out of social and human capital, thereby impeding a pattern of more balanced economic growth and human development. This rather counter-intuitive phenomenon has been called the "paradox of plenty."

## Resource Boom and Dutch Disease

The idea that natural resources might be more of an economic liability than an advantage had been in existence since the work of Friedrich List was published in the nineteenth century, but it only began to re-emerge in the 1980s. The term *resource curse* was first used by Richard Auty in 1993, to describe how countries rich in natural resources were unable to use that wealth to boost their economies and how, counter-intuitively, they had lower economic growth rates than countries with a resource scarcity.[11] Empirical research in this domain had hypothesized several mechanisms through which a negative relationship between natural resources and economic growth might operate. On the one hand, there are social mechanisms, by which it is essentially meant that resource endowment is perceived as "easy riches" that makes people lazy and prompt them to neglect education and other productive investments.[12] Such mechanisms have a direct bearing on hindering innovation and investment in productive knowledge. On the other hand, there are purely economic and political-economic mechanisms, which imply that resource booms limit structural diversification and technology accumulation by creating opportunities for mismanagement, rent-seeking, and corruption that undermine effective spending of windfall gains.[13] When resource revenues are mismanaged and the influence of vested interests becomes stronger by rent-seeking, investment in innovative activities is the first to suffer from such a situation. Some of the other traditional theories regarding the paradoxically poor performance of resource-rich countries put more emphasis on the institutional aspects of the resource curse, arguing that bad economic policies, correlated with resource rents, are the main culprits of the low economic performance of resource-endowed countries. Such bad policies include, according to Robinson, et al.:[14]

- dysfunctional state behaviour and overspending resulting in unsuitable budgetary deficits;
- exhaustion of public capital by over-extraction of resources above the socially efficient extraction path by overly discounting the future;
- misallocation of resources throughout the economy through inefficient increases in public sector employment in the interest of securing loyalty.

From an institutional perspective, countries with institutions that promote accountability and state competence will shift political behavior away from patrimonial practices toward the use of rational and meritocratic criteria in the allocation of public sector resources. Such countries usually tend to benefit from resource booms, since their institutions correct the damaging political incentives that such booms create. Countries without such institutions, including, as we would argue, many African ones, may thus continue to suffer from a resource curse as long as the harmful effect of bad policies remain uncorrected. In addition to the above economic, social, and institutional explanations, other economic channels—namely declining terms-of-trade of primary exports relative to manufactures and declining world demand for primary goods relative to manufactures—can add to the above-mentioned factors and reinforce the poor growth prospects of resource-endowed countries.

Finally, even though many of the problems described above could be avoided through the sound management of resource revenues, there remains the structural problem that when there is an export boom in natural resources (as was the case over the last decade before the financial crisis), the exporting country is ultimately not shielded from any of the harmful indirect effects. Booms can indirectly harm the economy, as capital and labor that would otherwise be used in the manufacturing sector are pulled into the resources sector and the non-tradable sector, whose demand is also increased by domestic revenues from natural resources. The increased national revenue from the booming sector also often results in higher government spending, which increases the real exchange rate and raises wages. The boom in natural resources therefore shifts production factors from other sectors of economic activity, especially from manufacturing and other tradables. Such booms, accompanied by a shift of resources across sectors, tend to shrink the tradable sector and hinder innovative sectors. The resource reallocation from the tradable sectors, notably agriculture and manufacturing, to the booming resources sector, makes the former less competitive in world markets. This weakening of the innovative sectors exposed to international competition results in an even greater dependence on natural resource revenue, and leaves the economy even more vulnerable to price changes in the resource sector.[15] If the innovative manufacturing sector has externalities such as forward or backward linkages, the shrinkage of the manufacturing of tradable goods results in a chronically low growth path, as the economy loses the benefits from externalities as well as the advantages of innovation, learning effects, and increasing returns to scale that are usually associated with the manufacturing sector and are often nonexistent in the capital intensive mining sector.[16]

Through the loss of externalities, the overvaluation of the exchange rate, and an increase of the wage rate, the so-called Dutch disease can ultimately reduce total exports relative to GNP or at least skew the composition of exports away from manufacturing and service exports that would otherwise have contributed more significantly to economic growth. This well-known phenomenon has occurred in countries like Nigeria, the DRC, Zambia, and many other resource-rich sub-Saharan African countries that have failed to translate resource abundance into equitable and sustainable growth. For the majority of African countries, with perhaps the exception of Botswana, the abundance of natural resources appears to provide apt illustration of the resource curse hypothesis.

Dependence on other primary commodities, like coffee, cotton, or cocoa also bring to light additional problems such as the fragility of small economies that rely on these export products, known since Jagdish Baghwati described the phenomenon first as "immiserizing growth."[17] The sudden drop in coffee prices in the world markets at the end of the 1980s led to a sharp loss of income for small farmers and to widespread famine for countries like Rwanda, as farmers no longer had money to purchase food. The ensuing austerity program imposed by the IMF in turn led only to a collapse in the education and health systems, with dramatic increases in severe child malnutrition as a consequence.

## Wealth and the Tree on which Wealth Grows

More importantly, even if a country were able to avoid all the problems evoked so far, dependence on the export of natural resources for a country's development remains symptomatic of a broader fundamental problem: the ignorance of what foreign countries produce with these raw materials, hence the total dependence of one's economic value generation on foreign value added. The exploitation system developed during the colonial period has left in place an education system that favors the training of an administrative apparatus suited to manage resource revenues rather than to run new and complex industries that use these resources to produce finished goods. This lack of knowledge to transform raw materials is at the very root of the long-run terms-of-trade disadvantage for primary commodity dependent countries, as the price collapse at the onset of the current crisis reminds us. Failure to break out of this vicious circle of dependence is precisely what Friedrich List denounced as a source of weakness that in the long run leads to the relinquishment of powers of production, freedom, and independence into the hands of those who possess more production knowledge.[18] Failure to recognize the depth of List's message is economically suicidal because production knowledge is ultimately the only long-term source of power that can enable a country to attain prosperity. In List's words, "Power is more important than wealth. And why? Simply because national power is a dynamic force by which new production resources are opened up, and because the forces of production are the tree on which wealth grows…"[19]

Perennial reliance on natural resources and other primary commodities as a development strategy is, therefore, problematic, as it tends to confine resource-dependent countries in the illusion of "nature-given wealth," delaying investments in activities that would help speed up the harnessing of productive knowledge. The idea that a continuous pattern of resource export is a natural outcome for resource-rich countries stems from a rather narrow and static interpretation of the classical trade theories of comparative advantage. According to these schools of thought, countries endowed with natural resources would be expected to naturally specialize in the export of these resources, covering their need for other goods and services by importing them from their trade partners, at mutual benefit. However, such theories remain static in their analysis;[20] in their actual enactment, they lead to various forms of immiserizing wealth and other Prebisch-Singer development traps.[21] They also tend to ignore the important economic benefits of diversification, as established in empirical literature by Al-Marhubi and Amin Guitiérrez de Piñeres, et al.[22]

It is interesting to observe in this context that the national accounts system used to measure a country's production usually records the total selling price of exported resources in the gross national product, even if that production is, in an extreme example, about the product of oil pumped by capital equipment controlled by foreign companies, with more or less insignificant local productive input. This tends to give a distorted image of the productive power of the resource-exporting country because there is only a conversion of natural capital into financial capital, with little to no value-added. Just as US president Barack Obama exposed the flaws of an economic system that records the selling of a derivative by a giant insurance company as a contribution to GDP, to record the oil pumping in the Niger Delta by a foreign oil company as part of the Nigerian GNP, when the drilling equipment, the pump installations, the pipeline, and the whole management thereof are in the hands of foreigners, while the local population merely stands by and the national authorities cash in on the revenues, appears to be a similar error. What value, then, can Nigeria add to its natural endowment in order to justify the recording of production as a part of GNP?

## Conclusions

The illusion of wealth created by rich endowments in natural resources has hindered many African countries in their attempts to harness technological knowledge and build up productive power so as to ensure future prosperity for their citizens. As a result of its continued dependence on the export of raw materials instead of finished products, sub-Saharan Africa has remained mired in poverty, while a handful of resource-scarce countries in East Asia have engaged in manufacture, closed the income gap, and approached industrialized countries' productivity levels. African countries have barely benefited from the tremendous expansion of the world economy and increased productivity of the post-WWII period because these productivity gains occurred primarily in the manufacturing sector, while African exports have remained heavily dominated by natural resources and other primary products. One of the biggest development challenges for Africa, as underlined by Habiyaremye,[23] is thus to emancipate its economies from the dependence on natural resources by betting on the gradual accumulation of productive and innovative knowledge, which is the tree on which wealth grows. Such innovative knowledge must be geared towards economic diversification in productive activities that will allow Africa to compete in the global market. In contrast to the belief that Africa's future prosperity lies in properly managing its resource revenues while ignoring what others do with its raw materials, only productive knowledge can allow resource-rich Africa to emerge from its current state of poverty and assume a meaningful place in a competitive global system.

Those who produce finished goods retain the power to determine the value they want to attach to inputs, affecting the final value of the goods these inputs are used to produce. They will also direct research to material-saving technologies for those commodities which have risen most dramatically in price or where absolute scarcity becomes a major future challenge. Natural resource wealth is, in this sense, a very relative concept: its scarcity is rarely absolute but generally time-constrained. The way the current crisis has affected African economies in the middle of a resource boom is a source of important lessons. Beyond the common problems associated with dependence on natural resources, which, as we've argued here, has made their abundance an "immiserizing wealth" for many African countries, the derived demand nature of raw materials means that their possession by an otherwise poor country, although it could be seen as a possession of wealth, at best confers only transitory wealth, by itself incapable of bringing lasting prosperity to a nation. When the illusion of wealth persists, economic growth and the nation's long-run prosperity may be hampered by the reliance on natural resources through a lack of adequate investments, financial depth, and human capital resources needed to sustain economic performance.

The teachings of history tell us that productive knowledge is the seed of the tree on which wealth grows; the mastering of this knowledge is like the possession of an orchard yielding wealth for future prosperity. The harnessing of such knowledge requires a radical shift from the importance that has, to date, been placed on natural resources in many resource-rich countries' national economies. This necessitates the organizational capability to use currently available resources for the acquisition of a significant future production power. The issue of access to this knowledge is primarily the responsibility of those countries which need to acquire it: in a world characterized by global competition, the economic survival of entire communities will be determined by whether they have developed the required competence to participate in global exchange. This demands that resource-rich African countries cease to see themselves as wealthy and reassess the need to accumulate technological knowledge that can be transformed into a productive power enabling them to efficiently produce valuable goods and services for the global market.

As Habiyaremye[24] has stressed, for resource endowed African countries to acquire the necessary capacity to adopt these technologies, they must adapt the curricula offered by their universities and those followed by Africans sent to study in developed countries. The education system inherited from the colonial period is in many instances inadequate to tackle the current challenges of technology acquisition because that system was, by its mission, oriented towards resource exploitation. Instead of the current disproportionate share of students in literature, philology, and other philosophical disciplines, the curricula should reflect this need for the purposeful acquisition of specific knowledge directly applicable to the creation or expansion of productive power. This calls for a reassessment of the whole education system and the technology policies of many African countries to reflect the recognition of the primacy of the tree that bears fruit (creative knowledge) over the fruit itself (wealth).

Chapter 8

# Central and Eastern Europe: Shapes of Transformation, Crisis, and the Possible Futures

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In 2008, Europe was hit by the global economic crisis. Central and eastern European countries were not spared the economic turmoil. On the contrary, some of them paid a high price for their close integration with the global economy (thus importing a similar disease as the developed others), some for their own genuine policy mistakes which exacerbated the depth of the problem, and in many cases for both these processes combined. It was the second time in the post-Soviet period (1989–2010) that those countries passed through a rather deep economic turmoil. The first time, they were affected by the massive transformation recession that was caused by the radical change of their entire economic systems from socialist (or planned) economies to market economies in 1989–94; the second time was in 2008–9 (with quite unclear delimitation of the end of the current crisis).

It has been twenty years since most central and eastern European (CEE) countries started the process of political transformation and economic restructuring, with the former Soviet republics joining this process in 1991. For at least some in the region, EU accession was a watershed. The EU enlargement in 2004 comprised eight CEE countries, and Romania and Bulgaria joined in 2007. By that time, their economies had overcome the so-called transformation crisis that was related to the dramatic change of their economic models. The fiscal crisis of 2008, which translated itself into an open recession of the "real" economy the same year, was the second serious test for the CEE countries. This new crisis had different roots from the transformation recession, and the reaction of the CEE countries to it was thus different.

This chapter is the story of thirteen countries in central and eastern Europe (Belarus, Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Russia, Slovakia, Slovenia, and Ukraine) going through the world economic crisis of 2008–9. Our goal is to test one of the fundamental "transitology" theses, which proposed, in short, that during and after the post-Soviet transformation, the whole post-Soviet space, in social and economic terms, looked almost homogeneous as a result of almost fifty years of socialist-style systemic molding. Instead, we propose—based on twelve specially commissioned "country-specific" reports—that both the current crisis itself and state responses to it were quite differentiated among CEE countries.

In order to ground our analysis of the current crisis we start by providing a short historical context of the transformation of 1990s, then we discuss a taxonomy of the transformation that provides us with a base for our analysis of the extensive economic/policy data from twelve CEE countries for the 2008–9 period, and finally we theorize the crisis in CEE countries (and attempt to look forward to the potential future of their economies).

## 1. CEE Countries: A Historical Socioeconomic Context of the Present

To begin with, the term *CEE countries* itself is a contested notion and—for some people—even an "elusive" one.[1] It generally covers the territory of that part of Europe that was freeing itself in the late nineteenth century and in particular in the early interwar years (1918–23) from the subordination of four empires (Russian, Prussian, Habsburg, and Ottoman); for the previous four centuries, those empires had carved and divided among themselves a vast chunk of east-south Europe. The term is also an attempt to redefine Europe's cultural, ethnic, and political subdivisions, and it became particularly useful after 1945 as a convenient label for the "nominally independent countries which were caught inside the Soviet bloc."[2] Obviously, the fact that they were subordinated for a long time to different political and—to some extent—economic models made an important imprint on those countries, leaving long-lasting cultural and institutional legacies of subordination. As the dominant argument goes, this diversity was significantly diminished or even erased by the massive process of the imposition of the Soviet model and the concomitant de facto unification of the region after World War II. As a result, as one economic historian has argued, "in 1991, we find economically bankrupt states burdened by enormous foreign debts, inefficient and outdated industrial and agricultural systems, [and] grave environmental problems."[3]

If one would like to paint—with a thick brush—a series of historical sketches of CEE countries' economic thresholds until the beginning of the post-Communist transformation in 1989–91, one would need three canvases. The first painting would show that the eastern part of the CEE countries,[4] until the mid- to late nineteenth century, formed a zone of backwardness in Europe (in large part due to being swallowed by four empires that largely kept them as their resource- and agriculture-producing periphery).[5] As Daniel Chirot has insightfully concluded, "Eastern Europe was in some sense economically backward long before it was absorbed into a broader Western world market. CEE countries' backwardness had roots in a very distant past, not in any distortions imposed on Eastern Europe in the last few centuries."[6] This distant past should be traced at the very least to the so-called second serfdom of the sixteenth and eighteenth centuries that reversed in CEE countries the western and northern European historical trend of emerging out of feudalism and into capitalism and, by extension, decreasing the importance of agriculture in favor of laying the foundations of the industrial age. As Ivan Berend has argued, "The history of Central and Eastern Europe . . . followed an opposite trend from that of Western Europe. Instead of eliminating feudal institutions, . . . [CEE countries] regressed to an earlier stage of feudalism, a manorial-serf economy. . . . Serfs were again bound to land, and feudal dues were paid in crops and then in labor."[7] Indeed, CEE became a cheap grain-export region which allowed western Europe to focus on industrialization.

The second picture would show the interwar period (1918–39), when almost all CEE countries were trying to implement a variety of developmental strategies, ranging from copying Western models (in particular German, state-led market development) to inventing modern economic nationalism in order to catch up with the rest of western Europe. Most of these initiatives failed.

The third painting would show the Communist period.[8] That sketch would be mostly blurred, as debate over that period's economic and social performance is far from being intellectually concluded. On one side, there are powerful arguments focusing on the system's ability to quickly mobilize resources for structural changes, to accelerate economic growth, and to provide social welfare provisions on a massive scale; on the other, there are strong arguments of economic inefficiency and lack of political rights. The poor welfare-state system that began to crack in the late 1970s could not withstand the pressure of the world economy, to which it became more and more exposed, and by the end of 1990s the system was forced to undergo fundamental changes.

By the "time of the collapse" however, as János Kornai has calculated,[9] the socialist system appeared to be economically ineffective as compared to the rest of western Europe (see table 8.3 in the appendix). Kornai's research quite convincingly shows that only during the Stalinist period of the first half of the 1950s were the so-called socialist countries able to sustain (and in many cases even surpass) the rate of growth of their western European counterparts (although the fast-growing countries of southern Europe [Italy, Greece, Spain] were able to achieve even faster growth in the 1950s). From the 1960s on, CEE countries have been losing the economic and technological competition with the rest of Europe, and the developmental gap has been widening.

To recapitulate: most of the CEE countries have demonstrated an ongoing state of underdevelopment in comparison to the European core. The transformation that began in 1989–91 not only had to overcome the historical, long-term backwardness of the region but also had to deal with the mostly negative economic legacies of the more modern Communist period.

## 2. Post-Communist Transformation in CEE Countries (1989–2007)

The introduction of the Solidarity-backed government in Poland (September 1989) and the collapse of the Berlin Wall two months later marked a new phase in the history of CEE countries; some called it transition from Communism, some just transformation. In any case, it was a dramatic and socially painful process. Literally within months, CEE countries had to introduce three types of markets (financial, commodity, and information), reorganize prices, and reshape institutions: the legal system, the ownership system, and so on. All of them entered deep and prolonged economic recessions that lasted from two to four years (and, in the case of Ukraine and Russia, even longer). Economists still argue about the reasons behind faster or slower recovery from the deepest economic downturn of the twentieth century in the region. Some, such as Leszek Balcerowicz,[10] argue that the kind of policies implemented (such as, for instance, Poland's so-called shock therapy versus the slower-paced Czech or Hungarian "moderate reform"[11]) were behind the difference in the length of the recovery period; some, such as Vladimir Popov,[12] argue that the most important factors influencing the depth and duration of the slowdown and recession were the initial economic conditions of each country before the collapse of the system. Our position is that the combination of both—initial economic/institutional conditions and the types of the reform (economic policies) that were introduced in 1990–91—made some countries recover quicker than others during the transformation period of 1989–2000.

