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GLOBALIZATION AND THE POOR: EXPLOITATION OR EQUALIZER?

WILLIAM DRISCOLL &
JULIE CLARK, EDITORS

INTERNATIONAL DEBATE EDUCATION ASSOCIATION

Globalization and the Poor

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Exploitation or Equalizer?

Edited by William Driscoll and Julie Clark

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Introduction

In his novel *Hard Times*, Charles Dickens describes a "model" 19th century schoolroom, in which students are taught nothing but facts – including the basic facts of economics. But much of this instruction is lost upon Sissy Jupe, a poor, abandoned girl who has too much imagination (and compassion). In one scene, she tells her friend Louisa about an embarrassing encounter in the classroom, when the teacher, Mr. McChoakumchild, quizzed her about the concept of "National Prosperity."

> "…And he said, Now, this schoolroom is a Nation. And in this nation, there are fifty millions of money. Isn't this a prosperous nation? Girl number twenty, isn't this a prosperous nation, and an't you in a thriving state?"
>
> "What did you say?" asked Louisa.
>
> "Miss Louisa, I said I didn't know. I thought I couldn't know whether it was a prosperous nation or not, and whether I was thriving or not, unless who I knew who had got the money, and whether any of it was mine. But that had nothing to do with it. It was not in the figures at all," said Sissy, wiping her eyes…
>
> "Then Mr. McChoakumchild said he would try me again. And he said, This schoolroom is an immense town, and in it there are a million of inhabitants, and only five-and-twenty are starved to death in the course of a year. What is your remark on that proportion? And my remark was – for I couldn't think of a better one – that I thought it must be just as hard upon those who were starved, whether the others were a million, or a million million. And that was wrong, too."

With her naïve responses, Sissy raises one of the fundamental moral questions of economics: What is the effect of an economic system on the lives of the people who live under it? This book aims to explore that question in the context of the economic system that emerged to dominate the world in the last decade of the 20th century: globalization.

At one level, globalization refers to the interpenetration of world markets; main street stores in America, for example, sell goods that are made throughout the world, and American products are found all over the globe (not just in stores, but in movie theatres, on television screens, and in fast-food restaurants). But such international trade is nothing new; more than 200 years ago, Samuel Johnson remarked that a lady in London could not have her morning tea without the products of India and China.

What is new about globalization is that international trade has become easier and cheaper. Increasingly, countries have lowered or eliminated protective barriers and tariffs. Once, it might have been prohibitively expensive for an Argentine company to sell its products in Europe; now it is common (especially given reductions in the cost of transportation and shipping as well).

Even more important, the globalized world has allowed the movement of capital, as well as the movement of products. A generation ago, it would have been impossible for a foreign company to own a factory in China; today, foreign investment is welcomed. And the investment of capital, of course, is not always in bricks and mortar. Capital is also invested in stocks and other financial instruments – and it is the change in financial markets that is perhaps the most significant aspect of globalization. As in the old days, the manager of an endowment fund sitting in New England can invest his university's capital in U.S. Treasury bonds, and in Wall Street equities, but he can also buy bonds issued by Belarus, or sell shares of stocks that are traded on the market in Hong Kong. Capital moves easily – and given the emergence of the Internet, it moves faster than ever before.

How did globalization come about? In simple terms, it happened because countries decided to "open" their markets to imports, exports, investments and trade. This process is called "liberalization"

– that is, the process frees markets to work by the laws of supply and demand; companies compete in the market without "undue interference" from the government. (The change is most easily seen in some formerly Communist countries that switched from centrally controlled economies to free-market economies during the 1990's.)

There are also international agencies that have promoted globalization. The World Bank and the International Monetary Fund (IMF) were both founded during World War II, in order to ensure the stability of the world economy in the post-war world. The World Bank's mandate was actually to promote reconstruction and development and to combat poverty; the IMF's mandate was to promote economic stability, primarily by lending money to countries going through economic downturns – the founders wanted to prevent a recurrence of the widening downward economic spiral that marked the Great Depression of the 1930's. These two institutions were joined in 1947 by the General Agreement on Tarriffs and Trade (GATT), an organization that was devoted to working out trade agreements among member nations; GATT was succeeded by the World Trade Organization (WTO) in 1995. During the 1990's, all three organizations made the liberalization of markets a priority. The IMF, for example, lends money to countries in need, but it imposes conditions upon its loans: if a country wants to receive money, it must make structural changes in its economy (involving, in part, market liberalization) that are dictated by the IMF. Similarly, the WTO will admit a country to membership only if it meets certain criteria – and those criteria include the freedom of markets.

By standard economic measures, globalization has been a success: trade has increased dramatically throughout the world, and the wealth of nations has increased. But still we are left with those questions raised by Sissy Jupe. There is more wealth – but who is getting it? Sissy wondered about the 25 people who starved to death in the prosperous nation; today, we must ask ourselves about the billions of people around the world who live in absolute poverty. Has globalization benefited them?

Specifically, this book aims to address the question of inequality, on two different levels. On one level, there is a significant disparity

in the wealth of individual countries: although it has a population almost quadruple that of the United States, India is a far poorer country; the wealth of all of sub-Saharan Africa is less than the wealth of Singapore. The other level of inequality is the disparity in the wealth of citizens within a particular country: in the United States, for example, the top 20% of the population receives half of the nation's income; even more significantly, the top 10% of the population controls three-quarters of the nation's wealth, with almost 40% of wealth concentrated in the hands of the top 1% of the population. There are similar disparities in other countries. Chinese living on the coast around Shanghai, for example, have a per capita income 75% above the national average; the Chinese living far to the west, near Tibet, have a per capita income 35% below the national average.

The question, then, is whether globalization is part of the problem, or part of the solution. Some critics argue that globalization unfairly favors wealthy countries, and that it increases the inequality between the developed world and the developing world; other analysts insist that globalization has improved the status of countries that have embraced it, and it is only countries who refuse to globalize that are being left behind. Along the same lines, critics charge that globalization increases the wealth of only a small portion of a country's population, and the poor do not benefit; on the other side, there are those who argue that globalization is directly responsible for the alleviation of poverty in some parts of the world. These two perspectives will be found in the first two sections of this book.

There is also considerable debate about the role and the effectiveness of the international organizations that manage so much of the world's economy. Some economists and social critics feel that the IMF in particular has taken on too broad and important a role – and that its activity is especially problematic, given that it is not a democratic or representative organization. Much the same is said of the WTO: member countries, it is argued, surrender their economic sovereignty when they join the organization, and are forced to accept the dictates of other interests. Naturally, the organizations themselves contend that they are valid and necessary – but they are also

supported by many economic thinkers. The role of international institutions will be explored in the third section of this book.

Finally, the fourth section of this book will examine the question of the IMF's performance during the East Asia crisis of 1997. The crisis began with the collapse of the currency in Thailand, but soon spread (via the interconnectedness of global markets) to other countries in the region – most notably, Malaysia, Indonesia, and Korea. As the economies of East Asia weakened, the results were felt in Russia – because it lost much of the market for its oil exports. The IMF was actively involved, and imposed policy changes on the governments that sought its help. Eventually, the crisis eased, and some economists give credit to the IMF for instigating the recovery; in their view, the crisis was caused by bad economic policies and practices in the countries involved, and the IMF forced those countries to make necessary corrections. Other economists, however, argue that IMF policies were responsible for the conditions that led to the crisis in the first place, and that the IMF's action after the collapse of the *baht* only made things worse.

So: there is considerable disagreement about globalization and the way that it works. But there is widespread agreement that globalization is here to stay; even some of its harshest critics will say that globalization is not going to go away – anymore than something like the Internet is going to go away. That does not mean, however, that the course is set for the future. Globalization is a system that can be shaped and managed in many different ways, with many different priorities. The essays in this book are part of the dialogue that will inform the creation of economic policies for the 21st century.

William Driscoll
January 2003

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Part 1
Questions and Criticisms

We can identify three distinct strands in the process of globalization: 1) increased freedom in the movement of goods; 2) increased foreign direct investment — that is, investment in factories, facilities and the like; and 3) increased foreign investment in financial markets. Critics of globalization see problems with all three strands.

First, there are problems when developing countries open their markets to foreign imports, and when they try to compete themselves in world markets. When poor countries drop their trade barriers and adopt free trade practices, they are at a distinct disadvantage. Established multinational corporations have advantages of scale and scope, making their products less expensive to manufacture and ship. When these cheaper commodities enter a newly opened market, they can drive local, small businesses (manufacturing at higher operating costs) out of the market. Small businesses face the same difficulties on an international scale when they try to export. Small businesses have difficulty entering a market dominated by well-established, large multi-national corporations. As these small businesses fail, social problems multiply. As workers and farmers are put out of business and seek jobs, there is a population flood toward urban areas. As housing and employment become more and more scarce, living conditions worsen, creating opportunities for disease to spread. This population influx and destitution put a strain on social programs, such as education, health care and unemployment benefits. (Indeed, many developing countries have only recently introduced unemployment insurance, which is a standard expectation in developed countries.)

Second, there are problems when foreign corporations build or own factories in developing countries. Their primary motivation in making such an investment is to cut their labor costs, since workers in poor countries are paid far less than workers in developed countries. But the desire to increase profits can lead to exploitation. As

rules regarding labor in these countries are frequently non-existent or unenforced, the jobs made available by foreign investment can have unfair labor practices, including exceptionally long hours, low pay, no work breaks, late or incomplete pay, and dangerous working conditions. Moreover, the same lack of rules regarding environmental regulations can lead to strip mining, deforestation, and pollution.

Third, there are problems created by the free movement of capital. Investors aim to maximize the return on their investments – very often, on a short-term basis. The corollary is that many investors have little regard for the long-term economic wellbeing of the countries in which they invest. More important, financial markets are often unstable, and investors can make decisions on the basis of hunches and incomplete information. A crisis in confidence can lead investors to make enormous, sudden withdrawals that have a devastating destabilizing effect on national economies. Moreover, the free movement of capital can lead to currency speculation, which can also destabilize an economy. To put it another way: the liberalization of capital is beneficial for foreign investors, but not for ordinary citizens.

In sum, critics contend that globalization has a negative impact on the economies of less developed countries – and that it is the poor who suffer most.

Inequality of world incomes: what should be done?

by Robert Hunter Wade

The evidence strongly suggests that global income inequality has risen in the last twenty years. The standards of measuring this change, and the reasons for it, are contested – but the trend is clear. The 'champagne glass' effect implies that advocacy of globalisation is not enough: international organisations need to move beyond integration into the world economy as the primary goal of policy.

The concentration of world income in the wealthiest quintile (20%) of the world's population is shocking, and cannot meet any plausible test of legitimacy. The diagram below shows the distribution of world income by population quintiles. Ironically, it resembles a champagne glass, with a wide shallow bowl at the top and the slenderest of stems below.

Development as integration?

Many champions of free trade and free capital movements – like the recent interviewees in Open Democracy, Maria Livanos Cattaui (of the International Chamber of Commerce) and Peter Sutherland (of Goldman Sachs International) – argue confidently that globalisation spreads benefits throughout the world. Even as they affirm an active

role for government, they would resist the idea that reducing world income inequality should be an objective of international public policy. In considering the impact of globalisation on inequality, the trend matters as well as the current picture. Many theories of growth and development generate predictions about *changes in* world income distribution. Indeed, the neoliberal paradigm — which has supplied the prescriptions known as the Washington Consensus that have dominated international public policy about development over the past 20 years — generates a strong expectation that as national economies become more densely interconnected through trade and investment, world income distribution tends to become more equal. If the paradigm was correct, this would be powerful evidence in favour of the "law of *even* Development", which implies that a developing country wishing to "catch up" with standards of living in the west should integrate fully into international markets — with lower tariffs, an end to trade restrictions, a privileging of foreign direct investment and foreign banks, and enforcement of intellectual property rights. The way to progress for developing countries lies, on this view, in allowing the decisions of private economic agents operating in free markets to determine the composition and volume of economic activities carried out within the national territory. Such an "integrationist" strategy would maximise the rate of development; or, to put the point a different way, the country's development strategy should be, in essence, an integrationist strategy.

This conception of income trends and policy strategy makes sense from the standpoint of the wealthy western democracies. It suggests that developing countries' demand for western products and capacity to absorb domestic population growth both expand, as they grow richer. The World Bank, the IMF, the WTO and the other global supervisory organisations are therefore quite justified in seeking to enforce maximum integration on developing countries for the common good.

The evidence on global income inequality

A lot is therefore at stake in the question of whether world income distribution has become more, or less, equal in the past generation.

But how to establish the trend? There are various methods: using a measure of inequality (like the Gini), a unit of inequality (countries or individuals weighted equally), or a common numerical standard (market or purchasing power exchange rates). These can be used singly or in combination. Then there is the further question of what kind of data is used – the national income accounts, or household income and expenditure surveys. However, the evidence suggests that of the eight possible measures of world income distribution, seven show varying degrees of increasing *inequality* in the last twenty years. And although the eighth (the Gini coefficient that weighs by purchasing power parity) shows no significant change, a recent paper by Steve Dowrick and Muhammad Akmal suggests that this contains a bias that makes incomes of developing countries appear higher than they are. However it is measured, the evidence points to rising inequality of world income distribution over the past twenty years. The trend is especially clear where market exchange rates, rather than purchasing power parity measures, are used to establish global income inequality. And using the former method, to convert incomes in different countries into a common numerical standard, is appropriate to most issues of global concern — migration flows, the capacity of developing countries to repay foreign debts and import capital goods, their marginalisation in the world polity. All four combinations of measures using market exchange rates show that world income distribution has become *much more unequal.*

Four causes of increasing inequality

It is very difficult to establish with certainty the causes of the rise in world income inequality. But four causes can be identified. First, differential population growth between poorer and richer countries. Second, the fall in non-oil commodity prices — by more than half in real terms between 1980 and the early 1990s — which affected especially the poorest countries. A third, the debt trap, deserves elaboration. We have seen repeatedly over the 1980s and 1990s that countries that liberalise their financial systems and then borrow heavily — even if to raise investment rather than consumption — run a significant risk of financial crisis. The crisis pulls them back

down the world income hierarchy. Hence the debt trap might be thought of as a world economy force distantly analogous to gravity. A fourth basic cause is technological change, whose recent form reinforces the tendency for high value-added activities (including innovation) to cluster in the (high-cost) western economies rather than disperse to lower-cost developing countries (Silicon Valley is the paradigmatic case). Technological change might be thought of as distantly analogous to electromagnetic levitation — a force that keeps the twenty percent of the world's population living in the OECD countries comfortably floating above the rest of the world in the income hierarchy. If we have world economy analogues to gravity and electromagnetism, can the world economy analogue of relativity theory be far behind?

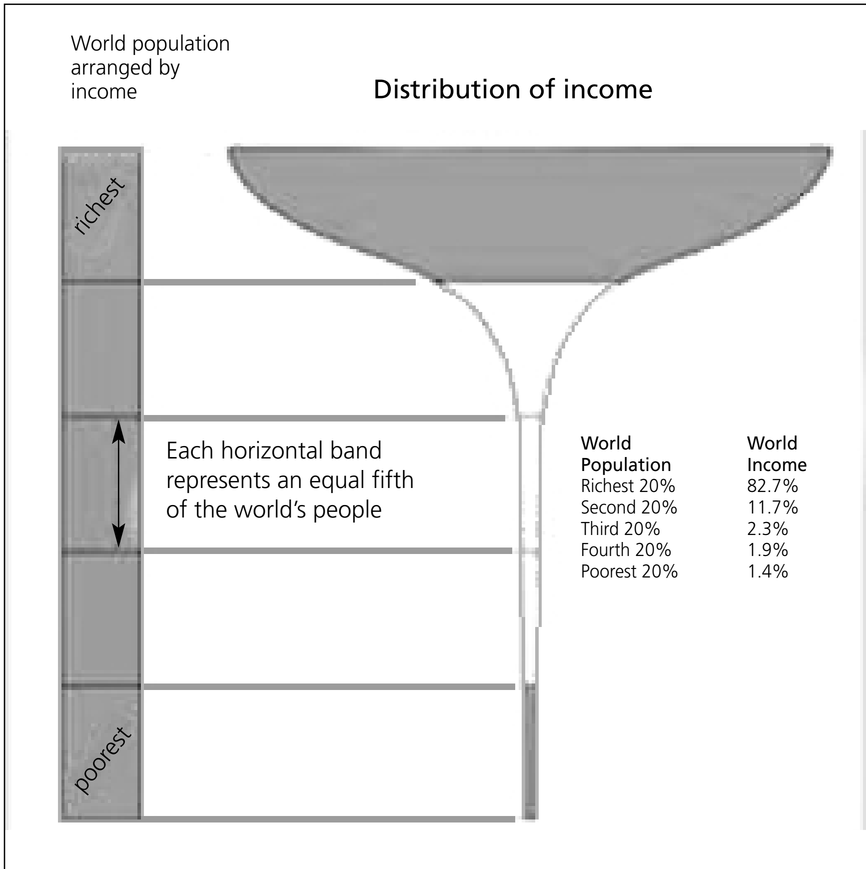
Zones of peace and turmoil

The consequences of global income divergence are equally variable. One is the polarisation of the world system between a zone of peace and a zone of turmoil. In the first, a strengthening republican order of economic growth and liberal tolerance (except towards migrants) develops, with technological innovation able to substitute for depleting natural capital. In the second, many states find their capacity to govern stagnating or eroding.

In the zone of turmoil, a rising proportion of the population find their access to basic necessities restricted at the same time as they see others driving Mercedes. The result is a large mass of unemployed and angry young people, mostly males. Economic growth in these countries often depletes natural capital and therefore future growth potential. Large numbers see migration to the wealthy zone as their only salvation, and a few are driven to redemptive terrorism directed at the symbolic centres of the powerful.

The need to reorient international organisations

The World Bank and the IMF have paid remarkably little attention to global inequality. The *World Development Report 2000: Attacking Poverty*, says explicitly that rising income inequality "should not be seen as negative," provided the incomes at the bottom do not fall and



the number of people in poverty does not rise. In fact, incomes in the lower deciles of the world income distribution probably have fallen absolutely since the 1980s.

But an absolute rise in incomes of the lower deciles, and a fall in the numbers in absolute poverty, could still be accompanied by a damaging rise in inequality. The World Bank's view that a rise in inequality need not be negative ignores the associated political instabilities that can harm the lives of the citizens of the rich world and the democratic character of their states. And this point holds even without any reference to notions of justice, fairness and common humanity.

The global supervisory organisations — the World Bank, the IMF, the WTO, and the UN system should be giving the issue of global income inequality much more attention. If we can act on global

warming (with similarly diffuse and long-term effects), why not global inequality? We should start by rejecting the neoliberal assumption of the Bretton Woods institutions over the past two decades, now powerfully reinforced by the emergent WTO, that the only viable development strategy is domestic reform to facilitate maximum integration of each individual economy into the world economy. The evidence on world income distribution casts doubt on this. International public policy to reduce world income inequality requires a different policy orientation for these organisations. The key change would be to allow governments to focus and nourish domestic strategy and institutional innovations. My book, *Governing the Market*, discusses the principles that might guide such a course.

DEBATE QUESTIONS

The author recognizes that proponents of globalization believe that it will foster equality in incomes around the world. What is the logic that sustains this belief? Why does the author think that this logic is false?

The author argues that the evidence shows that global inequality is increasing, not decreasing. He offers four reasons for this trend. What are they?

The author argues that the inequality of income distribution gives rise to social instability. What in particular does he see as troublesome?

The last section of the essay calls for a 'reorientation of international organisations.' What are these organisations, and how should their orientation be changed?

NOTES

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Are Promises All We Can Offer?: Globalization, Poverty, Inequality, and Human Rights

by Silvia Borzutzky

Introduction

It has become very clear that these [neoliberal] policies which were first developed by the monetarist school and later adopted and recommended [to developing countries] by the IMF and the World Bank have not produced the expected effect. It appears that these policies were aimed at changing not only the economic policy making, but the entire structure and culture of the society. It is also important to note that the policies have not only failed to achieve their goals, but most importantly, they have had a negative effect on poverty, inequality, and rates of economic growth. Because poverty entails a deprivation of individual freedom, these policies have reduced freedom and have often coexisted with repressive regimes.

The 1990's: Globalization and Poverty

Since the end of the Cold War, the term globalization has been widely used to simply explain the expansion of the capitalist system and the application of the neoliberal ideas throughout the world.

What is globalization? Globalization entails the idea of a shrinking world, indicating a growing integration of peoples and places. It also entails the idea that the boundaries of the nation-states are disappearing. Globalization according to Giddens is "the intensification

of world-wide social relations which link distinct localities in such a way that local happenings are shaped by events occurring many miles away and vice-versa." This leads to an intensification of the competition between localities and to a very uneven development. (Gwyne and Kay, *Latin America Transformed: Globalization and Modernity*, London: Arnold, 1999: p. 8)

In practice, globalization entails an expansion of the power of the developed countries and multinational corporations at the expense of the power of the Third World governments. The governments of the LDC have found themselves deprived of the means and mechanisms that would allow them to control their economic policies. Instead, we have seen the expansion of the power of institutions such as the IMF and the World Bank, as well as the power of the governments of the industrialized countries and large corporations. In the case of Latin America, given the traditional dependence on the US, globalization has entailed a new encroaching of US economic power. The countries are not only dependent on the US markets and investments, but their entire financial policies are often delineated in Washington. The best demonstration of this renewed influence is that a handful of countries in the region (El Salvador, Ecuador, and to some extent Argentina) have relinquished their own currencies and adopted the dollar as their national currencies.

Globalization has also meant an expansion of technological capabilities at a global scale. However, this expansion of capitalism, technology, and neoliberal economic ideas has not created the expected economic growth. Much to the contrary, what appears to be happening is a kind of global apartheid in which the divide between rich and poor has increased (Richard Falk, *Predatory Globalization: A Critique*, Oxford: Polity Press, 1999, p. 14).

While in the beginning of the process these consequences were interpreted as short term problems, by the end of the decade it had become apparent that the problem was here to stay. The economic crisis in Asia indicated that the policies suggested by the Washington Consensus were not even fulfilling their basic macroeconomic goals. Thus, at the end of the decade, the world had to confront what a World Bank Report calls "poverty and plenty. Of the world's 6 bil-

lion people, almost half live on less than $2 a day, and 1.2 billion — a fifth — live on less than $1 a day" (World Bank, *World Development Report 2000/2001: Attacking Poverty*, p. 3).

This destitution persists and has increased while technology, global wealth, and global connections have increased dramatically. The distribution of global wealth is not only extraordinarily unequal, but the gap between the rich and the poor has increased dramatically while at the same time wealth has also increased. The average income in the richest 20 countries is 37 times the average in the poorest 20 — a gap that has doubled in the past 40 years. While the number of poor people has declined in East Asia, it has increased elsewhere in the Less Developed world. In the transitional economies in Eastern Europe and Central Asia, the number of people living on less than $1 per day has increased twenty fold (World Bank, op. cit. p.3). It is important to note that East Asia, the Middle East and North Africa reduced the number of people in poverty in the last decade. East Asia did so dramatically, but in all the other regions, the number of people living in poverty has risen. In fact, the experience of the East Asian countries shows that strong social policy commitments enhanced economic growth on a relatively equitable basis. In Korea, for instance, the opening of the economy to international competition was accompanied by a wide range of social programmes, such as pension insurance, universal health insurance, and later unemployment insurance (*United Nations Report on the Social Impact of Macroeconomic Policy*, Nov 5-7, 2001, section 2, number 22-24).

In South Asia, the number of poor people in the last decade rose from 474 million to 522 million. In Latin America and the Caribbean, the number of poor people rose by 20 percent. In Europe and Central Asia, the number of poor rose from 1 million to 2.4 million and in Sub-Saharan Africa, the number of poor people increased from 217 million to 291 million. Thus in almost all parts of the world, we have seen a dramatic increase in poverty. It is important to note about 70 percent of the poor population is located in South Asia and Sub-Saharan Africa (World Bank, op. cit, p. 23). Although in China poverty has been reduced, still 20 percent of the Chinese population lives with less than $1 a day.

A central concern is the impact of globalization on economic growth. The neoliberal ideology and the Washington Consensus argue that the market oriented policies foster economic growth through market competition and free trade. The evidence gathered by analysts, including the World Bank and United Nations, indicates that globalization interferes with economic growth not only temporarily, but also on a permanent basis.

Furthermore, inequality within the countries has also increased with women and indigenous groups bearing the brunt of the consequences of globalization. In Eastern Europe, female employment fell significantly with respect to that of males. Trends toward greater inequality within societies are evident in Latin America, Eastern Europe, the former Soviet Republics, Africa, and even in some East Asian countries (United Nations, *Report on the World Social Situation, 2001*, p. 9).

While income distribution has worsened almost everywhere in the world in the last 30 years, the Latin American case is very important because this surge in inequality has taken place in countries that already had tremendous inequalities. In many countries, the labor share of the national income declined between 6 (Chile, Argentina, Venezuela) and 10 percent (Mexico). The same process is taking place in the Transitional Economies. For instance, in China the gap between the urban and the rural has increased dramatically. In Eastern Europe and the former Soviet Republics there has also been a dramatic increase in inequality due to rising incomes (UN Report 2001, pp. 50-52). Poverty rates rose in the former Soviet Union, Africa, and Latin America. During the 1990's, the number of poor people in Africa rose by 73 million and in Latin America by 15 million (UN Report, 2001, p. 61). In India, China, and Asia, the reduction of poverty came to a halt despite high rates of economic growth.

Reasons for the Growth in Poverty and Inequality: The Impact of the SAP Policies

Why have the SAPs created poverty and inequality in the Third World?

a) In the LDCs, rising inequality is associated with economic

recessions and demand contraction which in turn had been a result of the SAP.

b) Policies to control inflation entail a reduction of social programs and they in turn generate more poverty and inequality. Studies indicate that in 18 Latin American countries other structural reforms have a disequalizing effect.

c) In regards to trade liberalization, a wide array of studies indicate that wage differentials rose with liberalization in Latin America, the Philippines and other countries. The empirical evidence also shows that as labor markets became liberalized, wage inequality also rose (p. 60). This is true of Eastern Europe and at least 18 Latin American countries. The tax reforms that have taken place in the last 20 years have shifted the burden from the wealthy to the rich since the emphasis has shifted from direct to indirect taxes (*UN Report on the World Social Situation*, pp. 57-60).

d) Globalization and the dissemination of information and communication technologies further accentuated fragmentation of labor markets. They created a wider dispersion in salaries and living standards between different types of workers. One obvious result is the formal-informal sector dichotomy (*UN Report on the World Social Situation*, p. 9).

Several studies indicate that large increases in inequality slow down growth for a number of reasons, including lack of adequate reward for differences in individual talent and effort. High levels of inequality can also create personal insecurity and in some cases political instability (op. cit., p. 61). Instability, in turn, stifles growth creating a vicious cycle of inequality, poverty, and instability.

Attacking Poverty

Attacking poverty requires actions beyond the economic domain. According to the World Bank, it is not enough to invest in social services and remove anti-labor policies. The agenda should also include:

a) Promoting opportunity for poor people by stimulating overall growth and by building up their assets and increasing

return on these assets through a combination of market and non-market mechanisms.

b) Facilitating empowerment: making state institutions more accountable and responsive to poor people, strengthening the participation of the poor in the political process and local decision making, and removing the social barriers that result from distinctions of gender, race and social status.

c) Enhancing security: reducing poor people's vulnerability to ill health, economic shocks, policy induced dislocations, natural disasters and violence, as well as helping them cope with adverse shocks when they occur (World Bank Report, op. cit. p. 33).

It is clear that the success of the policies hinges on country-specific social and economic factors. Social stability, development, and cohesion are important conditions for sustained economic growth. It is also clear that these actions cannot be taken by the LDCs alone. They need the support of the international community. The markets of the rich countries should be open to the products of the poor countries and debt and aid relief must be increased. Technical and human assistance should also be included in order to facilitate the implementation of antipoverty policies.

What Drives Economic Growth?

Ultimately poverty will be reduced through economic growth. Thus, understanding what drives economic growth is critical. There is evidence that growth depends on education and life expectancy, particularly at lower incomes. On the other hand, wars, civil unrest, and natural disasters lower growth rates. There is also evidence that strong rule of law and the absence of corruption drives economic growth while ethnic fragmentation increases poverty.

The relationship between growth and poverty is mediated by the nature of the distribution of income. Thus, in Latin America, given the pronounced income differences, we have observed that in periods of high economic growth the income differences increase and consequently poverty also increases. In East Asia, on the other hand, periods of high economic growth have been associated with

improvements in the distribution of income and reduction of poverty as a result of the emphasis on educational and land policies.

DEBATE QUESTIONS

The author argues that globalization is a system that favors countries that are already developed, at the expense of the LDCs (that is, the Least Developed Countries). What evidence does she offer to support this argument?

The author cites numerous statistics about poverty, inequality and economic trends. What general conclusions can be drawn from these numbers?

According to the author, the increase in poverty is not felt equally throughout a country's population. Rather, there are specific groups that suffer most. Who are they?

The author blames SAPs (Structural Adjustment Programs) for the rise in poverty and inequality. Why does she think they are responsible?

The author's ultimate concern is to create policies that will reduce poverty and inequality. What steps does she suggest to achieve this goal?

NOTES

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The Unremarkable Record Of Liberalized Trade

by Christian E. Weller, Robert E. Scott, and Adam S. Hersh

After 20 years of global economic deregulation, poverty and inequality are as pervasive as ever

Recently, a growing number of policy makers have touted the potential for global economic integration to combat poverty and economic inequity in the world today. On September 24, 2001, for instance, U.S. Trade Representative Robert Zoellick (2001), arguing for new "fast track" trade promotion authority, cited a World Bank study claiming that globalization "reduces poverty because integrated economies tend to grow faster and this growth is usually widely diffused" (World Bank 2001a, 1). Yet the empirical evidence suggests that reductions in poverty and income inequality remain elusive in most parts of the world, and, moreover, that greater integration of deregulated trade and capital flows over the last two decades has likely undermined efforts to raise living standards for the world's poor.

In 1980, median income in the richest 10% of countries was 77 times greater than in the poorest 10%; by 1999, that gap had grown to 122 times. Inequality has also increased within many countries. Over the same period, any gains in poverty reduction have been relatively small and geographically isolated. The number of poor people rose from 1987 to 1998, and the share of poor people increased in

many countries — in 1998 close to half the population were considered poor in many parts of the world. In 1980, the world's poorest 10%, or 400 million people, lived on 72 cents a day or less. The same number of people had 79 cents (nominally) per day in 1990 and 78 cents in 1999.

While many social, political, and economic factors contribute to poverty, the evidence shows that unregulated capital and trade flows contribute to rising inequality and impede progress in poverty reduction.

Trade liberalization leads to more import competition and to a growing use of the threat to move production to lower-wage locales, thereby depressing wages. Deregulated international capital flows have led to rapid increases in short-term capital flows and more frequent economic crises, while simultaneously limiting the ability of governments to cope with crises. Economic upheavals disproportionately harm the poor, and thus contribute to the lack of success in poverty reduction and to rising income inequality.

The world's poor may stand to gain from global integration, but not under the unregulated version currently promoted by the World Bank and others. The lesson of the past 20 years is clear: it is time for a different approach to global integration, whereby living standards of the world's poor are raised rather than jeopardized.

Deregulated global trade and capital markets as the culprit

Over the past decades international capital mobility has grown as capital controls were reduced or eliminated virtually everywhere. Consequently, capital flows to developing countries have grown rapidly, from $1.9 billion in 1980 to $120.3 billion in 1997, the last year before the global financial crisis, or by more than 6,000%. Even in 1998, in the wake of the financial crisis, capital flows remained remarkably high at $56 billion. A substantial share of these capital flows (e.g., 36% in 1997) consisted of short-term portfolio investments (IMF 2001b).

Faster capital mobility in a relatively deregulated environment leads to rising inequality, both within countries and between countries, and to less poverty reduction or even increasing poverty.

The probability of financial crises in developing countries rises in direct relation to increases in unregulated short-term capital flows (Weller 2001; Easterly and Kraay 1999). Rising short-term capital inflows result in increased speculative financing and, subsequently, rising financial instability. Financial crises reduce the likelihood for the poor to escape poverty through economic growth because they are ill-equipped to weather the adverse macro-economic shocks (Bannister and Thugge 2001; Lustig 1998, 2000). Financial crises also lower short-term growth rates, and it is estimated that poverty increases by 2% for every percent decline in growth (Lustig 2000).

The burdens of financial crisis are disproportionately borne by a country's poor. Since higher-income earners have better access to insurance mechanisms that protect them from the fallout of a crisis (including capital flight), macro-economic crises lead to a more unequal income distribution within countries (Lustig 2000). Thus, economic crises increase the need for well-functioning social safety nets. Yet unfettered capital flows limit governments' abilities to design policies to help the poor when they need it most—in the middle of a crisis. The International Monetary Fund often opposes increased government expenditures to assist the poor during economic crises, and investors withdraw their funds following increased government expenditures (Blecker 1999).

Finally, developing countries are prone to experience more severe economic crises with greater frequency than are developed economies (Lustig 2000; Lindgren, Garcia, and Saal 1996), leading to greater inequality between countries.

Trade liberalization—the complement to deregulated capital markets in the global deregulation agenda—also plays a significant role in raising inequality and limiting efforts at poverty reduction. By inducing rapid structural change and shifting employment within industrializing countries, trade liberalization leads to falling real wages and declining working conditions and living standards (Bannister and Thugge 2001; Scott et al. 1997; Scott 2001a; Scott 2001b; Mishel et al. 2001). Trade liberalization also gives teeth to employers' threats to close plants or to relocate or outsource production abroad—where labor regulations are less stringent and more difficult

to enforce—and undermines workers' attempts to organize and bargain for improved wages and working conditions (Bronfenbrenner 1997, 2000). This trend fuels a race to the bottom in which national governments vie for needed investment by bidding down the cost to employers (and livings standards) of working people.

The connection between rapid trade liberalization and inequality appears to be universal, indicating downward wage pressures and rising inequality following trade liberalization in industrializing and industrialized economies (USTDRC 2000). A report by UNCTAD (1997) found that trade liberalization in Latin America led to widening wage gaps, falling real wages for unskilled workers (often more than 90% of the labor force in developing countries), and rising unemployment.

Rising inequality is common within many countries

Defenders of the current regime of global deregulation, including the World Bank, acknowledge that inequality has increased within countries. But in its most recent and rather comprehensive document on globalization and poverty (World Bank 2001a), the Bank raised two issues that supposedly mute the fact of rising intra-country inequality. First, data for China dwarfs observations for all other countries, thereby suggesting that rising inequality in globalizing countries does not exist outside of China (World Bank 2001a, 47). However, data for other countries show that growing inequality is indeed a widespread trend.

Second, the World Bank also claimed that rising inequality is not a result of increasing poverty, which thus makes it presumably less troubling (World Bank 2001a, 48). While this claim may hold true in China, it does not describe the trend in many other parts of the world.

There is a broad consensus that income inequality has risen in industrialized countries since 1980. The World Bank reports that there was a "serious…increase in within-country inequality in industrialized countries reversing the trend of [the period 1950-80]" (World Bank 2001a, 46). Similarly, Gottschalk and Smeeding (1997, 636) found that "almost all industrial economies experienced some

increase in wage inequality among prime-aged males" in the 1980s and early 1990s. Further, data from the Luxembourg Income Study (LIS 2001) show that, among 24 countries, 18 experienced increasing income inequality, five (Denmark, Luxembourg, the Netherlands, Spain, and Switzerland) experienced declining inequality, and one (France) saw no change.

Income inequality is also rising in industrializing countries. There was been an unambiguous rise in inequality in Latin America in the 1980s and 1990s (Lustig and Deutsch 1998; IADB 1999; UNCTAD 1997; ECLAC 1997). Other areas also saw inequality rise in the 1980s and 1990s (Faux and Mishel 2000; Ravallion and Chen 1997). Deininger and Squire (1996) found rising inequality in East Asia, Eastern Europe, and Central Asia since 1981, and growing polarization in South Asia. Only sub-Saharan Africa shows a trend toward more income equality since the 1980s.

While a widening gap between the rich and the poor within countries is not universal, it appears to have occurred at least in the majority of countries, and is affecting the income of the majority of people around the globe, contrary to claims by the World Bank that rising inequality within countries has been rare.

Poverty remains a large and widespread problem

The World Bank tries to divert attention from rising inequality by emphasizing its analyses of poverty reduction. It argues that "the long [term] trends of rising global inequality and rising numbers of people in absolute poverty have been halted and perhaps even reversed" due to greater globalization (World Bank 2001a, 49). However, the purported success in poverty reduction is elusive: the number of poor people is on the rise, relative poverty shares remain high in many parts of the world, and poverty shares are rising in many regions.

In assessing global poverty trends, the World Bank relies on a study that highlights the World Bank's *Global Poverty Monitoring* database and provides an overview of poverty trends from 1987 to 1998 (Chen and Ravallion 2001). The authors themselves, though, conclude that "[i]n the aggregate, and for some large regions, all…measures suggest that the 1990s did not see much progress

against consumption poverty in the developing world" (Chen and Ravallion 2001, 18). Also, the IMF (2000, Part IV, p. 1) reports that "[p]rogress in raising real incomes and alleviating poverty has been disappointingly slow in many developing countries."

The assessment of poverty trends by the World Bank suffers from several problems. First, measuring poverty is a difficult undertaking that can easily lead to errors. Different measures of poverty exist. The World Bank's *Global Poverty Monitoring* database, for example, uses an international poverty line of $1.08 per day in 1993 dollars based on purchasing power parity (PPP) exchange rates (Chen and Ravallion 2001; World Bank 2001b). But absolute poverty lines such as this one ignore regional or country-by-country differences.

The evidence shows that the use of an international poverty line tends to understate the share of people living in poverty, compared to other poverty measures. For example, a method using individual national poverty lines finds an additional 14% of the population to be considered poor compared to a method using the international poverty line (World Bank 2001b). An alternative to both the national and international poverty line methods is to use a relative poverty line based on mean consumption or income levels in each country. Using such a relative poverty line instead of the international poverty line shows on average an additional 8% of the population to be considered poor (Chen and Ravallion 2001).

Second, poverty lines are often inadequate to measure the true hardships people are facing in meeting the basic necessities of life. For instance, a recent U.S. study showed that 29% of working families did not earn enough to afford basic necessities, suggesting that a better approach to understanding poverty may lie in measuring household budgets rather than simple poverty lines (Boushey et al. 2001).

The third problem with the Bank's poverty assessment is that even the poverty reduction gains it does find are small and geographically isolated. In 1998, the share of the population living in poverty in industrializing countries was 32%, under a relative poverty line. Although that percentage was down from 36% in 1987, the actual number of people living in poverty increased from 1.5 billion to 1.6 bil-

lion. In 1998, the share of the population in poverty remained very high in some regions: over 40% in South Asia and over 50% in sub-Saharan Africa and Latin America (Table 1). Since 1987, the share of the poor has stayed relatively constant in sub-Saharan Africa and Latin America but more than tripled in Eastern Europe and Central Asia.

TABLE 1
Share of people living below relative poverty lines

	1987	1990	1993	1996	1998
East Asia	33.01%	33.69%	29.82%	19.03%	19.56%
East Asia, excluding China	45.06	38.68	30.76	23.16	24.55
Eastern Europe and Central Asia	7.54	16.19	25.34	26.08	25.60
Latin America and Caribbean	50.20	51.48	51.08	51.95	51.35
Middle East and North Africa	18.93	14.49	13.62	11.40	10.76
South Asia	45.20	44.21	42.52	42.49	40.20
Sub-Saharan Africa	51.09	52.05	54.01	52.80	50.49
Share of world:					
Living under $1.08/day	28.31%	28.95%	28.15%	24.53%	23.96%
Living under relative poverty lines	36.31	37.41	36.73	32.79	32.08
Maximum daily consumption of world's poorest 400 million (nominal)	$0.79	$0.79	$0.56	$0.84	$0.75

Note: The drop in 1993 reflects sharp decreases in per capita GDP in Nigeria, Ethiopia, Myanmar, and the Democratic Republic of Congo that, continued, made up 68% of the sample population in 1993. Calculations for the world's poorest 400 million are based on average nominal per capita GDP.

Sources: Chen and Rawallian (2001): IMF (2001a, 2001b): and authors' calculations.

Another way to look at the global trends in poverty is to consider the incomes of an absolute number of poor people. Take, for instance, the poorest 10% of the population in 1980, consisting of about 400 million people, based on average per capita GDP. The poorest 400 million lived on a nominal $0.72 a day in 1980, $0.79 a day in 1990, $0.84 in 1996, and $0.78 in 1999 (Table 1). In other words, the income of the world's poorest did not even keep up with inflation. Clearly, the economic burden worsened for a large number of people in the 1990s.

Fourth, since the data do not extend beyond 1998, the full impact of the crises in Asia, Latin America, and Russia is not included, making it likely that future revisions will show less progress in poverty reduction. Lustig (2000) argues that frequent macroeconomic crises are the single most important cause of rapid increases in poverty in

Latin America. Consequently, future revisions to the poverty trends in the late 1990s could show smaller average reductions or larger increases in the crisis-stricken areas. In fact, revisions to past data already show less success in poverty reduction than previously assumed. Chen and Ravallion (2001), for example, show that the reduction of people living below the poverty line between 1987 and 1993 was not four percentage points, as estimated in 1997 (Ravallion and Chen 1997), but less than one percentage point.