Economically speaking, there were simultaneously both similarities and wide disparities between CEE countries at the start of the transformation (early 1990s). The similarities were basically constructed by the general developmental model based on a planned economy (which was highly centralized, coordinated by state planning agencies, dominated by heavy and military industry, and lacking—in most cases—private productive assets), a model that shaped their economic and social systems for at least several decades.[13]

The differences were based in the ways that model was culturally and institutionally reshaped in the process of its implementation in each country (Russia-Ukraine as part of the USSR since the 1920s and other CEE countries between 1946 and 1948) to reflect its specific social and political environment. In other words, a more nuanced analysis reveals that the actually applied socialist-type developmental model had its different, quite wide-ranging, variations across CEE countries. For instance, Slovenia introduced workers' cooperatives, Poland retained private ownership of land, and some regions of Yugoslavia, Hungary, and Poland introduced private ownership of small family businesses.

These differences, combined with the countries' differentiated initial environment of transformation (we would include here basically the level of political determination and social support for different speeds of change and different types of economic policies that were implemented) resulted in the nationally diverse patterns of economic growth the region has seen during the past twenty years.[14]

Generally we can detect a quite clear pattern in the transformation process in CEE countries. Namely, they all have followed a J-curve pattern,[15] in which the first phase of restructuring was marked by a decline of the overall output (in some cases, such as in Russia or Ukraine, a dramatic decline of nearly 50 percent of GDP). The second phase was marked by differing speeds of recovery in the new, capitalist market environment. The speed of the recovery mostly depended—as we argued earlier—on a complex combination of some initial conditions (economic, social, and political), the type of economic policies that were implemented (and they ranged from "shock" to "slow-gradual" reforms), and the state's institutional capacity for their implementation. The third phase (2008–9) was highlighted by the 2008 global financial crisis, during which almost all CEE countries (except Poland) saw modest to severe GDP decline.

Some economists compare the transformation recession of the post-Communist countries to the Great Depression of the 1930s.[16] Indeed, particularly in the post-Soviet republics and in Russia itself, the scale of the decline in production is roughly comparable to the losses of the Great Depression of the 1930s—an approximate 30 percent drop in 1929–32, with the output restored by the late '30s. However, the world had never before seen output drop by 50 percent or more or seen a major drop take fifteen to twenty years to overcome. Examples of deeper and even more prolonged declines in production can be found in certain countries, but only in times of war, epidemics, or natural disasters—never as a result of economic policy. Indeed, the drop in output in the countries of the former USSR is described in economics textbooks as the biggest manmade economic crisis in the history of mankind.[17]

We argue, however, that in the limited case of the core CEE (despite ongoing and still-heated debates among economists), it is probably prudent to say that sudden exposure to an open market economy, liberalization of prices, withdrawal of subsidies, privatization (though nowhere was this a rapid process), lifting of bureaucratic obstacles, and allowing for rising unemployment (see the Polish case) was a largely successful strategy.[18] Notwithstanding, a heavy social price was paid for such growth, such as temporary lowering of the standard of living, growing social disparities, and diminishing welfare provisions. Countries that took the path of shallow, slow-paced reforms (for example, the Czech Republic and Hungary) ended up in the lower-performance category, catching up within a longer time frame.[19]

The Russian case seems to stand alone and does not fit into the preceding generalization, as reforms of the early 1990s were revolutionarily deep (so as to position Russia as a regional—and world—leader) but did not lead to a successful transformation. Quite the contrary: in the 1990s, the Russian state lost its capacity to govern and to manage the tremendous burden of transformational change. The state, facing internal and external pressures, almost withdrew from its basic functions (protection of its citizens, provision of health care, securing legally bounded transactions, monetary oversight). The situation only started to improve—in GDP terms—in the early 2000s, mostly due, however, to the price increase of the state's main export commodities and not due to an improvement in the overall economic efficiency or the success of structural change.

The comparison of Russia with the rest of CEE provides us with the important argument necessary for the fine-tuning of the previously outlined answer to the question of what was crucial for the successful transformation (the radicalism or speed of the implemented policies or the initial socioeconomic conditions in a given country). At this point, we introduce the state as one of the key actors whose performance had a strong impact on the overall speed, depth, and efficiency of the transformation. In other words, the state seems to be a strong corrective variable that plays an important role (in particular, through the efficiency of its institutions, the quality of its policies, and its ability to implement them). Thus, it seems that the transformational recession was brought on not so much by market liberalization as by the virtual collapse of the state.[20] In countries that were successful in keeping government revenues and spending from plunging drastically (as was the case in most CEE countries), the decline in production and associated social costs was less substantial. The Russian example shows that a weak state and low state capacity to implement policies are the main contributing factors in unsuccessful transformation.

At the beginning of the current crisis, in the worst situation were those CEE countries which seem to have paid the heavy social and economic price of the first years of post-Soviet transformation for nothing in return (i.e., they did not effectively restructure and modernize their economies). Russia, and especially Ukraine, are a case in point, since the social sacrifices and deep decline of overall production in 1991–95 have not led to sufficient restructuring and modernization of their economies.[21] To some extent, this can be explained by the fact that the post-Soviet states went through the greatest decline due to rapid collapse of the former strongly internally integrated economic system.

Interestingly—from the political-economy perspective—a complex process is emerging that can be called schizophrenia of transformation. The main symptoms of this illness prevalent among several CEE countries are the following: first, in many of them, quite dynamic market changes did not lead to (nor were they followed by) quality institutional change. They resulted in a mostly imitational form of political/institutional transformation. Particularly in the early 1990s, CEE countries were engaged in a politics of mimicry—a massive copying of liberal norms and institutions from the West (mainly the EU); this mimicry (or institutional imitation) was put into different historical-political-social contexts that in many cases did not correspond with the countries' own historically rooted institutions and political culture. From parliaments to banks, their structures and procedures were taken from outside (in particular, between 1989 through the mid-1990s) and established in CEE countries, but their behavioral and functional characteristics were in most cases well entrenched in the socialist past.

In fact, the case can be made that the level of successful mimicry depends largely on the extent to which the adopted new models have been compatible with the inherited ones. So in countries where the emerging synthesis between the old and the new did not gain systemic significance, political and societal transformation (as opposed to the dynamism and speed of the economic transformation) was slower and more volatile—almost along a zigzag trajectory. More than that, it appears that a combination of democratic rules (or even quasi-democratic arrangements) and weak institutions can lead to political and economic chaos, as has been the case in the Ukraine.

Second, there is also considerable volatility of the political scene in CEE countries, with shifts of voters between parties with opposing systems of values and exotic coalitions of entirely opposite ideologically political forces, made with the sole purpose of retaining power. And all of this is coupled with a much higher level of corruption than in western European countries and generally a low efficiency of institutions. Indeed, there is a noticeable disjunction between politics and economics (in some periods, there was almost a decoupling of the two, with business operating as a standalone operation, irrespective of government action or inaction).

In fact, our story starts to fully unfold at this point, as almost twenty years of transformational experience and extensive data that we collected by the end of 2009 (at the peak of the crisis in CEE) permit us to make some generalizations. Thus, first we outline a taxonomy of the economic transformation in CEE countries, and then (in the next section, devoted to the analysis of the crisis) we juxtapose it with empirical data that we have collected from twelve country cases.

Table 8.1: Economic Transformation Grid (until 2007)

| | |
|---|---|
| 1. LEADERS | Belarus (?), Estonia, Poland, Slovakia, Slovenia |
| 2. STRONG FOLLOWERS | Czech Republic, Hungary, Lithuania, Latvia |
| 3. STRAGGLERS | Bulgaria, Romania, Russia |
| 4. LOSER | Ukraine |

CEE countries' performances by the end of 2007[22] can be grouped in four different categories, creating the following performance grid:

1. The leaders: Poland, Slovenia, Slovakia, Estonia (but only until 2007), and—surprisingly—Belarus[23] managed to surpass their GDPs' initial 1989 levels by 50 percent or more.
2. The strong followers: Hungary, Czech Republic, Lithuania, Latvia (after 2007, however, the last two countries registered a sharp

decline of GDP) constitute the second group of countries, which were able to exceed their 1989 GDP level by more than one-third. Their growth was unstable, with some acceleration during the last period.

3. The stragglers: three countries, Romania, Russia, and Bulgaria, were not able to overcome 120 percent of the 1989 levels, which was due to a very deep decline at the beginning of the transformation period and/or unstable pace of growth afterward, in the case of the two Balkan states caused by shaky reforms. The Russian case is a specific one, since its recovery and strong growth stemmed from high prices for oil and gas, which accounted for two-thirds of Russian exports.[24] Russia thus is in a quite peculiar position, having strong oil/gas-based growth for the past eight years and having huge financial reserves (the highest in the region) but still not being able to reach the GDP level of its smaller neighbors.
4. Ukraine stands as a lonely loser, being a country with the most acute problems in emerging out of the recent recession. After a long period of decline (1991–2001), it saw a phase of fast growth (2002–7), which was due to the increased demand for traditional industrial products (such as steel). However, the most recent data (2008–9) show that this dynamic has been lost and that the country is back to economic and political turmoil, with no sound foundations for an economic recovery. In 2008, Ukraine reached only 70 percent of its GDP of 1990 (the time of its separation from the Soviet Union), and recent world crises wiped out another 15 percent in 2009, according to the official statistics; so Ukraine GDP is at 55 percent of the one twenty years ago. One should note, however, that the "real" economic situation of this country may not be as bad as the latest official statistics show, due to an exceptionally high share of hidden economy (estimated at 50 percent of GDP).[25]

Having established the historical and transformational contexts and having grouped CEE countries according to their performance before the crisis, we now turn our focus to the analysis of the current crisis; our analysis is based on twelve unique country studies commissioned specifically for this chapter.

## 3. CEE Countries and the Economic Crisis of 2008–10

CEE countries were obviously not spared from the economic turmoil of 2008–9. The crisis hit them, however, with different speed and depth. In general, the difference of GDP dynamics among this group during the crisis of 2008–10 is almost 20 percentage points, and the differences in unemployment rates are over 11 percentage points. Let us thus compare the precrisis and in-crisis performance of CEE countries.

Generally, the crisis affected all CEE countries negatively. Some members of each type were demoted, but there were not dramatic shifts. That is why we start by slightly revising our taxonomy by introducing a "superleague" category within the leaders and introducing changes that reflect available data. We do so to underline the quite unique position (it remains to be seen how stable this position will be) of Poland at the beginning of 2010 as the only country in CEE that recorded positive economic growth. Polish GDP did not decline in any single quarter throughout the global slump of 2008–9. In 2009, its GDP growth was 1.8 percent, and both consumption and fixed capital formation were growing. Inflation was low, with slowly growing unemployment. Domestic spending did not decrease. The total output of the construction sector increased by 3.6 percent (thanks mainly to major infrastructural projects cofinanced by the EU). A decline of 7.4 percent was observed in industrial output during the first seven months of 2009. The banking sector saw a decline in profits. Twenty-two out of seventy banks operating in Poland reported net losses during the first quarter of 2009. Public finance, as well, became exposed to tensions; the budgetary deficit had to be increased by one-third. In 2009, the deficit of public finance reached 4.6 percent of GDP. Foreign trade slowed down considerably. Exports in the first half of 2009 reached only two-thirds of exports during the first six months of 2008, and imports only 60 percent (which allowed for a decrease in the negative balance of foreign trade). Thus, until the end of 2009, the economic, social, and political situation in Poland was tense but stable.

Slovenia and Slovakia have maintained their economic leadership position among CEE countries, in spite of their temporary decline in GDP. Their economies seem still strong and public finance healthy. But we have moved Estonia—hopefully temporarily—to the category of the followers, as it was not able to cope with the crisis with the same effectiveness as its colleagues from the leaders group.

Slovenia faced a significant reduction of its GDP in 2009 (in the 7 percent range). Due to high integration with international trade flows (exports represented 69.5 percent of GDP before the crisis, as Slovenia is traditionally one of the most "trade open " countries in the region), Slovenia was heavily exposed to the effects of the crisis, and its exports of goods and services declined by 20.8 percent in real terms in the first half of 2009. Also in the first half of 2009, Slovenia's gross fixed capital formation dropped by 25 percent compared to the previous year, due to lower investments in buildings/infrastructure and machinery/equipment. A high level of uncertainty led to an increase in unemployment rates. As a result, private consumption dropped for the first time in nine years. Apart from an improved trade balance due to a fall in imports (which declined even more than exports in the first half of the year, by 24.6 percent), government consumption was the only GDP aggregate to increase in real terms.

Slovakia's prudent budgetary regime in the few years before the introduction of the euro in 2009 substantially limited risks in the public sphere and finance. Nevertheless, the Slovak economy is small, very open, and industrial/export oriented and thus became quite vulnerable to crisis. Strong dependency on exports was combined with acceptance of the euro, which brought advantages as well as risks. The Slovak banking sector, with its conservatism (in lending policies) coupled with the very conservative behavior of its clients (with preferential cash transactions), did not suffer too much but did see profits decrease compared to 2008. An extreme export dependency is an inevitable feature of small economies such as Slovakia. The decrease in exports was 25.1 percent for the first three quarters of 2009. High dependence on exports to other countries has resulted in a serious crisis in the Slovak economy, which in fact inherited its metal industry (now especially US Steel Slovakia) and heavy chemical industry as traditional national industries. As a result of the slowdown in demand abroad, Slovakia has faced a substantial drop in its industrial production. This, in turn, resulted in fast-growing unemployment in that sector; notably, the construction sector did not follow that path and managed to record even small growth. Other sectors such as travel and retail were also seriously injured (almost 20 percent on average

Table 8.2: Economic Transformation Grid (crisis of 2007–10)

| | |
|---|---|
| 1. LEADERS | Belarus (?), Poland, Slovakia, Slovenia |
| 2. STRONG FOLLOWERS | Czech Republic, Estonia, Romania |
| 3. STRAGGLERS | Bulgaria, Hungary, Latvia, Lithuania, Russia |
| 4. LOSER | Ukraine |

by 2009). Overall—despite slowdown—the Slovak economy is still strong by comparison with other CEE countries.

Estonia became another victim of the crisis, seeing its GDP decrease significantly (by almost 12 percent in 2009) as industrial production decreased by almost 30 percent virtually in all industries (with the exception of shipbuilding). The main reason for the decline was insufficient demand both in domestic and external markets. The unemployment rate rose to 13.5 percent in the second quarter of 2009 (by comparison, it was 4 percent in the previous year). The almost entirely foreign-owned banking system suffered significant losses, and within one year, Estonia was no longer the darling of investors. In our classification, it slipped a notch to the category of strong followers (with good prospects for a steady recovery).

The group of strong followers listed in table 8.1 (those that exceeded their 1989 GDP level by more than one-third) were struggling during 2008–9, with sharp declines of their GDP and industrial production, leading Hungary and Latvia to slip into the category of stragglers. Let us provide some key economic indicators to illustrate the level of the recession in that category. Czech industrial output fell 23 percent (2009); in Hungary, it reached 25 percent; and in Latvia, 16 percent. In some industries, the level of decline was dramatic—for instance, the Czech metallurgy industry saw a decline of 42.5 percent (2009), while the car industry lost 17 percent (2009); the Lithuanian construction industry lost 48 percent (in the second quarter of 2009).

Moderate GDP decline in the Czech Republic (3.4 percent in 2009) can be compared with Hungary's 6.7 percent decline, Romania's 9 percent decline, Latvia's 19 percent decline, and the highest decline in the region, Lithuania's 22 percent (in the second quarter of 2009). Hungary has since been bailed out by an IMF rescue package of twenty billion euros, while analysts are predicting that in the coming years Latvia and Lithuania are going to face prolonged economic downturn due to an unstable situation in the financial sector, a crash in real-estate markets, a fall in production, and growing unemployment.

By now, the category of stragglers in our economic-crisis performance matrix has grown. Russia, however, seems poised to recover quickly as oil and gas prices rise, creating strong upward momentum that may see it join the strong followers category very soon.

The lonely loser from the initial matrix—Ukraine—remains there, even after being given a life jacket in the form of an IMF loan and recently (after electing a new president in February, 2010) negotiating lower prices on Russian gas.

Our initial taxonomy was not dramatically reshaped by the crisis, but nevertheless there were some noticeable changes. Let us make some generalizations from this complex picture. Before the crisis, the Polish economy belonged to the leader category. At the beginning of 2010 (when we are writing this chapter), it is the only country that not only maintained this position during and "after" the crisis but has distinguished itself by being a clear and sole winner as the only country in the EU with positive growth in 2009 and without deeper social dislocations. Even if some observers have attributed this result to mere luck, we think that we can offer a more tangible explanation.[26] Some experts point out that despite success in dealing with the crisis, the Polish economy faces many serious problems, ranging from weak management of public finances and a still insufficiently reformed pension system to weak innovativeness. These weaknesses were, however, not strong enough to significantly contribute to the deepening of the crisis. We offer five broad explanations of this quite surprising situation.