Finally, the World Bank's conclusion that the lot of the poor has improved during the era of increasing trade and capital flow liberalization relies substantially on data from China and India, but the experiences of both countries are anomalies. In reality, the facts in these countries undermine the case for a connection between greater deregulation of capital and trade flows and falling poverty and inequality. While in China the percentage who are poor has fallen, there has been a rapid rise in inequality (World Bank 2001a).

Most notably, inequality between rural and urban areas and provinces with urban centers and those without grew from 1985 to 1995. Also, a large number of China's workers labor under abhorrent, and possibly worsening, slave or prison labor conditions (USTDRC 2000; U.S. Department of State 2000, 2001). This situation not only means that many workers are left out of China's economic growth, it also makes China an unappealing development model for the rest of the world. Thus, improvements in China are not universally shared and leave many workers behind, often in deplorable conditions.

Using India to illustrate the benefits of unregulated globalization is equally problematic to the World Bank's position, since India's progress was accomplished while remaining relatively closed off to the global economy. Total goods trade (exports plus imports) was about 20% of India's gross domestic product in 1998, or 10 percentage points less than in China and only about one-fifth the level of such export-oriented countries as Korea (IMF 2001a). Moreover, that the IMF (1999, 2000) continuously recommended further liberalization of India's trade and capital flows—the only large developing economy for which this was the case—suggests that the IMF viewed India as a laggard in deregulating its economy.

Continued income divergence across countries (besides China)

The arguments on changes in income inequality between countries take a few perspectives. The World Bank's conclusion that incomes between countries are converging is based on differentiating between countries that have embraced unregulated globalization and those that have not. The World Bank's assertion that "between countries, globalization is mostly reducing inequality" (World Bank 2001a, 1) seems to contrast directly with the IMF's assessment that "the relative gap between the richest and the poorest countries has continued to widen" in the 1990s (IMF 2000, Part IV, p. 1). Given this confusion, it is useful to take a global perspective that looks at all countries and the distribution of world income across all countries and across all people.

The distribution of world income between countries grew unambiguously in the 1980s and 1990s. In other words, rich countries have gotten richer and poor countries have gotten poorer (Table 2). The median per-capita income of the world's richest 10% of countries was 76.8 times that of the poorest 10% of countries in 1980, 119.6 times greater in 1990, and 121.8 times greater in 1999. The ratio of the average per capita incomes shows a similar, yet more dramatic, increase.

The distribution of world income across people, rather than coun-

TABLE 2

Distribution of world income, ratio of top 10% to bottom 10%

	1980	1990	1999
By countries			
Ratio of average incomes	86.2%	125.9%	148.8%
Ratio of median incomes	76.8	119.6	121.8
By population			
Ratio of average incomes	78.9	119.7	117.7
Ratio of median incomes	69.6	121.5	100.8
By population, excluding China			
Ratio of average incomes	90.3	135.5	154.4
Ratio of median imcomes	81.1	131.2	153.2

Note: Distributions are based on per capita GDP in current US dollars (IMF 2001a)

Source: Authors' calculations based on IMF (2001a, 2001b)

tries, witnessed some equitable improvement in the 1990s after a dramatic increase in inequality during the 1980s. While the richest 10% of the world's population had, on average, incomes that were 78.9 times higher than those of the poorest 10% of the world population in 1980, their incomes were 119.7 times higher in 1990. That ratio dropped to 117.7 in 1999. The improvement in equality in the 1990s was somewhat more pronounced in terms of median incomes, yet even under this measure the distribution of incomes was remarkably more inequitable in 1999 than at the beginning of the period in 1980.

Furthermore, the gains in the 1990s come solely from rising incomes in China. If China is excluded, there is an unambiguous trend toward growing income inequality across the remaining world population in the 1980s and 1990s (Table 2). Without China, the richest 10% of the world population had, on average, 90.3 times as much income as the poorest 10% in 1980, 135.5 times more in 1990, and 154.4 times more in 1999. However, since China's income distribution has become substantially more unequal in the 1990s, including China's per capita GDP in the distribution of world income across all people exaggerates improvements in the world's income distribution in the 1990s. Thus, the world's income is significantly more unequally distributed at the end of the almost 20-year experiment with unregulated global capitalism than at the beginning of it.

Conclusion

Criticism of the unregulated globalization agenda has been met with policy makers' renewed adherence to the doctrine that greater global deregulation of trade and capital flows helps to improve inequality between countries, to raise equality within countries, and to accelerate poverty reduction. But income distribution between countries worsened in the 1980s, and its apparent improvement (or leveling off) in the 1990s is the result solely of rising per capita income in China, where the enormous population tends to distort world averages. Within-country income inequality is also growing and is a widespread trend in countries with both advanced and developing economies. Success in reducing poverty has been limited.

The number of poor people has risen, and the share of poor people has grown in many areas, especially in Eastern Europe and Central Asia. And the share of poor people remained high at 40-50% in Latin America, sub-Saharan Africa, and South Asia.

The promises of more equal income distribution and reduced poverty around the globe have failed to materialize under the current form of unregulated globalization. Thus, it is time for multinational institutions and other international policy makers to develop a different set of strategies and programs to provide real benefits to the poor.

DEBATE QUESTIONS

The authors conclude their introduction by stating, "The lesson of the past 20 years is clear: it is time for a different approach to global integration, whereby living standards of the world's poor are raised rather than jeopardized." What is the evidence that makes that lesson clear? Why has the current approach jeopardized living standards of the poor?

The authors have concluded that deregulated capital markets are to blame for rising inequality around the world. What facts lead them to that conclusion? What are the immediate effects of deregulated capital markets, and how do those effects result in increased poverty?

The authors note that the World Bank defends its globalization policies by noting the decrease of poverty in countries that have liberalized their markets. But the authors find that this argument is misleading, and that poverty is actually increasing. What flaws do they see in the evidence used to demonstrate that poverty is decreasing?

The authors note that the inclusion of China skews the data used to measure world poverty in a particular direction. Why is the inclusion of China so significant, and how does the exclusion of China alter the data?

NOTES

The authors are associated with the Economic Policy Institute, "a nonprofit, nonpartisan think tank that seeks to broaden the public debate about strategies to achieve a prosperous and fair economy." Christian E. Weller is an international macro-economist at the Institute; Robert E. Scott is an international economist, and co-director of the Research Department; Adam S. Hersh is a research assistant.

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Globalization: Implications for Africa

by Peter J. Henriot, S.J.

When I left Zambia last week, one name was on everyone's lips: "El Niño." This climatic phenomenon originating in the middle of the Pacific Ocean is affecting the rainfall patterns in our land-locked African country many thousands of kilometres away. Drought is threatened, with consequent famine, disturbed social conditions, upset economic patterns, and unsettling political ramifications. "El Niño" affects many parts of the world — perhaps also here in India — with heavy rains, but in our country its effect is just the opposite, with the halt of rains and resultant severe drought. The awareness that we live on a very small and very inter-related globe has come home in varied and dramatic fashion in recent years, but for us in Zambia, that awareness is heightened by the serious challenge facing the country in the weeks ahead arising from such a dramatic global phenomenon.

"El Niño," I suggest, is an example in the natural order of "globalisation," the interdependence of diverse activities occurring across the expansion of the globe. At this conference we are looking at examples in the artificial, human-made order of globalisation, in the economic, political and cultural spheres of life. Specifically, we are exploring in this session analyses of the phenomenon of globalisation and its social consequences. My task here is to offer some brief reflections on the implications of globalisation for Africa. (Having lived and worked for some years in Zambia, my examples will most often be from my experience there.)

I. PREMISES

In order to understand the significance of globalisation in the African context, there are two premises that I believe focus the debate more realistically.

A. The first premise is that it is important to understand that today's "globalisation" is actually the fourth stage of outside penetration of Africa by forces which have negative social consequences for the African people's integral development. This outside penetration has occurred over the past five hundred years in a variety of forms.

The first stage was the period of slavery, during which the continent's most precious resources, African women and men, were stolen away by global traders, slavers, working for the benefit of Arab, European and North American countries. Estimates vary from two to ten million slaves extracted from the continent, with disastrous economic, social and psychological effects. I come originally from a country, the United States of America, whose industrial progress in the north during the eighteenth and nineteenth centuries depended upon agricultural progress built unjustly, inhumanely, on the backs of African slaves who toiled in the fields of the south.

The second stage was the period of colonialism, when British, French, Belgian, Portuguese, Italian and German interests dictated the way that map boundaries were drawn, transportation and communication lines established, agricultural and mineral resources exploited, religious and cultural patterns introduced. Whatever minimal benefits might have come to Africans because of colonialism were far outweighed by the many negative consequences of economic exploitation, environmental degradation, and social dependencies. Indeed, many of today's ethnic conflicts which attract international attention trace their origins back to colonial stratagems.

The third stage has been described as "neo-colonialism," what Pope Paul VI called "the form of political pressures and economic suzerainty aimed at maintaining or acquiring dominance." The independence struggles begun in the late 1950's may have brought local governmental rule to the many nations of the continent but did not break the ties — subtle and not so subtle — that bound Africa's

future to outside influences. Trade patterns, investment policies, debt arrangements, etc., all reinforced earlier conditions that were not beneficial to Africans. Another striking example was the political manipulation of African states as bargaining pawns during the Cold War, with the resulting legacies of armed conflicts, for example, in the Horn of Africa and in southern Africa.

We have now entered the fourth stage, the period of globalisation, characterised by an integration of the economies of the world through trade and financial flows, technology and information exchanges, and movement of people. The dominant actor in this stage is the free market. The globe is conceived as one market directed by profit motivations of private enterprises that know neither national boundaries nor local allegiances. In this stage, Africa experiences both minimal influence and maximum consequence.

B. The second premise is simply the statement of an obvious but not always acknowledged fact: globalisation is not working for the benefit of the majority of Africans today. While globalisation has increased opportunities for economic growth and development in some areas, there has been an increase in the disparities, and inequalities experienced especially in Africa. The Least Developed Countries 1997 Report (UNCTAD) notes that 33 of the 48 LDCs are in Africa; that the continent has the highest debt to exports ratio; that the average growth rate of these countries fell from 5.4% in 1995 to 4.6% in 1996; that the export primary commodity prices fell especially in tropical foods (e.g., coffee) and minerals (e.g., copper), areas of particular concern for Africa; and that aid flows have declined and foreign direct investment (FDI) flows have remained small.

The process of globalisation in Africa is a driving force behind the imposition of severe economic reforms under the structural adjustment programme (SAP). The burden of the transition from state-centred economies to free market economies has been borne unequally by those who already are suffering, the poor majority. SAP has meant increased prices of basic necessities, service fees for health and education, retrenchment of the formal employment force, and dismantling of local economic structures in the face of liberalised

trade patterns. While neo-liberal economists argue that there may be "short-term pain but long-term gain" in the implementation of SAP, it is increasingly clear throughout Africa that the short-term pain, for example, of social service cuts, ecological damages and industrial base erosion will in the long term have truly disastrous effects upon any hope for an integral and sustainable human development.

II. REALITIES

The reality of globalisation as it affects Africa can be seen from examples of the structures it takes and the consequences it induces.

A. Structures

Ideological: The basis for globalisation is the neo-liberal ideology (ideological structure) that many feel is the only alternative for the future, and some even argue marks "the end of history." This is an "economic fundamentalism" that puts an absolute value on the operation of the market and subordinates people's lives, the function of society, the policies of government and the role of the state to this unrestricted free market. Throughout Africa, socialism is dead and it is now not only capitalism that is alive but a version of capitalism that Pope John Paul II has poignantly called "savage capitalism."

Neo-liberal policies support economic growth as an end in itself and use macro-economic indicators as the primary measurements of a healthy society. As will be noted below, this ideology governs not only economic structures but also political arrangements. It assumes almost a religious character, as greed becomes a virtue, competition a commandment, and profit a sign of salvation. Dissenters are dismissed as non-believers at best, and heretics at worst.

Commercial: In Africa, the commercial structures of trade and investment are key factors in economic development. These were, of course, the major instruments of the colonialism that gripped the African continent for nearly a century. In recent times, the Uruguay Round of GATT agreements are implementations of a liberalised vision that free trade and unrestricted investment will solve development problems facing the continent. But a group of African non-governmental organisations (NGOs) meeting in South Africa in April 1996, prior to the

UNCTAD-IX gathering, challenged this vision on the basis of recent experiences. For example, poorer African countries have been opened up to foreign imports and firms which has led to the destruction of local enterprises. A process of "deindustrialisation" has taken place in many countries such as Zambia. Our once-flourishing textile industry has been wiped out by imports from Asia; several small industries such as tyre manufacturers and medical supply companies have folded in the face of competition from large South African firms.

The World Trade Organisation (WTO) is emerging as a very powerful actor in the globalisation process, but without much beneficial influence being exercised on its direction by African countries. The WTO is primarily an instrument of Northern governments and countries and its proposals for trade and investment are more in the interests of these elements. The promotion of foreign direct investment (FDI) is hailed as the new engine for development. But FDI flows to Africa are very small (under US$ 5 billion in 1996), are largely advantageous to only a few countries (such as South Africa), and tend to benefit the already privileged elite.

Technological: Africa is being affected in profound ways by the new electronic communication possibilities that bind together the globe in previously unimaginable ways. Personal computers, fiber electronics, satellites, cellular phones, networks of faxes, e-mail and the Internet: all of these structures make economic and political globalisation more and more a reality. Transfer of funds is almost as important as transfer of information and it is done instantaneously simply by punching keys and flipping switches. ("F1" opens, or closes, whole new worlds!) Human interface is frequently not necessary and often not desired. Throughout Africa, technological innovations are coming in rapidly and will be a major force in the future.

It is too early to say whether these technological innovations will truly benefit the majority of Africans. I know that I enjoy the advantages of e-mail and Internet connections and that it greatly enhances my work for social justice and peace in Zambia. But only a very small portion of the population of Africa presently have access to personal computers. Other technological structures are slow in developing on the continent.

Cultural: One commentator has called the process of globalisation the birth of the "McWorld" — a cultural integration and uniformity that mesmerises the world with fast music, fast computers, and fast food. This "McWorld" is the product of the influence of MTV, Macintosh and McDonald's. Cultural imperialism is not a new phenomenon, but it assumes alarming proportions today when driven by the new technologies and profit propensities of the dynamics of globalisation.

In Africa, this cultural structure of globalisation presents specific problems. Traditional African cultures (there are many cultures in Africa, not simply one) emphasise values such as community, family, respect of life, hospitality. But these cultural values come into strong confrontation with the values communicated through Western music, movies, videos, cable and satellite television, advertisements, and the idolised figures of entertainment and sports. One analyst speaks of the "predominance of geoculture over the geopolitical and the geoeconomic." Culture is gaining ground over the traditional sources of economic and political power, and the dominant geoculture of the West is an overwhelming force against traditional African cultures.

Political: An important new factor in the process of globalisation is that there is a significant change in the geo-political structures. There has been a breakdown of the bi-polar world. With the collapse at the end of the 1980's of the Soviet Empire and the end of the Cold War, there is no longer major political division along the economic lines of capitalist and socialist countries. The West reigns supreme, and if the "New World Order" proposed after the 1991 Gulf War is not yet a reality, at least there is no serious challenge to that supremacy. We in Africa experience that dynamic with the wane of the influence of competing Super Power interests in the local affairs, for example, of Ethiopia, Angola and Mozambique, and South Africa. Where outside interests do play a role — for example, in the current tragedies of the Great Lakes Region — they are French and English rather than East and West.

One significant political development of globalisation in Africa is the push toward democratisation. This includes a heightened empha-

sis on good governance and respect for human rights. But this development is not without serious questions. First, the West pushes for political reforms that it considers compatible with the neo-liberal economic order: free politics and free markets are too closely equated. And the understanding of state activity is minimist in the global neo-liberal vision. Second, donors' demands and pressures for policy changes, even when guided by the best of humanitarian motivations, can be interpreted as yet another "imperialist" or "neo-colonialist" imposition on African states. A "back-lash" can develop against this push toward democratisation. Recent events in Zambia have provided examples of these difficulties, when in 1996 donors suspended aid over disputes regarding constitutional and electoral issues, and when political crackdowns following the failed October 1997 coup attempt have brought increased international isolation to the country.

B. Consequences

Economy: One of the starkest consequences of globalisation in Africa today in economic terms is the rendering redundant of the African people. This may appear to be a harsh overstatement, but I believe its validity can be demonstrated. Last year I participated in a major study done for the UNDP and the ILO, analysing the employment situation in the neo-liberal economic model being pursued in Zambia. Our study noted that the SAP-driven governmental policy regarded the provision of people with meaningful work as a function mainly of sustained economic growth. Employment promotion was at best of secondary importance. As a consequence, formal employment of the labour force had dropped to as low as 14% in recent years, with no explicit employment generation policy included in government programmes.

The simple definition of economy that appeals to me is: women and men working together with the earth to meet basic needs. But there is neither cooperation nor progress when local people are ignored except as factors in profit maximisation by outside interests. Women especially feel the negative effects of economic reform. Globalisation views Africa and Africans as components of a global free market, independent of considerations of livelihoods and integral human development.

Ecology: Globalisation has a two-fold ecological consequence in Africa. First, there is the climatic impact of global warming (the so-called "greenhouse effect"), caused by pollution levels in northern industrial countries, and the dangerous practice of toxic waste dumping. Environmental concerns at the global level tend to pay more attention to effects in the rich countries of the north. Again, Africa is marginalised.

Second, poverty conditions induced by the severe SAP approach means both less care of the environment by cash-strapped governments and more encroachment on nature by persons desperately struggling for survival. For example, in Zambia soil erosion and deforestation are serious problems today and will be even more serious tomorrow. Trees are cut down for charcoal manufacture (an income-generating activity of the poor), resultant negative changes in rainfall patterns are experienced (causing drought and famine), and response mechanisms of over-grazing and excessive use of chemical fertilisers spoil previously fertile soil (decreasing future productive capacities of peasant farmers). Poverty hurts the whole community of creation, the natural environment as well as the human population.

Equity: The gap between rich and poor on both the global level and on the national level increases with the spread of globalisation. The famous "champagne glass" figure of global wealth distribution was portrayed in the 1992 Human Development Report of the United Nations Development Programme (UNDP). This Report documented that the richest 20% of the world's population receives 82.7% of global income, while the poorest 20% receives 1.4%. That gap is continuing to grow, having doubled over the past thirty years. Of the 45 countries listed in the "low human development" category in the 1997 Report, 33 are in sub-Saharan Africa.

The major beneficiary of globalisation in Africa, South Africa, already accounts for over 40% of the sub-Saharan GDP; its own GNP per capita of US$ 3010 contrasts sharply with Zambia's of US$ 350, Malawi's of US$ 145, and Tanzania's and Mozambique's of US$ 80. I know that India is described as a poor country, with GNP per capita of US$ 320 and over 50% of the population estimated to live below the poverty line. But the World Bank estimates more than 80% of

Zambians are below the poverty line, living in households with inadequate income to meet basic daily needs. Key to equity issues, of course, is the fact of what has been called the "feminisation of poverty," with the disproportionate numbers of the poor being women and those dependent on women.

III. RESPONSES

By way of conclusion, let me very briefly suggest three sets of responses that should be of concern for this conference as it addresses globalisation from the perspective of the victims of history.

A. Analytical

From the viewpoint of the countries of the so-called "developing world" (the poor countries), keen analysis must be made of the operations and outcomes of globalisation. This analysis cannot, however, be restricted to purely economic considerations but must take account of the human dimensions of the phenomenon. This, of course, is the outlook of this present conference and it is increasingly emphasised by studies from both secular and religious sources. One of the participants in the recent "Synod on Americas" noted that "globalisation is certainly not being driven by Christian principle of solidarity. It is being driven by the motive of financial profit and, very often, by just plain greed." Our analysis should point out the root causes of the suffering experienced by the majority of the world's population, and should take as the analytical starting-point the "preferential option for the poor."

B. Political

Africa's response to globalisation must be political in the sense of coordinated efforts to stand up to dominant outside forces that work for the detriment of the people. But to be honest, efforts undertaken with prominence in Africa frequently are more self-serving critiques or unabashed acceptances — and more rhetoric than resolves. Genuine political action is not forthcoming. The NGO community that might be expected to speak more honestly for the majority of people is frequently excluded from key decision-making processes.

The pre-eminent African political leader, Nelson Mandela, appears cautious in any critique of a globalisation process that at least initially is offering benefits to key sectors of the economy of South Africa. Robert Mugabe of Zimbabwe is reported to have urged the November 1997 meeting in Libreville, Gabon of APC nations (African, Pacific and Caribbean states bound together with European states through the Lome Treaties) that these nations should discuss and negotiate more as a single bloc in order to be strong in the face of the European Union. Frederick Chiluba of Zambia embraces SAP and all its components in a very uncritical fashion. Both Daniel Arap Moi of Kenya and General Sani Abacha of Nigeria speak critically of global forces more in their own self-defense of dictatorial policies than of concern for the majority of their own citizens.

C. Ethical

1. Globalisation of solidarity: A counter-emphasis — indeed, a "counter-cultural" emphasis — to the driving force of globalisation that today so negatively affects Africa is offered by John Paul II's expression, "a globalisation in solidarity, a globalisation without marginalisation." The Pope asks key questions about the process: "Will everyone be able to take advantage of a global market?... Will relations between States become more equitable, or will economic competition and rivalries between peoples and nations lead humanity towards a situation of even greater instability?" Solidarity is the central theme of the 1987 encyclical, *The Social Concerns of the Church*, where John Paul II critiques the structures of sin that mark so much of a globalisation driven by profit and power.

2. Family of God: A distinctly African emphasis that provides an ethical critique of the present process of globalisation is found in the discussions of the African Synod (1994). Here a model of church was proposed that envisions the church as the "family of God." As such, the church must be an "instrument of universal solidarity for building a world-wide community of justice and peace." An attractive approach to a human-friendly globalisation would be based on the familial values of respect and sharing that mark African traditions.

3. Globalisation from below: Integral human development, sustain-

able development, depends more on harmonious human relationships than on the organisation and operation of an unfettered free market. A fundamental fault with globalisation as experienced in Africa is that it is not rooted in community but structured from above according to abstract economic laws. To counter this situation in an ethically authentic and creative fashion calls for the promotion of local communities that work for integral human development and are effectively linked with similar groups across national boundaries. Much — but not all — of the recent worldwide explosion of non-governmental activity (NGOs) is an expression of this effort to build globalisation from below. Indeed, this very conference this week, as well as the conference coming up here early next month, "Colonialism to Globalisation," can be steps toward a qualitatively different globalisation that will have more positive implications for Africa.

NOTES

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SOURCE

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http://www.sedos.org/english/global.html

DEBATE QUESTIONS

The author suggests that globalization in Africa should be seen as "the fourth stage of outside penetration of Africa by forces which have negative social consequences for the African people's integral development." What were the first three stages, and how does the fourth stage differ?

The author argues that the process of globalization has not benefited Africa. What evidence does he use to support this argument?

The author argues that the economic process of globalization has significant consequences in other areas – e.g., politics and the environment. What are these consequences? How are political systems shaped by globalization? How does globalization increase environmental problems?

The author proposes changes to globalization that will benefit Africa. How does he think Africa should respond to globalization?

Part 2
In Defense of Globalization

Some critics of globalization have argued that its proponents care more about profits than poverty; but defenders of globalization have responded that globalization is the best way to alleviate poverty. The poor, they argue, cannot be helped only by handouts; poor people need jobs – and the best way to create jobs is by building the economy through globalization. The example of East Asia is often cited: countries that have embraced globalization (such as Korea, Thailand, and China) have seen a reduction in poverty and a commensurate increase in their standard of living; countries that have kept their economies closed (such as India) have seen poverty increase.

The generation of wealth is achieved primarily by foreign investment – especially direct investment in factories and facilities. Such investment provides an influx of capital, creating new industries and employment opportunities; developing countries gain new technologies, and the labor force acquires more sophisticated skills. In addition, foreign companies invest in a country's infrastructure (roads, railroads, ports, property systems, communications, etc.). That investment benefits everyone, not just the companies themselves. As people become employed, incomes rise, spreading wealth throughout the system. There is a wider selection of goods and services in the market – and competition in the market has driven down costs. The overall standard of living rises.

There are more benefits besides these economic advantages. One of the key benefits of higher incomes is frequently a lower disease rate as health information and health care become more available. The rise of a middle class is also often accompanied by greater participation in government; in short, globalization promotes democracy. More than that, globalization creates greater pressure for good government – foreign investors are not attracted to countries with badly managed economies, or widespread corruption. Globalization creates incentives for governments to become more open in their dealings, to ensure the rule of law, and to protect the rights of individuals owning property.

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The Challenge of Global Capitalism: The World Economy in the 21st Century

by Robert Gilpin

Issues in the Debate

The diversity, wide ranging nature, and imprecision of the definitions of globalization used by both proponents and critics complicate evaluation of the issues involved in the debate. Many, if not most, of the "blessings" and "evils" attributed to globalization are really due to such other factors as technological developments, historical accidents, and reckless or dubious national policies unconnected to globalization. West Europeans, for example, blame high rates of unemployment on globalization, when the real culprits are inflexible labor markets and the economic policies associated with creating a regional and not a global economy.

As already stated, I shall use the term "globalization" to refer to the increasing linkage of national economies through trade, financial flows, and foreign direct investment (FDI) by multinational firms. The debate encompasses many issues and provides an important vehicle for understanding both the real and the alleged consequences of economic globalization. However, because the issues are so wide-ranging, and in some cases so speculative, I shall concentrate just on those particularly relevant to domestic and international economic affairs, and I shall not directly address contentions that globalization

poses a serious threat to democracy, destroys local autonomy, and homogenizes societies into a formless mass. However, my discussion of the alleged economic effects of globalization is relevant to consideration of these political and social issues. If, as I believe, the present and future economic consequences of globalization have been greatly exaggerated, then its social and political consequences have also been exaggerated. There are many extremely serious social and political problems in the world at the turn of the century, and changes in policies are needed if these problems are to be solved or even ameliorated. However, blaming globalization and wishing that it would go away doesn't solve these problems, while changed national and regional policies could assist the poor and the downtrodden.

International Distribution of Wealth and Power

Proponents and opponents of economic globalization differ considerably in their expectations of its effects on the distribution of wealth and power within and among national economies. Proponents argue that globalization will eventually achieve greater equality and convergence of performance among national economies. Integration of the less developed economies (of the South) into the world economy will lead to great increases in their rates of economic growth and levels of productivity. In fact, the farther behind an economy is, the faster that economy could grow until it catches up with the more advanced countries. More rapid rates of economic growth will tend to "lift all boats" in these societies and will, in time, benefit the entire population. Indeed, most American economists and other commentators believe that developing countries will adopt the American model of a market-oriented economy and that globalization will increase worldwide acceptance of individualism and political democracy.

Populist and communitarian opponents of globalization present a very different assessment of its consequences. Populists believe that, although the economic and technological flows from developed to less developed countries may indeed be beneficial to the latter, they are harmful to the former. The process of convergence, they proclaim, has already seriously undermined and will continue to weaken the power, wealth, and security of the United States and other indus-

trialized countries. Investments in LDCs by American and other multinational corporations (MNCs), they allege, cause workers in developed economies to lose their jobs and their wages to fall.

Communitarians argue, on the other hand, that globalization creates an hierarchical international economic and political system composed of the rich core of developed economies and the exploited, impoverished periphery of less developed economies. Globalization, they argue, is leading to a massive concentration of corporate power within and across national boundaries, a concentration supported by the World Bank, the IMF, and other American-dominated international organizations. The communitarians (among whom one should include Pope John Paul II) argue that international trade and the activities of multinational corporations are leading to increased international inequality. As the Pope told his receptive audience in Cuba during his January 1998 visit, the rich everywhere are growing richer while the poor are growing poorer. In words reminiscent of now defunct dependency theory, communitarian critics charge that globalization is resulting in a “global apartheid” that is enriching developed countries and impoverishing less developed countries.

Such populists as Ross Perot, Patrick Buchanan, and the late James Goldsmith have expressed fear that diffusion of technology from developing to developed economies will increase the productivity and the competitiveness of the low-wage developing economies. Rejecting this argument, economists point out that wages and productivity have historically risen together. As the productivity of low-wage workers in developing countries increases, their wages will also rise, and thus their alleged threat to high-wage workers in the developed countries will be reduced; for example, as Korea has industrialized, the wages of South Korean workers have risen considerably and have approached Western levels. Although the developed countries will lose markets for those products in which the developing countries gain comparative advantage and which they can produce for themselves, the increased wealth of the latter will create enlarged markets for new exports in which the former retain or gain comparative advantage. In this way, both developing and developed economies will benefit from globalization and economic conver-

gence. How is it possible to evaluate these contradictory assessments of economic globalization and its consequences?

It is true that a disturbing concentration of economic power is forming as large corporations merge with one another, engage in takeovers and ally with one another. This restructuring and rationalization of corporate activities around the world is significantly transforming the global economy. Yet, this development must be kept in perspective. As critics of globalization themselves point out, this corporate restructuring is in response (at least in part) to the intensification of economic competition as trade and investment barriers fall. This increased competition itself constitutes a significant restraint on the exercise of corporate power. The entry of Japanese automobile firms into the American market, for example, has significantly reduced the monopoly power of American car makers and has been of great benefit to American consumers in terms of price and quality. The most disconcerting examples of the concentration of corporate power, such as the rise of immense media and telecommunications giants in the United States, have little to do with globalization, but are instead the consequences of technological and domestic economic developments. Insofar as the concentration of corporate power is a serious problem, it should be dealt with by strict enforcement of antitrust and competition laws and not the erection of trade and other economic barriers.

The impact of globalization on the distribution of power among nations, and especially between the developed and less developed countries, must also be placed in perspective. One must begin with the fact that every national system throughout history has been hierarchal and composed of dominant and subordinate economies; there has never been, and in the future there is not likely to be, an egalitarian and democratic international system, neither with globalization nor without it. In fact, despite the substantial increase in globalization of economic affairs, the distribution of wealth between developed and less developed countries has not significantly changed over the past half-century. The moderate amount of redistribution that has occurred has in fact favored less developed economies, as is exemplified by China becoming the world's third-largest economy as mea-

sured by total GNP. Nevertheless, at the beginning of the new century, the largest segment of the world's population has scarcely been touched by economic globalization. Indeed Africa and other impoverished regions are more threatened by marginalization and neglect than by globalization and exploitation.

In the modern world, the principal determinants of a nation's international standing in the world economy are factor accumulation (capital and skilled labor) and, over the longer term, its rate of productivity growth. With the possible exception of success or failure in war, the rate of productivity growth is more important than anything else in the determination of whether an economy rises or declines in the international hierarchy. Although the level of productivity of an economy is determined by investment, technological innovation, and effective institutions, there is overwhelming evidence that participation in the international economy is highly beneficial for an economy. Yet, even though trade, technological diffusion, and foreign investment can accelerate an economy's rates of economic and productivity growth, they can also make economies vulnerable to domination by foreign MNCs and subject to international financial troubles and other economic risks. However, if they isolate themselves from the international economy, as LDCs did in the early postwar period, they risk falling farther behind and dropping in the international hierarchy. Every country, especially developing ones, therefore, must face this dilemma and weigh the potential costs and benefits of participating in the global economy.

In an open global economy, there is a danger that a country will lose control over important aspects of its economy. If the past is any guide, such a situation gives rise to powerful nationalist reactions and becomes a source of serious political troubles. This possibility is already on the horizon. German investment in the transition economies of Eastern Europe, American investment in Latin America, and Japanese investment in Pacific Asia could trigger extremist attacks on foreign firms and investors. Such reactions would not only damage these economies but could also threaten the stability of the global economy. It is almost an unavoidable feature of the international economy that peoples will attempt to raise themselves in the

hierarchy of nations, preferably through economic means; but if that fails, through political means.

Assessment of the charge that globalization leads to a hierarchal structure composed of rich and poor must include consideration of the dynamics of the international system and of the ways in which the structure of that system changes over time. As economists emphasize, globalization has enabled a number of developing countries in Pacific Asia and Latin America to begin closing the economic and technological gap with the developed countries. Indeed, the transformation of many of these emerging markets into fierce competitors has provoked many of the strong reactions found among those populists and other economic nationalists in the developed nations who believe that globalization threatens the security and economic well-being of the United States and Europe. Such fears are by no means groundless, but the threat posed by the industrializing countries to the industrialized economies has been greatly exaggerated. The most pertinent danger in such a situation is that governments of developed countries will adopt dangerous and self-defeating protectionist policies.

As the distinguished Swedish economist S. B. Linder observed, the rapid economic rise of new industrial powers and exporters creates several problems for established economic powers. As rising economies gain a greater share of the world economy, the more advanced economies' relative share is inevitably reduced. Also, the rise of new economic powers and the consequent relative decline of established powers raise concerns about the national security of the established powers. Emergence of new industrial powers imposes on established industrial economies the costly task of adjusting to changes in their comparative advantage, and the increasing international competitiveness and enlarged trade share of rising powers intensifies trade friction and frequently results in a search for scapegoats and charges that rising powers are not playing "fair."

The extraordinarily rapid industrialization of the Pacific Asian economies and their emergence as important exporters have forced other nations to confront the problems caused by significant shifts in international competitiveness and in the international balance of

economic power. Similar problems have appeared before, with the sudden emergence of Great Britain in the early nineteenth century, the equally sudden emergence of unified Germany and subsequently of the United States as aggressive export economies in the late nineteenth and early twentieth centuries, and Japan's unprecedented export expansion beginning in the 1970's. Each of these significant shifts in economic power and international competitiveness produced severe economic and political tensions; for example, the economic expansion of Great Britain triggered the formation of the German *Zollverein* (customs union) in the early nineteenth century and subsequently stimulated the unification of Germany and its rapid rise as a great power. At the close of the twentieth century, the economic rise of China and other Pacific Asian economies is repeating this familiar pattern. Although it is probably inevitable that shifts in economic power will give rise to economic tensions, such developments do not have to result in serious economic and political conflict.

Although the developed countries' relative share of global wealth has declined moderately in the late twentieth century, they have not suffered absolute decline and their standard of living has continued to rise. While the developed countries have lost markets in some goods, these economies are still the world's largest exporters. American exports of capital goods to both industrial and industrializing economies even increased significantly in the 1990s. A substantial portion of the American economy's high growth rate after 1995 was due to a surge in exports. The export of capital goods increased because many industrializing countries needed to substitute capital equipment for labor in order to reduce their own costs. Despite the loss to the industrializing countries of America's competitive edge in some products, the United States has continued to have a strong comparative advantage in many others, such as computers, agriculture and aircraft. Continuation of America's successful adjustment to its changed position in the world is largely dependent on the continued inventiveness of the American economy and is by no means guaranteed.

As I pointed out in *The Political Economy of International Relations* (1987), the spread of industry from the industrialized to the industrializing economies produces opposed consequences. On the one

hand, the rise of new industrial powers "competes away" the markets and high profit margins of the established industrial powers. On the other hand, the increasing wealth of the rising powers creates new markets for those products and exports in which the older industrialized economies retain or gain comparative advantage. In this way, the rise of Pacific Asia poses both opportunities and challenges to the advanced industrialized economies. Whether the challenges or the opportunities will predominate will not be known for many years or even decades, and a number of different factors will determine whether the trade-creating or the trade-destroying consequences of industry diffusion will ultimately prevail.

The relations of the developed and the developing countries over the long term depend largely on whether or not the older industrial economies remain or become innovative and able to achieve a comparative advantage in new areas to replace exports of products in which rising industrial economies gain comparative advantage and which they can supply for themselves or export to world markets. Whether or not the industrializing economies open their markets to new exports from the older powers will also be very important. If they are to avoid economic tension and political conflict, each side must make compromises with the other and must not resort to protectionist policies except as temporary assurances.

The industrialized economies must not only avoid trade protectionism but must also carry out what economists call an "adjustment process"; they must adopt policies that encourage those businesses that lose comparative advantage to "phase out," while implementing policies that facilitate innovation of new economic activities and improve the economic performance of older ones. The American automobile industry provides an example of successful adjustment. Threatened by superior Japanese imports, the American Big Three automobile companies (Chrysler, Ford, and General Motors) greatly improved the performance of their products and regained international competitiveness. On the other hand, certain sectors of the American steel industry that tried to survive through protection alone provided an unfortunate example of what should not be done.

For their part, the industrializing economies must, at least over the

longer term, abandon import-substitution and protectionist policies and open their economies to exports from the industrialized economies. This is happening, but slowly. Brazil, for example, has partially opened its market to computer imports, but it has remained largely closed to automobile imports. Fortunately, greater openness is arising in more and more developing countries.

DEBATE QUESTIONS

The author contends that the effects of globalization – economic, political and social – have been over-exaggerated. How does he propose to define globalization in a more precise way?

Globalization has many opponents – and those opponents, says the author, have widely different reasons for their objections. What characterizes the "communitarian" school of thought? What characterizes the "populist" school?

The author argues that globalization should not be blamed as the cause of global inequality. What is his analysis of that inequality?

The author recognizes that the rise of new economic powers must inevitably cause a relative decline in the economic strength of established powers. Should this be a cause for concern? What is the author's recommendation?

NOTES

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SOURCE

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Grinding the Poor

by The Economist

Sceptics charge that globalisation especially hurts poor workers in the developing countries. It does not.

For the most part, it seems, workers in rich countries have little to fear from globalisation, and a lot to gain. But is the same thing true for workers in poor countries? The answer is that they are even more likely than their rich country counterparts to benefit, because they have less to lose and more to gain.

Orthodox economics takes an optimistic line on integration and the developing countries. Openness to foreign trade and investment should encourage capital to flow to poor economies. In the developing world, capital is scarce, so the returns on investment there should be higher than in the industrialized countries, where the best opportunities to make money by adding capital to labour have already been used up. If poor countries lower their barriers to trade and investment, the theory goes, rich foreigners will want to send over some of their capital.

If this inflow of resources arrives in the form of loans or portfolio investment, it will supplement domestic savings and loosen the financial constraint on additional investment by local companies. If it arrives in the form of new foreign-controlled operations, FDI, so

much the better; this kind of capital brings technology and skills from abroad packaged along with it, with less financial risk as well. In either case, the addition to investment ought to push incomes up, partly by raising the demand for labour and partly by making the labour more productive.

This is why workers in FDI-receiving countries should be in an even better position to profit from integration than workers in FDI-sending countries. Also, with or without inflows of foreign capital, the same static and dynamic gains from trade should apply in developing countries as in rich ones. This gains-from-trade logic often arouses suspicion, because the benefits seem to come from nowhere. Surely one side or the other must lose. Not so. The benefits that a rich country gets through trade do not come at the expense of its poor-country trading partners, or vice versa. Recall that according to the theory, trade is a positive sum game. In all these transactions, both sides — exporters and importers, borrowers and lenders, shareholders and workers — can gain.

What, if anything, might spoil the simple theory and make things go awry? Plenty, say the sceptics.

First, they argue, telling development countries to grow through trade, rather than through building industries to serve domestic markets, involves a fallacy of composition. If all poor countries tried to do this simultaneously, the price of their exports would be driven down on world markets. The success of the East Asian tigers, the argument continues, owed much to the fact that so many other developing countries chose to discourage trade rather than promote it. This theory of "export pessimism" was influential with many developing-country governments up until the 1980s, and seems to lie behind the thinking of many sceptics today.

A second objection to the openness-is-good orthodoxy concerns not trade but FDI. The standard thinking assumes that foreign capital pays for investment that makes economic sense — the kind that will foster development. Experience shows that this is often not so. For one reason or another, the inflow of capital may produce little or nothing of value, sometimes less than nothing. The money may be wasted or stolen. If it was borrowed, all there will be to show for it is

an insupportable debt to foreigners. Far from merely failing to advance development, this kind of financial integration sets it back.

Third, the sceptics point out, workers in developing countries lack the rights, legal protections and union representation enjoyed by their counterparts in rich countries. This is why, in the eyes of the multinationals, hiring them makes such good sense. Lacking in bargaining power, workers do not benefit as they should from an increase in the demand for labour. Their wages do not go up. They may have no choice but to work in sweatshops, suffering unhealthy or dangerous conditions, excessive hours or even physical abuse. In the worst cases, children as well as adults are the victims.

Is trade good for growth?

All this seems very complicated. Can the doubters be answered simply by measuring the overall effect of openness on economic growth? Some economists think so, and have produced a variety of much quoted econometric studies apparently confirming that trade promotes development. Studies by Jeffrey Sachs and Andrew Warner of Harvard, by David Dollar and Aart Kraay of the World Bank, and by Jeffrey Frankel of Harvard and David Romer of Berkeley, are among the most frequently cited. Studies such as these are enough to convince most economists that trade does indeed promote growth. But they cannot be said to settle the matter. If the application of econometrics to other big, complicated questions in economics is any guide, they probably never will; the precise economic linkages that underlie the correlations may always be too difficult to uncover.

This is why a good number of economists, including some of the most distinguished advocates of liberal trade, are unpersuaded by this kind of work. For every regression "proving" that trade promotes growth, it is too easy to tweak a choice of variable here and a period of analysis there to "prove" that it does not. Among the sceptics, Dani Rodrik has led the assault on the pro-trade regression studies. But economists such as Jagdish Bhagwati and T.N. Srinivasan, both celebrated advocates of trade liberalization, are also pretty scathing about the regression evidence.

Look elsewhere, though, and there is no lack of additional evi-

dence, albeit of a more variegated and less easily summarized sort, that trade promotes development. Of the three criticisms just stated of the orthodox preference for liberal trade, the first and most influential down the years has been the "export pessimism" argument — the idea that liberalizing trade will be self-defeating if too many developing countries try to do it simultaneously. What does the evidence say about that?

Pessimism confounded

It does not say that the claim in nonsense. History shows that the prediction of persistently falling export prices has proved correct for some commodity exporters: demand for some commodities has failed to keep pace with growth in global incomes. And nobody will ever know what would have happened over the past few decades if all the developing countries had promoted trade more vigorously, because they didn't. But there are good practical reasons to regard the pessimism argument, as applied to poor-country exports in general, as wrong.

The developing countries as a group may be enormous in terms of geography and population, but in economic terms they are small. Taken together, the exports of all the world's poor and middle income countries (including comparative giants such as China, India, Brazil and Mexico, big oil exporters such as Saudi Arabia, and large-scale manufacturers such as South Korea, Taiwan and Malaysia) represent only about 5% of global output. This is an amount roughly equivalent to the GDP of Britain. Even if growth in the global demand for imports were somehow capped, a concerted export drive by those parts of the developing world not already engaged in the effort would put no great strain on the global trading system.

In any event, though, the demand for imports is not capped. In effect, export pessimism involves a fallacy of its own — a "lump of trade" fallacy, akin to the idea of "lump of labour" (whereby a growing population is taken to imply an ever-rising rate of unemployment, there being only so many jobs to go round). The overall growth of trade, and the kinds of product that any particular country may buy or sell, are not pre-ordained. As Mr. Bhagwati and Mr. Srinivasan

argued in a recent review of the connections between trade and development, forecasts of the poor countries' potential to expand their exports have usually been too low, partly because forecasters concentrate on existing exports and neglect new ones, some of which may be completely unforeseen. Unexpected shifts in the pattern of output have often proved very important.

Pessimists also make too little of the scope for intra-industry specialization in trade, which gives developing countries a further set of new opportunities. The same goes for new trade among developing countries, as opposed to trade with the rich world. Often, as developing countries grow, they move away from labour-intensive manufactures to more sophisticated kinds of production: this makes room in the markets they previously served for goods from countries that are not yet so advanced. For example, in the 1970s, Japan withdrew from labour-intensive manufacturing, making way for exports from the East Asian tigers. In the 1980s and 1990s, the tigers did the same, as China began moving into those markets. And as developing countries grow by exporting, their own demand for imports rises.

It is one thing to argue that relying on trade is likely to be self-defeating, as the export pessimists claim; it is another to say that trade actually succeeds in promoting growth. The most persuasive evidence that it does lies in the contrasting experience from the 1950s onwards of the East Asian tigers, on one side, and the countries that chose to discourage trade and pursue "import-substituting industrialization" (ISI) on the other, such as India, much of Latin America, and much of Africa.

Years ago, in an overlapping series of research projects, great effort went into examining the developing countries' experience with trade policy during the 1950s, 60s, and early 70s. This period saw lasting surges of growth without precedent in history. At the outset, South Korea, for instance, was a poor country, with an income per head in 1955 of around $400 (in today's prices), and such poor economic prospects that American officials predicted abject and indefinite dependence on aid. Within a single generation it became a mighty exporter and world-ranking industrial power.

Examining the record up to the 1970s, and the experience of

development elsewhere in East Asia and other poor regions of the world, economists at the OECD, the World Bank and America's National Bureau of Economic Research came to see the crucial importance of "outward orientation" — that is, of the link between trade and growth. The finding held across a range of countries, regardless of differences in particular policies, institutions, and political conditions, all of which varied widely. An unusually impressive body of evidence and analysis discredited the ISI orthodoxy and replaced it with a new one, emphasizing trade.

The trouble with ISI

What was wrong with ISI, according to these researchers? In principle, nothing much; the problems arose over how it worked in practice. The whole idea of ISI was to drive a wedge between world prices and domestic prices, so as to create a bias in favor of producing for the home market and therefore a bias against producing for the export market. In principle, this bias could be modest and uniform; in practice, ISI often produced an anti-export bias both severe and wildly variable between industries. Managing the price-rigging apparatus proved too much for the governments that were attempting it: the policy produced inadvertently large and complex distortions in the pattern of production that often became self-perpetuating and even self-reinforcing. Once investment had been sunk in activities that were profitable only because of tariffs and quotas, any attempt to remove those restrictions was strongly resisted

ISI also often had an even more pernicious consequence: corruption. The more protected the economy, the greater the gains to be had from illicit activity such as smuggling. The bigger the economic distortions, the bigger the incentive to bribe the government to tweak the rules and tilt the corresponding pattern of surpluses and shortages. Corruption and controls go hand in hand. ISI is not the only instance of this rule in developing, but is has proved especially susceptible to shady practices.

Today, developing-country governments are constantly, and rightly, urged to battle corruption and establish the rule of law. This has become a cliché that all sides in the development debate can agree

on. But defeating corruption in an economy with pervasive market-suppressing controls, where the rewards to illegality are so high, is extraordinarily hard. This is a connection that people who favor closed or restricted markets prefer to ignore. Limited government, to be sure, is not necessarily clean; but unlimited government, history suggests, never is.

Remember, remember

On the whole, ISI failed; almost everywhere, trade has been good for growth. The trouble is, this verdict was handed down too long ago. Economists are notoriously ignorant of even recent economic history. The lessons about what world markets did for the tigers in the space of a few decades, and the missed opportunities of, say, India (which was well placed to achieve as much), have already been forgotten by many. The East Asian financial crisis of 1997-1998 also helped to erase whatever lessons had been learned. And yet the prosperity of East Asia today, crisis and continuing difficulties notwithstanding, bears no comparison with the economic position of India, or Pakistan, or any of the other countries that separated themselves for so much longer from the international economy.

By and large, though, the governments of many developing countries continue to be guided by the open-market orthodoxy that has prevailed since the 1980s. Many want to promote trade in particular and engagement with the world economy in general. Even some sceptics might agree that trade is good for growth — but they would add that growth is not necessarily good for poor workers. In fact, it is likely to be bad for the poor, they argue, if the growth in question has been promoted by trade or foreign capital.

Capital inflows, they say, make economies less stable, exposing workers to the risk of financial crisis and to the attentions of western banks and the International Monetary Fund. Also, they argue, growth that is driven by trade or by FDI gives western multinationals a leading role in third-world development. That is bad, because western multinationals are not interested in development at all, only in making bigger profits by ensuring that the poor stay poor. The proof of this, say sceptics, lies in the evidence that economic inequal-

ity increases even as developing countries (and rich countries, for that matter) increase their national income, and in the multinationals' direct or indirect use of third-world sweatshops. So if workers' welfare is your main concern, the fact that trade promotes growth, even if true, is beside the point.

Yet there is solid evidence that growth helps the poor. Developing countries that have achieved sustained and rapid growth, as in East Asia, have made remarkable progress in reducing poverty. And the countries where widespread poverty persists, or is worsening, are those where growth is weakest, notably in Africa. Although economic policy can make a big difference to the extent of poverty, in the long run growth is much more important.

It is sometimes claimed that growth is less effective in raising the incomes of the poor in developing countries than in rich countries. This is a fallacy. A recent study confirms that, in 80 countries across the world over the past 40 years, the incomes of the poor have risen one for one with overall growth.

If all this is true, why does global income inequality seem to be widening? First, the evidence is not at all clear-cut. Much depends on how you make your comparisons. An overall comparison of country aggregates — comparing rich countries with poor countries — is generally more encouraging than a comparison of the richest 10% of people in the world with the poorest 10%. In 1975, America's income per head was 19 times bigger than China's ($16,000 against $850); by 1995, the ratio had fallen to six ($23,000 against $3,700). On the other hand, it is true that Africa's income per head is rising more slowly than America's; as a result, their income-gap ratio has increased, from 12 in 1975 to 19 in 1995. But it would be odd to blame globalisation for holding Africa back. Africa has been left out of the global economy, partly because its governments used to prefer it that way. China has embraced the global economy with a vengeance — and see how well it has done.

Better than nothing

Statistical difficulties aside, suppose it were true that global inequality is increasing. Would that be a terrible indictment of globalisation, as

sceptics seem to suppose? Perhaps not. It would be disturbing, and extremely surprising, if poor countries engaged in globalisation were failing to catch up — but they aren't, as China and many other avid globalisers show. It would also be disturbing if inequality across the world as a whole were rising because the incomes of the poorest were falling in absolute terms, rather than merely in relative terms — but this is extremely rare. Even in Africa, which is doing so badly in relative terms, incomes have been rising and broader measures of development have been getting better. It may be too little, but it is not nothing, merely because other countries have been doing better.

The sceptics are right to be disturbed by sweatshops, child labour, bonded labour, and the other gross abuses that go on in many poor countries (and in the darkest corners of rich ones, too). But what makes people vulnerable to these practices is poverty. It is essential to ask if remedial measures proposed will reduce poverty: otherwise, in attacking the symptoms of the problem, you may be strengthening their underlying cause. It is one thing for the sceptics to insist, for instance, that child labour be prohibited; it is quite another to ensure that the children concerned go to school instead, rather than being driven to scrape a living in even crueler conditions.

The barriers to trade that many sceptics call for seem calculated to make these problems worse. Some sceptics want, in effect, to punish every export worker in India for the persistence of child labour in parts of the Indian economy. This seems morally indefensible as well as counter-productive in economic terms. The same goes for the campaign to hobble the multinationals. The more thoroughly these companies penetrate the markets of the third world, the faster they introduce their capital and working practices, the sooner poverty will retreat and the harder it will be for such abuses to persist.

This is not to deny that the multinationals are in it for the money — and will strive to hire labour as cheaply as they can. But this does not appear to be a problem for the workers who compete to take those jobs. People who go to work in a foreign-owned company do so because they prefer it to the alternative, whatever that may be. In their own judgment, the new jobs make them better off.

But suppose for the moment that the sceptics are right, and that

these workers, notwithstanding their own preferences, are victims of exploitation. One possibility would be to encourage foreign firms to pay higher wages in the third world. Another course, favored by many sceptics, is to discourage multinationals from operating in the third world at all. But if the aim is to help the developing-country workers, this second strategy is surely wrong. If multinationals stopped hiring in the third world, the workers concerned would, on their own estimation, become worse off.

Compared with demands that the multinationals stay out of the third world altogether, the idea of merely shaming them into paying their workers higher wages seems a model of logic and compassion. Still, even this apparently harmless plan needs to be handled cautiously.

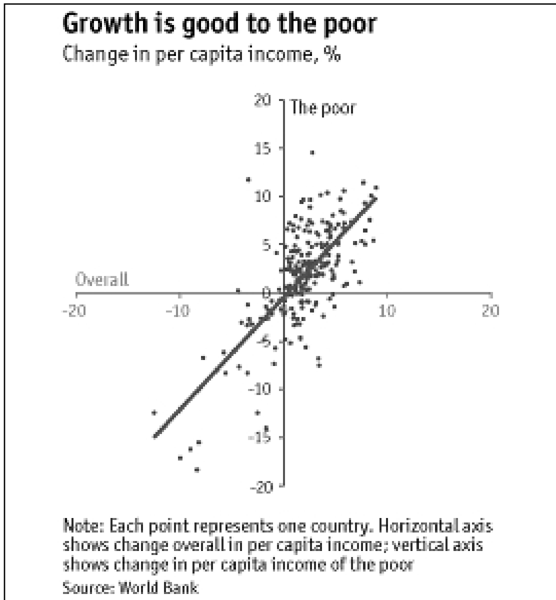
The question is, how much more is enough? At one extreme, you could argue that if a multinational company hires workers in developing countries for less than it pays their rich-country counterparts, it is guilty of exploitation. But to insist on parity would be tantamount to putting a stop to direct investment in the third world. By and large, workers in developing countries are paid less than workers in rich countries because they are less productive: those workers are attractive to rich-country firms, despite their lower productivity, because they are cheap. If you were to eliminate that offsetting advantage, you would make them unemployable.

Of course, you could argue that decency merely requires multinationals to pay wages that are "fair", even if not on a par with wages in the industrial countries. Any mandatory increase in wages runs the risk of reducing the number of jobs created, but you could reply that the improvement in welfare for those who get the higher pay, so long as the mandated increase was moderate and feasible, would outweigh that drawback. Even then, however, two difficult questions would still need to be answered. What is a "fair" wage, and who is to decide?

What fairness requires

A "fair" wage can be deduced, you might argue, from economic principles: if workers are paid a wage that is less than their marginal pro-

ductivity, you could say they are being exploited. Some sceptics regard it as obvious that third-world workers are being paid less than this. Their reasoning is that such workers are about as productive as their rich-country counterparts, and yet are paid only a small fraction of what rich-country workers receive. Yet there is clear evidence that third-world workers are not as productive as rich-country workers. Often they are working with less advanced machinery; and their productivity also depends on the surrounding economic infrastructure. More tellingly, though, if poor-country workers were being paid less than their marginal productivity, firms could raise their profits by hiring more of them in order to increase output. Sceptics should not need reminding that companies always prefer more profit to less.



Productivity aside, should "good practice" require, at least, that multinationals pay their poor-country employees more than other local workers? Not necessarily. To hire the workers they need, they may not have to offer a premium over local wages if they can provide other advantages. In any case, lack of a premium need not imply that they are failing to raise living standards. By entering the local labour market and adding to the total demand for labour, the multinationals would most likely be raising wages for all workers, not just those they hire.

In fact, though, the evidence suggests that multinationals do pay a wage premium — a reflection, presumably, of efforts to recruit relatively skilled workers. Table 5 shows that the wages paid by foreign affiliates to poor-country workers are about double the local manufacturing wage; wages paid by affiliates to workers in middle-income countries are about 1.8 times the local manufacturing wage (both calculations exclude wages paid to the firms' expatriate employees). The numbers come from calculations by Edward Graham at the Institute for International Economics. Mr. Graham cites other research which shows that wages in Mexico are highest near the border with the United States, where the operations of American-controlled firms are concentrated. Separate studies on Mexico, Venezuela, China and Indonesia have all found that foreign investors pay their local workers significantly better than other local employers.

The Lure of multinationals
Average wage paid by foreign affiliates and average domestic manufacturing wage by host-country income, 1994

	All countries	High-income	Middle-Income	Low income
Average wage paid by affiliates, $'000	15.1	32.4	9.5	3.4
Average domestic manufacturing wage, £'000	9.9	22.6	5.4	1.7
Ratio	1.5	1.4	1.8	2.0

Source: Edward M. Graham, Institute for International Economics

Despite all this, you might still claim that the workers are not being paid a "fair" wage. But in the end, who is to make this judgment? The sceptics distrust governments, politicians, international bureaucrats and markets alike. So they end up appointing themselves as judges, overruling not just governments and markets but also the voluntary preferences of the workers most directly concerned. That seems a great deal to take on.

SOURCE

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DEBATE QUESTIONS

The position taken by this article is clear at the outset: globalisation benefits poor workers in developing countries. The authors recognize, however, that this position is not universally shared, and begin by articulating three distinct arguments to the contrary. What are those arguments?

"Export pessimists" contend that a concentration on foreign trade can be self-defeating; as more countries export more goods, the value of those goods declines. What do export pessimists propose as an alternative economic policy?

What problems, according to the article, are caused by a country's dependence on Import-Substituting Industrialization (ISI)?

The article recognizes that studies have shown that global inequality is rising – but, the authors contend, that does not mean that globalisation is to blame, or that globalisation should be stopped. Why not?

Multinational corporations hire workers in less developed countries because they want to reduce their labour costs. Sceptics charge that this amounts to exploitation, but the article contends that a global economy requires different ways of thinking about fairness. How should the question of low-cost labour be addressed?

The Cause Of Antiglobalists Is Wrong In The Aggregate

by Edward M. Graham

Debate with Lori Wallach at Council on Foreign Relations
Washington, D.C., 13 February 2001

I am slightly uncomfortable in a debate where I am the defender of globalism. I don't find all antiglobalist claims wrong. Indeed, some of my own biases run somewhat parallel to the "green" perspective. Also, I have spent time in developing countries and I know that the "sweatshop" issue is real.

However, having said this, I believe that the cause espoused by the antiglobalists, while right in some of the particulars, is wrong in the aggregate. Indeed, precisely those people whom the antiglobalists purport to represent — the world's poorest people, especially those in developing countries and also the lower income cadres here in the United States — would be most adversely affected by the reversal of globalization.

A. Vast amounts of empirical evidence indicate that developing nations that are open to international trade and investment do better by a variety of measures than do those nations that are not open. The poorest nations, for example the Sahel nations, are among the least open to globalization and at least some of their misery stems from not being part of the global economy rather than from the excesses of globalization. This is not an idle statement; numerous empirical studies have examined this issue and have reached the same conclusion.

B. Also, the bulk of the evidence indicates that the lowest income cadre of workers in the United States is greatly hurt by protectionist measures. For example, the textile and apparel quota system to be sure, does protect some jobs in the United States. But it does so by raising the cost of clothing to all Americans. This cost is disproportionately borne by lower income persons. Our estimates show that the lowest quintile of American wage earners suffers the equivalent of a 5 percent loss of real disposable income as a result of these. By contrast, the only cadre of Americans who win are the uppermost quintile, largely because of bloated salaries of executives and returns to large shareholders in these industries.

C. Also, there is no evidence that globalization has cut the total number of jobs in the United States. The overall US unemployment has in recent years — especially in the years following the completion of the Uruguay Round — fallen to levels that many analysts believed impossible as few as 10 years ago. This is in some good measure due to globalization, in particular to the fact that rising demand achieved by full employment can now be met by imports rather than price increases, reducing the rate of unemployment that creates inflation. To be sure, there is some evidence that trade exacerbates a preexisting trend in the United States that favors skilled workers over less skilled ones, but this is largely to say that trade replaces lower paying jobs with higher paying ones.

D. Alas, there are costs associated with this displacement. IIE Visiting Fellow Lori Kletzer, for example, calculates that about one-half million Americans are displaced by imports each year. About a third of these will become re-employed with no lifetime earnings loss; many of them actually will experience income increases. But about a third will experience moderate lifetime earnings reductions and another third severe reductions. We at IIE believe that the US policy response to this has to date been inadequate and we advocate a program of wage insurance to help out these Americans who indeed are losers from globalization.
Also, in work done for us, Dartmouth economics professor Matthew Slaughter notes that about one-half of Americans do feel threatened by globalization. Almost invariably, this half is less educated; by and large, university graduates do not feel threatened. While wage insurance should address the very understandable anxiety of the less skilled, the long-run solution lies in improving the performance of the US education system.

E. On this, our own econometric work at IIE refutes, in particular, the contention that US direct investment has the effect of "exporting jobs". We find that actually new US outward investment stimulates US exports, rather than suppress them. Thus, outward US FDI results in job creation in the export sector, which generally commands a wage premium in the United States. Somewhat offsetting this, outward direct investment does stimulate imports. Interestingly, we find this to have a weaker effect than the export stimulation just mentioned. Thus, this investment does likely destroy some jobs in import-competing industries; but, again, this is offset by job creation in export industries.

F. Also on investment, and returning to developing nations, empirical work in these nations indicates that foreign-owned economic activity in these nations is associated with significant wage premiums. Also, empirical work indicates that developing nations with large amounts of such activity experience faster wage growth than nations that do not have large amounts of foreign direct investment.

In summary, then, antiglobalism suffers from a fallacy of composition. Specific ills are noted by the antiglobalists, and some of these ills are indeed the result of globalization. These ills of course should be corrected where they exist. But antiglobalists then extrapolate from these to condemn all of international trade and investment as pariahs. This is as wrong as to conclude that, because a few people on the George Washington Parkway drive so as to endanger other drivers, anyone on the George Washington Parkway is in grave danger and therefore it would be in everyone's interests to block access to this road.

Let me close by noting a real world example of this fallacy. Some years ago, I visited Bangladesh, where I had the opportunity to visit a number of apparel operations. Some of these were abominable: dirty, ill-lit shops wherein some workers clearly were underage and all were poorly treated. But other shops did not meet this description. I remember particularly well one plant that was clean, well-lit, and even provided day-care for children of women who worked in the plant, who were almost all female. Also, those workers who could not read or write

were required to attend literacy classes run by the employer. Was this latter an altruistic gesture? No, not really. The firm was implementing a computerized inventory control system that would require each worker to be able to read computer monitors. In a country where 90 percent of the female population was then illiterate, company-provided education was necessary to make the system operational.

What if antiglobalists had their way? The sweatshops in Bangladesh might then be forced to close. Alas, even this would be questionable in terms of social effects. This, after all, is a country where children by the hordes stand on street corners and beg for small change. In fact, begging in Bangladesh is organized. The adults who control these children are far worse masters than those in even the worst of the sweatshops. But also closed would be plants like the one I visited that were, at the margin, making a difference. These factories got the children off the streets and into safe environments. Furthermore, these plants gave the mothers of these children (who often were very young women, not much more than children themselves) the gift of literacy, a gift they otherwise would never have received.

Furthermore, Bangladesh would have been deprived of the only activity that had any chance whatsoever of lifting a very large population out of a very deep poverty. Working in a garment factory might not be a very good occupation. But, as the International Ladies Garment Workers Association has reminded us, a job sewing garments is better than no occupation at all. There is a big difference between Bangladesh and the United States in this regard. In the United States, the choice is not between working in a garment factory and not working at all. Rather, it is between working in a garment factory and getting the skills needed to hold a much better job. But in Bangladesh, the choice really is between the garment factory and the street. Globalization has at least brought the garment factory to Bangladesh, and it holds the promise of bringing better opportunities in the future. The antiglobalists, plainly and simply, would not only take these opportunities away. They would shut down the garment factory, and condemn those lucky enough to have a job to return to the street.

Are the antiglobalists winning? In an interview in Foreign Policy last year, Lori Wallach claims yes, citing the MAI defeat and Seattle.

My own view is that the antiglobalists have claimed too much credit at least for the first of these — see my own book on this. She identified the next targets to be the African trade bill and PNTR for China. Fortunately for the poor people of Africa and China, she lost these last two. And, although I am a fair-minded, sporting sort of guy, I can only say "may these losses not be the last."

DEBATE QUESTIONS

The author considers two strands of anti-globalism. Some critics of globalization object to its effect on workers in less developed countries; other critics contend that globalization hurts the American economy and American workers. How does the author refute the contention that globalization hurts the poor in other countries? How does he see that it benefits the American economy?

The author argues that anti-globalism suffers from the logical "fallacy of composition." What is that fallacy, and how is it evident in anti-globalist thinking?

The author concludes with a discussion of a garment factory he has visited in Bangladesh. How does he characterize this factory? What, in his view, would happen if anti-globalists had their way, and why would this be undesirable?

NOTES

Edward M. Graham is a Senior Fellow at the Institute for International Economics, "a private, nonprofit, nonpartisan research institution devoted to the study of international economic policy."

SOURCE

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Globalization and Developing Countries

by Aaron Lukas

Executive Summary
The "anti-globalization coalition" that paraded through the streets of Seattle in November and stormed police barricades in Washington, D.C., in April contends that international trade and investment are "lose-lose" propositions. On the one hand, organized labor argues that low-wage workers in developing countries will gain employment at the expense of American workers. On the other hand, self-appointed advocates of the developing world claim that trade with and investment from Western countries lead only to exploitation and continued poverty abroad. Given that negative view of globalization, it is not surprising that anti-trade activists are calling to "shrink or sink" the World Trade Organization.

The two previous Cato "WTO Report Cards" demonstrated that open markets have been a boon for the thriving U.S. economy and that the rules governing world trade do not infringe on U.S. sovereignty.

This third paper examines the other side of the equation: the effect of trade and investment liberalization on the world's poorer nations. According to the prevailing anti-trade line, developing countries suffer from a "race to the bottom" in abusive labor practices, environmental quality, and wages. Sweatshops and child labor, not economic opportunity, are the supposed consequences of free trade. In reality, however, the empirical experience with foreign trade and investment in the developing world has been overwhelmingly positive.

From rising wages to improved working conditions, the competi-

tion and cooperation that accompany liberalization are proving to be powerful forces for good. Moreover, the claim that developing countries were somehow bullied or tricked into opening their markets is simply false; the pace of economic liberalization has accelerated because poor countries have realized that liberalization is in their best interest.

In the half century since the founding of the General Agreement on Tariffs and Trade, the world economy has grown 6-fold, in part because trade has expanded 16-fold. Globalization has improved and will continue to measurably improve the lives of millions of people around the world.

Trade, Growth, and Development

> Millions of workers are losing out in a global economy that disrupts traditional economies and weakens the ability of their governments to assist them.
>
> — *Jay Mazur, president, Union of Needletrades, Industrial and Textile Employees*[1]

The essential prerequisite of a "globalized" economy is openness to foreign trade and investment. This means that a country's citizens must be free to buy and sell goods or services in the international marketplace, unburdened by excessive tariffs or other trade barriers. It also means that foreign businesses and investors must be allowed to purchase and own property in the local economy and that their investments must enjoy standard legal protections.

Developing countries embrace globalization for a variety of reasons. The removal of trade barriers immediately expands the range of choices for consumers and places downward pressure on prices, thus raising the real value of workers' earnings. Foreign investment provides more jobs, new production technologies, infrastructure improvements, and a source of capital for local entrepreneurs. Domestic businesses gain access to both cheaper inputs and vastly larger markets for their products. But for most people, the many and varied benefits of a liberal trade and investment regime can be boiled down to one very attractive proposition: globalization spurs economic growth, and growth raises living standards.

Empirical research supports the link between the freedom to conduct international transactions and economic growth. A well-known paper by Jeffrey Sachs and Andrew Warner of Harvard University, for example, found that developing countries with open economies grew by an average of 4.5 percent per year in the 1970s and 1980s while those with closed economies grew by only 0.7 percent.[2]

The same pattern held for developed countries: those with open economies grew by 2.3 percent per year while those with closed economies grew by 0.7 percent.[3] Other studies, such as a 1998 analysis by the Organization for Economic Cooperation and Development concluded that nations with relatively open trade regimes grow roughly twice as fast as do those with relatively closed regimes.[4]

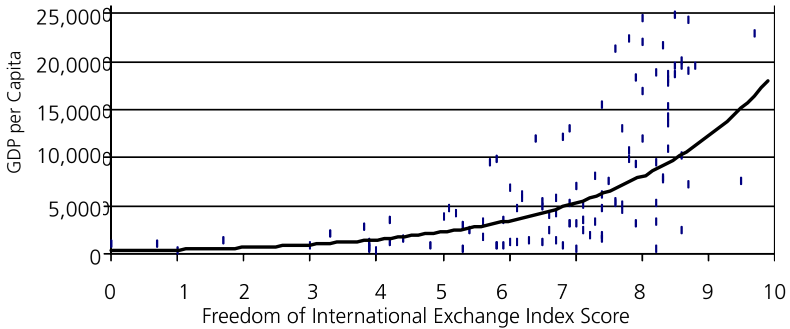
Obviously, developing countries that grew at the open-economy average have been converging with the industrial economies while their closed-economy counterparts have tended to fall further behind.

One of the broadest measures of economic openness is found in the *Economic Freedom of the World: 2000 Annual Report*, by James Gwartney, chief economist of the Joint Economic Committee, and Robert Lawson of Capital University.[5] *Economic Freedom* ranks countries, in addition to other areas, on their relative openness to international exchange.

The report ranks countries on a scale from 0 to 10 on the basis of such factors as mean tariff rate, taxes on international trade as a percentage of exports plus imports, nontariff barriers, and total size of trade sector. As Figure 1 shows, there is a clear correlation between per capita gross domestic product and openness to international trade and investment as measured by Gwartney and Lawson.

Critics of cross-country comparisons correctly point out that isolating the effects of trade liberalization from those of other variables is methodologically daunting, since reductions in trade barriers are frequently made in conjunction with a host of other reforms. Two points, however, are crystal clear. First, there is an undeniable relationship between growth rates and economic freedom, including the freedom to conduct international transactions. Second, contrary to the claims of the anti-trade forces, there is no evidence whatsoever

Figure 1
Freedom of International Exchange Index and GDP, 1995



Sources: James Gwartney and Robert Lawson, Economic Freedom of the World: 2000 Annual Report (Vancouver, B.C.: Fraser Institute, 2000); and the World Almanac 1998 (New York: World Almanac, 1998).

Note: Although Gwartney and Lawson provide an index of international exchange openness for 1997, the data beyond 1995 are incomplete.

that countries that have shut themselves off from global markets have prospered over the long term.

Perhaps the strongest evidence of the benefits of economic liberalization is that developing countries over the past couple of decades have been opening their markets voluntarily, independent of any quid pro quo negotiations. Countries as diverse as Argentina, the Philippines, Chile, and Thailand have taken aggressive unilateral steps toward integration into the global economy. Even the most traditionally closed economies are finally abandoning the failed autarkic model of protectionism in favor of freer trade. Over just the past few years, India has reduced its average industrial tariffs from 71 to 32 percent, Brazil from 41 to 27 percent, and Venezuela from 50 to 31 percent.[6] The World Trade Organization's own history illustrates the "bottom-up" popularity of trade liberalization. Established in 1948, the General Agreement on Tariffs and Trade — the precursor to the WTO — had only 23 contracting parties, most of which were industrialized nations. Today, more than three-quarters of the WTO's 136 members are developing nations and 20 more are eagerly waiting to join.[7]

The Asian "Miracle": Exports and Investment

The experience of East Asia is one reason for the current trend

toward economic openness among developing countries. Perhaps more clearly than anywhere else in the world, East Asia has demonstrated the rapid improvement in human welfare that is possible when developing nations adopt an outward-oriented development strategy.

Real per capita incomes in the region have grown at an average annual rate of 4 to 6 percent since the 1960s.[8] That compares extremely favorably with development experience elsewhere: from 1960 to 1990, the top eight Asian economies grew approximately three times faster than did the economies of Latin America and South Asia and five times faster than those of sub-Saharan Africa.[9] Moreover, as Table 1 shows, the recent Asian financial crisis appears to have presented only a temporary obstacle to those burgeoning economies. Even if the crisis had stopped all economic progress for five years, the Asian economies would have performed well above the world average for the past three decades.

Such robust economic growth has translated into dramatically improved standards of living that are readily observable to anyone visiting the region. South Korea in the 1960s, for example, was comparable to many West African countries in terms of economic development. Today its citizens enjoy incomes on a par with those in European countries. Tiny Singapore, which has few natural resources, has transformed itself into a trade and technology powerhouse. In China, per capita

Table 1
Changes in Real GDP in East Asia (in percentage)

	1996	1997	1998	1999E
South Korea	6.8	5.0	–5.8	10.2
Malaysia	8.6	7.5	–7.5	4.9
Thailand	5.5	–1.3	–10.0	4.0
Indonesia	8.0	4.5	–13.7	0.5
Hong Kong	4.5	5.3	–5.1	1.9
Singapore	7.5	9.0	0.3	5.5
Taiwan	5.7	6.8	4.8	5.4
China	9.6	8.8	7.8	7.1

Source: World Bank and independent forecasts, cited in Eduardo Lachica, "World Bank Predicts Improvement in Asia," Asian Wall Street Journal, February 8, 2000, p. 3.

Note: E = Estimate.

GDP has nearly quadrupled in just 20 years. As a result, an estimated 160 million people in China have emerged from absolute poverty, defined as per capita income below $1 per day.[10] Since 1970, per capita food intake in Indonesia has risen from fewer than 2,100 to more than 2,800 calories per day.[11] In 1972, nearly 68 million Indonesians were living in what their government deemed poverty; by 1982, that number had fallen to 30 million — a decline of 56 percent.[12] Up and down the Pacific Rim, active engagement in world markets and an openness to foreign investment have wrought breathtaking improvements in the lives of hundreds of millions of people.

The East Asian economic "miracle" is not difficult to comprehend. Its success rests on two basic factors: export-friendly policies and access to foreign markets. By contrast, many developing countries in other regions pursued policies of "import substitution," which entailed sealing off their economies from the outside world with import restrictions, maintaining overvalued exchange rates, shunning foreign investment capital, and fostering industries to serve domestic markets. East Asian countries followed a very different path. Although the exact policy mix differed from country to country, the common denominator was an emphasis on growth through competing in world markets. Specializing in industries in which lower labor costs gave them a competitive advantage, East Asian economies opened to foreign capital, technology, and the inputs necessary to produce competitive exports for sale to foreign customers. That strategy enabled the Asian economies to grow much faster than if their prospects had been limited to domestic demand.

The export-led growth strategy was a stunning success. As a group, the eight highest performing Asian economies increased their share of world exports from 8 percent in 1965 to 13 percent in 1980 and to 18 percent in 1990.[13] Initially, that export-led growth was compatible with the significant protectionism in those economies but led eventually to greater demand for imports — both producer goods for expanding businesses and consumer goods for emerging middle classes — and tariffs were cut in response. The pattern of greater openness of the East Asian economies is reflected in their ratios of trade to GDP — the value of exports plus imports divided by GDP (Table 2).

Table 2
Ratio of Trade to GDP in East Asian Economies, 1970–88

Economy	1970	1980	1985	1988
Hong Kong	1.50	1.52	1.78	2.82
Indonesia	0.25	0.46	0.38	0.42
South Korea	0.32	0.63	0.66	0.66
Malaysia	0.89	1.00	0.85	1.09
Singapore	2.12	3.70	2.77	3.47
Taiwan	0.53	0.95	0.82	0.90
Thailand	0.28	0.49	0.44	0.35

Source: World Bank, The East Asian Miracle: Economic Growth and Public Policy (Oxford: Oxford University Press, 1993).

The recent financial crisis in Asia has not prompted a retreat from economic liberalization. On the contrary, Asian governments have realized that to keep prosperity going they must continue to open their economies to world trade and investment. In a story typical of the region, the government of Thailand successfully resisted protectionist pressures despite a severe recession — real GDP dropped nearly 12 percent between 1997 and 1998 — that resulted from the crisis. "One of the most striking aspects of the [Thai] government's policy response to the crisis," notes a WTO report, "is its liberalization of several aspects of its trade and foreign investment regime in order to speed up structural adjustment."[14]

The East Asian experience contrasts sharply with that of sub-Saharan Africa, which has largely pursued a development strategy based on protectionism and foreign aid. Most of Africa's so-called infant industries have never developed, the region's share of world trade remains distressingly low, and GDP per capita actually shrank by 0.6 percent between 1991 and 1998.[15] In addition to maintaining closed economies, many African countries have used foreign aid to underwrite unsound policies and general economic mismanagement, including the creation of bloated, inefficient public sectors; the restriction of prices and production; perverse monetary, fiscal, and credit policies; and the shunning of foreign investment. The combination of foreign aid and isolation from international competition

has thus allowed many African governments to postpone implementing necessary market reforms, thereby trapping their citizens in a never-ending cycle of poverty.

The lesson is clear: export-led growth has a proven record of success, while its alternative — protectionism and foreign aid — has failed where it has been tried. The question is, will the rest of the developing world be allowed to repeat the Asian miracle? If other developing countries are to re-create the Asian experience, they must have relatively free access to U.S. and Western markets. If Americans want to help the impoverished masses of the developing world, we must open our markets to its exports and allow U.S. investors to invest overseas.

It is no coincidence that economic growth has been accompanied by beneficial political changes in many developing countries, including those in East Asia. Both South Korea and Taiwan, for example, began to implement democratic reforms in the late 1980s, after a rapidly growing middle class became involved in widespread civil protests. The depth of such reforms was demonstrated in the recent presidential election in Taiwan, which proved that even long-entrenched ruling parties are now subject to the will of the people.

It is extremely likely that the growth of capitalism generally and the opening of developing economies to international trade and investment in particular have contributed to what Samuel Huntington has called a "third wave of democratization." At the very least, economic globalization has existed alongside democratization. In 1973, of a total of 122 countries with more than 1 million people, a mere 20 nations were democratic, while 92 were nondemocratic. By 1990, however, of 129 countries, 58 were democratic, while 71 were nondemocratic. Those are startling figures: for the first time in the 20th century — during a period of unprecedented economic liberalization and globalization — the number of authoritarian or nondemocratic states actually decreased.

The relationship between economic liberalization and democratization can be further illustrated by comparing cross-country data measuring economic openness and political and civil liberties. Using the *Economic Freedom of the World* index of openness to international

exchange and the Freedom House ratings of "free," "partly free," and "not free," Daniel Griswold, associate director of the Cato Institute's Center for Trade Policy Studies, has demonstrated a strong correlation between the two kinds of freedom.[16] Nations that are classified by Freedom House as being free score an average of 7.9 on the scale of economic openness.

Those that are partly free averaged a less open 6.7, and those that are not free scored the lowest, 5.4. Reversing the data reveals that of the countries in the top third of the Gwartney-Lawson scale of economic openness, 84 percent earned a political-civil ranking of free. Of those in the middle third, 57 percent were free, but in the bottom third, only 22 percent were free. In other words, citizens who enjoy the freedom to engage in international commerce are about four times more likely to be free from political and civil oppression than are those who do not enjoy such freedom.

None of these data is meant to imply that there is a rigidly deterministic relationship between economic liberalization and democratic reforms. Nevertheless, it seems obvious that the growth of autonomous interest groups and sources of wealth within a country, foreign investments conditioned on solid property rights and a functioning legal system, and privatization of state-owned enterprises in response to international competition have benefited prodemocracy movements around the world.[17]

There will never be a magic formula for development or democratization. But the East Asian experience is a powerful testament to the rapid progress that can be achieved when developing countries embrace the basic tenets of globalization. The stakes are high. With the exception of countries that have embraced export-oriented development, the gap between the developed and the developing world has been either stable or growing throughout most of modern history. The export-oriented countries are succeeding because they have created outward-oriented economies that provide faster growth through exports and access to foreign technology, capital, and productivity enhancing imports. Those who wish to improve the lives — both politically and economically — of the citizens of developing countries should be thinking of ways to facilitate globalization, not attempting to stop it.

Jobs, Wages, and Labor Standards

> Behind this [clothing] label is a shameful story of political prisoners and forced labor camps; of wages as low as thirteen cents an hour; of a country that routinely violates trade rules; flooding our markets; draining American jobs.
> — *AFL-CIO television advertisement*

It is an article of faith among "globaphobes" that the low-skilled jobs in the export industries of the developing world amount to exploitation of local workers. Globaphobes evoke images of third-world "sweatshops" and labor-intensive factories with hellish working conditions and slave wages to justify U.S. trade barriers against developing-country imports.

Shutting down those factories, by any means necessary, is now a top priority of anti–free traders. In one recent high-profile example, students at the University of Pennsylvania, the University of Michigan, and Indiana University staged sit-in protests against the licensing of school logos to companies producing clothing in developing countries.[18] Despite the good intentions of those students, such trade-reducing actions do nothing to help improve conditions in poor countries.

It is certainly true that workers in the export sector of developing countries earn far less than their Western counterparts earn and often work in much harsher conditions. The proper comparison, however, is not between U.S. wages and developing-country wages but between export-sector wages in developing countries and other locally available opportunities.

After all, it is not as though low wages and poor working conditions were a creation of multinational companies — that combination has been the rule throughout history. It is lamentable that nearly 3 billion people currently live on less than two dollars a day,[19] but the critical question to ask is, why are the other 3 billion people doing better? Globalization is an important part of that answer. Wherever new export industries have taken hold, there has been a measurable improvement in local incomes and working conditions. In 1998 Edward M. Graham of the Institute for International Economics estimated the wages and salaries (not including fringe benefits, which

generally average about 25 percent of wages and salaries) paid to local employees of U.S. affiliate companies.[20] His results — which are summarized in Table 3 — suggest that, although developing-country employees of U.S. affiliates are indeed paid less than their developed-country counterparts are paid, they are paid significantly more than the average wage for the country where they live. In low-income countries, for example, workers fortunate enough to gain employment with a U.S.-based company earn more than eight times the average per capita salary. For middle-income countries, such workers earn about three times the average local yearly wages.

Table 3
Ratio of Average Wages and Salaries Paid to Non-U.S. Citizens by Affiliates of U.S. Multinationals to per Capita GDP, 1994 (by income level of host country group)

	Total	High	Middle	Low
Average wages and salaries ($1,000)	25.6	32.4	9.5	3.4
Per capita GDP ($1,000)	11.5	20.9	3.2	0.4
Ratio of wages and salaries to per capita GDP	2.2	1.6	3.0	8.5

Source: Edward M. Graham, "Trade and Investment at the WTO: Just Do It!" in Launching New Global Trade Talks:

Anecdotal evidence supports Graham's statistical analysis. For example, a recent survey of 48 U.S.-based companies in China, conducted by the U.S. Chamber of Commerce in Beijing, found that respondents pay an average hourly wage of $5.25, excluding benefits, or about $10,900 per year.[21] Similarly, workers at a Shanghai factory owned jointly by General Motors and the Shanghai Automotive Industry Corporation earn about $4.59 per hour, including benefits but not counting generous performance bonuses that can almost double take-home pay.[22] While such wages are far below the average for a unionized autoworker in the United States, they are about three times higher than wages for comparable work at a non-U.S. factory in Shanghai and nearly eight times higher than the United Auto Workers' estimate: "A 'good paying' factory job with a company like General Motors pays about 59 cents an hour" in China.[23]

Other research, such as that by Jeffrey A. Frankel and David Romer of the University of California at Berkeley, has shown that

trade, as distinct from foreign investment, also has a positive impact on developing-country wages. In a 1999 paper those authors concluded that trade exerts "a qualitatively large and robust . . . positive effect on income." After analyzing data from 150 countries, they estimated that an increase in the ratio of trade to GDP by one percentage point can be expected to raise income per person by between 0.5 and 2 percent.[24]

Both trade and investment affect the long-term production trend in developing economies, which also reinforces the gains to workers. Specifically, poor countries tend to move away from labor-intensive production as they scale the ladder of economic development. The share of textiles and apparel in South Korea's exports, for example, grew from 8 percent in 1960 to 40 percent in 1980 but then shrank to 19 percent by 1993.[25] Today South Korea is known more for its exports of automobiles and electronics than its clothing, and average wages have increased dramatically. The benefits of creating a dynamic, export-oriented manufacturing sector are even more apparent when wages are compared with those in Western countries. In 1960 the average manufacturing job in a developing country paid just over 10 percent of manufacturing wages received by workers in the United States. By 1992 wages in those countries had risen to nearly 30 percent of U.S. manufacturing wages.[26] In other words, as manufactured exports of developing countries have grown, so have wages in those countries — even in relation to U.S. wages, which also have risen.