The first, and most general, is that the Polish economy was not fully integrated with the global economy in terms of its financial system, and that fact, combined with a certain level of traditionalism among key banks and the fact that the foreign-owned banks in Poland were branches chartered under Polish law which prevented the mother banks from withdrawing capital, shielded Poland from the full brunt of the crisis. Second, the size of the domestic market—the largest among CEE countries—coupled with the influx of quite sizable remittances from the almost one million Poles working abroad, cushioned the impact of the spiraling collapse of demand that struck in many other EU countries. Third, having the flexibility afforded by a national currency (Poland did not join the eurozone) permitted for a quite rapid depreciation of the currency (from October 2008 to April 2009, the Polish złoty lost more than 70 percent to the dollar and 50 percent to the euro, and then it regained some of is value). Thus, Polish exports retained their competitiveness, and Poland avoided the fate of Slovakia, which adopted the euro with an overvalued national currency and lost a great deal of its international competitiveness (the same can be said about the Baltic republics and Bulgaria, which pegged their currencies to the euro). Fourth, an influx of EU funds for the financing of infrastructure investments and other regional projects was also an important economic stabilizing factor. And finally, the correct policies were enacted by the government, which neither sought huge savings nor spread money in order to spur domestic demand and at the same time dispersed soothing news that there was no crisis in the country, which calmed worries and which has not allowed for a self-fulfilling negative prophecy.

Is there, however, a universal lesson to be learned from the Polish example? We think not. One should distinguish between the pace of overcoming the crisis and the capacity for growth after the crisis ends. In many cases, these are contradicting abilities, since the anticrisis short-term measures may have an adverse effect on the competitiveness of a given economy in the longer run. We argue that this may be the case for Poland.

How can we explain some noticeable shifts in the economic performance of CEE countries before and during the crisis? What follows is a causal explanation of the main causes of the economic crisis in CEE countries that contributed to shaking the precrisis leaders-losers scale within the context of the global turmoil of 2008–9. We divide the causes into two general categories—external and internal—and then present a CEE-countries model, or country-based typology, of those causes.

The external causes of the CEE countries' crisis are mainly located in the process of importing the global crisis to the CEE. First, the dependence on *shrinking exports* hit those CEE countries that during their post-1989 transformation focused on export-oriented developmental strategies.

This is true both for the small economies (Slovakia, the Czech Republic, Hungary), as well as for the biggest of the group, Russia. Despite sectoral differences in all twelve cases, shrinking external demand may have been a serious negative factor leading to decrease of production. The second and most important factor was the *volatility of foreign banks* that were established in CEE countries. This situation was the most typical for the Baltic republics (Latvia, Estonia), whose banks are almost entirely owned by the banks of the Nordic countries and Germany. In these cases, the difficulties of the master banks were immediately translated into severe problems for their subsidiaries, which in turn led to the rapid decrease of approved loans and thus worsened the situation of local firms. Third, the rapid decrease of foreign direct investment (FDI), which happened without exception in all CEE countries, led to a *slowdown of economic processes and decreases in the balance of current accounts*; similarly, withdrawal of speculative capital increased the pressure on the denomination of local currencies and/or worsened the balance of current accounts.

It is hard to measure the level of the impact of the external versus internal causes of the depth of the crisis, because in the real economy they are more often than not firmly—if not indistinguishably—intertwined. For the analytical (our model-building) purpose, however, we may distinguish at least five categories of internal causes. The first is a strong dependence on *industrial specialization* in a narrow range of commodity groups (such as auto manufacturing, household appliances, raw materials, and the energy sector). During 2007–9, these industries were the most sensitive ones: a virtual collapse of demand for new cars in 2008 led to a dramatic drop in production in countries such as Slovakia and Poland; similarly, shrinking demand for raw materials negatively influenced the performance of the Russian economy, with its heavy dependence on exports.

The second category is the growth of wages outpacing productivity. This factor was especially pronounced in Latvia and Estonia, which enjoyed fast rates of growth in the years after 2000 (especially marked by their EU accession in 2004). A combination of an almost uncontrolled spiral of higher income, higher demand, cheap credit, and unshaken trust in a prosperous future—combined with the currency being pegged to the euro—led to a decline of international competitiveness of the economies that underwent this process as the fiscal policy tools were removed from their control. This process was exposed by the crisis and accelerated the highest GDP decline among CEE countries.

Third—quite common to all CEE countries but particularly damaging to Hungary, Latvia, and Estonia—was a *credit bubble* partly stemming from a rapid investment in real estate and often denominated in foreign currencies.[27]

The fourth category is an *overvalued national currency* (as a result of pegging it to the euro in Bulgaria and the Baltic republics) or entering the eurozone just before the crisis with an overvalued national currency (Slovakia). Unbalanced public finances before the crisis were one of the key factors for making the crisis worse in CEE countries (the most dramatic example being Hungary).

The fifth category, and the most debatable one from our perspective, is *institutional inefficiency* as a contributor or accelerator of the crisis; in a classic reading of developmental theory, an inefficient institutional system should be one of the causes of poor adaptation to a deteriorating international situation. It is a paradoxical and counterintuitive surprise that this factor seemed to work in the opposite direction in CEE countries: relatively poor and inefficient institutional settings appear to have been negatively correlated with performance during the crisis. In countries that seemed to enjoy transparent and modern institutions (such as Estonia), the crisis was much deeper than in the countries of traditionally "soft" institutional setting, such as Poland and especially Bulgaria, notorious for its widespread corruption, where the crisis decline in 2009 was not all that deep. It seems that in a crisis situation, the additional flexibility provided by national institutions with bending and murky rules, combined with (what seems to be an important but hard-to-measure factor) a vast "gray economy" sector, served as a sort of shock absorber that cushioned—at least temporarily—some of the symptoms of the crisis. Indeed, this suggests that what slows the system (and makes it less effective) during the normal capitalist cycle may have proved to be a positive factor in a time of crisis, as it allowed for rapid (unbounded by rules and policies) institutional flexibility and revealed the spare capacity of the system.

Such magnitude of world decline obviously created a nervous reaction in CEE countries, as they all found out that they were not immune to global trends; quite the opposite was true: those countries that were more incorporated with the global economy suffered the most. Their reaction was to analyze key economic measures and adjust their own policies. Three of those policies were applied across CEE countries. The first one was to pump public money into their economies in order to stimulate domestic demand and ease the fiscal strain of the banking system. This was accompanied by job-preserving fiscal incentives such as organizing large-scale public infrastructural projects. In the longer run, however, such initiatives might create higher inflation.

The second strategy was a series of attempts to restore the balance of public finance through a classic bundle of austerity measures such as reducing employment and/or salaries in public administration, scrapping some investment projects financed from public budgets, and so on; in some cases, applying these instruments was the condition for obtaining assistance from international financial institutions such as the IMF, as was the case in Hungary and Poland.

The third set of measures was oriented toward the more distant future and aimed at increasing the long-run competitiveness of the given economy. Increased spending on applied research and development and assistance for investing in new technologies undertaken by private companies are the best examples of this strategy. While this strategy was mainly applied in the United States and China during and after the crisis, it was also put into effect in some CEE countries.

We have synthesized the vast empirical material in a composite table that presents a range of policies that were applied in CEE countries in 2009 to counter the immediate effects of the crisis (see table 8.5 in the appendix). In most cases, all three approaches were used simultaneously. Slovenia seems to be the country with the most consistent stimulus package, which is directed not only to quantitative dimensions of the current domestic demand but also to the future technological advancement and innovativeness of the national economy. The Baltic states, with cuts in almost every facet of government spending and also in the social sphere, are representatives of the opposite strategy. Most of the other countries seem to apply both types of instruments—cuts on the one hand and, on the other, stimulating the business sphere, most often by state guarantees to banks and other financial institutions.

The relatively poor countries of CEE do not have the resources—or courage—to implement massive financial-incentive packages like the ones undertaken in the United States and in some western European countries. They seem to cope with the financial crisis mostly in a more prudent way (there are at least three explanation of that hesitancy to use the state: relative lack of experience in implementing massive-scale interventions, limited resources, and distrust of the state-led process) and try to keep the deficit of public finances under control (though in some cases it has soared—to about 8 percent of GDP in Hungary this year and to over 7 percent in Poland).

So what will be the CEE countries' situation after the recent phase of the crisis is over? One may presume that they will not lose their competitiveness and that in some ways the crisis will not only have short-term negative effects but might even bring some positive ones. It can be expected that the crisis can have an important cleansing role, involving the elimination of less competitive business entities. It has also an educational role, especially in CEE countries, where the citizens were still attached to the sheltering role of the state. It now appears that the economic reality is complex and that excessive household consumption or the inefficiency of an enterprise—as well as irresponsible policies of the public authorities—must lead to economic problems. In this way, the crisis could alter the economic power of individual firms and territorial systems and influence their competitiveness.

## Conclusions

We had at least two objectives in mind when writing this chapter. We wanted to empirically test the thesis that the whole post-Soviet space in social and economic terms looked almost identical as a result of socialist-type systemic molding and that this continued to be its main feature during the transition period. We also wanted to show the differentiated depth of the crisis in twelve CEE countries and the surprisingly consistent—with EU action—set of measures deployed to respond to it.

As the analysis progressed, we also looked at the intriguing phenomenon of institutional schizophrenia—a profound disconnect between the level of economic transformation and the quality of CEE countries' institutions. As the process of analyzing the data progressed, we went beyond those limited goals to extrapolate CEE countries' current experience and offer a glimpse of the future.

Let us offer some conclusions. First of all, the crisis has reinforced the transition-period experience that CEE countries no longer form a coherent socioeconomic group. It might be said that CEE countries have lost their collective identity; they became an integral part of the European space, and it therefore might be said that Hungary is closer (in an economic sense) to Portugal, and Latvia to Greece, than they are to each other. We have also shown a surprisingly deep "Europeanization" of most CEE countries in their response to the crisis but, simultaneously, also quite a high dependence on the European core.

Second, the crisis in CEE countries underlined some global trends but also proved the presence of a locally made variety; the most lethal combination was the parallel presence of foreign ownership of banks, wages that grew faster than productivity, overvalued currency, and a credit/housing bubble. This combination struck the Baltic republics (mainly Latvia and Estonia), though some of its aspects can also be detected (on a much smaller scale) in other countries.

Third, as a result of high specialization in exports of not highly innovative products—especially if coupled with an overvalued currency attached to the euro or the euro itself some countries—some countries became very vulnerable and recorded serious economic decline (as in the case of Slovakia).[28] Also, specialization in unprocessed raw materials became a serious crisis factor (as in the case of Russia).

Fourth, we found a strong correlation between the initial (precrisis) economic conditions and CEE countries' ability to cope with the crisis; as a rule, the precrisis imbalance of public finance aggravated the crisis and weakened the possible means of countervailing it (as was the case in Hungary and in Ukraine). What is surprising, generally, is not only that the depth of the crisis was quite differentiated across CEE countries but even more interestingly that the consequences were more shallow than in the core developed economies of the EU (except for Latvia and Hungary). We attributed this fact—paradoxically—to certain deficiencies in the institutional development in the region; weak financial institutions combined with quite conservative banking and a popular approach to borrowing/lending practices made CEE countries less exposed to the crisis in the financial sector.

Fifth, for CEE countries, the global crisis of late 2007–9 was not the only major slump during the past twenty years; while OECD countries all reported unprecedented growth (despite the dot-com bubble) for the past two decades, CEE countries experienced a huge downturn in the early to mid-1990s. In other words, there had already been a steep learning curve for those countries, and most of them passed the transformation lessons with medium to high grades. It was a very helpful experience in light of the current slowdown, as they faced the new situation without panic and with considerable policy confidence; moreover, the general public was less nervous than in most Western countries. There is, however, a considerable caveat to this story: the very fact that CEE countries generally coped well with the crisis challenges, combined with relatively shallow consequences of the crisis, paradoxically did not force them to more deeply rethink their economic policies and to come up with innovative solutions regarding their banking sectors, their dependence on the EU, or the structure of their economies. Quite the contrary—they seem to have entrenched themselves within the economic orthodoxies; most of the policymakers seem to count on the postcrisis era's being similar to that before the crisis.

The sixth observation distinguishes CEE countries from some other members of the EU. CEE countries—having been trained in overcoming several economic and political difficulties—seem to have passed through the crisis with necessary courage and the ability to sacrifice. This cannot be said about Greece, for example, but also about other nations and societies in Europe, who rather prefer defending the status quo and not paying too much attention to the future difficulties, which may stem from this attachment to the already attained—often too high—standard of living.

As for the possible future(s), there are multiple but uncertain conclusions. In a structural sense, the crisis has highlighted CEE countries' growing dependence on the EU core. So the stability or volatility of the EU will influence the shape of CEE countries. Also, as we pointed out earlier, EU funds helped to finance larger-scale infrastructural and construction projects (from the so-called Structural and Cohesion Funds) that were cushioning the impact of the crisis. Thus, the ability of the EU to continue providing those funds will influence the performance of CEE countries.

In political-economic terms, quite a chilly forecast is unfolding socially and politically; its contours may be summarized in three points. First, the welfare state is costly, and lesson number one is that one can dismantle such costly machinery with no significant political costs as part of the crisis austerity measures. Second, CEE countries served as a laboratory for another test—how far one can push labor without significant protests and political dislocations. The answer is quite clear based on recent experience: one can make labor flexible enough to diminish its collective demands to a minimum. Third, there are indicators (Hungary, Slovakia) that the aftermath of the crisis will generate more populist pressure and more robust political articulation of the populists' social sentiments that in turn may produce anti-immigrant, isolationist, and anti-EU policies, though this remains to be seen, for the political elites (recently changed in Hungary) have not yet presented their future policies.

In policy terms, the future is sketched in the answers to a few crucial questions. A first question is how CEE countries' map of regional economic development will change. We can forecast that the recovery will have different speeds; that will make recovery challenges similar across the CEE–EU core divide. Also, it seems that for some countries (for instance, Latvia, Hungary, and Bulgaria) social pressures stemming from cutbacks in public expenditure may grow (as unemployment will likely be quite persistent).

That leads to the second key question of what kind of regional developmental strategies are needed to meaningfully respond to the impact and legacies of the crisis. There is clearly a need to consider the future sources of competitiveness in CEE countries (as well as for the EU as a whole) and how the—frankly not too impressive—performance in innovation can be accelerated. In the pool of CEE countries, so far only Slovenia (and to some extent Russia) seems to be taking this possible future direction as a basis for its medium- to long-term policies. There is also a danger that CEE economies will be losing their competitiveness due to the fact that they will lose their comparative advantage stemming from low costs of production and will not be able to compete on the grounds of competitive advantage associated with innovativeness and technological advancement.

The third question—related to the institutional setting—is whether CEE countries have incentives to improve their institutions based on recent experience. The answer might be unnerving for some institutionalists, as the conventional wisdom is that the better the institutions, the better the performance of a given socioeconomic system. This thesis has not, as yet, found support in the current crisis in CEE countries. On the contrary, the better performance of some countries, such as Poland but also Bulgaria and Romania, may be attributed to their less-than-ideal institutional settings. Moreover, the lack of direct and strong links with the international financial system and reluctance to introduce advanced financial instruments may have saved the banks of some countries from importing financial turbulence. Therefore, certain deficiencies in the institutional development of some countries and their relative backwardness and weak financial institutions, combined with quite conservative banking and a prudent approach to borrowing/lending practices, made a few CEE countries less exposed to the crisis in the financial sector. As the *Economist* stated, "Countries that have a culture of prudence are more likely to adopt rules. So are countries that have had fiscal crises."[29]

Finally, there is a conceptual issue: are CEE countries' elites conceptually forward-looking? The answer seems to be that this is not the case, as most policymakers seem to count on the postcrisis era's being similar to that before the crisis. The crucial question of what a revamped capitalist economy will look like does not yet preoccupy CEE countries' policymakers and is being left to others.

# Appendix

## Table 8.3: Postwar GDP Dynamics, Selected European Countries

| | GDP PER CAPITA | | | AVERAGE GROWTH RATES OF GDP PER CAPITA (PERCENT) | | | |
|---|---|---|---|---|---|---|---|
| | 1950* | 1989* | 1990** | 1950s | 1960s | 1970s | 1980s |
| Czechoslovakia | 3 501 | 8 768 | 250 | 3.9 | 2.4 | 2.1 | 0.7 |
| USSR | 2 841 | 7 098 | 250 | 3.4 | 3.6 | 1.5 | 0.7 |
| Poland | 2 447 | 5 684 | 232 | 2.8 | 3.3 | 2.7 | -1.1 |
| Hungary | 2 480 | 6 903 | 278 | 4.0 | 3.3 | 2.3 | 0.3 |
| Socialist 4 | 2 817 | 7 113 | 252 | 3.8 | 3.4 | 2.7 | 0.0 |
| Austria | 3 706 | 16 369 | 442 | 6.3 | 4.2 | 4.0 | 2.0 |
| Belgium | 5 462 | 16 744 | 307 | 2.5 | 4.3 | 3.3 | 1.9 |
| Denmark | 6 943 | 18 261 | 263 | 2.9 | 3.8 | 2.1 | 1.8 |
| Finland | 4 253 | 16 946 | 398 | 3.4 | 4.5 | 3.4 | 3.2 |
| France | 5 271 | 17 730 | 336 | 3.7 | 4.6 | 3.0 | 1.7 |
| Germany | 3 881 | 16 558 | 427 | 8.2 | 3.8 | 3.0 | 1.7 |
| Greece | 1 915 | 10 086 | 527 | 5.0 | 6.6 | 4.5 | 1.3 |
| Ireland | 3 453 | 10 880 | 315 | 1.7 | 4.2 | 3.2 | 2.7 |
| Italy | 3 502 | 15 969 | 456 | 5.7 | 5.4 | 2.9 | 2.3 |
| Netherlands | 5 996 | 16 695 | 278 | 2.8 | 4.0 | 2.5 | 1.3 |
| Portugal | 2 086 | 10 372 | 497 | 3.1 | 6.0 | 4.6 | 3.0 |
| Spain | 2 189 | 11 582 | 529 | 3.6 | 7.1 | 4.2 | 2.5 |
| Sweden | 6 739 | 17 593 | 261 | 2.5 | 3.8 | 2.0 | 1.8 |
| UK | 6 939 | 16 414 | 237 | 1.7 | 2.5 | 2.3 | 2.3 |
| EU 14 | 4 453 | 15 416 | 346 | 3.8 | 4.6 | 3.2 | 2.1 |

* 1990 dollars

** 1950 = 100

Source: Adapted from János Kornai, "The Great Transformation of Central Eastern Europe: Success and Disappointment" (paper, Harvard University, Collegium Budapest, and Central European University, Marrakech, 2005), http://www.colbud.hu/fellows/kornai_publ/recent_paperthegreattransfln_english.pdf.