Foreign-owned businesses not only pay their workers more, they also provide a positive example of quality of life in the workplace. In fact, in the few high-profile cases in which Western companies were tied to labor abuses, those abuses were overwhelmingly committed by indigenous firms that were selling on contract.

As awareness of worker mistreatment has grown, foreign-owned firms — and, in particular, American-owned firms — have actively taken measures to ensure that workers are treated humanely. Companies have established codes of conduct for their suppliers. As the International Labor Organization reports, "Available information suggests that the world's largest multinational enterprises (MNEs), and in particular US-based MNEs in the [textiles, clothing, footwear,]

and related commerce sectors (e.g., manufacturers, retailers including department stores, mass merchandisers, specialty stores and mail order clothing companies), have led the trend toward usage of codes as a means of responsible sourcing."[27]

Consider the Nike Corporation, which for years has been the company that globaphobes have loved to hate. After taking voluntary steps to improve its procurement process, Nike hired former U.S. ambassador to the United Nations Andrew Young to conduct an independent investigation of the company's labor practices.[28] Focused consumer pressure, not blunt government sanctions, was responsible for Nike's internal reforms.

Zhou Latai, one of China's foremost labor attorneys who represents injured workers in the southern city of Shenzhen, puts it this way: "American consumers are a main catalyst for better worker rights in China. They are the ones who pressure Nike and Reebok to improve working conditions at Hong Kong– and Taiwan-run factories here. If Nike and Reebok go — and they could very well if [normal trade relations] is rejected — this pressure evaporates. This is obvious."[29]

Again, it is important to remember that low wages, poverty, and difficult working conditions are not new to the developing world; they have always been the norm. No doubt there will always be horror stories about unscrupulous employers, just as such stories persist in this country. Globalization is not a panacea, but curtailing trade and foreign investment will only ensure that workers are forced into the nonexport sector. For most people, that means eking a miserable living from small plots of land, or sometimes worse. More than any government program or aid package, the spread of free trade, free markets, and investment across international borders by private companies and investors is proving to be the most effective anti-poverty measure the world has ever seen.

The Seattle and Washington, D.C., protesters called for better working conditions in the developing world while denouncing the policy that would most help bring such improvements about: free trade. Instead of closing our markets, we should be opening them further. No amount of aid money or insistence on living-wage standards could match the benefits for poor workers that tariff-free access to

Western markets could offer. That access would create jobs, reduce unemployment, put upward pressure on wages, and even create a hospitable climate for labor-organizing efforts. Those are precisely the goals being sought by the anti-trade movement. Ironically, the WTO's failure in Seattle was due not to fear of free trade on the part of developing countries but rather to the reluctance of developed countries to fully embrace it. As Sri Lankan commerce minister Kingsley Wickramaraine noted, a large number of developing countries "are yet to find any meaningful market access opportunities for products of export interest to them."[30]

Unfortunately, Wickramaraine is correct: the United States and other industrialized countries continue to block imports from developing countries, especially through abnormally high tariffs on textiles and clothing, an unfair antidumping regime, and quotas on various agricultural products.[31] Such discriminatory protectionism persists despite promises made during the Uruguay Round of trade talks. In the WTO Agreement on Textiles and Clothing, for instance, the United States pledged to phase out all textile and apparel quotas over a 10-year period, but as of 1999 only 1 percent of U.S. quotas had been eliminated.[32]

On average, developing countries face tariffs on their manufactured exports that are nearly four times the tariffs facing exports of developed countries.[33] Because of that inequitable pattern of protectionism, Thomas W. Hertel and Will Martin of the World Bank have concluded that developing countries would capture around 75 percent of the world economic benefits from further trade liberalization in the manufacturing sector.[34]

Trade and the Environment

> The greenies have tried to organize campaigns around the World Bank for 15 or 20 years now and have never ignited 1 percent of the people that are organized around the WTO.
>
> — *Dan Seligman, director, Sierra Club's Responsible Trade Program*[35]

Critics of globalization argue that multinational companies tend to invest in nations that maintain low standards of environmental protection.

As international investment in developing countries becomes more widespread, competition for capital supposedly forces recipient countries into a destructive spiral by continually weakening their environmental laws and regulations.

The developed countries, the critics warn, are not immune to competitive pressures and are also forced to weaken their currently high environmental standards. This supposed race to the bottom will, it is argued, lead to massive global environmental degradation.

This theory rests on the assumption that lower environmental standards give developing countries a significant advantage in attracting investment capital. Both logic and empirical experience suggest that the opposite is true.

First, environmental standards are only one of many factors that businesses take into account when choosing the best location to set up shop.

Such considerations as guaranteed property rights protection, a functioning legal system, a well-educated workforce, and sufficient infrastructure figure much more prominently in the calculations of most entrepreneurs and business managers than do environmental regulations.

Given those facts, it is not surprising that there is scant evidence that governments actually lower environmental standards in order to attract investment.[36] Second, there are considerable cost savings associated with standardized production techniques. Thus, companies tend to operate at the *highest* environmental world standard rather than adopt multiple production technologies for use in different areas.[37] Third, much of the foreign direct investment (FDI) directed to developing countries is used to privatize inefficient state-owned manufacturers, which tend to become less polluting as they are restructured. Finally, trade and investment help speed the spread of pollution control technology and enable developing countries to purchase cleaner energy inputs on world markets.

The most important result of trade and investment, however, is economic growth, which in turn leads to a better environment. That is true because, as incomes rise, the demand for improved environmental quality also rises.

Numerous studies have confirmed that, in practice, trade and investment activities usually have a positive impact on the environment.[38] This is not to imply that a cleaner environment is the immediate result of economic development. Empirical studies have revealed the existence of an inverted U–shaped relationship, often called an "Environmental Kuznets Curve," after the late American economist Simon Kuznets, between environmental degradation and income per capita. The Kuznets Curve describes a process whereby environmental quality in a developing nation initially deteriorates as the economy begins to industrialize but improves after its citizens reach a certain standard of living. Research by Alan Krueger and Gene Grossman of Princeton University, for instance, indicates that the turning point occurs at about $5,000 annual income per capita: "We find no evidence that environmental quality deteriorates steadily with economic growth. Rather, for most indicators, economic growth brings an initial phase of deterioration followed by a subsequent phase of improvement." By $8,000 per capita income, the authors found that almost all the pollutant categories had begun to improve.[39]

The case for the pro-environment effects of trade and development is further supported by the experience of the Western world, and of the United States in particular. Standards for air and water quality in OECD countries are much higher now than they were even just 30 years ago — an improvement that has taken place just as FDI and the share of those economies devoted to trade have grown higher than ever.[40]

There is no evidence that increasing trade with developing countries is placing downward pressure on U.S. environmental standards. The United States is one of the world's most open economies, and its environment is one of the cleanest. Over the past decade, the United States has continued to pursue a liberal trade agenda by signing the 1994 North American Free Trade Agreement and by helping create the WTO. Meanwhile, two-way trade and foreign investment continue to climb as percentages of GDP. That growth of international trade and investment has been accompanied by ever more stringent environmental standards.

According to the President's Council on Environmental Quality, mean ambient concentrations of sulfur dioxide and carbon monoxide in the atmosphere of the United States have both dropped by nearly 40 percent since 1988.[41] During that same period, 1988–97, the number of annual "bad air days" in major U.S. cities fell by two thirds.[42] The direct discharge of toxic water pollutants is down dramatically as well.[43] Since the early 1970s, during a time of growing globalization of the U.S. economy, real spending by government and business on the environment and natural resource protection has doubled.[44]

Just as it is clear that there are serious problems of environmental degradation in developing countries, it is equally clear that cutting off their access to our markets is no solution.

Depriving poor countries of trading opportunities will simply diminish their growth rates, thus delaying their departure from the ranks of countries with low GDPs, in which environmental problems are the most serious. Free trade, however, can help make industrial production less polluting even in those countries by rationalizing the use of resources both within and among developing economies. For instance, free trade often promotes the transition from heavy-resource-processing sectors to light manufacturing ones, reducing wasteful global overcapacity in higher-polluting sectors.[45] In other words, by encouraging nations to concentrate on production in their areas of greatest comparative advantage, globalization enhances total world economic efficiency and minimizes inevitable environmental costs.

Globalization Close to Home: The Case of Mexico

Although East Asia has been the most celebrated example of rapid export-driven development, the trend is also visible elsewhere, in countries as varied as Egypt, Estonia, and Chile. Of special relevance to the United States is its southern neighbor, Mexico, which was granted relatively free access to the U.S. and Canadian markets under NAFTA. For most of the 20th century, Mexico had closed itself off from international trade and capital flows by setting up currency controls and trade barriers. Only with the Latin American debt crisis of the 1980s did Mexico slowly begin to open its economy to global trade and investment. The payoffs to Mexico's economy and

workers are today undeniable.

In 1980 the percentage of Mexico's exports to the United States classified as "manufactured" was a paltry 0.7 percent. By 1990 that figure had climbed to 3.7 percent, and by 1995 it had shot up to 19.3 percent, reflecting Mexico's ongoing transformation from a stagnant oil-based economy to a more diverse manufacturing-based economy.[46] Between 1993 and 1999 Mexico climbed from 26th place to 8th place among the world's largest exporters, and in recent years Mexico's exports have fueled growth rates of 4 percent.[47]

That startling transformation has been led by the growth of manufacturing maquiladoras[48] and the development of import-export business. Those new businesses are not the result of an industrial policy designed to "force" industrialization — a strategy Mexico unsuccessfully pursued for decades — but rather a natural consequence of Mexico's comparative advantages under freer trade. Clearly, the combination of reduced trade barriers and a stable legal framework for foreign investment under NAFTA helped make that shift to more manufactured exports possible.

The resulting positive changes in Mexico's economy have been astounding. "NAFTA," says Jesus Reyes-Heroles, Mexico's ambassador to the United States, "is the most important thing to happen to Mexico in the past 100 years … Those who oppose it should come to Mexico." Since NAFTA's implementation, one of every four jobs generated in Mexico has been in a company that receives FDI. In total over 20 percent of the Mexican workforce are currently employed by companies that receive FDI. "In a poor country like ours," he observes, "the alternative to low paying jobs isn't high-paying jobs — it's no jobs at all."[49] Mexico's president, Ernesto Zedillo, has reached a similar conclusion: "Native people employed in the new apparel plants located in many of the Yucatan's Maya towns, migrants from the south of Mexico working at huge maquiladora industries in the northern cities of Tijuana and Juarez, young engineers with good jobs at high-tech factories in Monterrey and Guadalajara, and many others have assured me that their new occupations — unthinkable in a closed economy — are much better than their prior ones, if any."[50]

Mexico's overall stability has been enhanced by its commitments to economic openness. Opponents of free trade wrongly blame NAFTA for Mexico's disastrous peso crisis of 1994–95, which was actually caused by a combination of loose monetary policy and an inflexible and overvalued exchange rate. In fact, Mexico has suffered a severe financial crisis in every election cycle since 1976 — long before anyone had ever heard of NAFTA.[51] However, Mexico's relatively rapid recovery from the most recent crisis contrasts starkly with the protracted slump that followed its 1982 debt crisis.[52] More important, whereas the slump of 1982 prompted the Mexican government to nationalize its banks and raise trade barriers, the present government successfully resisted backsliding. Just as free-trade supporters on both sides of the border had predicted, NAFTA helped to buttress Mexico's broader economic and political reforms.

The involvement of U.S. businesses has positively influenced both labor conditions and environmental quality in Mexico. First, through competition: domestic firms are increasingly forced to compete with foreign-owned businesses and join ventures by offering better working conditions and higher pay. Second, by example: U.S. production methods and technology are demonstrating to Mexican businesses that it is possible to be both "green" *and* profitable. Far from "racing to the bottom," the Mexican government has actually *strengthened* its environmental regulations and enforcement procedures since NAFTA has been in place. Indeed, the Zedillo administration has instituted an aggressive plan to clean up Mexico's environment — which has suffered from decades of neglect by government and bloated state-owned businesses — by adopting a "polluter pays" strategy in concert with a system of voluntary environmental audits.[53]

The most obvious beneficiaries of trade, however, have been average Mexican workers, who were shielded from the most severe fallout of their government's unsound monetary policies.

Because of the sharp devaluation of the peso, in March 1997 real manufacturing wages were still 23 percent below their precrisis level. The situation was better, however, for manufacturing jobs supported by exports. Firms with between 40 and 80 percent of their total sales going to exports during the 1994–96 period paid wages that were, at

the low end, 11 percent higher than wages of non-export-oriented firms; for companies with export sales above 80 percent, wages were between 58 and 67 percent higher.[54]

Workers in the oft-maligned maquiladora sector fared relatively well, experiencing only a 12 percent real wage reduction between 1994 and 1996. Overall, the maquila wage has risen from rough parity with nonexport workers in 1993 to 16 percent above nonexport workers in 1996.[55]

The successful liberalization of trade and investment in Mexico under NAFTA has not resulted in a backlash against globalization. On the contrary, it has resulted in an even greater commitment to open Mexico's markets to other regions of the globe. A large step in that direction is the recent free-trade agreement negotiated between Mexico and the European Union, under which about 95 percent of tariffs on products traded will be completely phased out.[56] Mexico is also pursuing bilateral trade agreements with Japan, Brazil, and other countries. This strategy implies that Mexican voters are generally satisfied with the results of trade and investment liberalization in their country.

Democracy in Mexico has thrived as its economy has been opened. In fact, the current presidential elections mark the first serious threat to the long-ruling Institutional Revolutionary Party (PRI), which has held power since the 1920s. A recent opinion poll showed that Vicente Fox of the opposition National Action Party had pulled within three points of PRI's Francisco Labastida.[57] Support for Fox is particularly strong among Mexico's emerging middle class, a significant percent of whom work in sectors directly tied to international trade and foreign investment. Regardless of who ultimately prevails in the July 2 vote, the image of inevitable one-party rule in Mexico has already been shattered.

Many Mexicans will undoubtedly continue to live in conditions of grinding poverty for the foreseeable future. Nevertheless, for perhaps the first time in Mexico's history, parents can be confident that their children will have greater opportunity than they had. That is what globalization really means to our neighbors south of the border.

Saving the Poor from Development

> A [broken] storefront window becomes a vent to let some fresh air into the oppressive atmosphere of a retail outlet.
>
> — *Internet communiqué from the N30 Black Bloc, an "anarchist" group active in Seattle*[58]

The anti-trade agenda that coalesced on the streets of Seattle and Washington, D.C., is — intentionally or not — aimed squarely at keeping poor countries poor. Consider one of the less extreme demands of the protesters: that the WTO impose labor and environmental standards and enforce them.

Labor Standards

There is only one reason for negotiating a WTO agreement for labor standards: to impose trade sanctions on poor countries that fail to live up to it. There is already a duly constituted body, the International Labor Organization, whose mission is to raise labor standards around the world. Why then do labor activists want to bypass the ILO and start over again with the WTO? The answer is clear: the WTO, unlike the ILO, authorizes the imposition of trade sanctions against countries that violate its agreements. The campaign to include labor standards on the WTO agenda is thus a new excuse for protectionism. The justification offered for WTO rules in this area is that the lack of proper labor standards constitutes a form of unfair competition that distorts trade and investment flows to favor countries with abusive practices. But there is no evidence that a lack of core labor standards plays a significant role in attracting foreign investment or in enhancing export performance.

In fact, the OECD has found strong evidence that the opposite, a "positive association over time between sustained trade reforms and improvements in core standards," is true.[59]

Raising trade barriers against poor countries will not improve the plight of workers in those countries. Instead, trade barriers will slow down growth in developing countries and keep people mired in poverty. In most developing countries, resource-strapped governments are simply unable to afford or enforce above-market wages and better working conditions, so no improvement will result from reduc-

ing trade. In cases in which oppression truly exists, the offending governments are unlikely to respond to the severing of international economic ties by cleaning up their acts. Indeed, isolating a country economically often has the perverse effect of weakening internal political opposition and further concentrating power in the hands of the ruling regime.

As the prominent Chinese dissident Bao Tong has stated: "I appreciate the efforts of friends and colleagues to help our human rights situation, but it doesn't make sense to use trade as a lever. It just doesn't work."[60]

From the U.S. perspective, imposing trade barriers in the name of humanitarian concerns is as morally questionable as it is economically unsound. Even if the goal is the admirable one of higher wages for everyone in the long run, the means being used to achieve that goal are making some people in poor countries worse off in the short run — by destroying their livelihoods.

Impoverishing average citizens has never been an effective way to change the policies of autocratic leaders, and it is even less effective in encouraging economic growth. This wrongheaded approach has been compared to the Vietnam War strategy of burning the village in order to save it.[61] That strategy has not improved with age.

The mere act of mixing labor and trade concerns inevitably hinders good-faith efforts to deal with the real problems of poverty and labor abuses. The tendency will be to focus not on where those problems are most severe but on situations in which the competitive challenges to politically powerful domestic producers are the strongest. That is why it is important to keep institutional objectives separate. As Jagdish Bhagwati of Columbia University noted: "You cannot kill two birds with one stone. . . . If you seek to do that, you will likely miss both birds."[62]

The heart-rending problem of child labor, which is often cited as a reason to bring the issue of labor standards into the WTO, is a case in point. In 1993, of an estimated 80 million children under the age of 15 who were working around the world, about 95 percent were living in developing countries.[63] According to the OECD, most child labor does not involve exports. Child labor is found most commonly in

rural areas, usually on family farms, and is unpaid.[64] In urban areas, children tend to work in the informal sector, in family businesses and small shops. In general, children are compelled to work because of lack of economic opportunity, not because of malice or a lack of adequate regulation. After all, parents in developing countries want the best for their children, just as do parents in the United States. For poor families, child labor is often simply a matter of survival, not exploitation. Besides, not all child labor is inherently bad. Even in the developed world, work by children is widely accepted (and even applauded) as long as the burden is not unreasonable and does not interfere with schooling.

According to the ILO, the bulk of child labor takes place in the nontradable agricultural sectors of developing economies. Nearly 70 percent of working children toil as unpaid family workers.[65] Thus, attempts to root out child labor by applying trade sanctions are doomed to fail and will have a negligible impact on most child workers. Sanctions will, however, drive those children who currently work in export-related industries into the nontradable sector — a result that is quite surely not to the children's benefit. Moreover, child labor is most common in those places — such as most African countries — that have been the least touched by trade and globalization. Like most other problems faced by developing countries, child labor can be best addressed by development — by embracing the global economy.

Conditioning access to Western markets on the elimination of child labor would be far more likely to harm than help poor children. There is no convincing case for including labor standards in the international trading system. The result would be to undermine the low-wage comparative advantage of developing countries without raising those wages, to corrupt the trade-liberalizing mission of the WTO, and to harm the very people, including children, that such standards are supposedly intended to help.

Environmental Standards

With respect to trade rules on environmental issues, the situation is somewhat more complicated. Under limited circumstances, there

may be tensions between trade policy goals and environmental goals — namely, in cases of import restrictions on products that threaten the importing country's environment or the health and safety of its citizens. WTO rules, though, already recognize the authority of national governments to restrict trade under such circumstances. But those who call for additional WTO environmental standards want to restrict such national environmental autonomy. They want the top-down imposition of one-size-fits-all regulations to be enforced by trade sanctions.

The intrusion of the WTO into environmental policymaking would be a terrible mistake. As discussed above, free trade assists the cause of rising environmental standards. Isolation from the world economy breeds only stagnation and environmental degradation — as the miserable environmental record of the Soviet-style economies attests. Imposing trade sanctions on poor countries that do not live up to international regulations would only retard those countries' development and thus slow their ability to achieve higher environmental quality. Furthermore, environmentalists in the United States insist that this country should be free to set whatever level of environmental protection it desires — a right that must also be granted to developing countries. In fact, the principle of regulatory self-determination is enshrined in the WTO itself. As Deputy U.S. Trade Representative Susan G. Esserman has pointed out, it recognizes "the right of Members to take science-based measures to achieve those levels of health, safety and environmental protection that they deem appropriate — even when such levels of protection are higher than those provided by international standards."[66] But self-determination should not be a one-way street: There are legitimate differences in culture and environmental quality preferences that should be tolerated even when they result in lower standards. Thus, the indiscriminate use of trade restrictions to discourage purely domestic practices that Western environmentalists happen to consider offensive — such as the EU's ban on fur from animals caught in leg traps — should be avoided.

Because globalization promotes economic growth, which in turn promotes rising environmental standards, better environmental protection will occur in those countries that embrace globalization.

Attempting to link enforcement of developed-country environmental norms with trade sanctions will result only in reduced trade, slower growth, and a prolonged status quo. When legitimate cross-border environmental issues need to be addressed, the WTO is not the proper forum in which to address them.

A New Colonialism?

Anti-trade activists often voice concern for the political rights of the citizens of developing countries. Never mind that most members of the WTO are already functioning democracies — the presumption seems to be that a democratic electorate will naturally demand Western-style labor and environmental regulations, so when such regulations are not present, democracy must be a charade. The notion that there are silent, politically disenfranchised masses evidently makes championing their cause — often over the objections of duly elected representatives — more palatable to relatively affluent Western protesters.

Democratic reform, where it is needed, is a worthy goal. The most realistic path to achieving reform is through economic liberalization. Economic freedom and political freedom are intimately intertwined: the former cannot be established without creating intense pressures for the latter. And trade is first and foremost a matter of freedom. When a government tells its citizens that they may not buy from or sell to foreigners, it has significantly curtailed their liberty. Moreover, it is arrogant to argue that citizens of developing countries need to be protected from commercial dealings with other countries — that they will always be swindled, exploited, or outfoxed by savvy foreigners.

The anti-globalization demonstrations seem to have strengthened the resolve of developing countries to resist attempts by their self-appointed defenders to force a labor or an environmental agenda on the WTO. As one Gabonese diplomat who was blocked from attending the Seattle meetings noted with disgust, "[The protesters] understand nothing, and are as remote from our problems as you'd expect from middle-class whites in Washington State."[67] Or as Mexico's president, Ernesto Zedillo, recently observed: "A peculiar alliance has recently come into life. Forces from the extreme left, the extreme right, environmentalist groups, trade unions of developed countries

and some self-appointed representatives of civil society, are gathering around a common endeavor: to save the people of developing countries from — development."[68]

The spectacle of rich Americans marching unbidden in the name of downtrodden foreigners reached absurd heights during the April protests in Washington, D.C. Lacking a significant presence of protectionist-minded union members, the demonstrations were populated almost exclusively by students, many of whom wore costumes and used various forms of street theater to make their points. As a D.C. police officer sagely remarked to a group of teenage protesters as they faced each other over the barricades, "I understand that you all claim to want to help the poor oppressed people of the world, but what I don't understand is why none — and I mean *none* — of those people are here."[69]

A Pro-Trade, Pro-Freedom Agenda

There are many problems facing developing countries, but an excess of international trade and investment is not among those problems. Contrary to popular perception, U.S. businesses are not rapidly relocating production facilities to developing countries. For developing countries foreign investment is a blessing that is in woefully short supply. From 1985 to 1995, net outflows of FDI from industrial to developing countries were only about 2 percent of total capital formation in developed countries.[70] Indeed, a recent UN Conference on Trade and Development report described the "increasing marginalization" of the world's 48 poorest countries, which are in danger of falling further behind more developed competitors in an increasingly globalized economy. According to that report, the world's least-developed countries accounted for 13 percent of the world's population in 1997 but represented only a 0.4 percent share of the world's exports and a 0.6 percent share of imports.[71]

Despite the positive impact that international trade and investment have had in developing countries, poverty, worker mistreatment, and human rights abuses remain in some places. The natural response of Americans is to call for action that will improve those miserable conditions abroad. Useful policy tools do in fact exist, and new ones are continually being proposed.

Two rules, however, should guide U.S. policymakers when evaluating any policy designed to improve conditions in developing countries. First, it must be remembered that, despite often-noble intentions, the U.S. government is limited in its capacity to effect change abroad. Poor countries cannot be compelled to develop through threats or sanctions — they must make that journey voluntarily. The age of imperialism is over, and attempts to revive it in other guises are doomed to failure. Second, the following question must be asked of any proposed measure: Will it place limits on the freedom to engage in voluntary cross-border exchange? If the answer to that question is yes, the policy will imperil wealth creation and should be rejected.

Above all, the United States must remain a committed member of the WTO and a champion of a liberal world trading system. That means not only rejecting the current legislation in Congress that would end U.S. membership in the WTO but also keeping existing commitments to reduce trade barriers — an area in which Washington has often dragged its feet. In addition, U.S. negotiators should work to launch a new round of multilateral trade negotiations that would address such areas as services, agriculture, and electronic commerce. The WTO's dispute settlement mechanism, although on the whole a tremendous success, is also in need of reform with respect to the enforcement of WTO rulings. Specifically, countries that refuse to implement adverse rulings should be required to offer offsetting liberalization rather than be subject to trade-restricting sanctions.[72]

The United States should also take aggressive steps to unilaterally reduce its remaining trade barriers and end practices that unfairly discriminate against foreign producers and thereby encourage other nations to do the same. In particular, poor-country exports — for example, textiles and clothing — often face such barriers as absurdly high (12 to 30 percent) tariffs that should be scrapped. Tariffs on environmental goods and services — factory smokestack scrubbers and the like — should also be eliminated immediately, since trade in such products encourages environmental stewardship worldwide.

Another important step Washington should take, however, would be to repeal or reform the unfair U.S. antidumping law, the aggressive

use of which has seriously compromised our ability to encourage freer markets abroad.[73]

Of course, there are appropriate occasions to take actions against *specific* instances of human rights abuses abroad, such as cases of involuntary prison labor. Keeping in mind a core commitment to free trade, the following is a brief list of useful trade-friendly options that policymakers might consider if they believe they should address some particular abusive practice.

First, the United States should continue to work within the framework of the ILO when dealing with governments and corporations that engage in abusive practices. That can be accomplished by spotlighting such practices in official reports and investigations. The ILO is a better forum than the WTO for resolving disputes over labor standards, both because the ILO has more experience with those issues and because it is far less likely to provide cover for covert protectionism. Second, direct foreign aid payments can be suspended when foreign governments engage in abusive practices. Suspending direct aid is a viable way to signal strong disapproval of the actions of foreign governments without violating the rights of Americans or disrupting beneficial private commercial exchange. In addition, U.S. directors at international financial institutions, such as the International Monetary Fund and the World Bank, can be instructed, when circumstances warrant, to vote against loans to objectionable governments. Third, by blocking credits and loan guarantees from the Export-Import Bank and the Overseas Private Investment Corp., Congress can ban corporate welfare for companies that mistreat their workers or that do business with abusive governments. That will adversely affect some U.S. businesses, but subsidizing private investment abroad has never been a good idea. The provision of loan guarantees and subsidized insurance to the private sector has reduced pressure on foreign governments to create an investment environment that would attract foreign capital on its own. To attract investment, developing countries must establish secure property rights, a fair and uncorrupted judiciary, and transparent democratic accountability rather than rely on Washington-backed schemes that allow those reforms to be avoided.

Fourth, private initiatives can play an important role in ending abusive practices and alleviating the burdens of poverty abroad. As the AFL-CIO has noted, "Polls show that people are willing to pay more if they can be assured that their clothes were not made in sweatshops."[74] If that is the case, then corporations and investors will respond to consumer demand and public pressure, as many already have. Companies can label their products to show that they were made in compliance with appropriate labor and environmental standards. Outside auditors can ensure the integrity of such labeling. And consumers can vote with their wallets in favor of such products if they so choose. In addition, there are many worthwhile charitable activities to which people can contribute their money and time — such as building schools and hiring teachers for poor villages so that children have an alternative to working in the fields.

Finally, various "symbolic" sanctions — such as restrictions on U.S. visas for officials of abusive governments, or bans on countries' participation in international sporting events — can serve a useful purpose. Such narrowly targeted sanctions can be a powerful force for change, without inflicting the senseless collateral damage of economic sanctions. In 1993 the *Financial Times* noted that sporting sanctions against South Africa "were the most effective of all [sanctions] — not least because these measures had a clear and unambiguous impact, unlike economic sanctions whose effects are difficult to differentiate from normal market forces."[75]

It bears repeating that any blanket remedy that disrupts trade and investment is counterproductive and should be rejected. Import bans hurt poor people by making them more miserable in the short run in order to put pressure on leaders to make positive changes in the long run. Unfortunately, such pressure is rarely effective in a world where U.S. companies no longer dominate global trade. The decades-old embargo against Cuba, for example, has harmed the Cuban people and caused lost opportunities for U.S. businesses; yet the embargo has done nothing to bring about democratization in that country. Given that sanctions have a poor record of achieving foreign policy goals, we should not expect sanctions to be any more successful in achieving social objectives.

The humanitarian impulse is a commendable aspect of American culture. But humanitarians must be clear-eyed about the real options for the impoverished billions that still make up the majority of humankind. Poverty and want cannot be legislated away and cannot be cured by bureaucratic aid distribution; the evils of abject poverty and deprivation can be conquered only by the creation of wealth. Denying access to U.S. markets and investment capital makes it unnecessarily difficult for the world's poorest people to build better lives.

NOTES

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SOURCE

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DEBATE QUESTIONS

The author begins by arguing that there is a clear causal link between free trade and economic growth. What evidence does he use to establish this link?

In order to demonstrate the benefits of free trade, the author adduces the example of East Asia. How does he characterize the economy of East Asia? What does he cite as benefits? What does he see as the relationship between economic freedom and political freedom?

Opponents of globalization contend that it exploits poor workers in less developed countries. The author responds that the labor conditions in such countries are misrepresented and poorly understood. What does he see as the benefit of foreign investment in less developed countries?

There is little question that increased industrialization has a significant impact on the natural environment – and, for that reason, many environmentalists oppose globalization. The author argues, however, that environmental impact must be understood as part of a cycle. What is that cycle, and what does the author see as the long-term impact of globalization?

The author uses the example of Mexico to prove his thesis that globalization benefits developing countries. What evidence does he use to further his argument?

The author closes by noting that there are global problems – e.g., abusive labor practices, unfair trade restrictions, environmental damage – that must be addressed, but he insists that they cannot be solved by rejecting globalization. What steps does he recommend instead to solve these problems?

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Part 3
The Role of International Institutions

Globalization would be controversial, no matter how it came about. But much of contemporary controversy is focused on the international institutions — that is, the World Bank, the International Monetary Fund (IMF), and the World Trade Organization (WTO) — that have done so much to open markets around the world.

On one level, these institutions are controversial because of the way that they are constituted. Although there is international participation in all three organizations, they are in many ways dominated by the United States. (The IMF, for example, requires 85% approval for some measures; the United States, as the major shareholder in the Fund, controls 18% of the votes — giving it, in effect, veto power.) The corollary, for some critics, is that these institutions pursue policies that benefit the developed world, rather than poorer countries. But there is another criticism of the institutions that is the converse of this: some critics argue that the WTO is able to dictate policy to the United States (and has forced the United States to back off from environmental and labor standards); in this view, the WTO requires its members to surrender their sovereignty.

The international institutions have also been criticized for the policies they have pursued. Again, there is a broad spectrum of criticism. At one end, there are "market fundamentalists" who charge that the IMF in particular has interfered too much with free market operations by helping to bail out foundering countries. The presence of the IMF has created what is called "moral hazard" by insurance companies: knowing that more money from the IMF is forthcoming, debtor governments have taken imprudent economic risks. The converse of this argument is that the international institutions have cared too much about promoting free markets, and not enough about the reduction of poverty. Specifically, the IMF and the World Bank are criticized for instituting Structural Adjustment Programs (SAPs). SAPs stipulate that in order to receive loans, heavily indebted countries must balance

their books — but that often results in the strict curtailment of social programs.

In response, the World Bank and the IMF have argued that their policies are designed for the long-term benefit of the countries involved — and that includes the poor people who live in them. Too many countries, they argue, have lived "beyond their means" by borrowing heavily to finance programs that brought no financial return. To use an analogy: banks lend money to companies because they believe they will be repaid — and that is because they believe the companies to which they lend will eventually reap profits greater than their debts. So countries, too, must subject themselves to financial discipline and show that they are good credit risks; that will bring them not only funds from the international institutions, but will also make them more attractive to investors. Those investors, ultimately, will build their economy and benefit the poor.

The WTO is a different kind of institution: it does not lend money, like the World Bank and the IMF. Rather, it sets rules for trade among its member nations, and settles disputes between them. Ultimately, however, it claims the same objectives as the World Bank and the IMF — it aims to have all of its members, large and small, treated equally. It proposes that by making international trade fair, reliable, and rational, it gives all of its members the opportunity to grow economically.

Foreign Policy in Focus: World Trade Organization

by Sarah Anderson and John Cavanagh

* *World Trade Organization (WTO) rules apply to over 90 percent of international trade.*

* *The 1995 replacement of the General Agreement on Tariffs and Trade (GATT) by the WTO heightened concern among critics because its stronger enforcement powers represent a further shift in power from citizens and national governments to a global authority run by unelected bureaucrats.*

* *The most controversial outcomes of the Uruguay Round were the establishment of much stronger enforcement mechanisms in the WTO.*

The General Agreement on Tariffs and Trade (GATT) was an international organization created in 1947 to reduce trade barriers through multilateral negotiations. In January 1995, the GATT was replaced by a stronger World Trade Organization (WTO), the result of eight years of GATT negotiations. Today, member countries number 125 (nearly the whole world except China, some former communist countries, and a number of small nations) and WTO rules apply to over 90 percent of international trade.

Although still a little-known and little-understood institution, the WTO has become increasingly controversial as it has expanded the scope of its work from its original narrow GATT focus on reducing tariffs on manufactured goods. The WTO now also works to eliminate nontariff barriers, and can be used to challenge environmental, health, and other regulations that may serve legitimate social goals

but may be regarded as impediments to international trade. The 1995 replacement of GATT by the WTO heightened concern among critics because its stronger enforcement powers represent a further shift in power from citizens and national governments to a global authority run by unelected bureaucrats. Business, academic, and government supporters applaud the WTO as a more muscular sheriff of the world trading system.

Originally, GATT functions were intended to be part of a broader International Trade Organization (ITO), whose charter was negotiated in the mid-1940s. The ITO, which would have been under the aegis of the UN, was to have a broad regulatory mandate, covering trade, employment rules, and business practices. However, largely due to pressure from the business community and concerns about the ITO threatening U.S. sovereignty, the U.S. Senate killed the organization by refusing to ratify it, leaving the more narrowly focused GATT to evolve on its own.

Negotiators from member nations revised GATT rules and liberalized world trade several times in multi-year conferences called "Rounds." The GATT's (and now the WTO's) approach to reducing trade barriers was based on the "most-favored nation" principle, which requires that when a nation grants a trade privilege to one country, it must grant the same privilege to all GATT members. Another guiding principle is that of "national treatment," which requires nations to give equal treatment to foreign imports of goods or services as to domestic goods or services.

The most recent GATT Round, the Uruguay Round, concluded in 1993 and received U.S. congressional approval in November 1994. It is slated to result in average tariff reductions of 38 percent for developed economies, reducing average tariffs worldwide from 6.3 percent to 3.9 percent. In comparison, average tariff rates just after World War II were 40 percent. The most controversial outcome of the Uruguay Round was the establishment of much stronger enforcement mechanisms in the WTO. Although GATT always had a dispute resolution process, member nations often ignored its rulings since they lacked serious enforcement power. Unlike GATT, WTO panel decisions are binding. If one nation makes a complaint to the WTO that

another nation's law or regulation is protectionist and in violation of WTO rules, the WTO can make that nation bring the law into compliance with the WTO standard (with minor exceptions). If the country fails to comply, the WTO can authorize the complainant nation to impose trade sanctions.

Liberalization of investment was another goal of the Uruguay Round, but deadlocked negotiators had to extend the deadline for new rules in this area. Thus, at the WTO ministerial meeting in Singapore in December 1996, European nations, backed by the U.S. and Japan, pushed for talks on a proposed Multilateral Investment Agreement (MIA). The MIA would force national governments to grant foreign investors "national treatment," the same concept of nondiscrimination that is already applied to trade. If the MIA were adopted, corporations could invest without restrictions in any WTO member nation.

PROBLEMS WITH CURRENT U.S. POLICY

Key Problems

* *Although U.S. negotiators must consult with nongovernmental advisory committees, these entities have a disproportionate number of corporate lobbyists.*

* *The shift in power to a global-level bureaucracy undermines one of the cornerstones of democracy — the practice of citizens working with public officials to develop laws that protect the public welfare.*

* *The proposed Multilateral Investment Agreement would further diminish developing countries' power to protect local industries and cultures from being wiped out by foreign corporations.*

GATT negotiations take place behind closed doors in Geneva, Switzerland. Although U.S. negotiators must consult with nongovernmental advisory committees, these entities have a disproportionate number of corporate lobbyists. Labor unions and environmental groups have only token representation, while family farm, consumer, health, and other citizens groups are completely shut out. Likewise, the WTO lacks mechanisms for public accountability or participation. It is not required to consult with nongovernmental

organizations or release documents until after decisions are made. WTO dispute resolution panels are comprised of "trade experts" (chosen by government trade representatives from a set roster) who hold hearings and announce rulings in secret.

Under the WTO, member countries have the right to challenge other countries' local, state, or federal laws as impediments to international trade. If the WTO finds the law to be WTO-illegal, the federal government may overturn the law or face potential trade sanctions. This shift in power to a global-level bureaucracy undermines a cornerstone of democracy — the practice of citizens working with public officials to develop laws that protect the public welfare.

While promoters argue that the WTO gives developing countries expanded access to industrialized country markets, critics charge that trade liberalization undermines Southern nations' long-term development prospects. Small-scale, locally owned firms have difficulty competing with transnational firms because they lack comparable access to capital, economies of scale, or advanced technology. This concern is particularly acute in agriculture, where WTO rules on trade and domestic policy reform undermine national strategies to ensure food security.

New WTO rules also strip protections for local firms in the services sector. For example, countries must allow foreign banks to open branches in small towns, threatening locally owned banks with deeper ties to the community. Malaysian economist Martin Khor claims that new WTO rules could also decrease access to health care, because they require that private companies (primarily from the North) be allowed to buy up hospitals, which could raise costs for the public. The proposed Multilateral Investment Agreement would further diminish developing countries' power to protect local industries and cultures from being wiped out by foreign corporations.

The Uruguay Round did nothing to address what the AFL-CIO calls "the cruelest and most prevalent trade subsidy of all" — the suppression of worker rights. Members even refused to create a process for studying the inclusion of internationally recognized worker rights in the WTO, largely due to opposition from a coalition of Southern governments and a few nongovernmental groups concerned that

worker-rights standards would be used as nontariff barriers against the exports of low-income countries.

The argument for linking labor, as well as environmental standards, to the WTO is rooted in two concepts. First, the violation of core worker rights and environmental standards is often used by corporations and governments to gain unfair advantage in trade. Second, the core labor rights and environmental standards to be protected in the WTO must be only those that are internationally recognized in the UN-affiliated International Labor Organization (ILO) conventions and international environmental treaties.

Under the WTO, a nation cannot discriminate against products on the basis of how they are produced — be it by child labor or with environmentally destructive technologies. U.S. law, for example, has banned tuna imports from countries that allow long circular nets designed to catch tuna, but which also trapped and killed numerous dolphins. Yet in the eyes of the WTO, a can of tuna is a can of tuna, whether dolphins were killed in the production process or not.

One of the most contentious aspects of the WTO rules is the use of the "least trade-restrictive" test. Under GATT and now WTO rules, a measure is deemed "necessary" only if there is no less trade-restrictive means available to achieve the measure's legitimate health-related goals. This test limits a WTO member's ability to develop its own approach to environmental protection.

In 1994 the European Union used this principle to challenge the U.S. Corporate Average Fuel Economy (CAFE) standards, charging that the fuel conservation goals of the standards could have been just as easily obtained through gasoline taxes. The standards were ruled partially in violation of GATT.

In effect, the Uruguay Round places downward pressure on each country's laws to match lower international standards (in the areas where they exist). Thus, if a U.S. law sets a higher standard on health or food safety (e.g., allowable pesticide use) than the international norms codified by the UN, a country with a lower standard could challenge the law as an impediment to trade, and, depending on the outcome of the challenge, potentially force the U.S. to lower the standard down to a common denominator.

TOWARD A NEW FOREIGN POLICY

Key Recommendations

** The U.S. should re-examine its support for expansion of WTO powers into the investment realm.*

** The U.S. should argue more ardently the case for Worker Rights group as part of the WTO, since it is a necessary precondition to a serious discussion of how core international worker rights could be incorporated into the international trading system.*

** The original proposal for a International Trade Organization, which placed employment issues and corporate behavior on the agenda, should be reconsidered.*

Three sets of issues should be high on the U.S. agenda as it approaches the new WTO in the short term:

1. The expansion of WTO Powers: The U.S. should reexamine its support for expansion of WTO powers into the investment realm. Certain governments in the South have justifiably argued for a thorough evaluation of the current WTO before any new powers are considered. Such a review would benefit from participation by farm, labor, environmental, and other organizations that have been affected by the new trade rules.
2. Democracy and Transparency: European nongovernmental groups have taken the lead in arguing for an end to the secrecy which shrouds the operations of the WTO. As a public entity, the WTO should make all documents public immediately. Dispute resolution procedures should be open to public scrutiny. Nongovernmental groups should be recognized as important WTO monitors and contributors to WTO deliberations, and be allowed to observe WTO meetings.
3. Labor Rights and the Environment: The U.S. government has called for the establishment of a WTO Working Party on Worker Rights that will make proposals on the inclusion of labor standards within WTO rules. Yet the U.S. should argue the case for such a group more ardently, since it is a necessary precondition to a serious discussion of how core international worker rights could be incorporated into the WTO.

On the environment, the WTO's Committee on Trade and the Environment (see In Focus: Trade and the Environment) has been a total failure in addressing environmental concerns; indeed, governments have used it as a platform to undermine more stringent environmental regulations in Northern countries. Friends of the Earth and other environmental groups have advocated abolishing the committee and replacing it with a more effective environmental review process.

As criticism against the WTO rises among citizen groups in North and South and among a number of governments in the South, there is the longer-term challenge of posing an alternative to this institution that would better serve the needs of the majority in the world. Most governments and citizen groups agree that there is a need for a global trading body that has the authority to enforce the trade rules that are agreed upon among nations.

A more just and sustainable trade and investment order would be governed by a body that is more open and transparent, more democratic, is built upon a different set of rules, and is rooted in a different set of principles. The core principles of GATT — "national treatment" and nondiscrimination — work well only when all nations' level of development is equal.

In today's unequal world, nations must be given leeway to protect domestic industries and laws. For both the low-income countries of the South and U.S. communities concerned about maintaining and improving social and economic standards, a global trading body should allow governments to subsidize, favor, and protect local industries. Countries should be able to set domestic content levels to encourage local production, a practice now prohibited by the WTO. Communities should be able to protect seeds and homeopathic medicines from the "intellectual property" incursions of large seed and pharmaceutical companies.

Likewise, no global body should be able to challenge any nation's health, safety, environmental, or other laws as being too stringent; it is up to each nation to determine how high standards should go. At the same time, no nation should be allowed to gain unfair advantage in international trade through the denial of emerging international

worker rights and other standards, and a new global trading body should have the power to enforce this. As the debate emerges over what form a replacement of the WTO should assume, it is useful to put the old blueprints of the International Trade Organization on the table. While the world has changed markedly in four decades, the original architecture which placed employment issues and corporate behavior on the agenda may be applicable to today.

NOTES

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SOURCE

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DEBATE QUESTIONS

The World Trade Organization is the successor of GATT (the General Agreement on Tariffs and Trade), but in the view of the authors, it is a fundamentally different institution. In what ways do they see the WTO as different from GATT?

The authors single out the proposed Multilateral Investment Agreement (MIA) as a policy that will have a negative effect on developing economies. What is the nature of this agreement, and why would it hurt poor countries?

The authors argue that the creation of the WTO transferred power to a non-governmental bureaucracy. What, specifically, do they see as the powers of the WTO, and why do they object to it? What powers have member nations surrendered to the WTO?

Workers rights and the environment are issues of vital concern to the authors, and they feel that they cannot be addressed adequately by the WTO as presently constituted. Why is the WTO a problem, and how do they propose to change U.S. policy to address these issues?

IMF is a power unto itself

by Jeffrey Sachs

It is time that the world take a serious look at the International Monetary Fund. In the past three months, this small, secretive institution has dictated economic conditions to 350m people in Indonesia, South Korea, the Philippines, and Thailand. It has put on the line more than $100 billion of taxpayers' money in loans.

These bailout operations, if handled incorrectly, could end up helping a few dozen international banks to escape losses for risky loans by forcing Asian governments to cover the losses on private transactions that have gone bad. Yet the IMF decisions have been taken without any public debate, comment, or scrutiny.

While it pays lip service to "transparency", the IMF offers virtually no substantive public documentation of its decisions, except for a few pages in press releases that are shorn of the technical details needed for a serious professional evaluation of its programs. Remarkably, the international community accepts this state of affairs as normal.

The world waits to see what the Fund will demand of country X, assuming that the IMF has chosen the best course of action. The world accepts as normal the idea that crucial details of IMF programs should remain confidential, even though these "details" affect the well-being of millions. Staff at the Fund, meanwhile, are unaccountable for their decisions.

The people most affected by these policies have little knowledge or input. In Korea, the IMF insisted that all presidential candidates immediately "endorse" an agreement they had no part in drafting or negotiating — and no time to understand.

The situation is out of hand. However useful the IMF may be to the world community, it defies logic to believe that the small group of

1,000 economists on 19th Street in Washington should dictate the economic conditions of life to 75 developing countries with around 1.4 billion people.

These people constitute 57 per cent of the developing world outside China and India (which are not under IMF programs). Since perhaps half of the IMF's professional time is devoted to these countries — with the rest tied up in surveillance of advanced countries, management, research, and other tasks — about 500 staff cover the 75 countries. That is an average of about seven economists per country.

One might suspect that seven staffers would not be enough to get a very sophisticated view of what is happening. That suspicion would be right. The IMF threw together a draconian program for Korea in just a few days, without deep knowledge of the country's financial system and without any subtlety as to how to approach the problems.

Consider what the Fund said about Korea just three months ago in its 1997 annual report. "Directors welcomed Korea's continued impressive macroeconomic performance [and] praised the authorities for their enviable fiscal record." Three months ago there was not a hint of alarm, only a call for further financial sector reform — incidentally without mentioning the chaebol (conglomerates), or the issue of foreign ownership of banks, or banking supervision that now figure so prominently in the IMF's Korea program.

In the same report, the IMF had this to say about Thailand, at that moment on the edge of the financial abyss. "Directors strongly praised Thailand's remarkable economic performance and the authorities' consistent record of sound macroeconomic policies."

With a straight face, Michel Camdessus, the IMF managing director, now blames Asian governments for the deep failures of macroeconomic and financial policies that the IMF has discovered. It would have been more useful instead, for the IMF to ponder why the situation looked so much better three months ago, for therein lies a basic truth about the situation in Asia.

There is no "fundamental" reason for Asia's financial calamity except financial panic itself. Asia's need for significant financial sector reform is real, but not a sufficient cause for the panic, and not a justification for harsh macroeconomic policy adjustments. Asia's fun-

damentals are adequate to forestall an economic contraction: budgets are in balance or surplus, inflation is low, private saving rates are high, economies are poised for export growth.

Asia is reeling not from a crisis of fundamentals, but from a self-fulfilling withdrawal of short-term loans, one that is fuelled by each investor's recognition that all other investors are withdrawing their claims. Since short-term debts exceed foreign exchange reserves, it is "rational" for each investor to join in the panic.

Without wider professional debate, the IMF has decided to impose a severe macroeconomic contraction on top of the market panic that is already roiling these economies. Consider the Korea program (or at least those parts that have been announced to the public). The won has depreciated by around 80 per cent in the past 12 months, from around 840 a dollar to a record low of 1,565 yesterday; this currency depreciation will force up the prices of traded goods. Yet despite that, the IMF insists that Korea aim for an essentially unchanged inflation rate (5.2 per cent in 1998, in comparison with 4.2 per cent in 1997). To achieve unchanged low inflation in the face of a huge currency depreciation, Korea will need a brutal monetary squeeze. And indeed this is just what the Fund has ordered. Short-term interest rates jumped from 12½ per cent to 21 per cent upon the signing of the program, and have since risen further.

The Fund argues that these draconian monetary measures are "to restore and sustain calm in the markets" and "[to] demonstrate to markets the government's resolve to confront the present crisis." It is hard to see how recessionary monetary policy will restore calm. Indeed the panic has so intensified since the signing of the agreement that Korean banks may now be on the verge of outright default. Just one day after the measures were unveiled, the 11th largest-conglomerate declared bankruptcy when Korean banks abruptly refused to roll over its short-term debts. In recent days more well-known local companies have gone under.

In addition to the rise in interest rates, the IMF is insisting that fiscal policy be tightened by 1-1½ per cent of GDP. On top of this, the IMF required that 9 out of 30 merchant banks suspend operations. The IMF is aiming for Korean growth to fall to 2.5 per cent in

1998 from 6 per cent in 1997. But the projected slowdown may turn out to be the least of Korea's worries by next year, since the underlying macroeconomic measures could easily push the economy into outright contraction. None of this overkill makes sense for an economy that was (rightly) judged to be pursuing sound macroeconomic policies just months earlier.

A better approach would have been for the IMF to stress the strengths rather than the weaknesses of the Korean economy, thereby calming the markets rather than further convincing them of the need to flee the country. Months ago, when the financial crisis began, the Fund could have quietly encouraged Japan, the US and Europe to provide some credit support to the Bank of Korea. It might well have worked with the major banks to encourage them to roll over their short-term debts without inflaming the panic. With appropriate confidence-building measures, Korea could probably have got by with a modest slowdown in growth, no credit crunch, and a realistic time horizon of a few years to complete its needed financial reforms.

In more than six dozen developing countries, the IMF is in a position to choose make-or-break financial policies. While its instincts are often correct, they can sometimes be wrong, with serious consequences.

In recent years, the IMF mishandled the Russian reforms (for example, by insisting for more than a year that all 15 successor states to the Soviet Union share a common currency, thereby delaying stabilization and undermining the political support for reforms). In Bulgaria, the IMF signed a program in July 1996 based on 2.5 per cent growth and 20 per cent inflation in 1997. Instead, Bulgaria has suffered an outright collapse of gross domestic product of more than 10 per cent, and inflation in the hundreds of percent. The IMF (in common with others) failed to foresee the Mexico crisis in 1994, and the Asian crises in 1997.

Three general conclusions can be reached. First, the IMF is invested with too much power: no single agency should have responsibility for economic policy in half the developing world.

Second, the IMF's executive board should do its job of overseeing the staff, rather than simply rubber-stamp the staffs' proposals. It is high time the board consult outside expertise in the exploratory stages of IMF operations; it should also canvas international opinion

about the origins and policy implications of the Asian crisis.

Third, IMF operations should be made public, so that professional debate and review can help ensure the highest possible professionalism of the institution, especially since (for all its faults) the Fund will surely continue to play an important role for many years in the future.

DEBATE QUESTIONS

The author objects to the mandate and the practices of the IMF. Specifically, he objects to the amount of power given to the IMF; why is this a problem? Moreover, he objects to the way that the IMF conducts its business. What does he see as the problems in this regard?

The influence of the IMF is political and social, not just economic. What evidence does the author use to establish this contention?

At the time this article was written, the financial crisis of East Asia was unfolding, and the author was convinced that the IMF was incapable of addressing that crisis adequately. What evidence led him to that conclusion?

The author concludes with three recommendations for the IMF. In what ways do these recommendations rectify the problems that he sees?

NOTES

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WTO Report Card
An Exercise or Surrender of U.S. Sovereignty?

by William H. Lash III and Daniel T. Griswold

Executive Summary
Critics across the political spectrum allege that the World Trade Organization undermines the ability of the United States to determine its own trade, tax, environmental, and foreign policy. But an examination of how the WTO really works reveals that no such threat exists to U.S. sovereignty. The WTO is a contract organization that arbitrates disputes among its members on the basis of rules that all have agreed to follow. Like every other member, the United States has the power to veto any agreement of which it disapproves.

The WTO wields no power of enforcement. It has no authority or power to levy fines, impose sanctions, change tariff rates, or modify domestic laws in any way to bring about compliance. If a member refuses to comply with rules it previously agreed to follow, all the WTO can do is approve a request by the complaining member to impose sanctions — a "power" that member governments have always been able to wield against each other. The WTO's dispute settlement mechanism actually makes the use of sanctions less likely.

The WTO's basic charter contains explicit exemptions for broad categories of trade restrictions. Under the WTO charter, members can enact trade restrictions for reasons of national security, public health and safety, and conservation of natural resources and to ban imports made with forced or prison labor. Such barriers are not subject to challenge by other WTO members.

The same dispute settlement mechanism that can render judgments against U.S. laws has been used effectively to encourage other nations to scrap trade laws that discriminate against exports from the United States.

Membership in the WTO is not a surrender of U.S. sovereignty but its wise exercise. The WTO encourages the United States to keep its own markets open for the benefit of U.S. consumers and import-using industries. WTO membership also promotes trade liberalization abroad, which opens markets and keeps them open for U.S. exporters.

Introduction

Last November in Seattle, the Ministerial Meeting of the World Trade Organization was disrupted and effectively shut down for a day by sometimes-violent protests. The 50,000 protesters, ranging from labor and environmental activists to violent anarchists, were motivated by a grab bag of fears — fears of foreign economic competition, a "race to the bottom" on labor and environmental standards, and a loss of national sovereignty to a multinational body.

None of those fears holds up under scrutiny, but each has found traction in the public debate over America's participation in the WTO.[1] The sovereignty issue, in particular, has found an audience among conservatives and liberals alike and even a few libertarians who are otherwise sympathetic to the WTO's stated mission of trade liberalization.

In March a resolution to withdraw the United States from the WTO was introduced by Rep. Ron Paul (R-Tex.), one of the few self-described libertarians in Congress. In a statement announcing the introduction of the resolution, Paul declared: "The World Trade Organization is the furthest thing from free trade. Instead, it is an egregious attack upon our national sovereignty, and this is the reason we must vigorously oppose it. No nation can maintain its sovereignty if it surrenders its authority to an international collective."[2]

From the left, regulatory activist Ralph Nader has also denounced "the far-reaching, powerful" WTO, warning: "Under this new system, many decisions affecting people's daily lives are being shifted away

from our local and national governments and being placed increasingly in the hands of unelected trade bureaucrats sitting behind closed doors in Geneva, Switzerland. . . . Once the WTO's secret tribunals issue their edicts, no independent appeals are possible. Worldwide conformity or continued payment of fines are [sic] required."[3]

If the WTO were in fact dictating the domestic laws and regulations of its members, it would indeed be a threat to national sovereignty. But the WTO can do nothing of the kind. This briefing paper will describe what exactly the WTO is and how it works. The paper will then analyze the record of the WTO since its creation in 1995 and the impact, if any, it has had on the ability of its members to determine their own national policies.[4]

How the WTO Really Works

The WTO is a multilateral institution that provides a forum for negotiating international agreements to reduce trade barriers and for adjudicating complaints from any of its 135 members regarding breaches of those agreements. Created in 1995, after the eight-year negotiation of the Uruguay Round of the General Agreements on Tariffs and Trade, the new permanent body goes well beyond the GATT's historical focus on reducing tariffs on manufactured goods. The WTO includes agreements on services, government procurement, agriculture, intellectual property, and investment. In addition, it clarifies rules on subsidies and antidumping law.

Essentially, the WTO is a contract organization that reflects the consensus of its members. It arbitrates disputes among its members on the basis of rules that all members have agreed to follow. The WTO itself does not write the rules. That responsibility rests with the members, who can change the rules or create new ones only through negotiations, which are often long and sometimes tortuous. The agreements that result from those negotiations become WTO law only when all members have agreed to accept every word; if there is no agreement, the negotiations either end or continue until a compromise acceptable to all can be reached. As the failed WTO Ministerial Meeting in Seattle last year demonstrated, no agreements are reached or rules written until all members are ready to move forward together.

Accordingly, the United States cannot be outvoted as some critics have charged. Like every other member, the United States has the power to veto any agreement of which it disapproves. Moreover, no agreement that requires change in U.S. law can take effect here until the U.S. Congress passes the necessary implementing legislation.

Conservatives, in particular, are prone to lump the WTO with other multilateral organizations, such as the United Nations, the International Monetary Fund, and the World Bank, which they accuse of meddling in global markets or U.S. foreign policy. But the WTO is fundamentally different from those other organizations. It commands no troops or police, dispenses no loans or aid packages, administers no programs within the territory of its members, and strikes no deals with sovereign states.[5] The WTO's limited resources and mandate also contrast sharply with those of the European Union. From its headquarters in Brussels, the EU's executive arm, the European Commission, can issue regulations that are then automatically enforceable as national law in the EU member countries. The WTO possesses no such powers.

Dispute Settlement

The principal ongoing work of the WTO is to render decisions on whether members are in conformity with the organization's rules. But those decisions come only after a member has initiated a complaint and subsequent efforts to reach a negotiated settlement have failed. The main difference between the WTO and its predecessor, the GATT, is that panel rulings can no longer be suppressed by the losing party.

The tensions over and confusion about the power of the WTO system stem from a flawed understanding of U.S. power under the old GATT system. Traditionally, under the GATT, members could block or exercise veto power over decisions of dispute panels. Historically, the power of a member to block acceptance of a GATT ruling was popular when a decision went against the United States, but less popular when the United States was the complaining party. Under the strengthened WTO dispute settlement understanding (DSU), a panel decision becomes official unless all members agree to reject it, which

is a remote possibility. As a leading plaintiff in WTO complaints, the United States has a substantial interest in seeing determinations of dispute settlement panels accepted.

Critics of the WTO have cited the loss of the veto by the "losing" member as proof that the new dispute settlement system undermines U.S. sovereignty. But Georgetown University professor John Jackson, perhaps the nation's leading GATT expert, dismisses the sovereignty argument against the WTO as "ludicrous." According to Jackson, the WTO "has no more real power than that which existed for the GATT under the previous agreements."[6]

WTO dispute settlement procedures are designed to produce consensus, not further disputes or trade tension. The WTO dispute resolution mechanism is still based on old GATT principles of negotiation, conciliation, mediation, and arbitration. At any point in the dispute settlement process, the parties are free to mediate a resolution to the dispute. The only sanction under the WTO process is the suspension of the complaining party's WTO trade-agreement-based "concessions." Under the WTO agreement, such relief should be requested only as a last resort. The time-honored GATT rule of consensus has not disappeared. Parties are bound to accept panel or appellate body reports, but "bound" does not mean the WTO can or will "enforce" the decision. Enforcement is a coercive act, and the United States has not agreed to surrender sovereignty to the WTO or any other body.

No Power of Enforcement

In reality, the WTO wields no power of enforcement. It has no authority or power to levy fines, change tariff rates, or modify domestic laws in any way to bring about compliance. *The WTO has no power to make any member do anything the member doesn't want to do.* If a member's domestic laws are successfully challenged by another member through the WTO, the losing member remains free to exercise its sovereign will on the question of whether or not to conform.

In the unlikely event that the parties cannot come to any agreement at this stage, the complaining party may take retaliatory measures equal to the monetary harm caused by the actions of the

defendant. If the defendant member refuses to either change its out-of-conformity law or offer acceptable compensation, then under WTO rules the plaintiff member can impose trade sanctions against the offending member. The sanctions are meant to punish the defendant for flouting its obligations and to encourage it to make the challenged law WTO consistent.

Sanctions are not imposed by the WTO itself but at the discretion of the plaintiff member. The WTO does not confer a new "right" to impose sanctions; sovereign nations have always had the ability to impose trade sanctions against other nations for a variety of reasons. For example, Section 301 of the Trade Act of 1974 authorized unilateral sanctions against our trading partners for a variety of allegedly "unfair" trading practices. If anything, the WTO system makes the use of sanctions less likely by encouraging members to follow a set of procedures and seek conciliation before pulling the sanctions trigger.[7]

The dispute settlement system of the WTO is intended to provide "security and predictability" for the entire multilateral trading system. Members agree not to take unilateral action against perceived violations of trade rules; to refer disputes to the dispute settlement system; and, perhaps most important, to abide by its rules and findings.

The Principle of Nondiscrimination

WTO rules do not require that members adopt specific tariff rates or a certain level of domestic regulation. Those decisions are rightly left to individual members. What WTO rules do require is that members apply tariffs and regulations to other WTO members in a transparent and nondiscriminatory manner.

A fundamental obligation of WTO membership is the so-called most favored nation principle. Article I of the 1994 basic GATT agreement requires that "any advantage, favor, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties."[8] In other words, a WTO member must apply the same tariffs and rules to like imports, no matter from which member the imports originated.

Another fundamental obligation is the principle of "national treatment." Under Article III, WTO members agree that all internal taxes and regulations they impose on the transportation, distribution, and sale of goods and services "should not be applied to imported or domestic products so as to afford protection to domestic production."[9] That is, a WTO member cannot apply one set of domestic taxes and regulations to domestic products and another, more burdensome, set of rules to imported goods once they enter the country for sale.

Article III does not obligate the United States to lower its domestic health and environmental standards for imports; it obliges the United States only to set the same standard for domestic and imported products. The first case decided by a WTO panel involved U.S. Environmental Protection Agency regulations for imported gasoline. That case, brought by Venezuela and Brazil, asserted that EPA regulations on reformulated gasoline required that imported fuel quality be pegged to a tough 1990 U.S. baseline standard rather than the less restrictive standard for domestically produced fuel, which was determined individually for each refinery. Venezuela asserted that the guidelines placed imports at a disadvantage in U.S. markets. The WTO panel agreed that the U.S. gasoline regulations discriminated against foreign refiners.[10]

As a result of that early test of compliance with WTO rules the EPA issued new pollution rules for imported gasoline. The new rules give foreign refineries more flexibility in meeting the overall guidelines for reducing pollutioncausing chemicals in conventional gasoline; imported gasoline was allowed to contain the same level of pollutants as U.S.-refined gas. The EPA did not change U.S. rules on cleaner-burning "reformulated" gas despite a determination by the WTO that they were similarly discriminatory. Instead, the EPA simply let the reformulated gas rules expire at the end of 1997 as scheduled by law.

The United States ran afoul of WTO rules, not because the U.S. law on reformulated gasoline was too restrictive, but because it was blatantly discriminatory. It was clearly written to give domestic producers an unfair advantage over their foreign competition. Making U.S. law compliant with WTO rules did not require that U.S. law be

weakened or changed at all but that it be enforced in a way that does not discriminate against foreign producers for no other reason than that they are foreign.

The Primacy of Domestic Law

Many people who criticize the WTO on sovereignty grounds assume that the WTO is a self-executing agreement. But neither WTO agreements nor WTO rulings automatically become U.S. law. The WTO can neither rewrite U.S. laws nor levy taxes or fines on violators.

Leading legal scholars have joined in debunking the notion of a powerful WTO. Former appeals court judge Robert Bork, a constitutional law scholar generally respected by conservatives, has concluded that the sovereignty issue "is merely a scarecrow."[11] Under our constitutional system, he says, "no treaty or international agreement can bind the United States if it does not wish to be bound. Congress may at any time override such an agreement or any provision of it by statute."[12] Exercise of sovereign power over U.S. trade law resides exclusively in the U.S. federal government.

In congressional testimony before passage of the Uruguay Round Agreements Act in 1994, then–U.S. trade representative Mickey Kantor explained: "Nothing in the dispute settlement mechanism . . . requires the United States to change or alter its laws or pass new laws or to repeal old laws. Of course if . . . we're the subject of a negative finding of the panel, we might have to pay either compensation [in the form of lower tariff barriers] or be the subject of some trade action. That would be a choice we would make. We retain full sovereignty to make those choices on our own."[13] Kantor elaborated: "No ruling by any dispute panel, under this new dispute settlement mechanism . . . can force us to change any federal, state or local law or regulation. Not the city council of Los Angeles, nor the Senate of the United States can be bound by these dispute settlement rulings."[14]

Other international trade law experts have made similar statements. Former USTR general counsel Judith Bello states: "Like the GATT rules that preceded them, the WTO rules are simply not 'binding' in the traditional sense. . . . The WTO — essentially a confederation of sovereign national governments — relies upon volun-

tary compliance. The genius of the GATT/WTO system is the flexibility with which it accommodates the national exercise of sovereignty, yet promotes compliance with its trade rules through incentives."[15]

Congress Retains Power of Taxation

A timely example of the primacy of domestic law is the February 24, 2000, ruling by the WTO Appellate Body against a U.S. tax law on foreign sales corporations (FSCs). The FSC law allows U.S. multinational corporations to reduce their corporate income tax liability in part on the basis of export performance. Acting on a complaint from the EU, the WTO ruled that the FSC tax provisions amount to an illegal export subsidy under the WTO's Agreement on Subsidies and Countervailing Measures. If the United States does not change the FSC law to conform to WTO rules, the EU could eventually impose trade sanctions against exports from the United States.

Critics of the WTO have seized on that ruling as an example of the WTO's overriding even the sacred constitutional authority of Congress to determine U.S. tax law. The WTO ruling is nothing of the kind. The WTO Appellate Body did not strike down a single line of the U.S. tax code, nor did it even suggest an alternative law. It merely issued a legal opinion that the current FSC provisions of the U.S. tax code are inconsistent with WTO rules on export subsidies — rules that the U.S. government agreed to and the U.S. Congress ratified. The U.S. government is now free to leave the FSC law unchanged, or to seek a compromise with the EU to avoid the threat of sanctions. Whatever the outcome, U.S. tax law will change only when Congress decides to change it.

Beef, Bananas, and Nuts to the WTO

Proof of the WTO's lack of enforcement power can be plainly seen in the few cases in which members have refused outright to implement a dispute panel ruling. If a member government decides, for whatever reason, that it cannot or will not comply, all the WTO can do is flash a green light of approval to sanctions — a "power" that member governments have been able to wield against each other since the origin of the nation-state centuries ago. While sanctions raise the cost of

nonconformity, they cannot coerce a nation to change its laws if its sovereign government refuses to do so.

The chief example of the WTO's ultimate lack of enforcement power is the case of the EU and its import barriers against bananas and hormone-treated beef. In both cases, the EU has lost repeated dispute settlement decisions in the GATT and the WTO yet has refused to bring its domestic law into conformity with the WTO rules it agreed to follow.

In the case of bananas, the EU has for more than a decade discriminated in favor of bananas grown in former colonies of EU member states. The EU's discriminatory banana regime has hurt banana growers in Latin American countries such as Ecuador as well as U.S.-based banana distributors such as Chiquita. The United States challenged the law both under the old GATT system and under the WTO, winning favorable rulings at every stage. In response to that string of losses, the EU tinkered at the margins of its policy but has failed to make it consistent with WTO rules. In 1999 a WTO panel ruled that the EU banana regime was inflicting an annual cost on the U.S. economy of $191 million and that sanctions on an equivalent amount of EU imports to the United States would be within WTO rules. The United States imposed the sanctions in March 1999, but the EU has yet to make its banana regime WTO consistent.

A similar scenario has played out on the issue of hormone-treated beef. In 1989 the EU, citing health concerns, banned the importation of U.S. beef from livestock treated with growth-promoting hormones. The United States challenged the law in 1996 under the WTO Agreement on the Application of Sanitary and Phytosanitary Measures, which requires that such a ban be based on scientific risk assessment. The U.S. position was affirmed by a WTO panel in 1997 and upheld by the WTO Appellate Body in 1998. Despite lack of evidence that the U.S. beef imports pose any public health risk, the EU has refused to budge on its ban. After following established WTO procedures, the United States imposed $117 million in sanctions against the EU beginning in July 1999. The EU still refuses to change its policy and has no current plans to do so. EU trade policy on beef and bananas can be criticized as economically foolish and damaging

to the concept of a rules-based trading system.

What has not been and cannot be challenged, in the WTO or anywhere else, is the EU's right as a sovereign entity to maintain its own trade policies, no matter how unjustified or economically self-damaging some of those policies may be.

WTO Rules Exempt Nontrade Concerns

The WTO's basic charter contains explicit exemptions for broad categories of trade restrictions. Under Articles XX and XXI of the GATT, members can enact trade restrictions for reasons of national security, public health and safety, and conservation of natural resources and to ban imports made with forced or prison labor. Such barriers are not subject to challenge by other WTO members.

Article XX, under the heading "General Exceptions," lists a number of WTO legal justifications for erecting trade barriers, including these: "necessary to protect public morals"; "necessary to protect human, animal or plant life or health"; "relating to the products of prison labor"; "imposed for the protection of national treasures of artistic, historic or archeological value"; and "relating to the conservation of exhaustible natural resources."[16] Those exceptions mean that in the sensitive areas of national security and public health and safety, where fears about loss of sovereignty are most acute, the WTO explicitly recognizes the authority of member countries to deviate from open trade.

Health and Environment Trump Trade

WTO rules grant broad latitude for using trade measures in the name of resource conservation. Environmental critics of the WTO repeatedly cite the so-called Shrimp-Turtle case as an example of WTO rules trumping environmental protection. In fact, the case demonstrates how WTO rules accommodate a wide range of environmental concerns, including the preservation of endangered species outside a member's territory.

The Shrimp-Turtle dispute centers on a section of the U.S. Endangered Species Act aimed at protecting an endangered species of sea turtles. Section 609 of the act forbids the importation of

shrimp from countries whose fleets are not equipped with turtle-excluder devices that allow sea turtles to escape unharmed. The U.S. embargo was designed to safeguard sea turtles worldwide, not solely turtles within U.S. waters.

In defending the WTO consistency of U.S. law, the U.S. trade representative invoked GATT Article XX, which recognizes the right of members to block imports in an effort to protect natural resources. WTO members such as India, Malaysia, Thailand, and Pakistan were not able to conform to the letter of the U.S. law, which imposed shorter deadlines and more burdensome requirements on Asian shrimp exporters than on those in the Western Hemisphere. Even where Asian fisherman could demonstrate that no turtles had been injured, the imports were still banned because the exporting countries had been deemed not in compliance.[17]

The WTO Appellate Body agreed that the U.S. Shrimp-Turtle law fit within the scope of the Article XX exception for conservation measures. What the WTO panel found not in conformity was the arbitrary and discriminatory way the law was implemented. Specifically, the panel found that the United States had (1) negotiated a more favorable agreement with Caribbean shrimp exporters while issuing non-negotiable ultimatums to Asian exporters; (2) banned all shrimp from countries classified as "non-certified," even shrimp known to have been caught in nets with turtle-excluder devices; and (3) administered the certification process in a nontransparent manner.

The WTO's ruling in the Shrimp-Turtle case affirmed a key principle of international trade law: the United States can enact a broad range of laws to protect its own environment and can even act to protect international resources such as sea turtles, but such laws cannot treat other countries in an arbitrary or discriminatory way without running into conflict with WTO commitments.

Environmentalist critics of the WTO, such as the Naderite group Global Trade Watch, argue that trade interests have prevailed every time environmental laws have been challenged in the WTO. But in each of the half dozen cases in which environmental laws have been challenged, the rulings have not been against the purpose of the laws; the rulings have been against the unfair way the laws have been

implemented. In comparison with that handful of cases, thousands of restrictive environmental laws and regulations in the United States and other WTO members have gone unchallenged because they are manifestly consistent with the WTO's modest, narrow, and reasonable rules regarding trade and the environment.

National Security Paramount

National security is another area broadly exempted from WTO rules. Article XXI states that nothing in the agreement "shall be construed … to prevent any contracting party from taking any action which it considers necessary for the protection of its essential security interests."[18] That exemption has proven wide enough to exclude virtually any action a WTO member could take in the name of national security.

A prominent example is the Cuban Liberty and Democratic Solidarity Act passed by Congress in 1996. The so-called Helms-Burton law gives U.S. citizens whose property was seized by the Castro government in Cuba since 1959 the right to sue those who knowingly traffic in the stolen property. The law also denies U.S. visas to the traffickers. The law's main targets are European, Japanese, and Canadian companies that invest in Cuba.

Those nations have complained about the law's extraterritorial reach since its enactment. To ease tensions, President Clinton has suspended the right to sue under Helms-Burton, but the visa ban provisions remain in effect. The U.S. asserts that the law is exempt from WTO review, on the basis of Article XXI.

Article XXI acknowledges each member's right to act as it deems necessary for the protection of its essential security interests in time of war or other international emergency. Helms-Burton may not be wise. It has obvious economic flaws. As an extraterritorial application of U.S. policy, it embroils us in trade disputes with many of our closest trading partners. It is unlikely to bring the Castro regime to its knees. But, as a matter of customary international law, Helms-Burton and other foreign-policy-related measures are exempt from WTO challenge.

Article XXI explicitly recognizes that countries can act unilaterally in the name of essential security, but it declines to define exactly what constitutes essential security. In an early dispute involving U.S.

restrictions on exports to Czechoslovakia, the GATT determined that each country is the final judge on questions relating to its own security. For more than 35 years, WTO members have recognized that principle and that a country's security interest may be threatened by a potential as well as actual danger.

Sir Leon Brittan, former trade commissioner commissioner of the EU, denounced the Helms-Burton law. He has a short memory: in 1982 the EU imposed trade sanctions against Argentina in response to the invasion of the Falkland Islands — and cited the same Article XXI and 35 years of precedent to which the United States now points. The EU even argued, as the United States does today, that its action required no approval from the trade body.

This is not the first time that the United States has resorted to Article XXI. In 1985 the U.S. embargo against Nicaragua was exempt from challenge on the basis of the GATT security exception. The trade community accepted that — and so did the International Court of Justice. The ICJ did question whether the United States had correctly balanced its need to employ an Article XXI exemption against basic GATT objectives of stable trade relations. But the court then recognized that the GATT was ill equipped to deal with political questions that range beyond freetrade issues. That remains true today.

The subjective determination of essential security is crucial to maintaining the integrity and consensus of the WTO. If it tried to force members to abdicate the determination of their own foreign policy and national security interests, the WTO would splinter and collapse under a barrage of sovereignty claims. A WTO decision against Helms-Burton would fuel isolationism, drastically weakening domestic support for the multilateral organization.

Congressional supporters of Helms-Burton, in a letter to U.S. Trade Representative Charlene Barshefsky, cautioned that the United States must "prevent the WTO from undermining its own credibility by reaching a decision on a non-trade matter that purports to circumscribe our ability to adopt policies essential to our national security."[19] The WTO's own exceptions and precedent make such a confrontation a remote possibility.

The Benefits of a Rules-Based System

Despite its lack of enforcement power, the WTO system has been remarkably successful in encouraging compliance among its contracting members. In the overwhelming number of cases brought to dispute settlement, the losing party has modified its domestic laws or regulations enough to satisfy the complaining party. The reason behind this compliance is not the coercive power of an international body — the WTO wields no such power — but the realization of WTO members that it is in their long-term self-interest to follow a set of rules that promote mutual economic gain through trade liberalization.

Member states are using the new dispute settlement mechanism at a rate five times greater than the rate at which they used the old GATT system. Since the inception of the WTO, there have been 185 requests for consultation concerning 144 distinct matters. Currently, there are 25 active cases, 22 that have been adjudicated, and another 37 that have been settled or are inactive. This level of use and settlement shows that the system enjoys the respect of our trading partners.

The WTO DSU and the stability and credibility it provides are vital to U.S. economic interests. The United States is the complaining party in numerous cases, including cases involving protection of intellectual property in India and the importation of computers, bananas, and beef to Europe; periodicals to Canada; and shoes and apparel to Argentina. We challenge everything from protectionist health standards to protection of software, export subsidies, distribution systems, antidumping investigations, and discriminatory taxation of U.S. exports.

We are also the respondent in many trade disputes. Currently, those disputes involve dozens of states and issues ranging from foreign policy to trademarks to textile imports. The question of whether we will adhere to WTO panel dispute reports really hinges on what types of treatment we expect from our trading partners. If we routinely ignore panel reports when we are the losing party, we will be hard-pressed to justify our support for the WTO when we seek to have reports enforced in the event of a U.S. victory.

Fair Treatment for U.S. Exports

The same dispute settlement mechanism that can render judgments against U.S. laws has been used effectively to encourage other nations to scrap trade laws that discriminate against exports from the United States. In the first five years after the WTO was created, 1995–99, the United States filed 49 requests for consultation with other WTO members who the U.S. government believed were violating their WTO commitments. The U.S. position prevailed in 23 of the 25 cases that have been resolved so far — 13 through WTO panel rulings and 10 through out-of-court settlement.[20] Among the major U.S.-instigated victories for freer trade are the following:

- elimination of India's import bans and quotas on 2,700 categories of products, thereby opening markets to U.S. exports of consumer goods, farm products, textiles, petrochemicals, high-tech goods, and other industrial products;
- elimination of barriers to the export of U.S. magazines to the Canadian market;
- elimination of Indonesia's local content provisions on car production, which discriminated against automobiles imported from the United States;
- elimination of discriminatory taxes on U.S. liquor exports to Korea and Japan;
- elimination of Japanese restrictions on the importation of apples, cherries, and other fruits from the United States;
- greater market access for U.S. exports of pork and poultry to the Philippines;
- greater access for U.S. rice exports to the EU; and
- elimination of tax discrimination against U.S. movies in Turkey.

Even when the U.S. government "loses" a case brought by another WTO member, the people of the United States typically win. Those cases can pressure the U.S. government to lower its tariff barriers and to adopt nondiscriminatory regulations. In the first five years of the WTO, through 1999, U.S. laws and regulations were the target of 35 complaints filed by other WTO members. Of those, seven have worked their way through the system, with panels determining in six of them that U.S. law was inconsistent with WTO rules.

It's difficult to find a downside for the United States in most of those cases. In two of them, those dealing with the reformulated gasoline and Shrimp-Turtle regulations, the result was, not the "striking down" or even the "weakening" of U.S. regulations, but a less arbitrary and unfair application of those regulations. In two other cases, covering U.S. import barriers against underwear from Costa Rica and wool shirts and blouses from India, the WTO ruled against costly and self-defeating U.S. trade restrictions. Even though such cases are technically losses for the United States, they are clear victories for Americans who buy underwear, shirts, and blouses.

Under the dispute settlement mechanism of the WTO, neither the United States nor its trading partners can suppress the issuance of dispute panel reports, as members could under the old GATT. Nor should we want to. WTO panels provide an opportunity to test U.S. practices and laws to see if we are truly an open economy, dedicated to free trade. Examination of our policies by impartial panels of experts tests the validity of many laws and evaluates how we may be engaging in market-distorting activities while preaching free trade to others. Whether the United States is the complaining party or the respondent, we must bear in mind that the WTO does not have the power it is perceived as having. If the cost of this forum is constructive criticism and review of our policies, we should bear it gladly and without fear. As the leading complainant at the WTO, we should not fear being a respondent before the same body we so eagerly embrace for our own disputes.

Avoiding Trade Wars

Establishing the rule of law in international trade has been the crowning achievement of the WTO. The WTO embodies multilateral trade rules established by consensus and an impartial dispute settlement mechanism to interpret those rules. Under the current system, WTO members settle trade disputes through mutually agreed upon procedures, not through bluster and threats that, without constraint, can quickly escalate into tit-for-tat trade wars, leaving innocent workers and their families as the chief victims. Thanks to the WTO, the world is far less likely to suffer a repeat of the "beggar-thy-neigh-

bor" trade policies of the 1930s that deepened the global economic crisis that defined that era.

In contrast to the trade wars and economic turbulence of the interwar years, the GATT/WTO system has helped to define the postwar era as one of falling trade barriers, expanding integration, and rising prosperity for those nations that have decided to join the global economy. At the end of World War II, the average tariff on manufactured goods in the industrialized countries was 40 percent. Today, in part because of eight rounds of multilateral trade negotiations through the GATT/WTO, the average tariff is 4 percent.[21] Declining barriers to trade have led during that same period to a 16-fold expansion in the volume of world trade.[22]

Although the WTO's rules have not violated the sovereignty of its member governments, they have encouraged those governments to lower trade barriers and to keep them down. Americans today enjoy greater freedom to buy, sell, and invest in the international marketplace because of the rules and procedures established through the WTO. The WTO has enhanced the sovereignty of individual Americans as producers and consumers without compromising the sovereignty of the U.S. government to act on our collective behalf where necessary.[23]

Conclusion

Membership in the WTO is not a surrender of U.S. sovereignty but the wise exercise of it. The WTO encourages the United States to keep its own markets open, for the benefit of U.S. consumers and import-using industries. It also promotes trade liberalization abroad, which opens markets and keeps them open for U.S. exports.

By its nature, the WTO is incapable of infringing on U.S. sovereignty. It lacks any tangible enforcement power other than the respect and credibility its dispute settlement mechanism has built among its members. Unlike the International Monetary Fund or the World Bank, the WTO dispenses no large amounts of money with strings attached to foreign governments. Unlike the United Nations, it dispatches no troops with "WTO" written on their helmets. Unlike the EU, it writes no rules that are automatically enforceable in member countries. The WTO's chief function is to facilitate negotiations

among its members and then to render nonbinding, unenforceable opinions about whether particular laws and regulations of its members are consistent with the WTO rules — rules that each and every one of its members has agreed to follow.

The sovereignty of the U.S. government is protected behind an insurmountable series of firewalls. First, no trade rules can be adopted by the WTO without the agreement of every one of its members. This grants the U.S. government effective veto power over any change or expansion of WTO rules. Second, the WTO's basic charter explicitly authorizes member countries to impose trade restrictions in the name of national security, public health and safety, and other considerations that touch sensitive issues of sovereignty.

Third, any challenge to a U.S. trade-related law must be initiated by another WTO member and will proceed to a dispute settlement panel only after efforts to compromise have failed. The WTO itself does not challenge any U.S. law or regulation. Fourth, if the U.S. government actually "loses" a case in dispute settlement, the WTO has no authority or power to do anything to enforce the decision. If the U.S. government decides to ignore a WTO decision against it, the WTO possesses no coercive power of any kind that could be used to enforce any outcome the United States does not want to accept.