Table 8.4: Crisis Performance of CEE Countries, 2009

| | GDP PER CAPITA (1990 US$) | (1990 US$) | (1950 = 100) | AVERAGE GROWTH RATES OF GDP PER CAPITA (PERCENT) | | | |
|---|---|---|---|---|---|---|---|
| | 1950 | 1989 | 1990 | 1950s | 1960s | 1970s | 1980s |
| Czechoslovakia | 3 501 | 8 768 | 250 | 3.9 | 2.4 | 2.1 | 0.7 |
| USSR | 2 841 | 7 098 | 250 | 3.4 | 3.6 | 1.5 | 0.7 |
| Poland | 2 447 | 5 684 | 232 | 2.8 | 3.3 | 2.7 | -1.1 |
| Hungary | 2 480 | 6 903 | 278 | 4.0 | 3.3 | 2.3 | 0.3 |
| Socialist 4 | 2 817 | 7 113 | 252 | 3.8 | 3.4 | 2.7 | 0.0 |
| Austria | 3 706 | 16 369 | 442 | 6.3 | 4.2 | 4.0 | 2.0 |
| Belgium | 5 462 | 16 744 | 307 | 2.5 | 4.3 | 3.3 | 1.9 |
| Denmark | 6 943 | 18 261 | 263 | 2.9 | 3.8 | 2.1 | 1.8 |
| Finland | 4 253 | 16 946 | 398 | 3.4 | 4.5 | 3.4 | 3.2 |
| France | 5 271 | 17 730 | 336 | 3.7 | 4.6 | 3.0 | 1.7 |
| Germany | 3 881 | 16 558 | 427 | 8.2 | 3.8 | 3.0 | 1.7 |
| Greece | 1 915 | 10 086 | 527 | 5.0 | 6.6 | 4.5 | 1.3 |
| Ireland | 3 453 | 10 880 | 315 | 1.7 | 4.2 | 3.2 | 2.7 |
| Italy | 3 502 | 15 969 | 456 | 5.7 | 5.4 | 2.9 | 2.3 |
| Netherlands | 5 996 | 16 695 | 278 | 2.8 | 4.0 | 2.5 | 1.3 |
| Portugal | 2 086 | 10 372 | 497 | 3.1 | 6.0 | 4.6 | 3.0 |
| Spain | 2 189 | 11 582 | 529 | 3.6 | 7.1 | 4.2 | 2.5 |
| Sweden | 6 739 | 17 593 | 261 | 2.5 | 3.8 | 2.0 | 1.8 |
| UK | 6 939 | 16 414 | 237 | 1.7 | 2.5 | 2.3 | 2.3 |
| EU 14 | 4 453 | 15 416 | 346 | 3.8 | 4.6 | 3.2 | 2.1 |

Table 8.5: Anticrisis Policy Measures in the CEE Countries

| | **STRATEGIES DURING THE CRISIS:** INCREASED SPENDING, OWN MONEY | INCREASED SPENDING, EXTERNAL FUNDS | AUSTERITY MEASURES | INVESTING FOR THE FUTURE | **INSTITUTIONAL CHANGES:** |
|---|---|---|---|---|---|
| BULGARIA | Financial support for job retention; cheaper land for investors | Financial support and training to employees with reduced working time; infrastructural projects | Budget review, spending cuts | | Creation of the Bulgarian Bank for Development to support SMSs; accelerated VAT recovery; curbing corruption in European funds absorption |
| CZECH REPUBLIC | Reduction of payments of employers on social insurance; increased social benefits for low income families; increased unemployment benefits | | Cuts in transport infrastructure (2010) | Accelerated depreciation | National Economic Governmental Board (experts) |
| ESTONIA | State guarantees for credit, loans and exports | 550 million Euro loan from EIB for co-financing EU-projects | "Blank" cutting of the budget; no sickness compensation for first three days; suspension of payments for pension insurance by the state | | Relaxed law on state equity involvement in companies; simplified procedures for anti-crisis laws |
| HUNGARY | Job preservation and creation programs; PIT reduction | Open IMF credit line with conditionality | Less favourable pension schemes; rationalizing PIT; reducing inefficient subsidies; VAT increase | | Fiscal Responsibility Law and Fiscal Council |

| | | | | | |
|---|---|---|---|---|---|
| LATVIA | | 7.7 billion Euro liquidity injection from EU, WB, IMF, Nordic countries | 20% salary cuts in public administration; 10% pension and maternity benefits cuts; spending cuts; increased taxes, reduced exemptions | | Program to restore confidence and stabilize the economy |
| LITHUANIA | Few construction projects (planned) | | Increased taxes; cuts in public spending | | Reduction of bureaucratic restraints (planned) |
| POLAND | Guarantees for commercial banks (planned); support for unemployed unable to repay mortgage | Increased absorption of EU funds; open IMF credit line (20 billion USD) | Cuts in administration spending; budget review, deficit increased due to lower incomes | Support for firms preserving jobs; support for training schemes | Guarantees to retail deposits; curbing employees' rights |
| ROMANIA | Social assistance; minimal wage; credit guarantees | Increased absorption of EU funds; WB loan up to 1 billion Euro; support for banks (planned) | Restrictive monetary, fiscal and wage policy | | |
| RUSSIA | Fiscal support to enterprises | Support for banks | Job and spending cuts | Support for firms preserving jobs | Guarantee to ret |
| SLOVAKIA | Fiscal expansion (deficit < 3%); increased unemployment benefits; old cars scrapping schemes | More investment projects co-financed by the EU | Cuts in spending of administration | Companies' support | Guarantees for private deposits; Economic Crisis Council |
| SLOVENIA | Loans to and investment in financial institutions; tax reductions for firms | Enhanced financing for training and skills, venture capital, guarantees and subventions of interest rates for SMEs; increased absorption of EU funds | | Subsidies for investment in new tech; subsidies for R&D investment in companies; support for universities; broadband infrastructure | Group for Anti-Crisis Measures; ail deposits |

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Chapter 9

# The Post-Soviet Recoil to Periphery

*Georgi Derluguian*

The collapse of the Soviet Union in 1991 arguably served as a major enabling condition for the takeoff of globalization in its current form. The twin agenda of free markets and liberal democratization acquired a truly global reach and the exceptional stature of the sole sensible option after neoliberalism had been embraced by Moscow itself. The sudden end of state socialism evidently remains of central importance to any serious analysis of contemporary globality and its possible futures. But what exactly caused the improbable conversion of former Communists into their ideological opposite, and what came out of it?

Curiously, a whole two decades since the implosion of the Soviet bloc, such a tremendous historical event remains largely without a theorized explanation. To wit, there is a fast-growing body of detailed historical accounts based on eyewitness testimonies, memoirs, and newly available archival materials. In the meantime, political scientists and economists have produced an impressive volume of technical models and case studies pertaining to various aspects of what they have called, with rather unapologetic teleology, "market and democratic transitions." From a very different perspective of contemporary anthropology, sociology, and culture and gender studies, we have obtained a wealth of micro-level ethnographies and interpretations concerned with a wide range of human imaginations and experiences related to the post-Communist decades. Yet, for all their methodological sophistication, intellectual diversity, and empirical strengths, these burgeoning literatures have seldom offered explicit answers to the biggest question: Why? What structural shifts caused the Soviet bloc to collapse when it did, and what local or global forces gave divergent directions to its unraveling parts? After a long metatheoretical debate on social structure versus collective human agency, we might have lost both sides of the equation. The reason for this, however, seems to me more general than simply the lack of communication between scholarly disciplines or the much bemoaned retreat into the secure niches of narrow academic specialization.

A brief deconstruction is in order. When ideology attains hegemonic power, it becomes in the eyes of contemporaries a self-evident statement of human nature, the common sense that requires no special explanation whether one likes it or not. Over the past twenty years, neoliberalism has enjoyed this exclusive advantage to the effect that much of current scholarship on eastern Europe and by far the majority of eastern Europeans themselves have based their analyses and perceptions on its taken-for-granted ideological postulates. What is there to explain when it became common knowledge that the world is rapidly becoming global and market driven? In this vision, the region's present travails appear as a kind of earthly purgatory on the road from totalitarian past to the future of "normal countries" (to mention the favorite eastern European cliché). This is not an analysis but rather a matter of ideological faith. For all its pretense to scientific rationalism and hard-nosed realism, neoliberal imagination capitalizes on a quasi-religious, eschatological predestination pointing toward the near end of history. Of course, such avant-garde militancy in pushing for the realization of historical laws was once regarded the distinctive feature of erstwhile Marxism-Leninism. Irony aside, an unreflective combination of formal rationalist scientificity and passionately moralistic eschatology was the keystone of all successful modernist ideologies since the Age of Enlightenment. Consequently, Marxists (or, more exactly, orthodox Party Marxists) could never convincingly explain why their socialist project had first succeeded in the relatively backward Russian empire with its oppressive political traditions, predominantly peasant populations, and rudimentary industrial bases. Likewise, the neoliberals cannot and do not much care to explain why, after several decades of isolationism and pervasive repression, eastern Europeans and, still more mysteriously, many Communist rulers could one day overthrow their totalitarian dictatorships and exuberantly engage in democratization and capitalism. In sum, both Marxists and neoliberals tacitly shared a rather optimistic faith in the progressive march of history inevitably leading to the end of oppression and the arrival of a better society directed either by socialist workers and parties or the liberal middle classes and civil societies.

Abstract refutations, however, will do little good unless one can also demonstrate with necessary logic and historical detail why and how eastern Europe became socialist after 1917 or 1945 and then capitalist after 1989—what structural processes, dilemmas, and social forces drove these shifts in the organization of social power. A robust theory of the eastern European trajectory must be able to account within the same general framework for both its socialist interlude in the twentieth century and its recent transitions to capitalism. Moreover, such a theory must first explain the extremely contradictory historical legacies of Russian empire, which has long been the leading organizational actor as well as the main source of identities in this world region. Putting the region in world-historical perspective, I argue, provides a better understanding of its present-day situation and available options.

Until recently, eastern Europe used to be summarily called the "Second World." It was not quite the "First World" of advanced capitalist states primarily by the measure of economic wealth, life comforts, and political expression; yet it was certainly not the "Third World" of absolute poverty, backwardness, and colonial domination. Eastern Europe stood somewhere in between, a region of strong if also despotic states disposing of significant resources primarily for the purposes of maintaining military parity with the West. In fact, eastern Europe had been the "Second World" long before this expression became current in the 1950s. Ever since the beginning of the modern epoch, this region was always balancing somewhere between the world-system's core and periphery. Semiperiphery might best describe this inherently precarious position. And then, just before our still-blinking eyes, the Second World disappeared. Its westernmost edge, from Slovenia and Hungary to Poland and Estonia, eagerly shed the suspect adjective "eastern" to become central Europe and hopefully leaned toward the European Union. In the meantime, the bulk of the now defunct USSR—the now independent republics from Ukraine to

Armenia and Kazakhstan and moreover Russia—remained somewhere in limbo. This is primarily the region that I am trying to explain using the metaphor of recoil to periphery. Only a few years ago, this was a military-industrial superpower. Now its fragment states do seem pretty much to belong in the Third World. How come?

What follows here is, in the main, a very compressed outline of the primarily Russian (and, by implication, Ukrainian, Armenian, Uzbekistani) trajectory from past to future. In order to make the narrative more accessible, let me just say that for the more specialist readers versed in the recent macrohistorical debates in social sciences, it should soon become apparent that I am seeking to mesh the theories pertaining to geopolitics,[1] world-systems,[2] developmental states,[3] and contentious politics and revolutions.[4] How these theories might reinforce each other in explaining the patterns of Soviet collapse I have elaborated in an earlier monograph.[5] A broader audience, I hope, will not be deterred by this exceedingly technical passage, since the cumulative theory emerges from the historical narrative itself.

My main argument is that the USSR, taken in its historical context, was an extraordinarily successful developmentalist dictatorship. This state emerged from the horrific (need one be reminded?) world wars, and, in turn, it was fundamentally designed for mass industrial warfare. In the first half of the twentieth century, the ability to wage war with millions of conscripts and the enormous supplies of modern mechanized weapons became the ultimate condition of independence if not survival. It is downright scary to imagine the hypothetical alternative trajectories of the modern world without the USSR transformed by the draconian Stalinist industrialization in the 1930s. The geopolitical and internal organizational logic of Stalinism extended from the older imperial tradition going back to the previous modernizing despots, Ivan the Terrible and Peter the Great. This logic was never capitalist, although borrowing technological innovations from the capitalist West has always been a critical component in the Russian state strategy of modernizing by different means. Capitalism is all about controlling commodity flows and the sources of profit; by contrast, imperial state-building is about the conquest of territory and tributary populations.[6] Geopolitical territorialism is, of course, a much older variety of social power than capitalism. But since the technological and organizational means of war- and state-making have been rapidly advancing during the modern age, Russian empire and its Soviet successor were recurrently forced to catch up or "modernize" to the technical level of its time.

Remarkably, from the early 1500s to the 1960s, they were mostly successful. Far from coincidentally, the modernizations of the Russian imperial state before Stalin were associated with the infamously activist and despotic tsars Ivan the Terrible and Peter the Great. Their reigns marked the phases of rapid and violent advances of Russia into the ranks of contemporary great powers. In all three historical instances—Ivan in the 1540s–1580s, Peter in the 1690s–1720s, and Stalin in the 1920s–1950s—success was achieved by the coercive concentration of human and material resources gathered from a huge territory. The state, it should be stressed, gained those resources not only by exploiting the peasantry but no less by pressing elites into state service, which implied the dramatic abolition of old elite privileges and institutions. Each cycle of modernization thus meant a major reformation or revolution. Ivan the Terrible destroyed medieval feudalism, replacing previously autonomous lords with centralized autocracy on the contemporary Asian (mostly Turkish) model; Peter forcefully transformed the now obsolete autocracy with a far more bureaucratic and Westernized absolutism; the Bolsheviks built on the ruins of erstwhile agrarian empire an industrial superpower, consciously emulating its formidable opponents—German militarism and American mass-production Fordism.

In the 1960s, however, the Soviet Union had finally exhausted the traditional coercive-agrarian pattern of maintaining a special geopolitical position. At the peak of historical achievements, Soviet ruling elites ran into the obsolescence of two structural pillars central to their kind of power. First, the nuclear stalemate of the Cold War and the post-1945 sociopolitical pacification of the European continent made redundant the commitments of the Soviet state to the militarization of World War II vintage. Second, though perhaps more important, the despotic political controls inherited from Stalinism if not the tsars appeared increasingly obsolete in the face of irreversibly transformed demographics and social structure, which was now dominated by educated urban specialists and industrial workers. No more great wars to fight, no more enormous peasant masses to sacrifice for state goals—what could then secure the traditional great-power status in the new epoch? This dilemma remains without solution to this day. In fact, it directly flows from the Soviet success both in geopolitics and in transforming the economy and society. The bitter irony is that the dictatorship of military-industrial development proved extremely difficult to dismantle without collapsing the state and losing its advanced features in science, education, and social provision. But were there any alternatives? Perhaps so. Identifying the missed possibilities even in retrospect is still important for the sake of rationally expanding the range of future options.

Back at the moment of Soviet collapse, Giovanni Arrighi, Terence Hopkins, and Immanuel Wallerstein warned that, by embracing the neoliberal ideology in blind revolutionary rage against the oppressive bureaucratic state, eastern Europeans were moving not to the "promised land of North America, but to the harsher realities of Latin America, or worse."[7] The past twenty years in the history of the former Soviet republics have registered a transition to capitalism, albeit of distinctly Third World varieties. This seems a very stark realization indeed. What if the present historical period is not transitional at all, but rather, this is it, a superpower wreck simply stuck on the sidelines of capitalist globalization? Is there any hope for the region's bouncing back on some new basis? The catchword "modernization" emerges today throughout eastern European political discourses. For the ruling elites, especially in Moscow, the main condition for the renewal of their power and respectable international position is, unsurprisingly, a stronger state—but what exactly is now the meaning of "stronger"? The civil-society oppositionists, presently in defeat and disorganization, still demand liberalization and "normal world standards"—but what, soberly speaking, by world measures is normal and standard? Instead of joining the endless ideological polemic, let us look into the past to better see the present and, perhaps, the possible futures.

## Five Centuries of Imperial Modernizations

First, a fundamental clarification regarding the Russian state, long a chief actor in the region and thus the main focus of our analysis. How did it historically achieve and maintain its great-power status? Russia's vast geographic space and despotic control over large populations are the common yet deceptively easy answers. The same applied to any agrarian bureaucratic empire of early modernity which had coalesced at around 1500 across Eurasia, from the Ming and Manchu China to the Mughals in India, the Safavi Iran, the Ottomans, and for that matter, the Spanish Habsburgs in the far west. Yet by 1900, neither Turkey nor Spain, let alone China, Persia, or India, could be regarded great powers—while Russia, for all its internal contradictions and deficiencies, still was. This begs an explanation, which is not merely a historical matter because a theory of Russia's catching-up cycles extends well into the twentieth century. How did Russia manage for so long to escape the fate of great Asian empires which one after another have been succumbing to Western capitalism and moving into the periphery?

Geopolitics is the general answer. At the dawn of the modern epoch, the previously insignificant principality of Muscovy, with luck and cunning, emerged from the late medieval sorrows and disasters primarily due to its early adoption of guns. New technology is never a good explanation on its own, but in this case guns combined with marchland geopolitical advantage, meaning that the sixteenth-century Russian rulers faced mostly weaker foes within their strategic neighborhood. In the fragmenting realm of the former Mongol empire, guns gave the new Russian armies a huge "differential of force" against the Steppe nomadic cavalries. In turn, military victories delivered the ever-expanding fertile frontier for peasant settlement—hence the extraordinary geographic extent and population size of the Russian empire, on which it could draw for several centuries.