Finally, if the complaining member ultimately decides to impose sanctions against exports from the United States, the U.S. government retains exactly the same freedom of action it has always possessed in the face of foreign trade threats. Trade sanctions have been used and abused as a tool of foreign policy for decades, by the United States as well as by other nations. The WTO's "enforcement" mechanism has not conferred any power on other countries that those countries have not possessed all along. Indeed, by establishing a set procedure for settling trade disputes, WTO rules make it less likely that the United States will face the external pressure of sanctions.

Membership in the WTO enhances the freedom and the prosperity of Americans without surrendering an inch of national sovereignty.

NOTES

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SOURCE

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DEBATE QUESTIONS

Critics of the World Trade Organization contend that it represents a threat to national sovereignty. The authors note that this criticism comes from both ends of the political spectrum — from libertarians as well as liberals. Why do such different groups find the WTO objectionable?

The authors stress that the WTO has no "powers of enforcement." What does this mean, in practical terms? Why is this point central to their argument?

The WTO should be condemned, critics charge, for forcing the United States to weaken its environmental standards. The authors deny that this is the case. Why, in their account, did the WTO object to American gasoline standards?

The WTO does not have the power to overrule the laws, regulations or tax codes of its member nations, say the authors. What examples do they use to show that member nations have refused to follow rulings issued by the WTO?

The WTO ruled against a U.S. law that was designed to prevent the accidental harvesting of sea turtles — further evidence, say critics, that the WTO favors trade over the environment. How do the authors refute this claim?

The authors contend that membership in the WTO has been beneficial for the U.S. economy. What evidence supports this contention?

World Bank and IMF Activities in Africa: Poverty Alleviation, Debt Relief and HIV/AIDS

by Nancy Birdsall

Testimony before the House Financial Services Committee, Subcommittee on International Monetary and Trade Hearing on "World Bank and IMF Activities in Africa: Poverty Alleviation, Debt Relief and HIV/AIDS"
May 14, 2001

Mr. Chairman: The record of the IMF and the World Bank in Africa is far from perfect. However I want to speak today in favor of continued strong United States financial and other support for the activities of these two institutions in that region. The United States is the largest single shareholder in both these institutions, and has an impressive record of benign and constructive influence on their policies and practices.

Continued U.S. support for their programs in Africa should be linked to a strong commitment from the other shareholder governments and from managements of the World Bank and the IMF to be highly selective in their own future lending. Selectivity means focusing their large lending programs only on countries clearly able to use new resources well. The two institutions should also be pushed to

take leadership in encouraging the other large donors, including in Europe, to be more selective in new lending and grant-making to African governments. A focus on selectivity is all the more important if the benefits of the HIPC program of debt relief are to be fully realized.

The development challenge in Africa — including reducing poverty and dealing with debt and the AIDS pandemic — will only be met when and where African governments sustain the policies and institutions that attract the local private investment that creates jobs and drives growth. Over the last decade, the World Bank and the IMF have provided only about 10 percent of all the transfers (in the form of loans and grants) that the countries of sub-Saharan Africa have received. Most of the transfers have come from grants of the European Union and the governments of Western Europe. However, the two international institutions, because of their combined involvement across the full range of macroeconomic, infrastructure, social and other programs with governments, are looked to by the other official donors for analysis of governments' policy and institutional readiness to benefit from donor transfers. In particular, the development community looks to these two institutions on issues of economic management and financial accountability to signal when and which countries in Africa will benefit. Their work is key to our understanding of whether not only donor but local tax revenues and other resources are being used well in the fight for improved lives in Africa.

To complement the activities of the financial institutions, the U.S. as well as other donor governments should directly increase funding for global programs such as tropical agricultural research and the recently announced Global AIDS Fund. These global programs hold great promise for directly helping the poor in Africa improve their own lives, including in countries where conflict, corruption and weak institutions make effective implementation of many development programs impossible. They are critical complements to the lending and policy dialogue with African governments which are the principal business of the World Bank and the IMF and which they are so well placed to do.

In the rest of my remarks I first explain why despite well-known problems, there is good reason to expect development progress in at least some African countries. I then summarize briefly the evidence regarding the past effectiveness of World Bank and IMF support in Africa. I emphasize the need for selectivity across countries in lending by these institutions, i.e. the need to confine large lending programs to countries able to use the resources well. Finally I discuss the benefits of the current debt relief (HIPC) program, the problems with faster or deeper relief, and comment briefly on the AIDS/HIV issue.

Development assistance can make a difference in Africa

Over the last 50 years, the foreign aid and development programs of the U.S., including through the multilateral institutions, have been a success story in many countries. Though there are still millions of people in the developing world living in poverty, the fact is that in Latin America, Asia and much of Africa, infant mortality has been reduced, primary school enrollment is much closer to universal, and knowledge of and access to health care, clean water, new agricultural and other technologies have dramatically improved people's daily lives. Where countries have opened their markets, encouraged private initiative, and established reasonably good economic management, household income has grown rapidly. Of course development programs have not worked well where there has been conflict and corruption — but they have and do work in the right circumstances. Africa's problems with high debt and with the HIV/AIDS pandemic should not obscure the general point that development progress is possible.

Despite its problems, there is a sound logic for continuing efforts to assist Africa get onto a sustained development path. Many countries in the region have taken firm steps in the last decade in the direction of sensible economic management. Governments have established greater fiscal discipline, opened their markets, and reduced the role of the state through privatization of mining, banking and agricultural marketing boards. This first round of reforms has not been without its own shortcomings and problems implementation, and has not produced the kind of healthy growth Africa needs to

reduce poverty. (In South Africa good economic management has not in itself been sufficient to ensure aggressive handling of the AIDS problem, though in other countries, such as Uganda and Senegal, it has certainly helped). However, the fact is that due to the first round of reforms, growth did rise in reforming countries in the early 1990s. It has slowed in the last few years primarily due to the intensifying problems of conflict (in and around Angola, Sierra Leone and Liberia, Sudan and the Horn, and the Congo — all affecting many neighboring countries in loss of trade and investment opportunities) and the continuing deterioration in the prices of most of Africa's export commodities except oil. (New transfers to Africa's non-oil exporters in the last three decades are only slightly greater in value terms than the losses associated with the large declines in the terms of trade for those countries' exports.)

In the medium term, achieving more growth and reducing poverty faster requires a second round of reforms. These reforms include establishing and enforcing clear property rights, improving tax administration, developing incorruptible judicial systems and contract enforcement, and institutionalizing adequate public services, especially in health, education and transportation for the largely poor rural populations. But the first steps have been taken in many countries and are a sound start. Without them and the macroeconomic stability and predictable economic management they bring, future growth would be even less likely.

Lending should be even more focused on countries that are performing well

Much past development assistance has not been well spent, especially in Africa. The build-up of official debt (i.e. debt owed to donor governments and to the international institutions) of countries in Africa is sad testament to the problem. New projects and new lending went on in some countries for years despite poor results.

However, our understanding of what makes for effective aid to poor countries has improved, and in the last decade the World Bank and the IMF have shown increasing willingness and ability, in their own lending programs, to exploit that improved understanding. That

trend has to be reinforced and strengthened.

It is now amply documented that large infusions of development assistance only work, i.e. only help generate healthy growth and poverty reduction, when economic policies are sensible and public institutions function reasonably well in the recipient countries. This is equivalent to saying that financial assistance only works when reasonably good government is already in place. (In fact many reforming countries, including Uganda, Ghana, and Viet Nam, received relatively little aid in the early years of their reforms). The assumption that World Bank and IMF loans could induce recalcitrant or incompetent governments to institute and sustain economic reforms has proven wrong. Indeed recent evidence suggests that when governments are not prepared themselves to undertake reforms, lending and donor-financed grants simply finance inaction and delay of necessary reforms — as shown by experience in Kenya and Zambia.

On the other hand, once reasonably competent government is in place, lending and other foreign assistance — for roads, schools, improved judicial and banking systems — can make a huge difference in helping governments finance the programs that directly improve peoples' opportunities and well-being, and reinforce the political support they need to sustain sound economic management. Uganda, despite recent problems during its presidential election, is an example. In the last several years, the World Bank has supported major reform and new investments in its education system. Bank-sponsored household and community surveys showed that less than one-third of non-salary government spending was reaching the classroom. The government switched to a system of direct transfers to schools (with the amounts posted for the public at school entrances), eliminated school fees, and with financial support from the Bank increased substantially public spending on primary schooling. Bank support was tied to the improvements in the budgeting process. Primary school enrollment has doubled.

On the whole the evidence is that the World Bank, through its International Development Agency (IDA) concessional window lending, and the IMF have been reasonably selective in lending to countries in Africa, i.e. they have tended to do more lending (net of

debt service, as a percent of country GNP) to countries with better policies and institutional capacity and higher levels of poverty. Over the last decade, they have been more responsive to changes in the countries' policy environment than the bilateral government donors (who until the 1990s were often driven by political considerations and by historical colonial ties). The effort to be selective intensified in the 1990s with the institution of a system in the World Bank of scoring countries in terms of their capability, and tying the proposed lending program to those scores. The record for the IMF and for other donors in general is less good in the case of those African countries that accumulated high levels of debt to the World Bank and the IMF. Those countries got continued inflows of donor money independent of their policies and management, an issue I return to below. However even in the context of relatively good behavior, especially by the multilateral creditors, it is clear there is room for greater discipline in halting lending when countries' performance or policy environment deteriorates, such as today appears to be the case in Zimbabwe, the Central African Republic, and possibly Cote d'Ivoire, and more room for increasing support, especially for medium-term programs in education and infrastructure, to countries that have established a good record over several years, the case now in Uganda, Senegal and probably Mozambique. In the past mistakes were made in both directions. In the mid-1990s countries with mixed records of reform such as Cote d'Ivoire and Zambia were getting the highest levels of aid per capita (from all donors), at twice the levels received by Uganda and Ghana with their good records over the prior decade. In the latter two countries, transfers were tapering off in the mid-1990s though their capacity to manage more programs was probably increasing.

The United States can take a clear position on the selectivity issue, both in the context of the follow-up to the HIPC debt relief program and during the discussions of the next IDA replenishment. The U.S. can press for improvement in the country performance rating system, for making the methods and the ratings more transparent and available, at the least to the research community, and for more public disclosure and monitoring of the use of the performance-based

system. In addition, the United States could press for more explicit incorporation into the performance criteria of governments' efforts to meet the needs of the poor in such areas as health and education, as reflected in their public expenditures; and of governments' performance in reducing the corruption that erodes economic and democratic institutions, as reflected in financial management and commitment to the rule of law.

The HIPC program of debt relief: more now is no panacea

Of the 33 countries in sub-Saharan Africa eligible for the HIPC program of debt relief, 19 have reached the initial decision point. The debate about debt relief has focused largely on the timing and size of the program, with proponents of more debt relief arguing that faster and greater relief would free up resources for countries to spend more on social and other poverty reducing programs. Unfortunately the facts do not square with that idea. The HIPC-eligible countries in Africa have received in the last two decades annual inflows from donors consistently greater than the debt service they were paying out. They were not, in effect, "taxed" but on the contrary were "rewarded" for the debt they were accumulating. Higher levels of debt and debt service led to higher inflows of new resources. Indeed recent studies indicate that once countries in Africa had accumulated a level of debt to the IMF and the World Bank exceeding about 50 percent of their GNP, the donors as a group abandoned any pretense to selectivity and simply made transfers, largely in grant form, sufficient to ensure those countries would not fall into arrears with the multilateral creditors. (Arrears to the multilaterals are particularly feared because they lead to loss of trade credits and sudden cut-off from all other borrowing.) In that sense, the donors as a group as well as the debtor countries had fallen into what might be called a high multilateral debt trap.

For that reason, it is difficult to argue that the "burden" of debt service in the countries with high debt and high multilateral debt has been in itself the fundamental cause of insufficient public spending on health and education. The fundamental cause has been the poverty and lack of growth that led to the debt accumulation in the first

place. Nor is it clear that simply eliminating all the debt would in itself guarantee higher spending on these social programs or in itself deliver more growth and poverty reduction.

In the last decade there were repeated rounds of partial debt relief. But since the donors as a group were financing the debt service of the debtor countries, debt relief often led to no net increase in transfers. Donors, from relatively fixed aid budgets, financed the costs of debt relief by reducing new transfers. To use a crude example, a country like Malawi was receiving about $20 per person per year for donor-managed health, schooling, road and other projects in the 1990s, and paying back about $10 per person per year in debt service. In the past, debt service reduction programs that reduced Malawi's debt service to $5 per year would also lead to a reduction in the value of new donor projects to, say, $16 per year, for at best a small net gain in annual net donor inflows from $10 ($20 minus $10) to $11 ($16 minus $5) per person per year.

The benefits of the HIPC program as currently designed will thus come not in the widely expected form of "relief" from burdensome debt service liberating governments to spend more on their people. The benefits instead will come in one or both of two other forms.

> One is if the larger and more visible HIPC program of debt relief leads to additional net transfers from donors (so that in the example above a country like Malawi ends up after debt relief still receiving close to $20 in new inflows per person per year, while paying in debt service $5 instead of $10), at least for countries that are performing well.

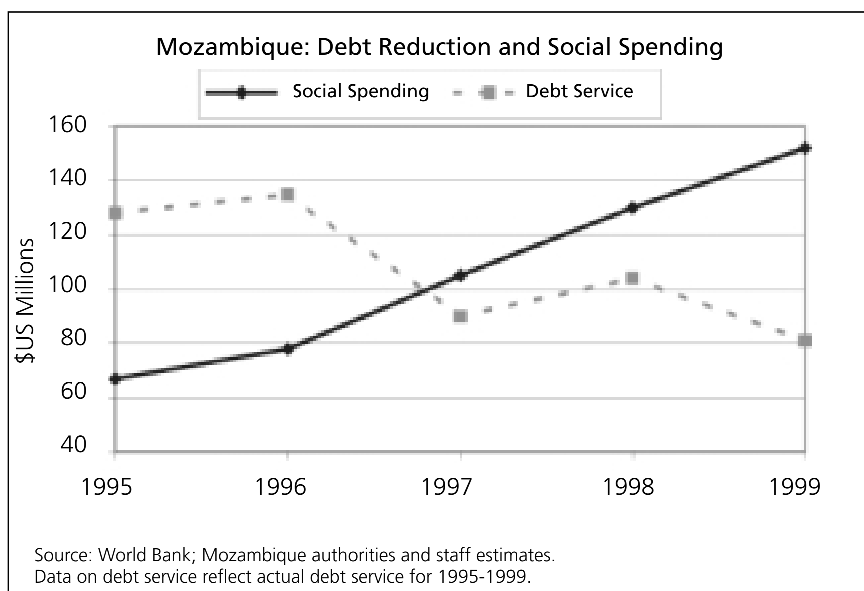
In the short run this seems possible, with some additional commitments from donors (the U.S. appropriation of some $400 million last year is an example), especially if limited donor funds are better focused on those countries best able to use them. This sort of country selectivity would ensure better use of aid and should encourage higher total commitments of aid in the future, especially from the United States (which spends much less given the size of its economy than the European donors). In fact a poorly understood benefit of the HIPC program is that it helps the donors escape the multilateral debt

trap described above, in effect liberating them to reintroduce selectivity in their lending and grant-making.

> The second benefit will come because the countries' economic policymakers and political leadership will have returned to them the management of their own resources.

Instead of receiving from literally dozens of different donors dozens of different forms of in-kind resources, often tied (to use of Italian consultants, or textbooks printed in the U.S., or construction materials from the European Union), countries will be able to take greater charge of their own destiny. In the above example it is worth noting that a country receiving $20 of in-kind assistance still had to generate $10 in tax revenue to finance its debt service. With more of its assistance in the form of debt relief instead of hundreds of discrete projects, it can make its own spending more predictable and manageable, using a lower proportion of its own revenues for debt service and a higher proportion of aid for own-managed programs. The graph illustrates the relationship between reduced debt service and higher social spending, including financed by new aid, in Mozambique.

Because of their broad knowledge of the economies and the sectoral issues and public expenditure patterns within every country, the



Source: World Bank; Mozambique authorities and staff estimates.
Data on debt service reflect actual debt service for 1995-1999.

IMF and the World Bank are particularly well placed to provide leadership in signaling when and which countries in the region are in a position to use new donor resources effectively. This requires of course that they become not only more selective, but more transparent in their choices.

In short, I would now put more emphasis on post-HIPC country selectivity as a key to making aid effective, rather than on a complete write-off of the debt of all countries. In some countries, deeper debt relief might well help somewhat more, and is morally compelling if the debt was taken on by prior kleptocratic or military governments. But donors, including the two multilaterals, can anyway "reward" countries that are burdened by bad histories and are now managing well in the form of new transfers. This can be done better than in the past, through broad budget support for social and other medium-term development programs (rather than uncoordinated in-kind projects tied to donor-specific procurement). A complete debt write-off would constitute the worst form of moral hazard, seeming to punish countries that had accumulated less debt, and reducing the repayments to the IMF and the World Bank, which are important sources of future lending. Ironically the main beneficiaries would be the World Bank and the IMF, whose balance sheets would be cleansed and accountability for past errors made less visible, at the cost of future transfers to worthy country recipients.

New U.S. appropriations for the HIV/AIDS global fund should be much larger

I hope others on this panel will speak directly to the logic of much more generosity by the United States in this area. A global fund can accelerate the time when a vaccine or other control methods such as microbicides can bring prevention. A global initiative can bring the kind of international cooperation that would reduce the fears of pharmaceutical firms of parallel imports of generic drugs undermining their patent rights in rich country markets. That would encourage competitive differential pricing and open the door for use of generics in poor country markets without undermining the property rights of firms in rich country markets. Brazil's example shows that rising to

the terrible challenge of caring for people with AIDS can catalyze broader and deeper initiatives to reform public health care systems. The World Bank can play an important role within countries, in supporting the infrastructure, training and service delivery needed. At the same time, much can be done to relieve the terrible human costs of the epidemic in Africa short of the kinds of structural economic reforms and sustained competence in economic management discussed above. The United States should be prepared to provide much greater financial and moral leadership than its initial commitment to the global fund signals.

The 1998 global financial crisis was a healthy reminder that we live in an increasingly interdependent world. Development assistance is in the interests not only of the millions of people in the developing world, but of all Americans. As I am sure the members of this committee know, polls show that Americans favor higher levels of such assistance than the United States now spends. That reflects not only their generosity but their intuition that development assistance is a critical input to a future world that is less divided in material terms and thus a more stable and safe global neighborhood for our children and grandchildren.

The IMF and the World Bank are central to the promotion of growth and stability across the globe, and to the reduction of poverty. In recent years, they have promised greater emphasis on poverty, the environment, and support for anti-corruption measures; reduction of their own administrative overhead (in the case of the World Bank); and greater openness and accountability. The United States has played the key role in promoting and monitoring these changes, and must continue to do so.

NOTES

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SOURCE

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DEBATE QUESTIONS

The author suggests that development aid to Africa has not produced optimal results. What does she see as obstacles to African development? What actions have fostered solid economic development?

The author talks about the need for reforms before development aid to Africa can be effective. What kind of reforms does she stipulate? What, in her opinion, is the relationship between aid and reform? Should help be given to governments that do not meet management standards set by the World Bank?

A controversial issue in Africa is debt relief — that is, the forgiveness of all or part of the debt taken on by African governments. The author does not favor universal debt relief. Why? What standards should be used, in her opinion, by donors who are willing to forgive debt?

What is the relationship between debt relief and social services? Does the author believe that debt reduction leads governments to provide greater services for their citizens? How should this question be considered in light of the services demanded by the AIDS crisis?

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Part 4
The East Asia Crisis

The mandate of the International Monetary Fund is to ensure economic stability – especially in case of economic downturns and currency fluctuations. The IMF was put to the test in 1997, when investors began to speculate on the value of the baht, the currency of Thailand. (Currency speculation involves borrowing in a currency that the borrower expects to be devalued; if he borrows 1000 baht, but then the baht becomes worth 40% less than its worth at the time of the loan, he profits – because it takes less "real money" to pay back the loan. Nominally, he must repay 1000 baht – but that amount is worth only 600 of the baht he borrowed, and has since converted to another, more stable currency.) In the event, the speculators were proved right, and the Thai currency collapsed. Given the interpenetration of markets, however, the effect of the collapse was not confined to Thailand; when the Thai economy declined, it triggered a decline in other countries in East Asia who were invested in Thailand, or had markets in Thailand.

The actions of the IMF have been debated by economists ever since. Basically, the IMF demanded that the Thai government institute "contractionary" economic policies: in the interests of keeping inflation low, interest rates were raised – meaning that investors could get a higher rate of return, but that borrowers encountered much higher costs. This, the IMF felt, would stabilize the economy, and minimize the flight of capital. The IMF stipulated similar policies in the other countries affected.

The logic of the IMF's position was that there were inherent problems in the economies of the affected countries. In other words, the crisis erupted because countries had too much debt, or inadequate currency reserves, or faulty financial systems. In order to overcome the crisis, those longstanding problems had to be solved; investors would come back only if they knew that the economies were fundamentally sound.

Critics of the IMF have charged that the crisis was in many ways

caused by IMF policies. Specifically, the IMF had promoted the opening of the capital market in Thailand – that is, it made it possible for investors to trade (and speculate) in Thai currency. Open capital markets may be a good thing in a developed country like the United States, but they leave developing economies highly vulnerable. Moreover, say the critics, the IMF took the wrong actions when it imposed contractionary policies: when they found it harder to get credit, many companies went bankrupt. As more and more people were thrown out of work, the economy got worse instead of better.

The economies of East Asia have recovered since the crisis – but economists continue to argue about the "what if's." Would there have been no crisis if the IMF's policies had been different? Would different actions have made the crisis shorter and less widespread? Would the economic situation of East Asia be even better today if the IMF had demanded fewer changes? Or would the crisis have been worse if the IMF had not intervened in the way that it did?

The Asian Financial Crisis of 1997-99

by Stephan Haggard

Introduction

The Asian economic crisis of 1997-99 was a singular event in the region's postwar economic history. Since the period of high growth began — a period dating to the 1950s for Japan and the 1960s for Korea, Taiwan, Hong Kong and Singapore — East Asia had not experienced a collective shock of this magnitude. Much of the debate about the crisis has focused on its economic dimensions, particularly on the market forces and economic policy choices that generated such a sharp contraction. The crisis, however, also had a strong international political dimension that centered on the perennial conflict between creditors and debtors in the world economy.

When economic crises erupt, creditors are concerned primarily about repayment, but also about potential policy reforms that will restore investor confidence. Creditors tend to believe that the origins of financial crises can be found primarily in the borrowing countries, for example, in mismanaged exchange rates or weakly regulated financial systems.

In contrast, debtor governments seek financial support to ease the tremendous social costs associated with the crisis, whether in the form of debt forgiveness, rescheduling, or new financing. Since creditors share responsibility for bad lending, debtor governments feel, not all the burdens of adjustment should fall on the citizens of the borrowing countries. During the Asian financial crisis, Malaysia argued repeatedly that the crisis was caused by increasing financial integra-

tion and that a recurrence could only be prevented by fundamental reforms of the international financial system.

Given their weak bargaining position, and the desire to maintain access to flows of both public and private credit, debtor governments typically make some policy adjustments; their sheer lack of resources often guarantees that this is the case. But they may or may not have an interest in undertaking the full panoply of reforms sought by their creditors and the international financial institutions, most centrally the IMF. Moreover, governments may also resist reforms because of interest group and constituent pressures or because of the nature of political institutions and decision-making processes.

Overview of Events I: The Crisis Breaks

As with most countries in East and Southeast Asia, Thailand maintained a fixed or pegged exchange rate regime prior to the financial crisis of 1997. This policy choice obligates a country's central bank to buy and sell foreign currency to hold the price of the currency — the exchange rate — within a narrow band. When the demand for local currency — the baht in Thailand's case — outstrips supply, the central bank will buy foreign currency with baht. Conversely, when there is excess demand for foreign currency, the central bank sells dollars or other foreign exchange at the fixed rate, using its foreign exchange reserves to do so.

This policy had several perceived advantages, including its attractiveness to investors. A stable currency eliminates (or at least appears to eliminate!) exchange rate risk. Over the course of the 1990s, Thailand mirrored other countries in the region by gradually opening its capital account, allowing domestic banks and firms to borrow abroad and foreigners to lend and invest more freely. This borrowing fueled economic booms throughout the region. In Korea, the boom took the form of aggressive fixed investment in infrastructure and equipment, but in other countries it was also made manifest in property speculation, stock market bubbles and outright financial fraud. Well prior to the foreign exchange crises of the second half of 1997, these bubbles had begun to burst, exposing the fragility of weak domestic banking sectors.

Beginning in 1995, Thailand began to experience speculative attacks: situations in which the sale of the baht was motivated by fears that the central bank would have inadequate reserves to maintain the fixed rate. On July 2, 1997 the demand for dollars proved overwhelming, and after several hours the central bank was forced to allow the baht to float; its value would be determined by supply and demand in the market without any obligation for the central bank to intervene. From a trading range of roughly 24-26 to the dollar in the months prior to the crisis, the baht fell to more than 29 to the dollar in a single day. Over the course of the next six months, it would hit a low of almost 55 to the dollar before stabilizing.

The successful assault on the Thai baht was immediately felt in the foreign exchange markets elsewhere in Southeast Asia, the phenomenon known as "contagion" (for a more extended chronology of the crisis, see http://www.stern.nyu.edu/globalmacro/, Asian Crisis; Basic Readings; Chronology). The Philippines was forced to float the peso on July 11, and Malaysia followed suit shortly thereafter. Although the crisis in Indonesia would ultimately prove to be the most severe in the region, the rupiah did not initially follow the domino pattern. Nevertheless, by mid-August Indonesia was also forced to abandon the use of a band for its currency, and within three months the rupiah had lost more than two-thirds of its value.

The crisis moved beyond Southeast Asia with a decision by Taiwan's monetary authorities on October 17, 1997 to let the New Taiwan dollar float. Speculation immediately shifted to the Hong Kong dollar, which had been pegged to the US dollar since an earlier foreign exchange crisis in 1983. With massive reserves (and the promise of even more support from Beijing, which had taken control of the former British colony in June), Hong Kong's financial authorities successfully defended the peg, but the sharp increase in interest rates required produced a dramatic sell-off in the Hong Kong stock market.

The sell-off in Hong Kong in October 1997 rippled through the stock markets in the United States and Europe, and marked the first sign that economic events in Asia could have global repercussions. Hong Kong's woes were felt most acutely in Korea, where the won came under intense pressure in early November. On November 21 it

too was allowed to float. The Korean economy was much larger than any of the Southeast Asian ones, and its crisis sent a new set of shockwaves through the world and regional economies.

The events in Korea did not mark the end of the currency crises of 1997-98; the effective Russian default of August 1998 provided another sharp shock to emerging markets, and Brazil experienced the fallout in early 1999. Other Latin American markets also came under pressure. But this case study focuses on the four Asian countries hit hardest by the crisis: Indonesia, Thailand, Malaysia and Korea.

The United States, Japan, and China Respond

The United States

When the crisis broke, the United States was in its sixth full year of robust economic growth. Nonetheless, the U.S. had strong concerns about the prospect that Asia's growth and exchange rates might collapse. In addition to the potential economic impact,[1] the Clinton administration feared the social and political effects of the crisis and even the prospect that countries' changing economic fortunes could upset the delicate strategic balance in the region.[2]

The Clinton administration had waged a difficult political battle over a rescue package for Mexico in early 1995, following a somewhat similar financial crisis there. Congressional leaders of both parties had initially supported a rescue package for the country, but that support quickly fell apart. President Clinton was forced to use American influence in the IMF and other international organizations, persuasion of allies, and discretionary resources in the Exchange Stabilization Fund to cobble together the Mexican bailout. In the aftermath of that program, Congress severely tied the hands of the president with respect to the assistance that could be provided without Congressional approval. A decision not to seek a waiver to this policy meant that the United States did not contribute directly to the first Asian rescue package, the $17 billion arrangement with Thailand signed in August. That decision appeared to signal American disinterest in the region's troubles.

Even had Congress not restricted the president's use of the

Exchange Stabilization Fund, the U.S. could not have acted alone in providing the enormous amounts of financing required to mitigate the multiple crises in the region. The centerpiece of U.S. strategy was therefore to rely heavily on the international financial institutions.

The key policy issues thus centered on what conditions the IMF and the World Bank would seek in return for their support. This issue proved highly controversial, because the crisis overlapped with a debate over expanding the IMF's financial resources. A "minimalist" line would have provided financial support for the purpose of restoring balance-of-payments equilibrium and applied limited conditions to the monetary, fiscal and exchange rate policies required to achieve this goal (see Martin Feldstein "Refocusing the IMF" at http://www.stern.nyu.edu/globalmacro/asian_crisis/imf_role.html).

This view was also held by a somewhat odd coalition of critics of the IMF on both the left and right of the political spectrum, some of whom argued that the IMF should be abolished altogether (See George Schultz, William Simon and Walter Wriston, "Who Needs the IMF?" at http://www.stern.nyu.edu/globalmacro/asian_crisis/-imf_role.html). These libertarian critics argued that IMF programs ended up bailing out not the countries and their citizens but foreign creditors. The prospect of such bailouts generated a problem known as "moral hazard": the prospect that creditors might be assisted by IMF programs made them less prudent in making loans in the first place, thus contributing precisely to the kinds of financial crises that the IMF should be trying to prevent.

Another strand of criticism, emanating from a number of prominent economists and anti-globalization activists, was that the IMF pursued the wrong economic strategy during the crisis (Jeffrey Sachs, "The Wrong Medicine for Asia," at http://www.stern.nyu.edu/globalmacro/, Asian Crisis, Basic Readings). Tight monetary and fiscal policies were designed to restore investor confidence, primarily by shoring up the exchange rate. In fact, some argued, these policies had the exact opposite effect. Investors saw high interest rates and tight fiscal policy as the prelude to even deeper recessions and continued to flee the currencies accordingly. The appropriate strategy for managing the crisis would have combined more relaxed monetary and fis-

cal policies with greater emphasis on forcing banks and other creditors either to accept losses or to reschedule debt.

Yet another set of views characterized the thinking at the Treasury Department, which played the leading role in defining the course of U.S. policy.[3] In the view of the Treasury, the need to restore confidence did in fact require a tightening of fiscal and monetary policy in the short run, even at some admitted economic cost. Following the initial failure of the IMF program in Korea, Treasury also came to support the need for banks to bear some responsibility through rescheduling exercises, the most comprehensive of which was reached for much of Korea's debt in March 1998.

But the problems of the East Asian countries did not stem solely from external financial events, nor were they short-term in nature. The new Washington consensus emphasized the fact that both public and private governance in the region was weak. Domestic banking systems had been an important conduit for foreign borrowing, and were poorly regulated. Corporate governance was characterized by lack of transparency and accountability to shareholders. Corruption appeared to play a role in the crisis as well, summed up in the view that the Asian economies were characterized by "crony capitalism." The reform agenda implied by this view was thus a highly ambitious one, involving not only short-term policy measures but longer-term institutional and regulatory reforms as well.

Japan

Japan's circumstances at the onset of the crisis were almost exactly the opposite of those in the United States. Rather than enjoying a long expansion, Japan was in the middle of a period of slow and erratic growth. Moreover, events in Japan had taken a decided turn for the worse just as the Asian financial crisis was breaking. In April 1997, the government implemented a tax increase that immediately sent the gradually-recovering economy back into recession. In November 1997, Yamaichi Securities and Hokkaido Taku-shoku Bank were closed, signaling the onset of a serious domestic banking crisis.

Throughout the crisis, the United States argued publicly that Japan's failure to address its internal economic problems — both

macroeconomic and microeconomic or financial — was costly for the region as a whole. The depreciation of the yen prior to the crisis placed direct competitive pressures on Korea and Taiwan, and undermined the competitiveness of the ASEAN countries as well. Currencies in that region were tied to the dollar, and as the yen fell, their currencies appreciated and their economies lost competitiveness. Weak growth in Japan also limited its ability to absorb exports from the region and to invest there.

Most importantly, the fragile balance sheets of Japanese banks made them particularly sensitive to adverse developments abroad. Japanese banks were much more heavily exposed to Asia than their American counterparts, with 40 percent of total foreign lending by Japanese banks going to the region. In many of the Asian crisis countries, Japanese banks had been among the first to call in lines of credit and to limit their exposure when the crisis struck.

Despite (or perhaps because of) its weakened economic position, Tokyo had a very different view of the crisis than Washington. It was more sympathetic to the policies of the countries in the region and less sympathetic to the emphasis on restoring confidence and market-oriented reform advanced by the Treasury Department and the IMF.

In the fall of 1997, the Ministry of Finance floated a proposal for an Asian Monetary Fund (AMF). The AMF would be used in cases where IMF funds were inadequate to meet the needs of countries seeking emergency balance-of-payments financing. It would disburse funds more quickly and in larger amounts than the IMF and with fewer conditions (see Eric Altbach, "The Asian Monetary Fund Proposal" at http://www.jei.org/Archive/JEIR97/9747f.html#Heading2).

Why the AMF? Japan was in any case being called upon to supply and organize regional assistance, given the manifest shortfalls in IMF resources. In the Thai package, for example, total IMF financing was over $10 billion short of what was needed, and Japan's contribution to the package equaled that of the IMF itself. As we have seen, the United States pledged nothing. The facility also indirectly supported Japan's own banking system, which as we have seen had the highest exposure to the region. But the proposal also reflected the views of a group of technocrats in the Ministry of Finance who sought to

counter U.S. and IMF influence with an institution based on an alternative economic philosophy.

The U.S. strongly rejected the AMF concept, primarily on the grounds that it threatened to weaken the authority of the IMF and its ability to impose appropriate conditions. When senior finance ministry and central bank officials from APEC countries met in Manila on November 18-19, the framework that they elaborated — the so-called "Manila Framework" — centered overwhelmingly on the IMF as the lead player (See Treasury Secretary Robert Rubin's summary of the framework at http://www.ustreas.gov/press/releases/pr2073.htm.).

Japan's ideas for assistance to the region resurfaced in October 1998 in bilateral guise when Japan's finance minister, Kiichi Miyazawa, unveiled a plan to disburse $30 billion in loans to the region (for an overview of the initiative, see the documents on the Ministry of Finance website at http://www.mof.go.jp/english/if/kousou.htm.). In announcing the plan, Miyazawa made a number of criticisms of the IMF's role in the crisis during the previous year, arguing that programs were inappropriately designed, were too harsh, and failed to involve the private sector. The Miyazawa plan, in contrast to the IMF's, would provide technical assistance, direct financing, guarantees, and interest-rate subsidies that would more directly assist private sector recovery. All lending would be in yen. In December 1998 and January 1999, support programs were announced for Malaysia, Thailand, Korea and the Philippines. Despite the critical overtone of the Miyazawa Plan announcement, the United States and the World Bank welcomed the Japanese effort.

China

Unlike the United States and Japan, China was not a creditor country, and therefore was not positioned to play a central role in defining the region's response to the crisis. Neither was it a crisis country. Despite substantial banking problems of its own, the country's relatively closed capital market insulated it from the short-term capital movements that undid others in the region.

However, China was able to use the crisis as an opportunity to expand its economic diplomacy in the region. Beijing committed not

to devalue its currency, an action that many feared would set off another spiral of competitive devaluations, and contributed directly to several of the rescue packages. Positive U.S. comments on Beijing's contribution contrasted sharply with the periodically tough words reserved for Tokyo coming from Washington during the first year of the crisis, and led some strategic analysts to see the crisis producing a subtle shift in the strategic balance in Asia.

Overview of Events III: Politics in the Region[4]

To what extent were these governments interested in, or capable of, undertaking the "orthodox" reforms demanded by creditors and the international financial institutions? To what extent did they pursue "heterodox" alternatives? To what extent did they simply muddle through? How did these policy choices affect their performance? (For detailed overviews of country performance, see http://wbln0018.worldbank.org/eap/eap.nsf, click on Regional Update).

The course of policy was in all cases driven by learning. In virtually all cases, initial IMF programs underestimated the depth of the crises, failed to reassure the markets, and required modification, typically in the direction of loosening fiscal policy to address the social dimensions of the crisis. However, the importance of politics can be seen by focusing on six administrations in four countries: four democratic ones, two in Korea's presidential system (Kim Young Sam [2/1993-2/1998 and Kim Dae Jung 2/1998-present), two in Thailand's parliamentary system (Chavalit [11/96-11/97] and Chuan [11/97-1/2001]); one semi-democratic, dominant-party parliamentary system (Mahathir in Malaysia [first elected 7/1981, most recently re-elected 4/1995 and 11/1999]), and one authoritarian system (Suharto in Indonesia [3/1966-5/1998]).

The Democracies: Thailand and Korea

In Thailand, all of the democratically-elected governments prior to the crisis — Chaitichai, Chuan, Banharn and Chavalit — had rested on shaky multiparty coalitions. These coalitions were made up of internally weak and fragmented parties that provided ample opportunities for private interests to gain access to the policy process. Party

leaders constructed parliamentary majorities from a pool of approximately a dozen parties, and coalitions typically consisted of six or more parties. Cabinet instability was a chronic problem. The parties, in turn, relied heavily on national or provincial businessmen with strong personal as well as political interests in financial markets and other economic policies.

The Chavalit government was made up of a six-party coalition including many parties from the previous government, but differed in that it attracted a highly-regarded team of technocrats. The Central Bank succeeded in staving off two speculative attacks on the baht prior to its final collapse in July, but the government failed in efforts to change the fixed exchange rate regime. The problems of coalition politics were most apparent in the recurrent difficulties the government faced in confronting the mounting problems in the financial sector. The government delayed in devising a plan for strengthening weak finance companies and continued to provide a number of them costly liquidity support.

These events unfolded prior to the collapse of the baht, and were taken by market analysts as signals of the government's weaknesses. The problems in formulating a coherent policy stance contributed directly to the resignation of the finance minister two weeks before the final assault on the baht in July of 1997, but even this crisis did not crystallize a more coherent response. The process of supporting failing finance companies was accused of corruption. On October 19 another finance minister resigned in frustration over the reversal of a small gas tax increase a mere three days after it had been announced as part of the government's IMF-backed program. With public protest against government ineptitude rising, including within the business community, Chavalit resigned.

Korea would appear to have been much better positioned to respond to the crisis than Thailand. The country has a presidential system in which the president possesses a range of legislative powers, and Kim Young Sam enjoyed a legislative majority. But a corruption scandal at the outset of 1997 involving loans to the Hanbo corporation, a giant steelmaker, had weakened the president. Moreover, a presidential election was scheduled for December 1997. Increasing

concern about the deteriorating economy fragmented the ruling party and contributed to the party's ultimate defeat in this election at the hands of Kim Dae Jung.

These political problems affected economic policy-making in two areas: the management of major corporate bankruptcies and the passage of important financial reform legislation. The most damaging corporate failure was of the Kia group. Kia's management exploited the upcoming elections to mount a major campaign in the summer of 1997 for government support in dealing with its creditors. By late October — prior to the onset of the crisis in Korea — the Korean banking system had been severely damaged not simply by the bankruptcies themselves, but by a highly politicized bankruptcy process.

In the meantime, the passage of a package of financial reform bills had also been stalled by disagreements within the ruling party. Once the crisis broke, their passage became an important signal of government commitment to resolving the crisis, but neither the ruling party's presidential candidate nor the opposition had any incentive to cooperate with the government in getting the legislation passed. It was in this politically-charged environment that the IMF's initial program failed to take hold and had to be revised immediately following the election.

In the light of these initial problems, the crisis generated disaffection with incumbents and led to changes in government. In Thailand, the fall of the Chavalit government led to the formation of a new government led by the Democrats. They also had to form a multi-party coalition, but the crisis allowed the Democrats to maintain control over the key economic portfolios. The new government was able to take decisive action on several fronts, most notably in the swift closure of virtually all of the suspended finance companies and the strengthening of the agency with responsibility for managing the disposition of their assets.

The new government, however, was not altogether immune from the constraints that had plagued its predecessor. The legislative process required review of legislation by a Senate populated with businessmen with a direct stake in important reform legislation, which they sought to modify and delay. Divisions both within the

coalition and within the Democrats in the cabinet slowed the introduction of a number of important reform measures for over a year, including new laws governing foreign investment and bankruptcy.

In Korea, by contrast, Kim Dae Jung was an outsider without the same ties to large corporations as his predecessor. He aggressively exploited his electoral honeymoon to pass a number of important reforms, including the same package of financial bills that had languished under Kim Young Sam and a range of reforms of corporate governance. As a result, Korea's recovery from the crisis was much faster than that of other countries in the region.

Malaysia

Malaysia's political system is difficult to categorize. On the one hand, its dominant-party system is more institutionalized and pluralistic than in Indonesia under Suharto, and the dominant party is subject to some electoral constraints and internal competition. But when the crisis struck in mid-1997, it did not face substantial challenges from coalition partners or the opposition, who were weak, nor from elections, which were not due until 2000. Moreover, the political leadership had not shied away from using intimidation and control of the legal system to blunt protest and opposition in the past.