The early success still had to be institutionalized. From the outset, Russia proved good at emulating the best contemporary practices—what Alexander Gerschenkron famously called the "advantage of backwardness."[8] In Russia's first catching-up cycle, however, its modernization did not equal Westernization. Long after the fall of Byzantium to the Ottomans, Constantinople still remained for the Muscovites a center of their mental, geopolitical, and commercial universe. In the early 1500s, Russia was successfully emulating the contemporary advanced practices of the Turks, then at their peak, in new gunpowder warfare, taxation, internal administration, and even political ideology.[9] The newly created musketeer army of Russian *streltsy* was a straightforward parallel to Ottoman janissaries, the temporary placement of aristocratic *pomeschiki* to collect tributes from villagers in exchange for the obligation to serve in imperial cavalry had precedent in the Ottoman sipahi, and so on.

Meanwhile, geography placed Muscovy safely beyond the effective range of Ottoman and Western military campaigns—or trade, for that matter. The logistical barrier in the western direction spared Russia the fate of Poland-Lithuania, once a major rival and a no-less-expansive nascent state in eastern Europe. Precocious involvement in the Baltic commodity trade gave Polish elites resources and incentives for self-aggrandizing, which severely undermined the state's centralization and taxing powers. Poland long boasted a splendid noble cavalry but lacked artillery and a navy because these new arms could be afforded only by a centralized state.[10] Poland remained in modern history a quintessential example of an early state overcome by its own elites and inexorably moving into periphery despite or, rather, because of proximity to the world centers of capitalism.

In contrast, the more remote Russia in the 1500s turned its guns against Asian nomads and thus reversed the secular pattern of nomadic predations over sedentary agrarian societies. Pursuing the ancient nomadic routes in the opposite direction, the Russian state eventually acquired a gigantic territory extending from the Pacific to the Black Sea. The centralized command of resources scattered across this expanse allowed it to build a formidable empire equipped with a modern, by contemporary standards, army and a tax-extracting bureaucracy. The sixteenth-century victories marked the apex of Russia's first modernizing cycle, the cycle of early guns.[11]

The Russian state also acquired in the process of expansion its distinctly authoritarian pattern. Contrary to common opinion, this was not just a cultural legacy of Byzantium or Genghis Khan. Medieval Russia, let me remind you, also contained the city republics of Novgorod and Pskov; its peasant and especially the frontier Cossack communities were internally governed by consensus. Autocracy rather emerged as a governance strategy, coercively concentrating resources from a very large yet generally poor and dispersed peasantry. Let me also remind that the state-building strategy of coercive centralization and extraction was far from exceptional in early modern Europe, let alone in the Asian agrarian empires. Imperial Spain, Prussia, Sweden, and Austria one way or another also tended to compensate with extensive coercion for their relative lack of concentrated capitalist resources.[12] It is Holland, England, parts of Germany, France, and northern Italy (i.e., the original capitalist core) that should be recognized as quite exceptional in their rich capitalist concentrations. The Russian empire had no access to private capitalist credit simply because it had no class of capitalists large enough to lend to the tsars. Consequently the tsars had no particular need to bargain over the political terms of contract with their subjects. Instead the imperial authorities developed a formidable coercive-extractive capacity directed at a very large if poor peasantry. Consider the Russian proverb: "A thread from each village [adds up to] a splendid shirt." In real history, the option of oppressing peasantry rather than bargaining with the (barely existent) bourgeoisie involved its own complex and often violent history of internecine conflicts, crises, and dilemmas. The peasants rebelled or fled to open frontiers; grand and petty nobles regularly conspired; the clergy were torn by schisms; not least of all, the tsar's officials tended to pocket not just bribes but also a good deal of collected taxes. This highly conflictual and contradictory process gave rise to the Russian autocracy. To summarize, autocracy emerging in the sixteenth century was not an archaism. It was a noncapitalist adaptation to the escalating costs of early modern warfare and state-building in the world region located well outside the cradle of capitalism where poor peasants and unruly noblemen by far outnumbered merchants and bankers.

It must be also stressed that contrary to the widely shared orthodox Marxist and liberal schemes of history, Russian autocracy, various forms of "Oriental despotism," Western absolutism, or any other agrarian-coercive order was not reducible to the dichotomy between rulers and peasants; it was rather a triangle.[13] The state rulers invariably had to keep in check—by means of terror, service incorporation, and ideology—the noble, ecclesiastic, and merchant elites, who could otherwise lay their own claims on the surpluses generated by peasants and trade flows. In fact, the breakdown of central control over elites seems the main social mechanism opening the way to the decline and peripheralization of non-Western empires in the modern world-system. The examples of Ottoman Turkey, Spain, Poland, and the rest of eastern Europe illustrate in various ways what happened when agrarian elites came to enjoy relative autonomy from their states. By contrast, the Russian empire ruthlessly benefited from the internal disorders and decline among its neighboring rivals: the Poles, the Turks, and also the overpowered Swedes. There was, however, more to Russian expansionism than the advantages of large territory and population and a centralized state. The game still had to be played, and, to further complicate things, the game's technique has been evolving apace.

Contingency in the actual course of history translates into the acts of great heroes or villains, into luck or misfortune. Russia's advance into the ranks of contemporary absolutist monarchies, for better or for worse, is dominated by the supremely charismatic and contradictory figure of Tsar Peter the Great (1672–1725). It was he who, in the famous verse of the poet Alexander Pushkin, forcefully cut Russia's "window to Europe" on the Baltic, around the new Dutch-looking capital of Saint Petersburg, erected from scratch on a northern swamp and at the cost of many thousands of lives and vastly increased taxation. Peter thus launched the second modernizing cycle—the cycle of navy and regular bureaucracy. The breakthrough looms immense in retrospect. Had Russia missed its opportunity at the turn of the seventeenth to the eighteenth century, it would have slid into the periphery, like so many early modern empires of Eurasia. In this case, the Bolsheviks in 1917 would simply have had no adequate geopolitical platform for building their revolutionary dictatorship.

Russian absolutism looks precocious if we expand the range of comparison from Europe to a larger world. In many ways, similar reforms were attempted during the eighteenth century by Austria, Portugal, Spain, and Prussia. In the nineteenth century, it was Ottoman Turkey, Egypt under Muhammad Ali, the Qajar Persia, and Japan. Curiously, the geopolitical conditions of Russia at the outset of Petrine reformation appear broadly analogous to those of Meiji Japan. Prior to the modernizing reforms, both were only second-rate powers in their world regions. Largely for this reason, both Tokugawa Japan and pre-Petrine Russia had been long safeguarding themselves with "obscurantist" defensive isolationism. Perhaps the combination of perceived vulnerability and relative geopolitical marginality is what forced on the absolutist reformers in Russia and Japan the sense of dire urgency in the face of Western invaders, combined with fascination and an enormous willingness to adopt Western appearances and techniques. However critical, such sentiments alone would hardly be enough. What set Russia and Japan apart was the political ability of reformers to vigorously mobilize the coercive-extractive potential of centralized monarchy—and then, just a dose of geopolitical contingency and luck. Prior to their reformations, Russia in the early seventeenth century and Japan in the 1850s had been frighteningly probed by Western invaders—and left alone for the reasons of logistical insularity and the presence of more promising objects for the foreign commercial and military penetration elsewhere in the neighborhood.

The historical breathing space which miraculously emerged after the Polish and Swedish occupations of Moscow in the early 1600s gave the seventeenth-century Russian state an opportunity to start a controlled importation of contemporary Western technologies along with a few artisans and military experts. Until the reign of Peter, this creeping modernization often looked inconsistent because it regularly ran into established institutions and the elite interests of clergy or military aristocracy. Yet the autocracy remained a paramount force in its realm because elites lacked bases for sustained autonomous contestation—hence the spectacular violence and vigor with which Peter the Great could attack the old institutions and interests, further concentrating coercive extraction and deploying the wrested resources to innovate now on a truly massive scale. Take the textbook example. When Peter urgently needed bronze to cast new cannons for the war with Sweden, he decreed to gather the church bells from across Russia. The Orthodox clergy grumbled but offered little resistance in the face of the infamously irritable "ungodly" tsar and his Westernized guard regiments, which besides fighting the Swedes also executed on a mass scale the former musketeer soldiery of *streltsy*. Still, the Orthodox Church was soon expropriated on a spectacular scale and, with the abolition of the patriarchate, subordinated to secular state bureaucracy. Note that the Petrine reformation was overcoming not any age-old eternal traditions but rather the organizational relics of sixteenth-century modernization. Instead of Schumpeterian bouts of "creative destruction" induced by capitalist markets, in modern Russian history the recurrent pattern was state-induced bouts of creative destruction violently clearing the place and releasing resources for new institutions and social groups.

In the end, Peter proved able to leave behind a much larger ruling class of Westernized nobles incorporated in the new state institutions of bureaucratic and military service. The peasantry paid for this achievement with hugely increased taxation and a much deeper enserfment to nobles and the state. Two eighteenth-century conquests validated the Petrine reformation and gave the Russian empire its lasting splendor. First, the acquisition of the eastern Baltic coast at the expense of Sweden wrested the lucrative export trade with the West in metals and naval supplies. Later in the same century, the conquest of the northern Black Sea and the partitions of Poland delivered the agrarian resources of a vast fertile hinterland. The glorious repulsion of the Napoleonic invasion marked the apex of Russia's second modernizing cycle. But it also became a historical trap.

Empires at the pinnacle of prestige and geopolitical aggrandizement grow resistant to further reforms. Unlike the defeated Austria and especially Prussia, the empire of the tsars soon abandoned its wartime plans to rationalize administration, to foster a modern public sphere, to expand higher education and sciences, to encourage trade and industry, and moreover to abolish the increasingly inefficient serfdom. Instead, imperial authorities adopted the defensive stance of militaristic conservatism and launched new conquests in the Caucasus and Central Asia that brought rapidly diminishing returns in terms of expanded agrarian lands and tributes. The Caucasus war turned into an unanticipated embarrassment and fiscal drain comparable to the Soviet invasion of Afghanistan. The irrepressible Poland, with its outsized and proud nobility, no less served as a source of recurrent troubles.

The empire was caught in its ideological commitments and obsession with maintaining a vastly expanded and therefore ever more complex and costlier geopolitical position. The industrial revolution in the West made the situation untenable in the long run. The autocracy was locked in the domestic balance between the conservative service nobility and the discontented famished peasantry, from whose mass began emerging a working class. There emerged, however, another highly disruptive social force, the famous intelligentsia. In another parallel to the later Soviet cycle, the coalescing of the intelligentsia was an unintended yet logical result of the state's inconsistent effort to maintain parity with advanced countries. The autocracy itself fostered the education of specialists but could not limit the process it started because higher education promised a new kind of modern and also quite autonomous prestige to the children of petty nobility, clergy, and the ablest of peasants. Many of them, however, were not finding adequate careers in rudimentary markets or state service still dominated by aristocratic connections. Depending on the ethnic origins and position of stymied professionals, their frustrations bred two intermeshing ideological vectors: liberal/socialist and nationalist. Both ideologies could effectively focus and politicize the discontent of the lower classes, thus turning the intelligentsia, at least in their imagination, into the ascendant counterelites by virtue of superior morality and modernist competence. A similar social group, and for largely similar reasons, powerfully reemerged in the tail phase of the third, socialist cycle of eastern European modernizations.

## Control and Collapse in Soviet Institutions

Like any analytical concept, the heuristic value of cycles has its limit. It helps to discern and explain comparatively some recurrent historical patterns. Yet *cycle* does not mean repetition, because each new cycle begins from the foundations laid by predecessors, which also implies a good deal of creative destruction, freeing the reformers and resources from the grip of historical legacies. Long waves rising, cresting, and falling over the tectonically moving structural bedrock might be a better image.

Eastern Europe over the past five centuries was balancing on the margins of the capitalist West. This region would have likely shared the fate of Ireland or Sicily, becoming an assortment of agrarian colonies, had it not been for the existence further east of deeper Russian hinterland, where an alternative power base could emerge. It stayed a serious contender in European geopolitics by coercively concentrating the material and human resources extracted from peasants and deploying these concentrations to acquire the military and organizational means to match the contemporary Western advances.

Many critics of the Bolshevik Revolution have long claimed that it owed more to the traditions of Russian autocracy than to Marxism. This is true only to the extent that the Bolsheviks ended up building on Russia's geopolitical position and, lacking capital, amply deployed coercive extraction for the purposes of technological modernization. Their model of development, however, derived from Western sources, albeit not the texts of Karl Marx but rather the example of military-industrial organization perfected in Wilhelmine Germany. It is not too surprising that in 1917 a group of radicals seized power in Russia amid state breakdown inflicted by the German war machine. Revolutionaries have typically obtained their opportunity in the wake of lost wars.[14] Truly novel and astonishing was that the Bolsheviks stayed in power. They did it by combining three institutional innovations, none of which had precedent in the imperial past or, for that matter, in the writings of Karl Marx. The first was a centrally planned and strictly rationed militarized economy, originally introduced during the civil war of 1917–21 and made permanent after 1930. This institution secured Soviet industrialization, the victory over the Nazi Reich, and the rapid postwar recovery, proceeding apace with the creation of superpower nuclear potential. The same institution, of course, eventually bankrupted Soviet developmentalism, but not before Moscow came to face conflicting budgetary priorities of the military and an emergent civil society.

The second innovation was the systematic use of Communist Party cadres in all positions of authority, or what was called the nomenklatura. This created a durable fusion of state and ruling party, the administrative and ideological functions. The political scientist Stephen Hanson has aptly called the result a kind of power "which Max Weber himself could not have imagined: a charismatic bureaucracy."[15] The corps of nomenklatura bureaucrats eventually grew rigid and self-serving, causing the ossification of the Soviet Union toward the end. Still, this evolution also needs to be explained.

The last major innovation must be attributed squarely to Lenin and Stalin: nationality republics. Along with the rest of Soviet institutional architecture, republics emerged in the course of civil war. It was a circumstantial adaptation to fighting on many different fronts so that various ethnic forces could be turned into allies. The system of nomenklatura appointments served to discipline and incorporate the political and cultural elites within the republics: cadres were to be selected from the native (or "titular") nationality of the respective republic. The historian Terry Martin captures the paradoxical result in the title of his monograph *The Affirmative Action Empire*.[16] Once again, the republics eventually undermined Soviet unity, but somehow they worked for several decades to harness nationalisms into the developmentalist project.

World War II provided the greatest test and legitimation of Bolshevik modernization. The Wehrmacht could never be stopped by the Russian climate and piles of dead bodies. This war was a deadly competition in mass industrial production. It also tested the newly acquired technical skills, discipline, and ideological commitment of Soviet men and women of many different nationalities who, despite grievous losses and privations, continued to work and fight. In a great paradox of modern history, the socialist revolution in Russia very likely saved capitalism in the face of Nazi world empire.

Achieving this military-industrial and ideological triumph irreversibly transformed the USSR. Old social classes and identities were erased wholesale. Massive induction of former peasants into the ranks of industrial labor and management drove a very massive and rapid urbanization. At the individual level, this meant learning new skills and creating new lifestyles. It also meant the demographic transition typical of industrialization: longer life expectancy and much fewer children. Within one generation, an agrarian empire was transformed into a nuclear superpower, which inspired numerous emulations across the postcolonial periphery; many supporters as well as opponents of the Soviet regime believed at the time that socialism was actually built.

The new society had a peculiarly simplified pattern, essentially a single class of wage earners employed in a gigantic state enterprise. But, depending on one's position, the Soviet system offered a range of officially and unofficially differentiated rewards, prestige, and possibilities. This engendered a hierarchy in which four social strata could be discerned: the dominant bureaucratic elite of the nomenklatura, presiding over all state branches from the military and industry to health care, science, and official culture; the dominated elite of educated specialists (engineers, officers, doctors, teachers), managing the various aspects of Soviet enterprise; and on a massive scale corresponding to the high level of Soviet industrialization, the workers proper. The last and the lowest in status was the class which some sociologists call the subproletariate.[17] They were recent peasants already torn from traditional village life but not yet incorporated into the properly urban workforce. Precariously positioned on the margins of the Soviet industrial edifice, in the chronically underinvested rural and "informal" suburban spaces, the Soviet subproletarians largely belonged to ethnic minorities concentrated mainly in the lesser-developed southern republics of the Caucasus and Central Asia. The subproletarians had very little bargaining power precisely because they were marginal to the production goals of the Soviet state, which pushed them into various informal markets, but they briefly served as enraged crowds in ethnic conflicts during the state collapse.

Developmentalist states, as shown by Peter Evans,[18] eventually come under internal pressures toward dismantling. Behind this generalization stand three different and potentially conflicting political vectors. First is the desire of ruling elites to relax the disciplinary reins of dictatorship and enjoy the fruits of power. It is, in short, corruption. The second is the struggle of a maturing working class, which realizes its shop-floor bargaining power and starts advancing the typical economic demands of better work conditions and pay, that is, the trade-unionist agenda. And third is the middle strata of various specialists who seek to convert their professional credentials and pivotal role in modern production and culture into the political demands for greater group autonomy and institutionalized role in decision making, in sum, democratization.

In the Soviet historical sequence, these vectors took several decades, from the 1950s to the 1980s, to fully take shape and come into the open. Stalin's death in 1953 allowed the civilian nomenklatura to establish itself as the "collective leadership" and to dismantle the apparatus of state terror. The regime's relaxation, however, provoked a wave of spontaneous popular demands, both loyally hopeful and on occasion violently contentious, as is now well documented by historians. In the meantime, professional specialists, led by celebrity cultural producers seeking a greater public role, undertook an impressive self-transformation into a new intelligentsia that collectively laid a strong moral claim to the leadership of society. The prevalent ideology of this movement, despite the emergence of liberal and nationalist dissidents on the fringes, so far remained socialist and, in fact, closely resembled the antiauthoritarian utopianism of the contemporary Western New Left.

The nomenklatura, rightly fearing for their own security, felt reluctant to reactivate the apparatus of terror. Instead, they began buying the compliance of subordinate strata with consumption subsidies and the tacit toleration of inefficiencies. The appeasement on the home front burdened the socialist superpower with two new costs in addition to world geopolitical rivalry. First were the rising expectations of workers and specialists, who readily left to history the perennial plight of their peasant ancestors and embraced the consumerist imagery spreading from the West. The windfall of petrodollars in the 1970s certainly helped the inertia. Labor productivity and discipline in the meantime lagged ever behind because the socialist regime no longer risked open confrontations. Denied the right to collectively bargain and strike, workers engaged in hidden decreases of labor efforts, as in the proverbial "they pretend to pay, we pretend to work."

The second escalating cost derived from the creeping insubordination of the nomenklatura themselves. The top administrative and economic management, perhaps like any bureaucracy left to its own devices, forged intra-elite networks, minimizing career risks, and devised dissimulative techniques, allowing them to mostly disregard the commands which would make their lives less comfortable. This explains why the USSR in the 1930s could develop from scratch a highly effective tank industry and later add to it nuclear and space-rocket potential but in the 1970s failed to keep up in the computer race despite having a very large cadre of scientists and technicians as well as the petrodollars to spend. The command economy required the Supreme Commander to reallocate resources and change its course. But after the death of Stalin and the forced retirement of Nikita Khrushchev, whom the nomenklatura considered too rambunctious, the Soviet colossus was growing inefficient, technologically stagnant, and politically unsteerable.

## Into the Nadir

Two factions began coalescing within the Soviet nomenklatura during the 1970s: the conservatives, who saw no reason to change anything once they had achieved security and comfort, and the progressives, who were, in fact, almost as conservative in what they regarded as their rank and prerogatives but who also saw the need to prevent technological stagnation. To them the solution seemed to lie in the West, more exactly in Germany, France, and perhaps also Japan. The bureaucratic-authoritarian traditions of these capitalist states and especially their postwar practices of social appeasement through corporativist paternalism intuitively appealed to perhaps the majority of the Soviet ruling elite. The main parameters of grand bargain began to coalesce during the international détente occasioned by the loss of American geopolitical prestige in Vietnam and the growing self-confidence of western European elites now seeking greater autonomy in world affairs. The Soviet bloc could contribute to the pan-European bargain a geopolitical and ideological relaxation, together with its enormous resources, production base, and potential markets. In exchange, the Soviets expected a durable cooperation if not merger with European elites, technological transfers, and a share of profits. The precedent was, in fact, southern Europe after the end of fascist dictatorships. The crucial difference was that both the Soviet bloc and its prospective capitalist partners in western Europe were deeply enmeshed in Cold War geopolitics centered on post-1945 American hegemony. But in the seventies and early eighties, American control over its allies seemed in decline, giving Moscow, along with Bonn and Paris (and Tokyo, too), the hope of convincing Washington to support their bargain.

Instead, the obsession with grand diplomacy proved to be the undoing of the last Soviet leader and his superpower itself. By 1989, Gorbachev obviously dropped the ball in his internal game while desperately hoping for miraculous rescue from the West. At the same time, a drastic reduction in world oil prices after 1985, allegedly engineered by the Americans and Saudis, suddenly reduced the Soviet export earnings to which Moscow had become accustomed in its politics of internal bargaining and taming subsidies. Some of the more farsighted policy experts in Moscow insisted at the time on the centrality of reforming the enormous military-industrial complex, which contained the bulk of the best Soviet assets. Their alternative plan envisioned a dramatic decrease in the state's orders for armaments, in the hope of inducing the military-industrial enterprises to seek instead civilian consumers among the population who had accumulated a significant mass of personal savings during the previous period of rising wages and chronic consumer shortages. The conversion of swordsmiths into the makers of ploughshares (or for that matter, Teflon pans) required, however, credits and subsidies, a judicious protectionist policy for the duration of such a transition, and not least, effective planning and political will. It also required time, of which Gorbachev had none. He demobilized the state's repressive apparatus; allowed the disintegration of the state's fiscal and redistributive capacities; invited the escalating political demands of the intelligentsia counterelite, now capable of mobilizing large public protests; and induced panic among the ruling elite. Mistakes evidently play a big role in history. In effect, perestroika ended in a chaotic bank run on the state which was started by the elites populating the upper tiers in that very state.

Here two ideological factors come into play that are commonly praised/blamed for the end of the USSR: nationalism and neoliberalism. But what and who exactly gave force to these ideological abstractions? A more attentive sociological analysis discovers among the contemporary market advocates and ethnic separatists essentially the same personages. From the one side were the aspiring intelligentsia politicians who sought to convert their professional skills, mainly in public speech and discursive manipulation, into political and economic capital in the emergent national polities and markets. And from the other side were the former members of the nomenklatura who discovered opportunities to convert their administrative prerogatives and connections into the political and economic capital for which they would owe nothing to their erstwhile superiors in Moscow. These strategies of conversion and personal aggrandizement blatantly violated two fundamental taboos which until 1989 secured the integrity of the Soviet state—the interdiction on private property and the unofficial varieties of nationalism. Both political strategies, however, now enjoyed ideological recognition, sanctioned by the hegemonic opinion of the West. Instead of the expected gradual accommodation with the capitalist world, the opening up of the Soviet bloc to the international flow of ideas provided inspiration and legitimacy to the domestic counterelites. Moscow, whose own ideological vigor had been long exhausted, was powerless to offer any credible alternatives to the ideologies of freedom perceived in terms of markets and national self-determination. What gave mass following to these ideological imports in the former socialist countries was, ironically enough, the creatively forgotten legacy of the 1968 New Left, with its pronounced aversion to bureaucrats and coercive centralism. A still greater irony is that privatizations and nationalism provided escape to many Communist officials, who reemerged as private owners of fabulous wealth or rulers of whole newly independent nations.

The divergent outcomes of the disintegration of the Soviet bloc clearly demonstrate a geographic gradient. The westernmost former members of the bloc, located in what became called central Europe, could rapidly switch their dependence on Moscow to the capitals of the European Union. Here the socioeconomic consequences might be mixed, with some sectors and groups eventually doing better than under state socialism, and others less so. The now canonical accounts of democratizations in the group of countries which were in 1989 becoming "central" Europe tend to gloss over that the promise of hitching Poland, Lithuania, or Hungary to the EU gave a major positive incentive to the emergent compromise between the former nomenklatura and the politicized intelligentsia. This is what has prevented ethnic irredentism in these countries (recall how many times Transylvania, as just one example, has changed hands over the past century), which otherwise looked as likely as in the former Yugoslavia or the Caucasus.

The main sites of ethnic wars became the countries where the nomenklatura at least for a moment dropped power in the face of rising democratic movements and where no external constraints, positive or coercive, were available at the time. That is the case for Moldova, Tajikistan, and the Caucasus republics. The majority of such wars ended in the restoration of the nomenklatura, who returned as the conservatively paternalistic nationalists. Elsewhere the nomenklatura either straightforwardly recast themselves into conservative national "patriarchies" or, as in the eccentric Belarusian dictatorship, submitted to a sly interloper who revamped the ruling elite under his personal tutelage. The second-wave "colored" revolutions in Georgia, Ukraine, Kyrgyzstan, and to some degree, Moldova changed little even in the elite factional composition, let alone the class relations of power and property.

The results of Soviet collapse, with the partial exception of new admissions to the EU, proved quite disastrous at all levels for former satellite countries. The former Soviet edifice simply fell apart along the erstwhile lines of bureaucratic control. In the absence of functioning legal guarantees, short-term concerns and the most predatory practices (asset stripping) became virtually the only rational strategy. The direly needed technological modernization of industry and infrastructure never arrived. The locus of accumulation shifted abruptly from public production to haphazardly privatized exchange. The demobilized populace now hardly mattered either as labor force, taxpayers, or even voters. Politics receded into the hidden abode of oligarchic intrigues, occasionally bursting into the open in puzzling scandals or mysterious contract killings. Social inequalities in the meantime grew to Third World levels.

## Bouncing Back?

The French economist Alain Lipietz has observed that we can rarely find the empirical instances in which foreign imperialists or corporations conspire in a deliberate and concerted manner to underdevelop Third

World countries.[19] It is rather the impersonal structures of the capitalist world economy that generate the games in which it becomes individually rational for the peripheral elites to pursue the strategies of wealth accumulation that undermine the collective positions of their own countries. This hypothesis seems to find ample proof in the post-Soviet area. The historical record shows that disciplining the elites has been a key condition of success in the imperial Russian and Soviet modernizations. Far from necessarily, this was achieved by terror; a combination of ideological faith, inspiration, status, and generous rewards for service could have done the trick. Elites can be also disciplined by democratic accountability and public transparency. In any event, it requires a strong state, whether authoritarian or democratic. The argument might seem circular—a state's coherence critically depends on its ability to discipline elites, which, in turn, is a main condition for a stronger state—but it seems to correspond to the self-reinforcing causal loop operating in reality.[20]

Viewed from this angle, we clearly see what calamity befell Russia and other former Soviet republics. Having exhausted, for better or for worse, the historical potential of racing against the West in geopolitics at the expense of drastically reduced popular consumption and highly oppressive internal controls, the Soviet elites found themselves in an unprecedented situation. Their external environment no longer threatened with direct military invasions, nor did it allow for much further aggrandizement. Internally, the undoing of the peasantry and the rise of new classes of educated specialists and industrial workers rendered ineffective and untenable the traditional reliance on coercion to extract the manpower and staples for state purposes. This double dilemma forced the Soviet state elites to seek negotiated bargains on all sides for as long as they preserved a sense of collective discipline and shared purpose. The vector of further evolution seemed pointing toward a kind of social democracy and international pacification, expanding on the post-1945 experience of western Europe. But the corporativist sense and discipline of the nomenklatura suddenly unraveled when Gorbachev's removal of political controls allowed the impatience of subaltern elites, the intelligentsia and specialists, to burst into the open. The nomenklatura, frightened by nationalist and radical liberal challenges which they could not contain, themselves took their own state apart, causing a precipitous downfall. The rest of the story was essentially scavenging.

Eastern Europe's recoil to periphery can prove durable. After all, history provides plenty of examples of human societies trapped in downward spirals for long historical periods. The structural conditions for such a scenario, sadly, are not difficult to list. The relatively high levels of previously achieved development might allow the elites, whose personnel would be rotating in the usual course of internecine intrigues, to live off the inherited resources for another generation or longer. Additional resources would probably be arriving as bribes or aid in exchange for continued foreign access or symbolic loyalty or simply to prevent worse embarrassments in the European neighborhood. A diminished social infrastructure would be more or less maintained, as in the past two decades, as a sort of insurance against outbreaks of collective discontent. Social problems in the meantime would also be prevented from reaching a boiling point by the combination of demographic decline and migration. Modern industries and social services would shrink to the export-oriented enclaves and gated communities for elites and necessary personnel. Elsewhere, social reproduction and control would fall to the various "informal" communities and mechanisms, prominently including criminality. These are all now familiar phenomena which will continue by default unless something changes at a much higher level of social organization.

And what might bring this change? In the past two decades, absorption into the European Union (or at least into NATO as a stepping stone) fed many hopes. But the recent financial crisis starkly put in doubt further expansion, if not the future of the EU itself. China looms large at the opposite end of Eurasia, but does it possess enough energy or interest?

Russia, then, remains a critically uncertain factor in shaping world futures. Its elites refuse to recognize their position as irreversibly diminished and "normalized" into the ranks of lesser states. But are they at all able to deliver on their ambitions? A reasoned hypothesis regarding the future prospects of Russia is especially difficult to formulate because the debate is so wholly dominated by the nationalist bombast of Russian ruling elites and the disgusted normative liberalism of foreign observers and Russian oppositionists. Let me still venture a few suggestions.

Russia's modernizing surges in the past exploited three main conditions, two of which are now absent and the third of which is doubtful. The quest for geopolitical aggrandizement becomes pointless when there is no war among great powers and when territorial conquest is entirely unlikely to deliver any material or prestigious payoff. The historical institutionalization of a capitalist world economy has been pushing wars to the periphery and pacifying in the core. True, this trend, dating back to the 1648 Treaty of Westphalia and the 1815 Vienna Congress, experienced a major breakdown in 1914–45. But one of the main reasons for the disappearance of the Soviet bloc was exactly that its military might gradually lost its purpose. Great-power war is just no longer a road to a central position in the world.

Furthermore, Russia's war-related modernizations relied on the coercive extraction of surpluses and recruits from the once large peasantry. This resource was finished by Stalin and his military industrialization. The dire demographic situation and prospects of Russia are now all too well known. A return from the periphery is unlikely and probably just cannot be financed again by a drastic requisition of lives and livelihoods from the aging and diminishing population.

The third condition was always a centralized strong state. Today the Kremlin propagandists (or image makers, as they fashionably style themselves) boast about the sovereignty of Russia. Indeed, its territory and resources are not under foreign control, and the country recently became free from debt. The most controversial policies of Vladimir Putin have been the suppression of regional separatisms, which included the war in Chechnya, the abolition of gubernatorial elections, and the repressions directed at the political billionaire "oligarchs" who had briefly reigned in the nineties. These untidy fights, however, deprivatized a great deal of economic resources, political power, and violence. A possibly significant indicator is that the journalistic chatter about the "Russian mafia" in recent years shifted to "officialized corruption." This is not exactly a cause for celebration since the corruption is by all accounts fabulous and built into the structure of rewards for state servants. This is not merely immoral but also a very inefficient mode of governance. Moreover, the major rents from oil and gas exports controlled by ranking officials create a powerful insider lobby interested in the continuation of dependent economic development. The picture looks mixed at best. On the one hand, the Russian state at present is a fairly autonomous structure endowed with significant resources. On the other hand, it is a sprawling and often glaringly incompetent hierarchy of venal offices. And then, in a hopeful sign, we register a very widespread realization that one cannot live like that. It is strangely reminiscent of the public mood on the eve of Gorbachev's reforms. Could it turn out differently this time?

Anticorruption measures are well known and look fairly simple on paper. The main problem always is that their implementation means political struggle against the very same elites who populate the state organization. A possibility to change things emerges with factional conflict among the elites which can be exploited by the rulers who aspire to rule for some usual reason such as upgrading their prestige and power base. Commoners and middle classes located outside the state apparatus but directly interested in its accountability and rationality—in short, civil society—can be very important allies who supply moral force, activism, public information, and, eventually, votes. This is what sociologists have learned from the study of the known instances of political modernization.[21]

Geopolitical context remains a crucial factor, albeit not the geopolitics of war but rather the geopolitics of markets and resources. Russia is still blessed/cursed with its territorial position in the middle of northern Eurasia, its natural riches, and its still relatively large population, whose modern skills significantly contradict the peripheral prospects. World crises, whether military or economic or environmental, have generated dangers as well as previously unevident or unattainable opportunities. It remains to be seen what lines of confrontation and new alliances might emerge in the current crisis or, perhaps, series of crises. The geopolitical axis of Paris-Berlin-Moscow remains one long-evident possibility whose conditions might yet coalesce. This is where the post-Soviet elites and societies would feel economically and culturally most at ease. An external configuration leaning more toward East Asia is another, perhaps reinforcing but perhaps conflicting, possibility. Joining the bargaining pool of activist Southern states, the so-called group of BRICs or its extended version, is yet another possibility. Moscow now seems to be casting in all these directions. If the world balance of power once again seems in flux, eastern Europe might yet obtain another chance.

The further conclusions emerging from this historical reinterpretation of eastern Europe point to the still bigger questions regarding the world. First of all, the global neoliberal turn in the 1990s appears more contingent than its advocates claim. It owed a lot to the contingency of Gorbachev's ideological blindness and political failure to operate simultaneously on several international and domestic fronts. Had the USSR remained intact or gradually integrated with the rest of Europe, the world would still be capitalist today but almost certainly in a different, more corporativist mode. One then wonders what could have been the effects on the United States itself?

The post-Soviet recoil to periphery appears to be the consequence of a failed democratization—not an imitational democratization after 1991 but democratization which originally surged from the midst of Soviet society in the 1960s and peaked in 1989. The prospect of losing power, however, caused a disastrous panic in ruling elites, whose stampede to the exit ruined the political and economic structures which the Soviet citizens hoped to democratize. Is another democratization still possible? The recent eastern European experience suggests that democratization does not imply merely the adoption of democratic values and institutions. It has to have a robust social carrier, the classes whose dignity and living conditions depend on democratization and which are also capable of politically organizing for this purpose—in short, the specialists, intelligentsia, and workers whose centrality in economic production gives them the collective ability to lay credible claims. But if war geopolitics, which previously drove the industrializing efforts of many modern states, now recedes in importance relative to the economic and ideological sources of power, what would support the near full employment, civilian and military, that used to provide bargaining power to the modern popular classes?

Lastly, there is the closely related question regarding states. Historically, states were primarily war machines, and only much later did they become, as we know them, the most extensive mechanisms for coordinating human efforts in economic and social affairs. Each economic crisis or security or environmental emergency provides the reminder that we still have no realistic substitute for states. State power has been the leitmotif of Russian and eastern European history, indeed the main source of its peculiarity, with all the infamies and glories. In the absence of a strong state, this region rapidly lost many of its achievements and slid into periphery. But what can reconstruct states if war is no longer their primary function? Eastern Europe shows that today the ruling elites, regardless of their public pronouncements, are often flagrantly disinterested in investing in state-building, precisely because great-power war is no longer their main occupation or concern. A locally monopolistic access to global markets provides plenty of alternatives in sustaining such ruling elites. Or does it? It remains to be seen how a world economic crisis might yet correct the currently prevalent elite strategies and perceptions. It is at least no less important what could become the popular reaction to another fall in living standards and diminishing life prospects. In this, eastern Europe remains a barometer of global trends.

Chapter 10

# The Great Crisis and the Financial Sector: What We Might Have Learned

*James K. Galbraith*

In subtitling this essay "What We Might Have Learned" I do not mean to imply that learning is impossible. Anyway I hope not. But if learning now comes at all, it will come late, too late probably for practical effect on public policy. And therefore it will have an academic character, suitable mainly for social scientists—for readers of a volume such as this one—rather than for political leaders.

I would like therefore to frame four questions, in Graham-Allison fashion,[1] each from a different disciplinary standpoint: policy analysis, economics and law, political science, and, finally, sociology. In each case, I will pose just one question. I have ideas—even convictions—about each question, of course, but they all remain at least partly unanswered so far.

The policy analyst is a naive and trusting person whose point of departure is the belief that economic and financial policies are made by public-spirited officials seeking the larger social welfare or perhaps—and I mention this because I help to write them—the statutory goals of "full employment, balanced growth and reasonable price stability" of the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978. It is a conceit, of course, for which I ask your indulgence only briefly.