Mahathir had built his political base on an affirmative-action policy that favored the development of the indigenous Malay private sector, although a number of Malaysian Chinese firms benefited from his policies as well. From the outset of the crisis, Mahathir took a nationalist response to the crisis and avoided recourse to the IMF. He argued that the crisis was a result of "speculators" and hedge funds, and hinted that capital controls — limits on both inflows and outflows of investment — might be required. Investors naturally feared that such controls would trap them in the Malaysian market. As a result, Mahathir's speeches created profound market uncertainties that contributed to the rapid decline of the ringgit in the second half of 1997. Efforts to bail out politically-favored companies added to this uncertainty.

In December, Mahathir reversed course by delegating authority to Deputy Prime Minister Anwar, who introduced an "IMF program without the IMF." For the next six months, policy seesawed between

Anwar's more orthodox views and those of Mahathir and his allies. These disagreements were related to the question of succession. Anwar's position as Deputy Prime Minister suggested that he would ultimately take over leadership of the party, and with it the position of prime minister. Following the fall of Suharto in May 1998, Anwar appeared to issue a more direct challenge to Mahathir, believing that the time was ripe for a "reformasi" movement that would champion political and economic reform and an attack on corruption. But the Prime Minister was able to rally the ruling party, sideline Anwar, and ultimately have him arrested and convicted on charges of corruption relating to a purported sexual scandal. As this political drama was unfolding, Mahathir also dismissed the Central Bank governor, took over the finance portfolio, and on September 1, 1998 — the day before sacking Anwar — imposed capital controls.

Indonesia

Although Malaysia followed a somewhat erratic and ultimately heterodox course, the existence of a dominant party and strong bases of private-sector and Malay support allowed Mahathir to consolidate his authority. In Indonesia, by contrast, Suharto initially cleaved closely to the IMF proposal and was initially seen as enjoying some of the "advantages" of a tough dictatorship. He responded quickly to the crisis by freeing the rupiah rather than subjecting the country to a costly defense, and initiated a number of reforms, some of which appeared to cut against the interests of cronies and family members.

But within months of these initiatives, Suharto began to undertake a number of rearguard actions that worked at cross-purposes, including several costly investment projects and damaging financial support to a number of crony banks following a mismanaged bank's closure in November. In December, Suharto failed to participate in an important international meeting, and rumors circulated that he was in poor health (it was later revealed that he had had a stroke).

In democracies, such rumors can be unsettling, but in a system as highly centralized as Indonesia's, where succession procedures are highly uncertain, they threatened the very regime and the entire set of property rights that went with it. Even before a controversial bud-

get speech in January, it was clear that Indonesia was experiencing much greater difficulties than other countries in the region. Suharto's choice of B. J. Habibie — an engineer with a record of strong support for interventionist industrial policy — as vice president in February created alarm among investors. In the spring, opposition to the Suharto regime mounted steadily. While other countries had begun to see some stabilization of exchange rates, Indonesia continued to experience high volatility. The opposition to the regime crested in mid-May, with riots in Jakarta that killed as many as 2,000 people and that resulted in Suharto's ouster. On all indicators, Indonesia fared worse than other countries in the region.

Theoretical Issues

The origins of financial crises are complex and cannot be reduced to any single factor. The East Asian countries pursued a risky exchange rate strategy, particularly as they opened their capital accounts to short-term capital flows. The increasing financial and trade integration of the Asia-Pacific region meant that once a crisis struck one country, it spread to others as well. The lessons to be drawn from this version of the crisis are that countries need to be extremely cautious in their choice of exchange rate regime and the opening of their capital accounts.

On a deeper level, however, the patterns of domestic investment associated with these large-scale capital inflows — whether in plant and equipment, real estate, or the stock market — suggest that the depth of the crisis cannot be attributed to international capital movements alone. Weak and poorly-regulated financial sectors bear some substantial responsibility for increasing national vulnerability, as do corporations characterized by weak systems of governance and accountability and, in some cases, outright corruption.

But financial crises also have a political dimension. How do different debtor governments respond to the risks that might generate crises? Does the political behavior of the government directly or indirectly affect the propensity to crisis? How do debtor governments respond once crisis erupts?

One of the most difficult questions is whether the economic con-

sequences of government action are determined completely by the appropriateness of the policy chosen: whether policy is "good" or "bad" given the circumstances. It is clear with the benefit of hindsight that the IMF miscalculated the depth of the recessions that followed the crisis, and thus held to a tight monetary and fiscal policy stance for somewhat longer than they should have. There is also evidence that they miscalculated the extent of the damage in the domestic financial sectors of the affected countries.

However, given the IMF's limited resources and its inability to force resources out of creditors, some macroeconomic policy adjustments were inevitable even without the IMF. Indeed, without the IMF — and in the absence either of some alternative source of funds or the willingness to default — those adjustments would have been even harsher.

Moreover, it is important to underscore two components to the policy choices of governments: the appropriateness of the policy given the circumstances, and the assessment by market actors of government intentions and capabilities. Clearly, politics affects these assessments.

Finally, we have seen that, while creditors have certain common interests in repayment, politics can also affect their policy choices as well; neither all debtors nor all creditors are alike. Given the creditors' influence over the international financial institutions, an interesting question to ponder is how — and if — the major powers are likely to reconfigure the international financial architecture in the wake of the Asian financial crisis.

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NOTES

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SOURCE

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DEBATE QUESTIONS

Prior to the crisis, the Thai government kept its currency at a fixed or "pegged" rate. What does this mean? Why was this policy attractive to investors? Why did the crisis force the government to abandon this policy, and what were the consequent effects on other countries?

When the crisis erupted, the United States did not take significant direct action to relieve Thailand, but instead relied on international organizations (e.g., the IMF) to provide relief. Why was the U.S. reluctant to become directly involved? What political considerations shaped U.S. policy?

In what ways did Japan's economic condition differ from that of the United States? What problems did the U.S. see in the Japanese economy? What was the Japanese response to the crisis, and why did the U.S. object to it?

The author argues that the economic crisis was intertwined with the political situations in the countries involved. Specifically, domestic politics affected the way that governments responded to the crisis after it occurred. How does the author characterize the government and its actions in Thailand? In Korea? In Malaysia? In Indonesia?

The author concludes that it was not simply the movement of capital markets that caused the crisis in East Asia. What does he see as other contributing causes? What evidence leads him to this conclusion?

What I Learned At The World Economic Crisis

by Joseph Stiglitz

Next week's meeting of the International Monetary Fund will bring to Washington, D.C., many of the same demonstrators who trashed the World Trade Organization in Seattle last fall. They'll say the IMF is arrogant. They'll say the IMF doesn't really listen to the developing countries it is supposed to help. They'll say the IMF is secretive and insulated from democratic accountability. They'll say the IMF's economic "remedies" often make things worse — turning slowdowns into recessions and recessions into depressions.

And they'll have a point. I was chief economist at the World Bank from 1996 until last November, during the gravest global economic crisis in a half-century. I saw how the IMF, in tandem with the U.S. Treasury Department, responded. And I was appalled.

The global economic crisis began in Thailand, on July 2, 1997. The countries of East Asia were coming off a miraculous three decades: incomes had soared, health had improved, poverty had fallen dramatically. Not only was literacy now universal, but, on international science and math tests, many of these countries outperformed the United States. Some had not suffered a single year of recession in 30 years.

But the seeds of calamity had already been planted. In the early '90s, East Asian countries had liberalized their financial and capital markets — not because they needed to attract more funds (savings rates were already 30 percent or more) but because of international pressure, including some from the U.S. Treasury Department. These changes provoked a flood of short-term capital — that is, the kind of

capital that looks for the highest return in the next day, week, or month, as opposed to long-term investment in things like factories. In Thailand, this short-term capital helped fuel an unsustainable real estate boom. And, as people around the world (including Americans) have painfully learned, every real estate bubble eventually bursts, often with disastrous consequences. Just as suddenly as capital flowed in, it flowed out. And, when everybody tries to pull their money out at the same time, it causes an economic problem. A big economic problem.

The last set of financial crises had occurred in Latin America in the 1980s, when bloated public deficits and loose monetary policies led to runaway inflation. There, the IMF had correctly imposed fiscal austerity (balanced budgets) and tighter monetary policies, demanding that governments pursue those policies as a precondition for receiving aid. So, in 1997 the IMF imposed the same demands on Thailand. Austerity, the fund's leaders said, would restore confidence in the Thai economy. As the crisis spread to other East Asian nations — and even as evidence of the policy's failure mounted — the IMF barely blinked, delivering the same medicine to each ailing nation that showed up on its doorstep.

I thought this was a mistake. For one thing, unlike the Latin American nations, the East Asian countries were already running budget surpluses. In Thailand, the government was running such large surpluses that it was actually starving the economy of much-needed investments in education and infrastructure, both essential to economic growth. And the East Asian nations already had tight monetary policies, as well: inflation was low and falling. (In South Korea, for example, inflation stood at a very respectable four percent.) The problem was not imprudent government, as in Latin America; the problem was an imprudent private sector — all those bankers and borrowers, for instance, who'd gambled on the real estate bubble.

Under such circumstances, I feared, austerity measures would not revive the economies of East Asia — it would plunge them into recession or even depression. High interest rates might devastate highly indebted East Asian firms, causing more bankruptcies and defaults. Reduced government expenditures would only shrink the economy further.

So I began lobbying to change the policy. I talked to Stanley Fischer, a distinguished former Massachusetts Institute of Technology economics professor and former chief economist of the World Bank, who had become the IMF's first deputy managing director. I met with fellow economists at the World Bank who might have contacts or influence within the IMF, encouraging them to do everything they could to move the IMF bureaucracy.

Convincing people at the World Bank of my analysis proved easy; changing minds at the IMF was virtually impossible. When I talked to senior officials at the IMF — explaining, for instance, how high interest rates might increase bankruptcies, thus making it even harder to restore confidence in East Asian economies — they would at first resist. Then, after failing to come up with an effective counterargument, they would retreat to another response: if only I understood the pressure coming from the IMF board of executive directors — the body, appointed by finance ministers from the advanced industrial countries, that approves all the IMF's loans. Their meaning was clear. The board's inclination was to be even more severe; these people were actually a moderating influence. My friends who were executive directors said they were the ones getting pressured. It was maddening, not just because the IMF's inertia was so hard to stop but because, with everything going on behind closed doors, it was impossible to know who was the real obstacle to change. Was the staff pushing the executive directors, or were the executive directors pushing the staff? I still do not know for certain.

Of course, everybody at the IMF assured me they would be flexible: if their policies really turned out to be overly contractionary, forcing the East Asian economies into deeper recession than necessary, then they would reverse them. This sent shudders down my spine. One of the first lessons economists teach their graduate students is the importance of lags: it takes twelve to 18 months before a change in monetary policy (raising or lowering interest rates) shows its full effects. When I worked in the White House as chairman of the Council of Economic Advisers, we focused all our energy on forecasting where the economy would be in the future, so we could know what policies to recommend today. To play catch-up was the height of folly. And

that was precisely what the IMF officials were proposing to do.

I shouldn't have been surprised. The IMF likes to go about its business without outsiders asking too many questions. In theory, the fund supports democratic institutions in the nations it assists. In practice, it undermines the democratic process by imposing policies. Officially, of course, the IMF doesn't "impose" anything. It "negotiates" the conditions for receiving aid. But all the power in the negotiations is on one side — the IMF's — and the fund rarely allows sufficient time for broad consensus-building or even widespread consultations with either parliaments or civil society. Sometimes the IMF dispenses with the pretense of openness altogether and negotiates secret covenants.

When the IMF decides to assist a country, it dispatches a "mission" of economists. These economists frequently lack extensive experience in the country; they are more likely to have firsthand knowledge of its five-star hotels than of the villages that dot its countryside. They work hard, poring over numbers deep into the night. But their task is impossible. In a period of days or, at most, weeks, they are charged with developing a coherent program sensitive to the needs of the country. Needless to say, a little number-crunching rarely provides adequate insights into the development strategy for an entire nation. Even worse, the number-crunching isn't always that good. The mathematical models the IMF uses are frequently flawed or out-of-date. Critics accuse the institution of taking a cookie-cutter approach to economics, and they're right. Country teams have been known to compose draft reports before visiting. I heard stories of one unfortunate incident when team members copied large parts of the text for one country's report and transferred them wholesale to another. They might have gotten away with it, except the "search and replace" function on the word processor didn't work properly, leaving the original country's name in a few places. Oops.

It's not fair to say that IMF economists don't care about the citizens of developing nations. But the older men who staff the fund — and they are overwhelmingly older men — act as if they are shouldering Rudyard Kipling's white man's burden. IMF experts believe they are brighter, more educated, and less politically motivated than the economists in the countries they visit. In fact, the economic leaders

from those countries are pretty good — in many cases brighter or better-educated than the IMF staff, which frequently consists of third-rank students from first-rate universities. (Trust me: I've taught at Oxford University, MIT, Stanford University, Yale University, and Princeton University, and the IMF almost never succeeded in recruiting any of the best students.) Last summer, I gave a seminar in China on competition policy in telecommunications. At least three Chinese economists in the audience asked questions as sophisticated as the best minds in the West would have asked.

As time passed, my frustration mounted. (One might have thought that since the World Bank was contributing literally billions of dollars to the rescue packages, its voice would be heard. But it was ignored almost as resolutely as the people in the affected countries.) The IMF claimed that all it was asking of the East Asian countries was that they balance their budgets at a time of recession. All? Hadn't the Clinton administration just fought a major battle with Congress to stave off a balanced-budget amendment in this country? And wasn't the administration's key argument that, in the face of recession, a little deficit spending might be necessary? This is what I and most other economists had been teaching our graduate students for 60 years. Quite frankly, a student who turned in the IMF's answer to the test question "What should be the fiscal stance of Thailand, facing an economic downturn?" would have gotten an F.

As the crisis spread to Indonesia, I became even more concerned. New research at the World Bank showed that recession in such an ethnically divided country could spark all kinds of social and political turmoil. So in late 1997, at a meeting of finance ministers and central-bank governors in Kuala Lumpur, I issued a carefully prepared statement vetted by the World Bank: I suggested that the excessively contractionary monetary and fiscal program could lead to political and social turmoil in Indonesia. Again, the IMF stood its ground. The fund's managing director, Michel Camdessus, said there what he'd said in public: that East Asia simply had to grit it out, as Mexico had. He went on to note that, for all of the short-term pain, Mexico emerged from the experience stronger.

But this was an absurd analogy. Mexico hadn't recovered because the

IMF forced it to strengthen its weak financial system, which remained weak years after the crisis. It recovered because of a surge of exports to the United States, which took off thanks to the U.S. economic boom, and because of NAFTA. By contrast, Indonesia's main trading partner was Japan — which was then, and still remains, mired in the doldrums. Furthermore, Indonesia was far more politically and socially explosive than Mexico, with a much deeper history of ethnic strife. And renewed strife would produce massive capital flight (made easy by relaxed currency-flow restrictions encouraged by the IMF). But none of these arguments mattered. The IMF pressed ahead, demanding reductions in government spending. And so subsidies for basic necessities like food and fuel were eliminated at the very time when contractionary policies made those subsidies more desperately needed than ever.

By January 1998, things had gotten so bad that the World Bank's vice president for East Asia, Jean Michel Severino, invoked the dreaded r-word ("recession") and d-word ("depression") in describing the economic calamity in Asia. Lawrence Summers, then deputy treasury secretary, railed against Severino for making things seem worse than they were, but what other way was there to describe what was happening? Output in some of the affected countries fell 16 percent or more. Half the businesses in Indonesia were in virtual bankruptcy or close to it, and, as a result, the country could not even take advantage of the export opportunities the lower exchange rates provided. Unemployment soared, increasing as much as tenfold, and real wages plummeted — in countries with basically no safety nets. Not only was the IMF not restoring economic confidence in East Asia, it was undermining the region's social fabric. And then, in the spring and summer of 1998, the crisis spread beyond East Asia to the most explosive country of all — Russia.

The calamity in Russia shared key characteristics with the calamity in East Asia — not least among them the role that IMF and U.S. Treasury policies played in abetting it. But, in Russia, the abetting began much earlier. Following the fall of the Berlin Wall, two schools of thought had emerged concerning Russia's transition to a market economy. One of these, to which I belonged, consisted of a melange of experts on the region, Nobel Prize winners like Kenneth Arrow and others.

This group emphasized the importance of the institutional infrastructure of a market economy — from legal structures that enforce contracts to regulatory structures that make a financial system work. Arrow and I had both been part of a National Academy of Sciences group that had, a decade earlier, discussed with the Chinese their transition strategy. We emphasized the importance of fostering competition — rather than just privatizing state-owned industries — and favored a more gradual transition to a market economy (although we agreed that occasional strong measures might be needed to combat hyperinflation).

The second group consisted largely of macroeconomists, whose faith in the market was unmatched by an appreciation of the subtleties of its underpinnings — that is, of the conditions required for it to work effectively. These economists typically had little knowledge of the history or details of the Russian economy and didn't believe they needed any. The great strength, and the ultimate weakness, of the economic doctrines upon which they relied is that the doctrines are — or are supposed to be — universal. Institutions, history, or even the distribution of income simply do not matter. Good economists know the universal truths and can look beyond the array of facts and details that obscure these truths. And the universal truth is that shock therapy works for countries in transition to a market economy: the stronger the medicine (and the more painful the reaction), the quicker the recovery. Or so the argument goes.

Unfortunately for Russia, the latter school won the debate in the Treasury Department and in the IMF. Or, to be more accurate, the Treasury Department and the IMF made sure there was no open debate and then proceeded blindly along the second route. Those who opposed this course were either not consulted or not consulted for long. On the Council of Economic Advisers, for example, there was a brilliant economist, Peter Orszag, who had served as a close adviser to the Russian government and had worked with many of the young economists who eventually assumed positions of influence there. He was just the sort of person whose expertise Treasury and the IMF needed. Yet, perhaps because he knew too much, they almost never consulted him.

We all know what happened next. In the December 1993 elec-

tions, Russian voters dealt the reformers a huge setback, a setback from which they have yet really to recover. Strobe Talbott, then in charge of the noneconomic aspects of Russia policy, admitted that Russia had experienced "too much shock and too little therapy." And all that shock hadn't moved Russia toward a real market economy at all. The rapid privatization urged upon Moscow by the IMF and the Treasury Department had allowed a small group of oligarchs to gain control of state assets. The IMF and Treasury had rejiggered Russia's economic incentives, all right — but the wrong way. By paying insufficient attention to the institutional infrastructure that would allow a market economy to flourish — and by easing the flow of capital in and out of Russia — the IMF and Treasury had laid the groundwork for the oligarchs' plundering. While the government lacked the money to pay pensioners, the oligarchs were sending money obtained by stripping assets and selling the country's precious national resources into Cypriot and Swiss bank accounts.

The United States was implicated in these awful developments. In mid-1998, Summers, soon to be named Robert Rubin's successor as secretary of the treasury, actually made a public display of appearing with Anatoly Chubais, the chief architect of Russia's privatization. In so doing, the United States seemed to be aligning itself with the very forces impoverishing the Russian people. No wonder anti-Americanism spread like wildfire.

At first, Talbott's admission notwithstanding, the true believers at Treasury and the IMF continued to insist that the problem was not too much therapy but too little shock. But, through the mid-'90s, the Russian economy continued to implode. Output plummeted by half. While only two percent of the population had lived in poverty even at the end of the dismal Soviet period, "reform" saw poverty rates soar to almost 50 percent, with more than half of Russia's children living below the poverty line. Only recently have the IMF and Treasury conceded that therapy was undervalued — though they now insist they said so all along.

Today, Russia remains in desperate shape. High oil prices and the long-resisted ruble devaluation have helped it regain some footing. But standards of living remain far below where they were at the start

of the transition. The nation is beset by enormous inequality, and most Russians, embittered by experience, have lost confidence in the free market. A significant fall in oil prices would almost certainly reverse what modest progress has been made.

East Asia is better off, though it still struggles, too. Close to 40 percent of Thailand's loans are still not performing; Indonesia remains deeply mired in recession. Unemployment rates remain far higher than they were before the crisis, even in East Asia's best-performing country, Korea. IMF boosters suggest that the recession's end is a testament to the effectiveness of the agency's policies. Nonsense. Every recession eventually ends. All the IMF did was make East Asia's recessions deeper, longer, and harder. Indeed, Thailand, which followed the IMF's prescriptions the most closely, has performed worse than Malaysia and South Korea, which followed more independent courses.

I was often asked how smart — even brilliant — people could have created such bad policies. One reason is that these smart people were not using smart economics. Time and again, I was dismayed at how out-of-date — and how out-of-tune with reality — the models Washington economists employed were. For example, microeconomic phenomena such as bankruptcy and the fear of default were at the center of the East Asian crisis. But the macroeconomic models used to analyze these crises were not typically rooted in microfoundations, so they took no account of bankruptcy.

But bad economics was only a symptom of the real problem: secrecy. Smart people are more likely to do stupid things when they close themselves off from outside criticism and advice. If there's one thing I've learned in government, it's that openness is most essential in those realms where expertise seems to matter most. If the IMF and Treasury had invited greater scrutiny, their folly might have become much clearer, much earlier. Critics from the right, such as Martin Feldstein, chairman of Reagan's Council of Economic Advisers, and George Shultz, Reagan's secretary of state, joined Jeff Sachs, Paul Krugman, and me in condemning the policies. But, with the IMF insisting its policies were beyond reproach — and with no institutional structure to make it pay attention — our criticisms were of little use. More frightening, even internal critics, particularly those

with direct democratic accountability, were kept in the dark. The Treasury Department is so arrogant about its economic analyses and prescriptions that it often keeps tight — much too tight — control over what even the president sees.

Open discussion would have raised profound questions that still receive very little attention in the American press: To what extent did the IMF and the Treasury Department push policies that actually contributed to the increased global economic volatility? (Treasury pushed liberalization in Korea in 1993 over the opposition of the Council of Economic Advisers. Treasury won the internal White House battle, but Korea, and the world, paid a high price.) Were some of the IMF's harsh criticisms of East Asia intended to detract attention from the agency's own culpability? Most importantly, did America — and the IMF — push policies because we, or they, believed the policies would help East Asia or because we believed they would benefit financial interests in the United States and the advanced industrial world? And, if we believed our policies were helping East Asia, where was the evidence? As a participant in these debates, I got to see the evidence. There was none.

Since the end of the cold war, tremendous power has flowed to the people entrusted to bring the gospel of the market to the far corners of the globe. These economists, bureaucrats, and officials act in the name of the United States and the other advanced industrial countries, and yet they speak a language that few average citizens understand and that few policymakers bother to translate. Economic policy is today perhaps the most important part of America's interaction with the rest of the world. And yet the culture of international economic policy in the world's most powerful democracy is not democratic.

This is what the demonstrators shouting outside the IMF next week will try to say. Of course, the streets are not the best place to discuss these highly complex issues. Some of the protesters are no more interested in open debate than the officials at the IMF are. And not everything the protesters say will be right. But, if the people we entrust to manage the global economy — in the IMF and in the Treasury Department — don't begin a dialogue and take their criticisms to heart, things will continue to go very, very wrong. I've seen it happen.

DEBATE QUESTIONS

Economists have proposed various causes for the East Asia crisis; here, the author cites one primary cause. What is it, and how, in his opinion, did it trigger the crisis?

The author says that he believed that the policy of the IMF, formed in response to the crisis, was "mistaken." What was that policy? Why was it formulated? What made it a mistake, according to the author?

The author asserts that the task of the IMF is "impossible." What practices, in his view, keep the IMF from formulating effective policies?

The director of the IMF, says the author, drew a parallel between the crisis in Asia and an earlier crisis in Mexico, suggesting that the same policy would produce the same results. The author finds this analogy unsound. Why?

The economic policies of the IMF helped to destabilize the political system in Indonesia, the author argues. Why does he think so? Why does he think that U.S. economic policies had a similarly destabilizing effect on Russia?

NOTES

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SOURCE

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The Asian Crisis: A View from the IMF

by Stanley Fischer

Remarks at the Midwinter Conference of the Bankers' Association for Foreign Trade
Washington, D.C.,
January 22, 1998

As the crisis has unfolded in Asia, the IMF has become, at least for this brief moment in history, almost a household name. But even if the institution has become more well known, its role in Asia and more broadly in the world economy is not widely understood. Thus, I am very pleased to have this opportunity to discuss the Asian crisis, what the IMF is doing to help contain it, and the institution's wider role in the international monetary system.

Asia's economic success

The crisis in Asia has occurred after several decades of outstanding economic performance. Annual GDP growth in the ASEAN-5 (Indonesia, Malaysia, the Philippines, Singapore, and Thailand) averaged close to 8 percent over the last decade. Indeed, during the 30 years preceding the crisis per capita income levels had increased tenfold in Korea, fivefold in Thailand, and fourfold in Malaysia. Moreover, per capita income levels in Hong Kong and Singapore now exceed those in some industrial countries. Until the current crisis, Asia attracted almost half of total capital inflows to developing

countries — nearly $100 billion in 1996. In the last decade, the share of developing and emerging market economies of Asia in world exports has nearly doubled to almost one fifth of the total.

This record growth and strong trade performance is unprecedented, a remarkable historical achievement. Moreover, Asia's success has also been good for the rest of the world. The developing and emerging market economies of Asia have not just been major exporters; they have been an increasingly important market for other countries' exports. For example, these countries bought about 19 percent of U.S. exports in 1996, up from about 15 percent in 1990. Likewise, the dynamism of these economies helped cushion the impact of successive downturns in industrial economies on the world economy during 1991-93. In recent years, they have also been a source of attractive investment returns. For all these reasons, the developing and emerging market economies of Asia have been a major engine of growth in the world economy.

So what went wrong? Let me start with the common underlying factors.

The origins of the crisis

The key domestic factors that led to the present difficulties appear to have been: first, the failure to dampen overheating pressures that had become increasingly evident in Thailand and many other countries in the region and were manifested in large external deficits and property and stock market bubbles; second, the maintenance of pegged exchange rate regimes for too long, which encouraged external borrowing and led to excessive exposure to foreign exchange risk in both the financial and corporate sectors; and third, lax prudential rules and financial oversight, which led to a sharp deterioration in the quality of banks' loan portfolios. As the crises unfolded, political uncertainties and doubts about the authorities' commitment and ability to implement the necessary adjustment and reforms exacerbated pressures on currencies and stock markets. Reluctance to tighten monetary conditions and to close insolvent financial institutions has clearly added to the turbulence in financial markets.

Although the problems in these countries were mostly home-

grown, developments in the advanced economies and global financial markets contributed significantly to the buildup of the imbalances that eventually led to the crises. Specifically, with Japan and Europe experiencing weak growth since the beginning of the 1990s, attractive domestic investment opportunities have fallen short of available saving; meanwhile, monetary policy has remained appropriately accommodative, and interest rates have been low. Large private capital flows to emerging markets, including the so-called "carry trade," were driven, to an important degree, by these phenomena and by an imprudent search for high yields by international investors without due regard to potential risks. Also contributing to the buildup to the crisis were the wide swings of the yen/dollar exchange rate over the past three years.

The crisis erupted in Thailand in the summer. Starting in 1996, a confluence of domestic and external shocks revealed weaknesses in the Thai economy that until then had been masked by the rapid pace of economic growth and the weakness of the U.S. dollar to which the Thai currency, the baht, was pegged. To an extent, Thailand's difficulties resulted from its earlier economic success. Strong growth, averaging almost 10 percent per year from 1987-95, and generally prudent macroeconomic management, as seen in continuous public sector fiscal surpluses over the same period, had attracted large capital inflows, much of them short-term — and many of them attracted by the establishment of the Bangkok International Banking Facility in 1993. And while these inflows had permitted faster growth, they had also allowed domestic banks to expand lending rapidly, fueling imprudent investments and unrealistic increases in asset prices. Past success also may also have contributed to a sense of denial among the Thai authorities about the severity of Thailand's problems and the need for policy action, which neither the IMF in its continuous dialogue with the Thais during the 18 months prior to the floating of the baht last July, nor increasing exchange market pressure, could overcome. Finally, in the absence of convincing policy action, and after a desperate defense of the currency by the central bank, the crisis broke.

Contagion to other economies in the region appeared relentless.

Some of the contagion reflected rational market behavior. The depreciation of the baht could be expected to erode the competitiveness of Thailand's trade competitors, and this put some downward pressure on their currencies. Moreover, after their experience in Thailand, markets began to take a closer look at the problems in Indonesia, Korea, and other neighboring countries. And what they saw to different degrees in different countries were some of the same problems as in Thailand, particularly in the financial sector. Added to this was the fact that as currencies continued to slide, the debt service costs of the domestic private sector increased. Fearful about how far this process might go, domestic residents rushed to hedge their external liabilities, thereby intensifying exchange rate pressures. But the amount of exchange rate adjustment that has taken place far exceeds any reasonable estimate of what might have been required to correct the initial overvaluation of the Thai baht, the Indonesian rupiah, and the Korean won, among other currencies. In this respect, markets have overreacted.

So, in many respects, Thailand, Indonesia and Korea do face similar problems. They all have suffered a loss of confidence, and their currencies are deeply depreciated. Moreover, in each country, weak financial systems, excessive unhedged foreign borrowing by the domestic private sector, and a lack of transparency about the ties between government, business, and banks have both contributed to the crisis and complicated efforts to defuse it.

But the situations in these countries also differ in important ways. One notable difference is that Thailand was running an exceptionally large (8 percent of GDP) current account deficit, while Korea's was on a downward path, and Indonesia's was already at a more manageable level ($3^1/_4$ percent of GDP). These countries also called in the IMF at different stages of their crises. Thailand called on the IMF when the central bank had nearly run out of usable reserves. Korea came still closer to catastrophe, a situation which has improved following the election of Kim Dae-Jung, the forceful implementation of the IMF-supported program even before he takes office, and the start of discussions with commercial banks on the rollover of Korea's short-term debt.

Indonesia, on the other hand, requested IMF assistance at an earlier stage, and at the start — in early November — the reform program seemed to be working well. But questions about the implementation of the program and the President's health, as well as contagion from Korea, all took their toll. Last week, after intense consultations and negotiations with the IMF, President Suharto decided to accelerate the reform program. Important measures to deal with banking sector difficulties and to increase confidence in the banks should be announced in the next few days. Corporate sector debt difficulties will have to be dealt with in a way that preserves the principle that the solution is primarily up to individual debtors and their creditors. The Philippines, for its part, has not escaped the turmoil, but its decision to extend the IMF-supported program that it had already been implementing successfully for several years has helped mitigate the effects of the crisis.

IMF-supported Programs in Asia

The design of the IMF-supported programs in these countries reflects these similarities and differences. All three programs have called for a substantial rise in interest rates to attempt to halt the downward spiral of currency depreciation. And all three programs have called for forceful, up-front action to put the financial system on a sounder footing as soon as possible.

To this end, non-viable institutions are being closed down, and other institutions are required to come up with restructuring plans and comply — within a reasonable period that varies according to country circumstances — with internationally accepted best practices, including the Basle capital adequacy standards and internationally accepted accounting practices and disclosure rules. Institutional changes are under way to strengthen financial sector regulation and supervision, increase transparency in the corporate and government sectors, create a more level playing field for private sector activity, and open Asian markets to foreign participants. Needless to say, all of these reforms will require a vast change in domestic business practices, corporate culture, and government behavior, which will take time. But the process is in motion, and already some dramatic steps have been taken.

The fiscal programs vary from country to country. In each case, the IMF asked for a fiscal adjustment that would cover the carrying costs of financial sector restructuring — the full cost of which is being spread over many years — and to help restore a sustainable balance of payments. In Thailand, this translated into an initial fiscal adjustment of 3 percent of GDP; in Korea, 1½ percent of GDP; and in Indonesia, 1 percent of GDP, much of which will be achieved by reducing public investment in projects with low economic returns.

Some have argued that these programs are too tough, either in calling for higher interest rates, tightening government budget deficits, or closing down financial institutions. Let's take the question of interest rates first. By the time these countries approached the IMF, the value of their currencies was plummeting, and in the case of Thailand and Korea, reserves were perilously low. Thus, the first order of business was, and still is, to restore confidence in the currency. Here, I would like to dispel the notion that the deep currency depreciations seen in Asia in recent months have occurred by IMF design. On the contrary, as I noted a moment ago, we believe that currencies have depreciated far more than is warranted or desirable. Moreover, without IMF support as part of an international effort to stabilize these economies, it is likely that these currencies would have lost still more of their value. To reverse this process, countries have to make it more attractive to hold domestic currency, and that means temporarily raising interest rates, even if this complicates the situation of weak banks and corporations. This is a key lesson of the "tequila crisis" in Latin America 1994-95, as well as from the more recent experience of Brazil, Hong Kong, and the Czech Republic, all of which have fended off attacks on their currencies over the past few months with a timely and forceful tightening of interest rates along with other supporting policy measures. Once confidence is restored, interest rates should return to more normal levels.

Let me add that companies with substantial foreign currency debts are likely to suffer far more from a long, steep slide in the value of their domestic currency than from a temporary rise in domestic interest rates. Moreover, when interest rate action is delayed, confidence continues to erode. Thus, the increase in interest rates needed to sta-

bilize the situation is likely to be far larger than if decisive action had been taken at the outset. Indeed, the reluctance to tighten interest rates in a determined way at the beginning has been one of the factors perpetuating the crisis. Higher interest rates should also encourage the corporate sector to restructure its financing away from debt and toward equity, which will be most welcome in some cases, such as Korea.

Other observers have advocated more expansionary fiscal programs to offset the inevitable slowdown in economic growth. The balance here is a fine one. As already noted, at the outset of the crisis, countries need to firm their fiscal positions, to deal both with the future costs of financial restructuring and — depending on the balance of payments situation — the need to reduce the current account deficit. Beyond that, if the economic situation worsens, the IMF generally agrees with the country to let automatic stabilizers work and the deficit to widen somewhat. However, we cannot remain indifferent to the level of the fiscal deficit, particularly since a country in crisis typically has only limited access to borrowing and since the alternative of printing money would be potentially disastrous in these circumstances.

Likewise, we have been urged not to recommend rapid action on banks. However, it would be a mistake to allow clearly bankrupt banks to remain open, as this would be a recipe for perpetuating the region's financial crisis, not resolving it. The best course is to recapitalize or close insolvent banks, protect small depositors, and require shareholders to take their losses. At the same time, banking regulation and supervision must be improved. Of course, we take individual country circumstances into account in deciding how quickly all of this can be accomplished.

In short, the best approach is to effect a sharp, but temporary, increase in interest rates to stem the outflow of capital, while making a decisive start on the longer-term tasks of restructuring the financial sector, bringing financial sector regulation and supervision up to international standards, and increasing domestic competition and transparency. None of this will be easy, and unfortunately, the pace of economic activity in these economies will inevitably slow. But the

slowdown would be much more dramatic, the costs to the general population much higher, and the risks to the international economy much greater without the assistance of the international community, provided through the IMF, the World Bank, and bilateral sources, including the United States.

Most major industrial countries appear well positioned to absorb the adverse effects of the Asian crisis. In the United States, consumer spending and investment remain strong and incoming data for the fourth quarter point to further robust growth in output and household spending. Consumer confidence remains at or near all-time highs, and the unemployment rate stood at 4.7 percent in December, only slightly above the November rate of 4.6 percent, which was the lowest rate in 24 years. Direct measures of prices indicate that inflationary pressures are receding, and the strong dollar and weak import and commodity prices suggest that this trend will continue for a while longer. Nevertheless, it does not take a great deal of imagination to see how the problems in Asia could take on larger proportions, with more profound effects on global growth and financial market stability. That is why the international community has decided to work together through the IMF to try to overcome the crisis in a way that does the least damage to the global economy.

Moral Hazard

Of course, not everyone agrees with the international community's approach of trying to cushion the effects of such crises. Some say that it would be better simply to let the chips fall where they may, arguing that to come to the assistance of countries in crisis will only encourage more reckless behavior on the part of borrowers and lenders. I do not share the view that we should step aside in these cases. To begin with, the notion that the availability of IMF programs encourages reckless behavior by countries is far-fetched: no country would deliberately court such a crisis even if it thought international assistance would be forthcoming. The economic, financial, social, and political pain is simply too great; nor do countries show any great desire to enter IMF programs unless they absolutely have to.

On the side of the lenders, despite the constant talk of bailouts,

most investors have made substantial losses in the crisis. With stock markets and exchange rates plunging, foreign equity investors have lost nearly three-quarters of the value of their equity holdings in some Asian markets. Many firms and financial institutions in these countries will go bankrupt, and their foreign and domestic lenders will share in the losses. International banks are also sharing in the cost of the crisis. Some lenders may be forced to write down their claims, especially against corporate borrowers. In addition, foreign commercial banks are having to roll over their loans at a time when they would not normally choose to do so. And although some banks may benefit from higher interest rates on their rollovers than they would otherwise receive, the fourth quarter earnings reports now becoming available indicate that, overall, the Asian crisis has indeed been costly for foreign commercial banks.

In effect, we face a trade-off. Faced with a crisis, we could allow it to deepen and possibly teach international lenders a lesson in the process; alternatively, we can step in to do what we can to mitigate the effects of the crisis on the region and the world economy in a way that places some of the burden on borrowers and lenders, although possibly with some undesired side effects. The latter approach — doing what we can to mitigate the crisis — makes more sense. The global interest, and indeed the U.S. interest, lies in an economically strong Asia that imports as well as exports and thereby supports global growth.

Simply letting the chips fall where they may would surely cause more bankruptcies, larger layoffs, deeper recessions, and even deeper depreciations than would otherwise be necessary to put these economies back on a sound footing. The result would not be more prosperity, more open markets and faster adjustment, but rather greater trade and payments restrictions, a more significant downturn in world trade, and slower world growth. That is not in the interest of the United States, nor of any other IMF member.

Role of the IMF

If I am emphatic on that point, it is because the IMF was founded in the hope that establishing a permanent forum for cooperation on international monetary problems would help avoid the competitive devalu-

ations, exchange restrictions, and other destructive economic policies that had contributed to the Great Depression and the outbreak of war. The international economy has changed considerably since then, and so has the IMF. But its primary purposes remain the same; they are (and here I quote from the IMF's Articles of Agreement):

* "to facilitate...the balanced growth of international trade, and to contribute thereby to...high levels of growth and real income" — and we have consistently promoted trade liberalization;
* "to promote exchange rate stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation"; and
* to provide members "with opportunities to correct maladjustments in their balance of payments, without resorting to measures destructive of national or international prosperity."

Our approach to these tasks is straightforward: it is to encourage all members to pursue sound economic policies and to open their economies to trade and investment. It is also to seek to avert crises by keeping close watch on member countries' economies and to warn them when trouble threatens. Sometimes we succeed, in that we warn countries and they take action. Sometimes we warn, but our advice is not followed, even when it is timely and on the mark. And sometimes despite our continuous efforts to strengthen our surveillance over member policies and performance, we might see some of the key elements of an emerging crisis, but fail to draw their full implications. We will continue to seek to strengthen surveillance — but it would be unrealistic to expect that every crisis can be anticipated.

When crisis does strike, the IMF has been willing to act in accordance with its purposes to deal with major problems confronting the international economy. On numerous occasions, the IMF has helped provide the expertise and vision needed to come up with pragmatic solutions to important international monetary problems, and it has helped mobilize the international resources to make them work. This was true during the energy crisis in 1973-74, when the IMF established a mechanism for recycling the surpluses of oil exporters and helping to finance the oil-related deficits of other countries. It was

true in the mid-1980s, when the IMF played a central role in the debt strategy. It was true in 1989 and after, when the IMF helped design and finance the massive effort to help the 26 transition countries cast off the shackles of central planning. And it was true in 1994-95, when the IMF came forward to help avert Mexico's financial collapse — and to prevent the crisis from spilling over into the markets, forcing other countries to resort to exchange controls and debt moratoria, and possibly causing a dramatic disruption in private capital flows to developing countries. Because of the authorities' efforts and IMF support, Mexico's markets remained open and capital continued to flow.

There is no denying that each of these crises has been difficult — especially for the IMF members most adversely affected. In each case we, the IMF and the international community as a whole, learned from our experiences. And in each case, it is clear that without Fund assistance, things would have been much worse. The IMF's effectiveness derives from the fact that as an international institution with a nearly global membership, it can carry on a policy dialogue with member countries and make policy recommendations in situations where a bilateral approach would not be accepted. At the same time, the IMF provides a mechanism for sharing the responsibility of supporting the international monetary system among the entire international community.

IMF Resources

Part of that shared responsibility is to provide resources to the IMF. Let me emphasize that the IMF is not a charitable institution, nor does it carry out its operations at taxpayers' expense. On the contrary, it operates much like a credit union. On joining the IMF, each member country subscribes a sum of money called its quota. Members normally pay 25 percent of their quota subscriptions out of their foreign reserves, the rest in their national currencies. The quota is like a deposit in the credit union, and the country continues to own it. The size of the quota determines the country's voting rights, and the United States, with over 18 percent of the shares, is the largest shareholder. Many key issues require an 85 percent majority, so that the United States effectively has a veto over major Fund decisions.

When a member borrows from the Fund, it exchanges a certain amount of its own national currency for the use of an equivalent amount of currency of a country in a strong external position. The borrowing country pays interest at a floating market rate on the amount it has borrowed, while the country whose currency is being used receives interest. Since the interest received from the IMF is broadly in line with market rates, the provision of financial resources to the Fund has involved little cost, if any, to creditor countries, including the United States.