For the policy analyst, the central question posed by the Great Crisis is how to distinguish extreme from normal conditions in real time and how to actualize that distinction in the modern bureaucratic policymaking process. The technocratic mind-set is conditioned by the data-rich postwar world and loses sight of the fact that the institutions that measured also regulated, so the postwar world represented a regime shift (as economists say), a Great Moderation which dates from long before Ben Bernanke and his colleagues started applying that term to the years after 1982.[2]

In this context, was the Great Crisis just another fluctuation within postwar norms? Or was it a prewar event, an end-of-regime breakdown? If it was the latter, then economic forecasts based on postwar norms would prove misleading, and policies based on those norms—the stimulus package, notably—would prove insufficient. The right policy in that event would be to predicate action on a worst-case scenario, to adopt a greatest-possible-action, throw-everything-you-have-at-it program, accompanied by an open-minded willingness to declare victory and change course if the system proves unexpectedly resilient.

Some of us made that case at the time.[3] But policymakers remained prisoners of the routines they know, brushed off our warnings, and burned their political capital on measures that would only work if the crisis were not, in fact, a distinctive historical event. Too bad. But it is too late now. We are stuck with the aftermath of a program that was effective so far as it went but inadequate to the conditions. From a political point of view, the moment for another bite at that apple has passed.

And we still lack an analytical reappraisal of the process, capable of providing better and timely guidance for the next time. There remains no circuit-breaker, no pattern-recognition device for extreme conditions. It is a problem as old as Cassandra, who was always right but never believed.

From the perspective of economics and law, we may ask what the Great Crisis teaches about the concept of "market discipline." This was the notion that markets impose good behavior on private enterprise and therefore that formal standards and their enforcement can be dispensed with. This was the Chicago Doctrine, implemented under Reagan, Clinton, and the Bushes, and particularly under George W. Bush, who placed radical deregulators in key agencies, promoted the most deferential and incompetent supervisors from the savings-and-loan era, and withdrew the police authority from the financial sector. (Specifically in September 2001, five hundred FBI agents were transferred from white-collar crime to counterterrorism, and were never replaced, despite a public FBI warning in 2004 that we faced an "epidemic of mortgage fraud.")[4] Nor can one forget the moment when the director of the Office of Thrift Supervision, James Gilleran, staged a press conference featuring copies of the *Federal Register*—pertaining to underwriting standards—and a chainsaw.[5] The message was not subtle, and it was also not ineffective.

The result was a graphic reminder that the proper function of the law is not to articulate an etiquette for market participants to observe and for markets to enforce. It is to define coercively the boundaries of tolerable behavior on the (entirely realistic) assumption that if standards are relaxed or left unenforced, people will violate them, and that people who violate them will succeed, in the market, far better than people who do not.

What actually happened can be described in the precise language of a criminal ring:

- The mortgage originators were, in effect, *counterfeiters*. They produced documents that resembled mortgages but which were known, by those who made them, to be fakes—destined either to be renegotiated or to default. An entire underworld lexicon described this craft: liars' loans, NINJA loans (no income, no job or assets), neutron loans (that would destroy the people but leave the buildings intact), toxic waste. This fact alone reveals clearly that the participants knew what they were about. And there is other information, such as the fact that virtually all appraisers in some areas reported being pressured to inflate their appraisals so as to justify larger loans. There is no honest reason for an inflated appraisal.

- The counterfeit mortgages were then bundled and *laundered*—in the precise sense known to the drug trade—by the ratings agencies, who relabeled BBB paper as AAA without ever looking for, or at, the underlying documentation. This was (again) despite the public FBI warning of September 2004 of an "epidemic of mortgage fraud." When Fitch Ratings conducted a small survey of highly rated residential mortgage-backed securities, they found "startling" evidence of "fraud, abuse or missing documentation in virtually every file."[6]

- The laundered paper was then *fenced,* again in the precise sense known to purveyors of stolen goods, by the large investment banks. Lehman Brothers, for instance, did the biggest trade in liars' loans. Goldman Sachs was long in toxic bonds until the end was nigh, at which point that firm went massively short, dumping its holdings on trusting clients, to their later chagrin.[7]
- The *mark*—basically anyone with money to invest and trust in the investment banks and in the ratings agencies—was apparently known generically in the industry as "Düsseldorf."[8] In this way, when the collapse came, major losses fell on Europe, triggering the flight to safety that became the European sovereign-debt crisis. This is globalization with a criminal face, and with victims largely in denial about the nature of the crime—perhaps this is because they do not wish to be exposed as fools.
- We might have learned from all of this that the line between bankers and crooks can be quite thin. It is imperative to police that neighborhood. So far, we have learned nothing of the sort, and the statute of limitations is running out. Following the savings-and-loan crisis, over a thousand industry insiders faced federal prosecution, were convicted, and went to prison.[9] In this crisis, far larger and more aggressive perpetrators remain at large.

For the political scientist, perhaps the right way to phrase the interesting question is this: By whom exactly are we ruled? This question was raised in acute form to some Democratic members of Congress in late September 2008 when the Treasury Department, headed at the time by a former CEO of Goldman Sachs, demanded in a three-page bill draft unlimited and unsupervised authority for $700 billion of financial transactions, mainly to buy toxic assets from the banking system. Was this a desperate measure, necessary to save the system in an extreme situation? Was it a calculated rip-off by and for the undeserving rich? Or was it a punt—a fourth-down handoff of power to the Democratic Congress by a panicked, incompetent, and disintegrating Republican administration?

Members of Congress did not know. I was one of three outsiders invited on the Sunday before the vote on the Troubled Asset Relief Program to speak with some forty members—the skeptics' caucus—in a basement room in the Capitol building. I heard all three viewpoints expressed—depending partly on how close a member was to the leadership, partly on how badly burned by the Bush administration on other matters. Ultimately members voted, I think, on gut instinct and politics, including a desire not to be seen responsible for the final crash of the system and a desire not to take a step that might have elected John McCain to the presidency.

But the issue remains, and into the new administration. Why were AIG's counterparties paid in full? Why were stress tests administered, whose results were negotiated with the banks before they were finalized and released to the public—contrary to all normal regulatory practice? Was their purpose to send a convincing signal that the banks were sound? Or was it to send a convincing signal that the government would back the banks whether they were sound or not? Why was mark-to-market accounting relaxed on toxic assets that will plainly never recover value? Why was a derivatives apologist made the chief of enforcement at the Federal Reserve?

Further: why was Chairman Bernanke reappointed by President Obama? Why was President Geithner of the New York Federal Reserve Bank promoted to Treasury secretary? More broadly, why has practically nothing been done about bankers' pay, with obviously disastrous political consequences as bonus reports came in? No one can say that the administration handled this matter with an eye on public opinion.

All of this remains rich fodder for followers of Thomas Ferguson's investment theory of American politics,[10] for researchers in the tradition of Peter Dale Scott into deep politics or the politics of the Deep State[11]—and even for retired Kremlinologists, if there are any, looking for new vistas for their disused professional skills.

Finally, what should the sociologists do? I am not a sociologist, so perhaps what I am about to suggest might be better suited for the new generation of rogue anthropologists—Janine Wedel's work on the neoconservatives comes to mind[12]—for social psychologists or even for behavioral economists, who actually seem to find fascination in what goes on in the minds of people who frequent classrooms in economics. However that may be, someone should do this. And sociologists as a group have been put upon and disparaged enough by economists, for a generation or more, that it might as well be them.

Here is my suggestion. Plainly we need an objective, dispassionate, thorough, and scholarly inquiry into the sociopathology of modern academic economics. How was it that an entire discipline managed to be overrun by a radical cult, its interests perfectly aligned with predatory financial power, which staged a colossally successful assault on the citadels of academic prestige and which at this moment holds all power of significant appointment, significant publication, and significant recognition in the discipline? By what technique was an ideological monopoly akin to the Soviet nomenklatura established in the American university?

It is not of course the case that no economists foresaw the crisis. Followers of John Maynard Keynes in the analytical traditions of Wynne Godley and Hyman Minsky foresaw it clearly and were on top of events in real time, as were those working in the Veblen-Galbraith-Galbraith tradition of institutional analysis, especially the criminological allied field pioneered by George Akerlof and Paul Romer and by William K. Black.[13] I have surveyed this work in detail[14] and will not repeat that here.

What is true is that these traditions are totally outside the present academic mainstream in economics. Not a single article forewarning the crisis appeared in any so-called leading journal in the field, excepting possibly Raghuram Rajan's carefully worded warning at the Jackson Hole meetings of the Kansas City Federal Reserve Bank.[15] No specialist in these areas holds a post in any so-called leading department. None will be named president of the American Economic Association, nor (I am willing to bet) will any be awarded the so-called Nobel Prize. Nor is there any sign that this situation might change.

Truly this is a strange situation, in which, under conditions of advanced academic freedom, there emerges a *pensée unique*—a single approved line of thought—from which any deviation produces exile to the intellectual Siberia of liberal arts colleges and second-tier state universities. Surely there must be some contrasting intellectual structure—perhaps in, say, sociology?—that is capable of yielding a more diverse, robust, and superior result?

Or perhaps not. Charles Sanders Peirce, let me remind you, already analyzed this situation in his famous essay "The Fixation of Belief." Here is what he wrote:[16]

> The method of authority will always govern the mass of mankind, and those who wield the various forms of organized force in the

> state will never be convinced that dangerous reasoning ought not to be suppressed in some way. If liberty of speech is to be untrammeled from the grosser forms of constraint, the uniformity of opinion will be secured by a moral terrorism to which the respectability of society will give its thorough approval.[17]

I leave you with that thought, and to your duty.

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# Notes

## *Notes to the Introduction*

1. Joseph Stiglitz, a Nobel laureate and former World Bank economist, has stood out among the most visible dissidents. See *Globalization and Its Discontents* (New York: Norton, 2003). But if Stiglitz is the most famous insider to question the dominant orientations of the Washington Consensus, critical examination has been more enduring and often more penetrating from a number of "heterodox" economists outside the centers of US academic economics and Washington policy, who are increasingly influential. And though there are debates about how deep the change is, the World Bank itself has renounced some of its former official views.

2. On this topic, the work of Carlotta Perez stands out, especially *Technological Revolutions and Financial Capital: the Dynamics of Bubbles and Golden Ages* (Cheltenham: Edward Elgar, 2002). See also Naomi R. Lamoreaux and Kenneth L. Sokoloff, eds., *Financing Innovation in the United States, 1870 to the Present* (Cambridge, MA: MIT, 2007).

3. See, for example, Erik Reinert, *How Rich Countries Got Rich and Why Poor Countries Stay Poor* (London: Constable & Robinson, 2007). See also the complementary neo-Schumpeterian work of Perez, *Technological Revolutions and Financial Capital*. And see Ha-Joon Chang's chapter here and his book *Kicking Away the Ladder* (London: Anthem, 2002).

4. Rogers Brubaker, "Economic Crisis, Nationalism, and Politicized Ethnicity," in *The Deepening Crisis: Governance Challenges after*

*Neoliberalism*, ed. Craig Calhoun and Georgi Derluguian (New York: NYU Press, 2011), chapter 4.

5. For in-depth analysis of Russia's current socioeconomic trends, see the companion volume to the Possible Futures Series: *Russia: The Challenges of Transformation*, ed. Piotr Dutkiewicz and Demitri Trenin (New York: NYU Press, 2011).

*Notes to Chapter 1*

1. S. Sassen, "A Savage Sorting of Winners and Losers: Contemporary Versions of Primitive Accumulation," *Globalizations* 7, nos. 1–2 (March–June 2010): 23–50.

2. I develop this proposition in S. Sassen, "Mortgage Capital and Its Particularities: A New Frontier for Global Finance," *Journal of International Affairs* 62, no. 1 (2008): 187–212.

3. S. Sassen, *Territory, Authority, Rights: From Medieval to Global Assemblages* (Princeton, N.J.: Princeton University Press, 2008), chapters 4 and 5.

4. This is only one component of the financial system. There are vast components of finance that consist of interactions between rich and powerful investors in which these mechanisms of primitive accumulation are not at issue. And there are some other major components which also are subject to mechanisms of primitive accumulation, notably pension funds and mutual funds, which often have to pay multiple small fees and commissions that have been shown to amount to significant and unwarranted losses for the pensioners and the consumers who buy shares in mutual funds.

5. Sassen, *Territory*; Sassen, *A Savage Sorting*.

6. Sassen, *Territory*, chapter 7.

7. More detail can be found in S. Sassen, "A Bad Idea: A Financial Solution to the Financial Crisis," *Huffington Post,* November 20, 2008, http://www.huffingtonpost.com/saskia-sassen/a-bad-idea-using-a-financ_b_145283.html.

8. G. Arrighi, *The Long Twentieth Century: Money, Power, and the Origins of Our Times*, Part I. (London:Verso, 1994).

9. McKinsey & Company, "Mapping Global Capital Markets Fourth Annual Report 2008," http://www.mckinsey.com/mgi/reports/pdfs/Mapping_Global/ MGI_Mapping_Global_full_Report.pdf

10. Yet another way to portray where we are at is the different orders of magnitude involved in banking and finance. For instance, in September 2008, when the current phase of the crisis exploded into the open, the value of bank assets amounted to several trillion dollars, but the total value of credit-default swaps, which was the straw that broke the camel's back, stood at almost US$60 trillion, more than the global GDP; these were debts that were due, and the money was not there.

11. Sassen, "Mortgage Capital and Its Particularities."

12. S. Sassen, *The Global City* (Princeton, NJ: Princeton University Press), chapter 4.

13. World Bank and IMF staff estimates, International Monetary Fund, "Global Financial Stability Report: Containing Risks and Restoring Financial Soundness" (Washington, DC: International Monetary Fund, 2008), 13, http://www.imf.org/external/pubs/ft/gfsr/2008/01/pdf/text.pdf.

14. Goldman Sachs, UBS, and IMF staff estimates, "Global Financial Stability Report: Containing Risks and Restoring Financial Soundness" (Washington, DC: International Monetary Fund, 2008), 13, http://www.imf.org/external/pubs/ft/gfsr/2008/01/pdf/text.pdf

15. Sassen, *Territory*, chapter 7.

16. I develop this idea in Saskia Sassen, "Pulling the Economy Down into Our Communities," *ZNet,* July 17, 2009, http://www.zcommunications.org/znet/viewArticle/22035; this is part of a large, multifaceted, and international set of proposals for the "Reimagining Society Project" hosted by Z Communications at http://www.zcommunications.org/zparecon/reimaginingsociety.htm.

## *Notes to Chapter 2*

I thank Craig Calhoun for his encouragement. I thank Vladimir Popov for helpful discussion and the audiences at my presentations at the University of East Anglia and the World Social Science Forum in Bergen for their useful comments. I am grateful to Sara Maria Acosta for her efficient help with the logistics.

1. A. Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, ed. Edwin Cannan, preface by Max Lerner (New York: Modern Library, 1937), 347–48.

2. For further details, see H.-J. Chang, *Kicking Away the Ladder* (London: Anthem, 2002), chapter 2; and H.-J. Chang, *Bad Samaritans* (New York: Bloomsbury, 2007), chapter 2.

3. For further details, see H.-J. Chang and D. Green, *The Northern WTO Agenda on Investment: Do as We Say, Not as We Did* (London: CAFOD, 2003); and Chang, *Bad Samaritans,* chapter 4.

4. For further details, see Chang, *Bad Samaritans*, chapter 5; and H.-J. Chang, "State-Owned Enterprise Reform in the United Nations Department of Social and Economic Affairs," in *National Development Strategies: Policy Notes*, UN Department of Economic and Social Affairs (New York: United Nations, 2008).

5. For further details, see H.-J. Chang, "Intellectual Property Rights and Economic Development: Historical Lessons and Emerging Issues," *Journal of Human Development* 2, no. 2 (2001): 287–309; and Chang, *Bad Samaritans*, chapter 6.

6. When you think about it, this is a much more coherent position than the position taken today by many free-trade economists, who support competition in the trade in goods but not in the trade of ideas.

7. F. List, *The National System of Political Economy*, trans. Sampson Lloyd (London: Longmans, Green, 1885), 295–96.

8. The following four paragraphs are drawn, with slight condensation, from Chang, *Kicking Away the Ladder*, 51–53.

9. N. Brisco, *The Economic Policy of Robert Walpole* (New York: Columbia University Press, 1907), 157.

10. P. Bairoch, *Economics and World History: Myths and Paradoxes* (Brighton, UK: Wheatsheaf, 1993), 89.

11. C. Johnson, *MITI and the Japanese Miracle* (Palo Alto: Stanford University Press), 25.

12. I. Little, T. Scitovsky, and M. Scott, *Industry in Trade in Some Developing Countries: A Comparative Study* (London: Oxford University Press, 1970), 163–64.

13. World Bank, *World Development Report, 1991 – The Development Challenge* (New York: Oxford University Press, 1991), 102.

14. E. Reinert, "Increasing Poverty in a Globalized World: Marshall Plans and Morgenthau Plans as Mechanisms of Polarization of World Incomes," in *Rethinking Development Economics,* ed. H.-J. Chang (London: Anthem, 2003).

15. On the industrial tariffs issue in the Doha Round, see H.-J. Chang, *Why Developing Countries Need Tariffs: How WTO NAMA Negotiations Could Deny Developing Countries' Right to a Future* (Oxford: Oxfam, 2005).

16. Third World Network, "The IMF's Financial Crisis Loans: No Change in Conditionalities" (report submitted to the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System, March 2009). The nine countries were Georgia (September 2008), Ukraine (October 2008), Hungary (November 2008), Iceland (November 2008), Latvia (December 2008), Pakistan (December 2008), Serbia (December 2008), Belarus (January 2009), and El Salvador (January 2009).

17. M. Weisbrot, R. Ray, J. Johnston, J.A. Cordero, and J.A. Montecino, *IMF-Supported Macroeconomic Policies and the World Recession: A Look at Forty-one Borrowing Countries* (Washington, DC: CEPR, 2009). The forty-one countries are Afghanistan, Armenia, Belarus, Bosnia and Herzegovina, Burkina Faso, Burundi, the Central African Republic, Republic of the Congo, Costa Rica, Côte d'Ivoire, Djibouti, El Salvador, Gabon, The Gambia, Georgia, Ghana, Grenada, Guatemala, Haiti, Hungary, Iceland, Kyrgyz Republic, Latvia, Liberia, Malawi, Mali, Mozambique, Mongolia, Niger, Pakistan, Romania, São Tomé and Príncipe, Senegal, Republic of Serbia, Seychelles, Sierra Leone, Tajikistan, Tanzania, Togo, Ukraine, and Zambia.

18. P. Temin, *Lessons from the Great Depression* (Cambridge: MIT Press, 1989).

## Notes to Chapter 3

This is a revised version of a paper prepared for the Commission on Growth and Development and published in Michael Spence and Danny Leipziger, eds., *Globalization and Growth: Implications for a Post-Crisis World* (Washington, DC: World Bank, 2010).

1. Dani Rodrik, *One Economics, Many Recipes* (Princeton: Princeton University Press, 2007), chapter 1.

2. Dani Rodrik, "What's So Special about China's Exports?" *China and World Economy* 14, no. 5 (September–October 2006): 1–19.

3. See Jesus Felipe, Miguel Leon-Ledesma, Matteo Lanzafame, and Gemma Estrada, "Sectoral Engines of Growth in Developing Asia: Stylized Facts and Implications" (ERD Working Paper Series No. 107, Asian Development Bank, November 2007), for a recent analysis of structural change patterns in Asia which emphasizes that many services have become important contributors to economy-wide TFP (total-factor productivity) growth alongside industry.

4. Dani Rodrik, "The Real Exchange Rate and Economic Growth," in *Brookings Papers on Economic Activity: Fall 2008,* ed. Douglas W. Elmendorf, N. Gregory Mankiw, and Lawrence H. Summers (Washington, DC: Brookings Institution, 2009).

5. What is striking also is that there exists significant heterogeneity in productivity within modern activities as well. This is documented in detailed McKinsey productivity studies as well as in recent academic work. See McKinsey Global Institute, *India: The Growth Imperative* (San Francisco: McKinsey, 2001) and *Turkey: Making the Growth and Productivity Breakthrough* (Istanbul: McKinsey, 2003); Eric Bartelsman, John Haltiwanger, and Stefano Scarpetta, "Cross Country Differences in Productivity: The Role of Allocative Efficiency" (paper presented at RAL 2.3 Workshop on Policy Implications from Recent Advances in the Economics of Innovation and Industrial Dynamics, December 15, 2006), http://www.dime-eu.org/Bartelsman_et-ali_paper; Chang-Tai Hsieh and Peter J. Klenow, "Misallocation and Manufacturing TFP in China and India" (NBER Working Paper No. 13290, August 2007). One way to interpret these findings is that segments of what we normally think of as modern are really more akin to traditional activities. The structural transformation that is called for is also *within* these sectors.

6. Rodrik, "The Real Exchange Rate and Economic Growth."

7. Dani Rodrik, "Normalizing Industrial Policy" (paper prepared at the Commission on Growth and Development, August 2007).

8. Adapted from Rodrik, "The Real Exchange Rate and Economic Growth."

9. Ibid.

10. Similar results are reported in Victor Polterovich and Vladimir Popov, "Accumulation of Foreign Exchange Reserves and Long Term Growth" (paper no. 20069, Munich Personal RePEc Archive [MPRA], Munich, 2003); S. S. Bhalla, "Economic Development and the Role of

Currency Undervaluation," *Cato Journal* 28, no. 2 (2008): 313–40; and Andrew Berg and Yanliang Miao, "The Real Exchange Rate and Growth: The Washington Consensus Strikes Back?" (IMF working paper, WP/10/58, March 2009). Ridha Nouira and Khalid Sekkat find weaker results in "Desperately Seeking the Positive Impact of Undervaluation on Growth" (unpublished paper, University of Brussels, Belgium, September 2010).

11. Rodrik, "The Real Exchange Rate and Economic Growth."

12. Eswar Prasad, Raghuram G. Rajan, and Arvind Subramanian, "Foreign Capital and Economic Growth," *Brookings Papers on Economic Activity* 1 (2007): 153–209.

13. Ibid.; Rodrik, "The Real Exchange Rate and Economic Growth."

14. Dani Rodrik and Arvind Subramanian, "Why Did Financial Globalization Disappoint?" *IMF Staff Papers* 56, no. 1 (Spring 2009).

15. Ricardo Hausmann, "In Search of the Chains that Hold Brazil Back" (HKS working paper no. RWP08-061, Center for International Development, Harvard Kennedy School, October 31, 2008), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1338262.

16. M. Ayhan Kose, Eswar S. Prasad, and Marco E. Terrones, "How Does Financial Globalization Affect Risk Sharing? Patterns and Channels" (unpublished paper, IMF, June 2007).

17. This need not be the case always, of course. Some government-imposed constraints ("red tape") are easier to fix than others (e.g., inefficient courts).

18. Dani Rodrik, "Normalizing Industrial Policyy," and Rodrik, *One Economics, Many Recipes,* chapter 4.

19. See Rodrik, *One Economics, Many Recipes,* chapter 4.

20. Rodrik, *One Economics, Many Recipes,* chapter 4.

21. There is a good case to be made that the prohibition on subsidies has little economic rationale, independently from the developmental argument I am making here. After all, subsidies are trade creating (unlike import barriers), and a country that subsidizes its tradables provides the rest of the world an economic "gift" to the extent that the subsidy results in greater supply and lowers world prices. The WTO's approach to subsidies is mercantilist and overly influenced by the interests of competing producers.

22. Oversight over currency practices is usually thought of as being the province of the IMF. But Mattoo and Subramanian have argued that the WTO is a much more suitable organization for this purpose, since what is at stake are imbalances in trade flows and the WTO actually has the capacity to make its rulings stick. Aaditya Mattoo and Arvind Subramanian, "Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization" (Peterson Institute working paper, Washington, DC, January 2008). The discussion here suggests that any move in this direction should have as a direct quid pro quo the weakening of the discipline on subsidies.

*Notes to Chapter 4*

1. Despite the immediate success of the New Deal programs, President Roosevelt quickly backed down and promised the nation that "a balanced budget [was] on the way." In 1938, he slashed government spending for fear of inflation, although unemployment shot up to 19 percent. See Michael J. Sandel, *Democracy's Discontent: America in Search of a Public Philosophy* (Cambridge: Harvard University Press, 1996).

2. See UNEP, "Renewable Energy: Generating Power, Jobs and Development," *Our Planet,* December 2008. Also see Alex Bowen and Nicholas Stern, "Environmental Policy and the Economic Downturn" (working paper no. 18, Centre for Climate Change Economics and Policy; and working paper no. 16, Grantham Research Institute on Climate Change and the Environment, 2010).

3. This chapter is not principally about the Bretton Woods conference or the system it engendered. For an insightful review of the life and death of the Bretton Woods system set in the evolving international monetary system, see Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System* (Princeton: Princeton University Press, 1996). Also see Eric Helleiner "The Contemporary Reform of Global Financial Governance: Implications of and Lessons from the Past" (working paper, no. 55, UNCTAD, Geneva, 2009); and Michael D. Bordo and Barry Eichengreen, eds., *A Retrospective on the Bretton Woods System: Lessons for International Monetary Reform* (Chicago: University of Chicago Press, 1993). For a radical-revisionist perspective on the Bretton Woods system, emphasizing the role of economic and political

power in relations among the leading capitalist countries, see Fred Block, *The Origins of International Economic Disorder: A Study of United States International Monetary Policy from World War Two to the Present* (Berkeley: University of California Press, 1978).

4. The original name of the World Bank.

5. Reviewing the performance of the developing countries over twenty-five years (1950–75), the World Bank's *World Development Report 1978* noted, "The developing countries have grown impressively over the past 25 years: income per person has increased by almost 3 percent a year, with the annual growth rate accelerating from about 2 percent in the 1950s to 3.4 percent in the 1960s. . . . Moreover, it compared extremely favourably with growth rates achieved by the now developed countries over the period of their industrialization: income per person grew less than 2 percent a year in most of the industrialized nations of the West over the 100 years of industrialization" (3).

The report also noted, "The progress made by developing countries is more impressive considering that their populations have been growing at historically unprecedented rates. During 1950–1975, their total population increased at 2.4 percent a year. This is substantially faster than the population growth rates—typically about 1 percent a year—that the now developed countries had to contend with during the period of their industrialization" (4–5).

6. Unusually, this decision was made without consulting members of the international monetary system or even his own State Department and was soon dubbed the "Nixon Shock."

7. For a discussion of the implications of the 1970s turn from Keynesian economics and development economics, see John Toye, *Dilemmas of Development: Reflections on the Counter-Revolution in Development Theory and Policy* (Oxford: Blackwell, 1987).

8. See, for example, Edith R. Wilson, *The IMF and the Asian Crisis: Time to Return to Bretton Woods* (Washington, DC: Progressive Policy Institute, 1998). Also see Joseph Stiglitz, *Globalization and Its Discontents* (New York: Norton, 2002).

9. Simon Johnson, "The Quiet Coup," *Atlantic Monthly,* May 2009; Stiglitz, *Globalization and Its Discontents.*

10. Ayhan Kose, Marco E. Terrones, and Eswar Prasad, "How Do Trade and Financial Integration Affect the Relationship between Growth

and Volatility?" *Proceedings, Federal Reserve Bank of San Francisco,* June 2004, http://www.sf.frb.org/economics/conferences/0406/Kose.pdf.

11. This was aided by the political shift toward conservatism with the election of Margaret Thatcher in the United Kingdom and Ronald Reagan in the United States.

12. See Joseph Stiglitz, *Free Fall* (New York: Norton, 2010).

13. Johnson, "The Quiet Coup."

14. Jagdish Bhagwati, "The Capital Myth: The Difference between Trade in Widgets and Dollars," *Foreign Affairs,* May–June 1998, 7.

15. Dorothy Power and Gerald Epstein, "Rentier Incomes and Financial Crises: An Empirical Examination of Trends and Cycles in Some OECD Countries" (working paper wp57, Political Economy Research Institute, University of Massachusetts at Amherst, 2003), http://www.peri.umass.edu/fileadmin/pdf/working_papers/working_papers_51-100/WP57.pdf.

16. For the economist, rents refer to "excess incomes," which should not exist in efficient markets. More precisely, a person gets a rent if he or she earns an income higher than the minimum that he or she would have accepted, the minimum being usually defined as the income in his or her next-best opportunity. "Schumpeterian rents" are earned by innovators and occur during the period of time between the introduction of an innovation and its successful diffusion. It is expected that successful innovations, in time, will be imitated, but until that occurs, the innovator will earn Schumpeterian rents. This type of rent is also called entrepreneurial rent. See Joseph Schumpeter, *The Theory of Economic Development* (Cambridge, MA: Transaction, 1934); and Joseph Schumpeter, *Capitalism, Socialism, and Democracy* (London: Routledge, 1942).

17. Peter F. Drucker, "The Changed World Economy," *Foreign Affairs,* Spring 1986.

18. Robert Lucas, "Why Doesn't Capital Flow from Rich to Poor Countries?" *American Economic Review* 80 (1990): 92–96.

19. See, for a good review, John Bellamy Foster, "The Financialization of Capitalism," *Monthly Review* 58, no. 11 (April 2007). For distributional implications, effects on the US economy, international dimensions and the monetary system, financial crises and policy responses of financialization, see Gerald Epstein, *Financialization and the World Economy* (Northampton, MA: Elgar, 2005).

20. United Nations, *World Economic Situation and Prospects, 2010* (New York: United Nations, 2010).

21. For a good discussion, see Free Exchange blog, "Rethinking the Great Moderation," *Economist,* October 28, 2009, http://www.economist.com/blogs/freeexchange/2009/10/rethinking_the_great_moderatio.

22. In November 2008, the IMF projected a global growth rate of 2.2 percent for 2009. In July 2007, just a month before the first tremors of the US subprime-mortgage crisis were felt, the IMF in its much-cited *World Economic Outlook* noted, "The strong global expansion is continuing, and projections for global growth in both 2007 and 2008 have been revised [upward]." The IMF is not the only international agency which got it wrong. Just three months before the US-centric financial crisis began in August 2007, the OECD released its 2007 *Economic Outlook,* in which it commented,

> In its Economic Outlook last Autumn, the OECD took the view that the US slowdown was not heralding a period of worldwide economic weakness, unlike, for instance, in 2001. Rather, a "smooth" rebalancing was to be expected, with Europe taking over the baton from the United States in driving OECD growth.
>
> Recent developments have broadly confirmed this prognosis. Indeed, the current economic situation is in many ways better than what we have experienced in years. Against that background, we have stuck to the rebalancing scenario. Our central forecast remains indeed quite benign: a soft landing in the United States, a strong and sustained recovery in Europe, a solid trajectory in Japan and buoyant activity in China and India. In line with recent trends, sustained growth in OECD economies would be underpinned by strong job creation and falling unemployment.

OECD, *OECD Economic Outlook* 81 (2007): 7.

23. Bob Sutcliffe, "World Inequality and Globalization," *Oxford Review of Economic Policy* 20, no. 1 (2004): 15–17. Also see United Nations World Institute for Development Economics Research, *The World Distribution of Household Wealth* (Helsinki: UNU-WIDER, 2006); and United Nations, *The Inequality Predicament: Report on the World Social Situation 2005* (New York: UNDESA, 2005).

24. Andrew K. Rose, "Business Cycles Become Less Synchronised over Time: Debunking 'Decoupling,'" *VoxEU,* August 1, 2009, http://www.voxeu.org/index.php?q=node/3829. Also see for implications for developing countries, Dirk Willem te Velde, "The Global Financial Crisis and Developing Countries" (ODI Background Note, October 2008), http://www.odi.org.uk/resources/download/2462.pdf.

25. See Dirk Willem te Velde and others, "The Global Financial Crisis and Developing Countries: Synthesis of the Findings of 10 Country Case Studies" (ODI working paper no. 306, 2009). For poverty impacts, see Andy Sumner and Sara Wolcott, "What Are the Likely Poverty Impacts of the Current Crises?" (IDS In Focus Policy Briefing no. 7, March 2009).

26. For discussions of issues pertaining to developing countries, see Yilmaz Akyüz, *Policy Response to the Global Financial Crisis: Key Issues for Developing Countries* (Geneva: South Centre, 2009). Also see Wim Naude, "The Global Economic Crisis after One Year: Is a New Paradigm for Recovery in Developing Countries Emerging?" (WIDER Policy Brief no. 2, 2009).

27. Speaking at the Korea International Financial Association, First International Conference, Seoul, Korea, October 16, 2009, Takatoshi Kato, deputy managing director of the International Monetary Fund, noted,

> The current recovery is unlikely to maintain the momentum of recent months and growth may not return to pre-crisis levels so soon. This has important implications for the design and implementation of exit strategies. . . . The current rebound is to a considerable extent driven by a restocking of global inventories. At the peak of the current crisis, production fell more than final demand, partly because of the disruptions in trade and other financing. As a result, inventories reached historical lows in many parts of the world. Some of the economic activity we are seeing today is the rebuilding of stocks and, therefore, not sustainable. Put differently, production is partly making up for its earlier undershooting, but will remain weak over the medium-term, unless final demand recovers.

Takatoshi Kato, "Impact of the Global Financial Crisis and Its Implications for the East Asian Economy" (keynote speech), http://www.imf.org/external/np/speeches/2009/101609.htm. Also see United

Nations, *World Economic Situation and Prospects, 2010*; and World Bank, *Global Economic Prospects 2010* (Washington, DC: World Bank, 2010).

28. Carmen Reinhart and Kenneth Rogoff, "The Aftermath of Financial Crises" (NBER Working Paper no. 14656, 2008).

### *Notes to Chapter 5*

The views presented in this chapter represent the authors' personal analyses and interpretations and should not be associated with the institutions with which they are associated.

1. Robert Hunter Wade, "Is Globalization Reducing Poverty and Inequality?" *World Development* 32, no. 4 (2004): 567-589.

2. H.-J. Chang, *Kicking Away the Ladder* (London: Anthem, 2002).

3. Francisco Rodriguez and Dani Rodrik, "Trade Policy and Economic Growth: A Skeptic's Guide to the Cross-National Evidence" (CEPR Discussion Paper no. 2143, 1999); Kevin H. O'Rourke and Jeffrey G. Williamson, "From Malthus to Ohlin: Trade, Growth and Distribution since 1500" (NBER Working Papers 8955, 2002); K.H. O'Rourke and R. Sinnott, "The Determinants of Individual Trade Policy Preferences: International Survey Evidence" (Economic Papers 200110, Trinity College Dublin, Economics Department, 2001). For a survey, see Jeffrey G. Williamson, "Winners and Losers over Two Centuries of Globalization" (WIDER annual lecture 6, WIDER/UNU, November 2002).

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***y*** = CONST. + ***CONTR. VAR***. + 0.02****FDI*** (***ICI*** −80.5),

where ***y*** = annual average growth rate of GDP per capita in 1975–99, ***ICI*** = investment climate index in 1984, ***FDI*** = average foreign direct investment inflow as a percentage of GDP in 1980–99.

The threshold investment climate index is very high—about 80 percent, which is basically the level of developed countries. Only a few developing countries (Botswana, Hong Kong, Kuwait) have such a good investment climate. Polterovich and Popov, "Appropriate Economic Policies at Different Stages of Development"; Polterovich and Popov, "Stages of Development, Economic Policies and New World Economic Order."

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$y = 0.68^{*}\, Ycap + 0.12^{***} CA + 0.05,$

$\quad\quad (1.80) \quad (3.44)$

N = 91, $R^2 = 0.23$, robust standard errors, T-statistics in parentheses below, where

$y$ = annual average growth rates of per capita GDP in 1960–99,

$Ycap$ = logarithm of per-capita PPP GDP in 1975,

$CA$ = average current-account-to-GDP ratio in 1960–99, percent.

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## *Notes to Chapter 7*

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## Notes to Chapter 9

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## Notes to Chapter 10

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# Index