As you are no doubt aware, the Fund's membership has recently agreed to increase IMF quotas by 45 percent, about $88 billion, which will raise the capital base of the institution to some $284 billion. The United States' share of this increase would be nearly $16 billion. In addition, the Fund has taken steps to augment its financial resources through the agreement on the New Arrangements to Borrow (NAB). Under the NAB, participants would be prepared to lend up to about $45 billion when additional resources are needed to forestall or cope with an impairment of the international monetary system, or to deal with an exceptional situation that poses a threat to the stability of the system.

These are large sums. They are often described as an expense to the taxpayer. We are deeply aware in the IMF that our support derives ultimately from the legislatures that vote to establish their countries' quotas — their deposits — in the IMF. We must justify that support. But it must also be recognized that contributions to the IMF are not fundamentally an expense to the taxpayer; rather, they are investments. They are an investment in the narrow sense that member countries earn interest on their deposits in the IMF. Far more important, they are also an investment in a broader sense, an investment in the stability and the prosperity of the world economy.

NOTES

Stanley Fischer was First Deputy Managing Director of the International Monetary Fund from 1994 to 2001. He is currently Vice Chairman of Citigroup Inc. and President of Citigroup International.

SOURCE

Remarks were prepared for presentation on January 22, 1998. The text appears on the website of the International Monetary Fund, and is reproduced with their permission.

DEBATE QUESTIONS

The author sees three reasons for the eruption of the financial crisis in East Asia. What are these reasons, and what evidence does he use to support them?

The author asserts that the contagion – that is, the spread of the crisis to other countries – was a reflection of "rational market behavior." Why? What would it mean for the market to behave irrationally?

In response to the crisis, the IMF told the countries seeking help that they must raise their interest rates. The author notes that this step was controversial. Why did critics object to it? How does the author defend the logic of the IMF's decision? Similarly, the IMF said that contractionary economic policies should be put in place, while critics advocated expansionary policies. Why does the author think that the IMF plan was wiser?

Some critics have charged that the behavior of the IMF creates "moral hazard" – that is, borrowers (and lenders) take imprudent risks when they feel confident that the IMF will bail them out. The author rejects this reasoning, and argues in favor of IMF intervention. What are his reasons for recurring interventions?

The IMF was created in the final years of WWII, in order to stabilize the economy of the postwar world. Some critics say that it has exceeded its original mandate, and no longer serves the purposes for which it was designed. The author defends the IMF as an institution, and defends its policies. What evidence does he use to argue that the IMF is both necessary and beneficial?

The IMF's Role in Asia: Part of the Problem or Part of the Solution?

by Thomas C. Dawson

Prepared text for remarks at the Institute of Policy Studies and Singapore Management University Forum
Singapore, July 10, 2002

Thank you for the invitation to be here today. I'm happy to get away from the United States for a few days and get a break from all the talk of crony capitalism, lack of transparency, collapsing asset values, and large current account deficits. What a difference five years makes! It is the United States that is going through a time of soul-searching and adjustment, while East Asia appears to be back on track (though I am aware that Singapore, having survived the Asian crisis in relatively good form, has had a tough time the last couple of years as a result of the global economic slowdown).

Let me turn to the theme of today's event. Is the IMF part of the problem or part of the solution? I know it would make my talk quite interesting for you if I said that it is part of the problem, but I'm not ready to retire from the IMF just yet. It would also not be an accurate statement, given the many changes the IMF has made in recent years in the way it does business.

Many of the changes I'll describe were undertaken in response to the lessons learnt from the experience of the Asian crisis. This crisis tested the IMF as never before. Though we had issued, in private,

several yellow flags warning Thailand of an impending crisis, the extent of the downturn in Thailand, and the speed and virulence with which the crisis spread to other countries in the region, was not forecast by us or anyone else. Many questioned our advice to the crisis countries on the appropriate fiscal policy and monetary policy to follow, and the latter remains a topic of intense debate to this day. Some of the conditions attached to the IMF-supported programs were criticized as being so extensive that they strained countries' capacity to implement reforms and tested the bounds of the IMF's expertise. In short, almost every aspect of our core operations came in for scrutiny and criticism.

Let's begin with the causes of the Asian crisis. As work by many scholars, including Professor Tan, has shown, the crisis was the result of the interaction of several factors. According to some, one factor was the zeal shown by the U.S. Treasury and the IMF in encouraging countries to open up to short-term foreign capital in the mid-1990s. These critics say that the entry of foreign capital into, and the subsequent hasty exodus from, economies whose financial and supervisory structures were ill-equipped to regulate and absorb the capital was devastating.

Is this a valid characterization? It's useful to recall a bit of history first. When the IMF was created in 1944, its founders envisioned a world in which trade was free but in which the restrictions on movement of capital across countries then in place were to be retained. In the jargon, current accounts were to be open, but capital accounts highly regulated. Capital account restrictions were considered necessary to support the "Bretton Woods system", the system of fixed exchange rates then in place. There is no denying the vision of the world being promoted by the IMF in the mid-1990s was different: at the 1997 IMF-World Bank meetings the proposal on the table was to amend the IMF's articles of agreement to give it jurisdiction over the liberalization of capital movements.

But while the popular characterization of a greater push toward capital account liberalization is broadly correct, it is inaccurate in many important details. The IMF did not encourage countries to liberalize short-term flows through the banking sector, which is what

turned out to be the Achilles Heel during the Asian crisis. And many countries liberalize for their own reasons rather than as a consequence of external prodding. Thailand, for instance, was keen to have Bangkok emerge as an international financial center like Singapore and Hong Kong; an editorial last week in the Bangkok Post noted that "it was the (Thai) Democrat party that opened up the Pandora's box with the establishment of the Bangkok International Banking Facility, a pompous name for a good idea that went wildly wrong."

Nevertheless, as a result of the criticism received during and after the crisis, the IMF is more vocal in pointing out the risks of rapid capital account liberalization. While such cautionary notes have always been present in IMF advice, today they are much more likely to be given greater prominence. For instance, six weeks ago, although unnoticed by anyone in the international media but the Dow Jones newswires, we advised Sri Lanka against opening up its capital account until its financial sector was further strengthened.

As I noted, we were surprised by the speed and virulence with which the crisis spread to many countries in the region. The experience revealed the IMF had not kept up with the rapid developments in international capital markets, a deficiency it has tried to rectify through a number of steps taken over the last couple of years. We now have a International Capital Markets department that issues a quarterly Global Financial Stability Report on risks and vulnerabilities in these markets. Our management and senior staff now meet for an informal but regular dialogue with representatives of internationally-active private institutions through the Capital Market Consultative Group. CMCG meetings have taken place in various financial centers around the globe, including in Asia.

Better monitoring of international capital markets is just one of the steps through which we hope to reduce the incidence of crises. Other measures include a new program to better identify risks and vulnerabilities in financial sectors and development of standards and codes that assess how well countries are measuring up to international benchmarks.

A more thorough health check-up of the financial sectors of our

member countries is being conducted through a new program. It's called the Financial Sector Assessment Program (FSAP) and it's conducted jointly with the World Bank. To supplement the expertise of our own staffs, the program makes use of outside experts, whose knowledge and judgment provides an element of international peer review.

Our work on standards and codes seeks to provide a stronger basis for investors to make judgments about the allocation of private capital. The IMF has begun producing Reports on the Observance of Standards and Codes (ROSCs), which aim to enhance the coverage of institutional issues, in particular on data dissemination, fiscal transparency, monetary and financial policy transparency, and financial sector issues. We have already made considerable progress — as of end-March, over 200 ROSC modules had been completed for over 70 countries (including 33 for APEC members), three-fourths of which had been published.

We are also taking steps to resolve faster crises that do occur. There are three parts to our efforts to strengthen the framework for crisis resolution. First, we are trying to reach better-informed and more systematic judgments about debt sustainability. This is essential for deciding whether a major debt restructuring, possibly involving a substantial write-down of claims, is called for; or whether it is appropriate for the Fund, in conjunction with others, to provide financial support for policy measures to help restore confidence and catalyze the resumption of private capital inflows.

Second, we are working to establish a clearer definition of the conditions for and limits to access to IMF financing. This is a complex issue, but ultimately we cannot escape the fact that the IMF is not a global lender of last resort with the ability to create liquidity by issuing money. Some participants in this debate would like to establish quantitative limits on IMF financing, while others — including many in emerging markets — believe that this would not be appropriate, in view of the widely differing circumstances that countries may face.

Whatever the outcome of this debate, it is clear that the IMF's resources are limited. Hence it is useful to regions to develop some

mechanisms for self-help, as Asian countries have increasingly been doing. The IMF supports these efforts. Our deputy managing director, Mr. Sugisaki, said in a speech at the APEC meeting in Beijing in May that "the numerous efforts underway to strengthen regional economic and financial cooperation in Asia, such as APEC itself, the Manila Framework Group, ASEAN, and the 'Chiang Mai' initiative also can play a very useful role in helping to foster regional and global financial stability." These initiatives promote the exchange of information and policy dialogue among countries, which is a useful complement to the efforts of global institutions like the IMF.

Third, for cases where debt has become unsustainable, we are trying to develop ways to facilitate debt restructuring without unnecessary destruction of asset values or economic disruption. More ambitious use of collective action clauses will almost certainly be an important element in the solution, and we are actively engaged in an effort to design model clauses for this purpose. But as the use of collective actions clauses alone is unlikely to be sufficient, Anne Krueger has put forward a complementary proposal for a new Sovereign Debt Restructuring Mechanism (SDRM).

Turning now to our macroeconomic advice during the Asian crisis, one feature that has drawn a lot of attention is the belt-tightening recommended to Thailand at the start of the crisis. It is worth recalling that in July 1997, Thailand was still expected to post reasonable growth, it had a huge and growing current account deficit (more than 8 percent of GDP), and it faced large, though as yet unrecognized, fiscal liabilities to recapitalize the financial system. It was against this background that the IMF recommended a roughly-unchanged fiscal position. However, once the scope of the crisis in Thailand and in the region became evident, we quickly changed course. Indeed, IMF-supported programs in Thailand and other crisis countries were soon marked by large budget deficits, in part because of increases in spending on social safety net programs. As a result of the experience during the Asian crisis, our fiscal policy advice these days is much more attuned to the need to allow automatic stabilizers to work and to shield vulnerable segments of the population from the effects of the financial crisis.

The more acrimonious debate is on the appropriateness of the IMF's advice on monetary policy during the Asian crisis. The IMF's position that a temporary increase in interest rates may be necessary to restore financial stability during a crisis continues to have its supporters. As Larry Summers noted recently, "When a country's exchange rate is declining rapidly because capital is trying to leave the country, and the country's financial institutions are in real trouble, there is a fundamental conflict between restoring external confidence by raising interest rates and providing for financial repair through increased liquidity. It's a classic problem of a single instrument and multiple targets. Confidence is widely recognized as essential in combating financial crises."

Others have taken similar positions. Rudi Dornbusch for instance says that "investors will take confidence and bring money back when they see fiscal conservatism and high interest rates. Do that for a few months and you are on the right track." Our former chief economist Michael Mussa said in his typically colorful language that those who advocate lowering interest rates at the onset of a financial crisis are smoking something "not entirely legal." I used to think Mussa's comment could not be topped, but a couple of weeks ago our current chief economist Ken Rogoff ably rose to the challenge.

The debate over this issue has launched a thousand doctoral dissertations. Ph.D. students and their professors have been studying the relative costs of higher interest rates versus exchange rate depreciation. To the extent that there is a professional consensus on this topic at the moment, it is that the costs of letting the exchange rate go are much higher than that of a temporary increase in interest rates. The issue is far from settled, but clearly what's needed is honest debate and a closer look at the empirical evidence, not polemics.

Let me conclude by discussing the changes the Asian experience has had on IMF conditionality, the conditions that countries are asked to fulfill in order to get and retain access to IMF funding. Exactly one year ago, the Japanese Ministry of Finance and the IMF convened a conference in Tokyo which brought together many of the key players during the Asian crisis — on the IMF's side Stan Fischer and several senior staff, on the Asian side several of those who had

been involved in putting together the IMF-supported programs during the Asian crisis.

Looking back on their experience, some of the Asian policymakers wondered if all the conditions had been necessary or effective. The Philippine central bank's Cy Tetangco — who I've had the privilege of knowing for some years — noted that with its record of 20 IMF programs in the last 40 years, the Philippines was a "veteran" in negotiations with the IMF. While acknowledging the overall benefits to the Philippines of IMF assistance and conditionality, Tetangco pointed out that the 1998 program had over 100 conditions in 8 areas. Some of them, he thought, were critical to helping the Philippines weather the crisis; but many others were not or were, in any event, better handled by the multilateral developments banks than by the IMF. (See the full text of Mr. Tetangco's remarks at http://www.imf.org/external/np/pdr/cond/2001/eng/sem/071001at.htm.)

In the case of Indonesia, Mr. Boediono (currently the country's Finance Minister) said that "perhaps the dismantling of the clove monopoly and the rationalization of the national car and airplane industries could have been postponed until our head was above water." (See the full text of Mr. Boediono's remarks at http://www.imf.org/external/np/pdr/cond/2001/eng/sem/071001bo.htm).

As a result of input of this kind from people whose opinions we highly value, and as a result as well of our own internal assessments, we have been moving in the direction of streamlining IMF conditionality. The intent is to have fewer and less intrusive conditions and to limit them to areas critical to achieving the goals of the IMF-supported program.

We have also being looking into the possibility of using what is called "outcomes-based conditionality", in which the disbursement of IMF money is conditioned on the attainment of certain outcomes. This could help avoid micro-management by the IMF and give the governments somewhat greater flexibility in exploring alternate policies to achieve agreed goals. This might address another of the points made at the Tokyo conference. Some participants there called for IMF programs to be flexible enough to allow countries some choice in how to go about achieving commonly-agreed goals, noting Deng

Tsiao-Ping's advice that it does not matter whether the cat is black or white, as long as it catches mice.

The way the IMF has gone about this so-called "conditionality review" illustrates the way the Fund has increasingly been carrying out its reforms. We have encouraged open debate on conditionality by holding conferences in Tokyo and other locations throughout the world. We have also invited comments through our website from interested stakeholders everywhere (http://www.imf.org/external/-np/pdr/cond/2001/eng/collab/071701.pdf). And we have relied, of course, on the wide experience of our own staff, and the judgments of our Executive Board, on how to make conditionality more effective.

Many of the changes I've described are of fairly recent vintage; so I do not want to claim that they have transformed the IMF's way of doing business completely as yet. But I hope they at least convey the sense that the institution is trying very hard to change, and trying very hard to be part of the solution to Asia's challenges.

NOTES

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SOURCE

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DEBATE QUESTIONS

The author notes that many critics have identified the liberalization of capital markets as the cause of the Asian crisis. He argues that this liberalization has been mischaracterized. How? What does he see as a more accurate identification of the cause of the crisis?

The IMF was surprised, the author admits, by the speed and virulence of the Asian crisis. He notes that the IMF has changed some of its practices and procedures as a result. What are these changes, and how are they intended to help the IMF to function effectively?

The author remarks that the IMF is addressing its capacity to respond to crises. What questions does he raise about providing relief when crises occur?

When the crisis erupted, the IMF said that the countries involved must raise their interest rates. The author notes that this is the single most controversial action taken during the crisis. To what degree is he willing to defend the IMF's actions, given the wisdom of a few years' hindsight?

The IMF has been criticized for the conditions that it imposes when lending money to needy countries. It will continue to do so, says the author, but it will make changes as a result of the experience gained in the Asia crisis. How is the IMF changing? Do the proposed changes address the problems raised by the crisis?

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Part 5
Source Readings

Human Development Report 1999:

Globalization with a Human Face

United Nations Development Programme

Global Integration — Rapid but Unbalanced

Global integration is proceeding at breakneck speed and with amazing reach. But the process is uneven and unbalanced, with uneven participation of countries and people in the expanding opportunities of globalization — in the global economy, in global technology, in the global spread of cultures and in global governance. The new rules of globalization — and the players writing them — focus on integrating global markets, neglecting the needs of people that markets cannot meet. The process is concentrating power and marginalizing the poor, both countries and people.

Global Economy

The steady expansion of exports and the phenomenal growth of capital flows mask the enormous disparities in experience across countries and regions.

- World exports of goods and services almost tripled between the 1970s and 1997 in real terms. Botswana, China, the Dominican Republic and the Republic of Korea enjoyed 10-13% average annual growth in their exports. But many countries did not share in the benefits, with exports declining in Bulgaria, Niger, Togo, and Zambia.
- Since the 1970s the share of manufacturers in merchandise

exports has grown considerably for some countries — from 13% to 71% in Mauritius, 32% to 81% in Mexico, 25% to 78% in Tunisia. But for 28 countries, manufactures still make up less than 10% of merchandise exports.

- In 1997 foreign domestic investment zoomed to $400 billion, seven times the level of the 1970s, but 58% of it went to industrial countries, 37% to developing countries, and just 5% to the transitional economies of Eastern Europe and the CIS.
- More than 80% of the foreign direct investment in developing and transitional economies in the 1990s has gone to just 20 countries, mainly China. For 100 countries, foreign direct investment has averaged less than $100 million a year since 1990, and for nine countries net flows have been negative.
- Some 94% of the portfolio and other short-term capital flows to developing countries and transition economies went to just 20 of them in 1996, the year before the East Asian crisis. Today only 25 developing countries have access to private markets for bonds, commercial bank loans and portfolio equity. The rest are shut out by their lack of credit rating.

To sum up: the top fifth of the world's people in the richest countries enjoy 82% of the expanding export trade and 68% of foreign direct investment — the bottom fifth, barely more than 1%.

These trends reinforce economic stagnation and low human development. And they have further marginalized many developing countries from the most dynamic areas of global economic growth. The 1980s and 1990s have seen strong growth in the trade of manufactures, services and "knowledge goods". While some developing countries have made major advances, others have missed out entirely. Manufacturing exports should have been a step towards transforming their economies and creating more jobs. But only 33 countries managed to sustain 3% annual growth in GNP per capita during 1980-96. For 59 countries — mainly in Sub-Saharan Africa and Eastern Europe and the CIS — GNP per capita declined.

Economic integration is thus dividing developing countries and transition economies into those that are benefiting from global opportunities and those that are not. The uneven divide cuts across levels of income and human development — and across

regions. Contrast China, Chile, Costa Rica, Mauritius, and Poland with Cameroon, Niger, Venezuela and Russia.

Ironically, those left behind are deeply integrated in world trade. Sub-Saharan Africa has a higher export-to-GDP ratio (29% in the 1990s) than Latin America (15%). But Africa's exports are still mainly in primary commodities, and foreign direct investment is concentrated in mineral extraction — so the region's apparent integration is actually a vulnerability to the whims of primary commodity markets.

Countries are not the only major actors — more and more it is multinational corporations that dominate global markets. Their foreign affiliates accounted for an estimated $9.5 trillion in sales in 1997. Their value added was 7% of world GDP in 1997, up from 5% in the mid-1980s to a third in 1995. US-based multinationals account for more than a quarter of US GDP — $2 trillion of $7.3 trillion. And the large multinationals are becoming even larger as takeovers and mergers proliferate.

Capital is becoming even more concentrated globally as megacorporations merge, often across borders — Chrysler and Daimler, Hoechst and Rhone-Poulenc, Exxon and Mobil. From 1990 to 1997 the annual number of mergers and acquisitions more than doubled, from 11,300 to 24,600. Cross-border mergers and acquisitions accounted for $236 billion in 1997. Multinational corporations now dwarf governments in economic power.

Generating Employment?

Conventional economic theory predicts that trade liberalization will increase productivity and wages, especially for tradable goods, thus expanding jobs and opportunities for poor people. Sometimes the theory has been right. In the 1980s and 1990s great progress in reducing global poverty and advancing human development was propelled by many countries seizing global opportunities.

- China, Indonesia, the Republic of Korea, Malaysia, and many others achieved rapid economic growth, and linked that growth to advancing human development and reducing poverty.
- Many countries generated good employment opportunities by

tapping into global markets — take software programming in Bangalore, India, computer assembly in Costa Rica, high-tech services in Ireland.

- Others used foreign direct investment to improve the quality of employment. Foreign owned companies in Hungary accounted for more than 80% of manufacturing investment in 1996, a third of employment and three-quarters of export earnings.

But expansion of trade does not always mean more employment and better wages. In the OECD countries employment creation has lagged behind GDP growth and the expansion of trade and investment. Despite 2-3% growth in per capita GDP over the past two decades, unemployment did not decline, staying at around 7%, with a higher rate in the European Union (10-11%) and lower rates in Japan, Norway, and the United States. More than 35 million people are unemployed, and another 10 million have given up looking for a job. Among the youth, one in five is unemployed.

People are facing job losses alongside job creation in many countries — from corporate restructuring, mergers and acquisitions, the spread of globally integrated production by multinational corporations and, in the OECD countries, shifts to knowledge-based sectors.

A common perception in the OECD countries is that jobs are being exported to the South. OECD imports of manufactures from developing countries have certainly increased since 1970, but such imports were just 2% of the combined GDP of the OECD countries in 1996. So, it is not surprising that trade and immigration contributed only about a tenth of the increase in wage dispersion in the United States in the early 1980s. Moreover, North-South trade has mainly raised wages for skilled labour in OECD countries through exports, not depressed wages for unskilled labor. So, "dislocation" of jobs to the South does not appear to be the main source of job stress in the North.

Expanding opportunities — migration

Migration in today's globalizing world is also marked by uneven human opportunities and uneven human impacts. An estimated 130-145 million people live outside their countries, up from 104 million in 1985 and 84 million in 1975. These estimates include only

legally registered immigrants, so the real number is much higher. For many countries workers remittances are a major source of foreign exchange, sometimes the primary source.

Three points about migration. First, global employment opportunities may be opening for some, but they are closing for most others. The global market for high-skilled labor is now more integrated, with high mobility and standardized wages. But the market for unskilled labor is highly restricted by national barriers, even though it accounts for a larger share of international migration. Australia, Canada and the United States have programs to attract skilled migrants, so the brain drain from developing countries continues. As many as 30,000 African Ph.D.s live abroad, while the continent is left with only one scientist and engineer per 10,000 people.

Second, undocumented migration continues unabated. The United States alone has an estimated 4 million undocumented immigrants. European countries estimate that half their immigrants are undocumented, up from a quarter in the mid-1980s. Developing countries also host large numbers of undocumented immigrants — 3 million in Cote d'Ivoire in 1988, 1 million in Thailand and 700,000 in Malaysia in 1997, 1 million in Gabon in 1993, 1 million in Argentina in 1996. Lacking papers, illegal immigrants face not only discrimination but also denial of human rights. They often have to accept wages and conditions that do not meet minimum labor standards. And they often have to pay traffickers — as much as $35,000 from China to the United States. Trafficking is a booming business, moving 4 million people a year, generating $7 billion.

Third, there is a gender face to much migration. At least 50 million migrants are women, 30 million in developing countries. A large share of migrants from the Philippines, Sri Lanka and elsewhere are women. Many end up in activities that are dirty, dangerous, and demeaning.

Global Governance

Governance is not government — it is the framework of rules, institutions and practices that set limits on the behavior of individuals, organizations and companies. In today's integrating world there is

clear need for global governance for the good of society, economy and environment. And a form of global governance is indeed emerging — but the imbalances in the process are cause for concern.

Intergovernmental policy-making in today's global economy is in the hands of the major industrial powers and the international institutions they control — the World Bank, the International Monetary Fund, the Bank for International Settlements. Their rule-making may create a secure environment for open markets, but there are no countervailing rules to protect human rights and promote human development. And developing countries, with about 80% of the world's people but less than a fifth of the global GDP, have little influence.

Ad hoc and self-selected policy groups have emerged in the past decade to make de facto global economic policy, outside the United Nations or any other formal system with democratic processes and participation. The finance ministers of the major industrial countries are in daily telephone contact — and their staff in e-mail contact — shaping the annual G-7 meetings to discuss global economic and political issues. The United States took the initiative in 1998 to form the G-22 — from the G-7 and 15 others, including the largest emerging economies — to review the global financial system in the wake of the East Asian crisis. The G-10 central bankers still guide the supervision of banking systems. All these groups play a key part in international economic policy making, yet only the G-22 has any consultation with developing countries, and then only with a select few.

Poor countries participate little in the formulation and implementation of the new rules that govern global markets. The 1994 Uruguay Round of GATT shows the difficulties facing small and poor countries. Of the 29 least developed countries in the WTO, only 12 had missions in Geneva, most staffed with a handful of people to cover the gamut of UN work. Few African countries had delegations supported by staff or in-depth analysis to defend their national interests, weaknesses that carry through all negotiating and dispute settlement procedures. Many small and poor countries had difficulty even ensuring representation at meetings. And although the WTO is representative in its voting structure, its procedures, which rely on con-

sensus for decision-making and on committees with selected membership, leave much scope for the delegations with more resources to influence outcomes. Indeed, the 1996 ministerial meeting in Singapore agreed on the need to review these procedures.

Compounding these weaknesses in negotiating capacity is the breakup of the common "South" position on global trade issues in the 1990s — and the pursuit of diverging interests. The different situations of developing countries — from the newly industrializing to the least developed — only deepen the schisms.

The rapidly increasing multilateral agreements — the new ones — are highly binding on national governments and constrain domestic policy choices, including those critical for human development. They drive a convergence of policies in a world of enormous diversity in conditions — economic, social, ecological. For example, most developing countries previously exempted agriculture, medicines and other products from national patent laws, but with the passage of the agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), almost all knowledge-based production is now subject to tight intellectual property protection, unified internationally. Further, the TRIPS agreement is unbalanced: it provides an enabling environment for multinationals, tightening their dominant ownership of technology, impeding and increasing the cost of transfer to developing countries.

These new rules and institutions advance global markets. But there has been much less progress in strengthening rules and institutions to promote universal ethics and norms — especially human rights to promote human development and to empower poor people and poor countries. Fortunately, two important forces of social governance are gaining strength.

Social Fragmentation — Reversals in Progress and Threats to Human Security

Uneven globalization is bringing not only integration but also fragmentation — dividing communities, nations and regions into those that are integrated and those that are excluded.

Social tensions and conflicts are ignited when there are extremes

of inequality between the marginal and the powerful. Indonesia shows what can happen when an economic crisis sets off latent social tensions between ethnic groups — or between the rich and poor.

Recent research on complex humanitarian emergencies concluded that "horizontal inequalities" between groups — whether ethnic, religious, or social — are the major cause of the current wave of civil conflicts. Inequalities — and insecurities — matter not only in incomes but in political participation (in parliaments, cabinets, armies and local governments), in economic assets (in land, human capital and communal resources) and in social conditions (in education, housing and employment).

The shrinking of time and space is creating new threats to human security. The fast-changing world presents many risks of sudden disruptions in the patterns of daily life — in jobs, in livelihoods, in health and personal safety, in the social and cultural cohesion of societies. Threats to human security can now speed their way around the world — the collapse of financial markets, HIV/AIDS, global warming, global crime. Global threats are increasing, outgrowing national abilities to tackle them, and outpacing national responses.

Widening Disparities in Income

Gaps in income between the poorest and the richest people and countries have continued to widen. In 1960 the 20% of the world's people in the richest countries had 30 times the income of the poorest 20% — in 1997, 74 times as much. This continues the trend of nearly two centuries.

Gaps are widening both between and within countries. In East Asia per capita incomes today are more than seven times what they were in 1960, three times what they were in 1980. But in Sub-Saharan African and other least developed countries, per capita incomes today are lower than they were in 1970. The transition economies of Eastern Europe and the CIS have experienced the fastest rise in inequality ever. Russia now has the greatest inequality — the income share of the richest 20% is 11 times that of the poorest 20%. Income inequalities also grew markedly in China, Indonesia, Thailand, and other east and southeast Asian countries that had achieved high

growth while improving income distribution and reducing poverty in earlier decades.

Recent studies show inequality rising in most OECD countries during the 1980s and into the early 1990s. Of 19 countries, only one showed a slight improvement. The deterioration was worst in Sweden, the United Kingdom, and the United States. In the United Kingdom the number of families below the poverty line rose by 60% in the 1980s, in the Netherlands, by nearly 40%. And in Australia, Canada, the United Kingdom and the United States at least half the single-parent households with children have incomes below the poverty line. Contrast that with the staggering concentration of wealth among the ultra-rich. The net worth of the world's 200 richest people increased from $440 billion to more than $1 trillion in just the four years from 1994 to 1998. The assets of the three richest people were more than the combined GNP of the 48 least developed countries.

Job and Income Security

In both poor countries and rich, dislocations from economic and corporate restructuring and dismantled social protection have meant heavy job losses and worsening employment conditions. Jobs and incomes have become more precarious. The pressures of global competition have led countries and employers to adopt more flexible labor policies, and work arrangements with no long-term commitment between employer and employee are on the rise.

In Latin America, for example, reforms in labor laws increased labor market flexibility, and more flexible contracts were introduced. By 1996 the share of workers without contracts increased to 30% in Chile, 36% in Argentina, 39% in Colombia and 41% in Peru. In Egypt an increasingly common practice is to require new recruits to sign a resignation letter before taking the job. Belgium, France, Germany and the United Kingdom all weakened their worker dismissal laws. And the Netherlands, Spain and the United Kingdom decentralized wage bargaining.

With the ever changing technology, people need ever-changing skills — yet even in the richest countries many lack the basics.

Despite universal primary and secondary education in OECD countries, one person in six is functionally illiterate — unable to fill out a job application, excluded from the rapidly changing world that demands new skills in processing information. With unemployment a luxury few can afford, people who cannot get formal employment end up in the informal sector. In Latin America in the 1990s, informal employment has expanded from 52% to 58%, and 85 of every 100 jobs created are informal.

As multinationals merge, corporate restructuring means job losses. Though the loss of corporate jobs may be compensated by employment creation elsewhere, it adds to the insecurity of people in their jobs and lives.

Bust and Boom Economies — Financial Volatility

The financial crisis in East Asia destabilized the lives of millions and reduced the prospects for growth in that region and in the world. In Indonesia, the Republic of Korea, Malaysia, the Philippines and Thailand, human costs were severe. Escalating prices of essentials such as food and medicines were accompanied by increases in bankruptcies, unemployment, suicides, domestic violence and other consequences. Signs of economic recovery are beginning to emerge in 1999. But studies of past economic crises show that unemployment persists long after inflation subsides and exchange rates recover. People take longer to recover than economies.

An analysis of this crisis spotlights two important lesions about global capital markets. The first is that financial volatility is a permanent feature of today's globally integrated financial markets. The East Asian crisis is not an isolated accident — it is a symptom of general weakness in global capital markets. Recent UNCTAD studies show a rising frequency of financial crises with the growth in international capital flows of the 1990s. Flows can be volatile, fed by herd behavior and inadequate information for investors around the world, with investor confidence and risk ratings tumbling overnight. Technological innovations link global financial markets in real time, allowing instantaneous decisions around the world. Markets have also become increasingly sophisticated, with financial innovations

that have made available countless financial instruments — from derivatives to hedge funds. In theory, these instruments were intended to transfer and spread risk. In practice, they have become part of the volatility of today's capital markets.

A central feature of the financial crisis in East Asia was the massive new inflows of short term capital, followed by sudden reversals. A rapid buildup in the early 1990s followed the deregulation of capital controls and the restructuring of financial policies. Net financial inflows to Indonesia, Korea, Malaysia, the Philippines, and Thailand totaled $93 billion in 1996. In 1997, as turmoil hit financial markets, these flows reversed in just weeks to a net outflow of $12 billion, a swing of $105 billion, or 11% of the precrisis GDPs of the five countries.

The second lesson is that extreme caution is required in opening up to foreign short-term (often speculative) capital, especially when financial market institutions are not well developed. There are increasing doubts among economists about the benefits of short term flows. They do not have the same potential as long-term investments to contribute to development. They can even be disastrous, creating macro-economic imbalances, overvaluing the currency, reducing international competitiveness and seriously destabilizing domestic banking systems.

NOTES

UNDP is the United Nations' global development network, which "advocates for change and connects countries to knowledge, experience and resources to help people build a better life."

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Social Impacts of the Asian Crisis: Policy Challenges and Lessons

by Jong-Wha Lee and Changyong Rhee

Abstract
This paper documents the social impacts of the financial crisis in Asia. We provide a general overview of the causes and the evolution of the crisis and highlight the differences as well as the similarities among the affected Asian countries. In particular, the impacts of the crisis on unemployment, real wage, poverty, and income inequality are analyzed using a cross-country data set, which consists of all the countries that have received financial assistance from the IMF over the period from 1973 to 1994. The stylized pattern of employment growth in previous IMF program countries indicates that employment growth is more sluggish in the recovery process compared with other macroeconomic variables. Hence, unemployment rates can remain high for a long period even after the crisis ends in the Asian countries. We also find that the crisis aggravates poverty for marginal groups of the population over a significant period, even though it does not bear a long-term effect on overall income distribution. Policy implications of our findings in building social safety nets in Asia are also discussed.

III. Social Impact of the Asian Crisis and the IMF Program

In this section, we analyze the social impact of financial crises and IMF adjustment programs in East Asia. Over the past 20 years, East Asian countries were remarkably successful in reducing poverty and achieving high employment growth. The present crisis, however, has jeopardized this hard-won reputation for economic performance that

has provided better living standards for Asians and offered millions of people in other regions the hope of rescuing themselves from poverty. The financial meltdown in Asia, currently translating into rising social and political unrest, has resulted in more people being thrown out of employment and joining the ranks of the poor.

As the Asian Crisis is still unraveling, only limited information is currently available for assessing its social impact. Given this difficulty, this paper will focus only on its impact on employment, real wage, income distribution, and poverty. To examine how the financial crisis affects these social variables, we consult the past records of countries that experienced a currency crisis and received conditional financial assistance from the IMF. In order to accurately measure the impact of both the financial crisis and the IMF adjustment program, we have to evaluate the performance of program countries in comparison with the performance that would have prevailed in the absence of the crisis and adjustment program. In other words, we have to evaluate whether the IMF programs were associated with better or worse social outcomes than would otherwise have occurred. It is very difficult both conceptually and practically to identify the hypothetical reference point and to disentangle the effects of IMF programs from those of other factors. In this section, we first briefly discuss several methodologies for evaluating the effects of IMF programs. Then we will analyze the social impact of IMF programs in past program countries from 1973 to 1994. Based on these empirical results and specific East Asian characteristics, we will try to assess the social impact of the recent financial crisis and IMF programs in East Asia.

III. 1. Methodology to Evaluate the Programs in a Cross-country Framework

A number of previous studies have tried to assess the effects of Fund programs based on cross-sectional country data. The methodology in evaluating IMF programs can be classified into three categories: the "before-after" approach; the "control-group" approach; and the "modified control-group" approach.[22] The first and most popular method is the "before-after" approach, which compares performance during a program with that prior to the program. It uses non-parametric statis-

tical methods to evaluate whether there is a significant change in some essential variables over time. Therefore, while easy to employ and seemingly objective, this approach often gives biased results due to the assumption that had it not been for the program, the performance indicators would have taken their pre-crisis period values.

The "control-group" methodology attempts to overcome some of the limitations of the "before-after" approach. Here, the behavior in key variables in the program countries was compared to their behavior in non-program countries (a control group). Thus it implicitly assumes that only the imposition of the IMF program itself distinguishes the group of program countries from the control group. The external environment is assumed to affect program and no-program countries equally.

The third methodology is the so-called "modified control-group" approach, which consists of regressions that control for differences in initial conditions and policies undertaken in program and non-program countries. That is, this approach identifies the differences between program and non-program countries in the pre-program period, and then controls these differences statistically in order to find out the isolated impacts of the programs in the post-reform performance.

A substantial body of research has adopted one of these approaches to assess the impact of IMF programs. In particular, since the primary purpose of the IMF program is to assist the member country in restoring a sustainable balance of payments, reducing inflation and creating the conditions for sustainable income growth, most of the studies focused on evaluating how successfully these primary macroeconomic goals have been achieved (see Goldstein and Montiel (1986), Khan(1990), and Conway(1994)). However, little investigation has been conducted on the analysis of the social impact of IMF programs. A notable exception is a study by Garuda (1998) that conducts an extensive cross-country investigation into the distributional effects of IMF programs in 39 countries from 1975 to 1991.

III.2. Evaluation of the Social Impact of the IMF Programs, 1973-1994

We examine the social impact of IMF programs, using data of all

developing countries that received stand-by and extended arrangements from mid-1973 to mid-1994. During this period, 88 non-OECD countries received financial support from the IMF at least once and the total number of programs amounted to 455.[23] In order to avoid "double counting" of economic crises or IMF programs we pay special attention to the programs which were continued from the previous year. That is, in our sample, a consecutive approval of programs or a program of more than one year in length is counted as only one program and is identified by the first year of the program. This procedure yields a total of 313 programs.

For each program in our sample, we estimate the social outcomes following the "before-after" approach, and then compare them to the average outcomes of non-program countries following the "control group" approach. We focus on two key social outcomes: employment and real wage on the one hand; poverty and income distribution on the other hand. The changes in these social variables are measured over the period of three years preceding, and one to five years following the approval of the IMF program. We also construct a control group of "tranquil" observations. If a country had not been subject to any IMF program within a window of plus/minus five years surrounding a specific year, it is counted as a non-program country in that specific year. We use all these observations as our control group of non-program "tranquil" observations. We have not tried to control statistically the differences between program and non-program countries as in the "modified control group" approach.

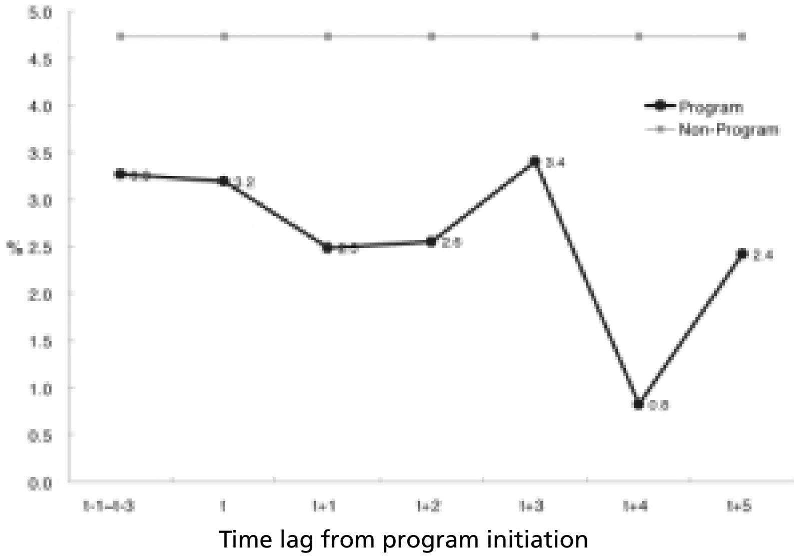
Changes in Employment and Real Wage

To analyze the effects of IMF programs on employment and real wage, we use data on manufacturing employment and wage growth rates available from the World Bank's *World Tables*. The data were compiled for the period of 1968 to 1994 to examine the lagging effects of IMF programs. The data covers 1,306 observations for employment and 1,157 for real wage, of which a total of 138 and 126 observations respectively, correspond to IMF program years.[24]

Figure 3.1 shows the changes in employment and real wage growth rates before and after the initiation of IMF programs. In panel (a) of

Figure 3.1 Changes in Employment and Real Wage
Before and After IMF Programs

(a): Employment growth



(b): Real Wage Growth

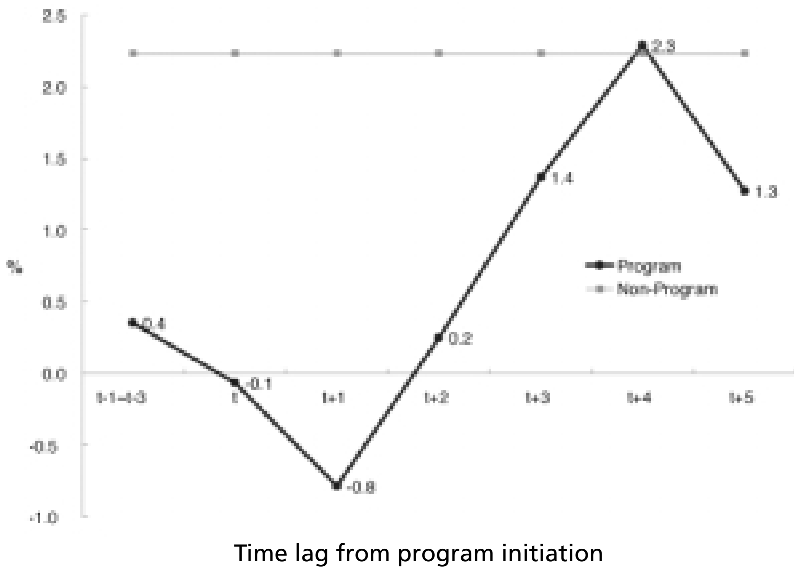


Figure 3.1, we plot the behavior of average employment growth rate at the onset of the IMF programs; during the three preceding years; and in each of the following five years. For comparison, we include the straight line in the panel, which indicates the average employment growth rate during the tranquil period that did not have an IMF program within a window of plus/minus five years.

We can clearly see that employment growth rates in program periods were significantly lower than those in non-program periods throughout the periods surrounding the initiation of programs. It is not hard to understand why the employment growth rate prior to the initiation of programs was lower than those in non-program periods: it indicates aggravated economic conditions prior to the crisis. But what is surprising is the fact that the employment growth rate did not recover its pre-crisis level even five years after the crisis. The average employment growth rate was 3.2 percent in the initial program year, which was essentially identical to the average of the three years before the program. As programs proceeded, the employment growth rate fell to 2.5 percent in the year following the program and then remained, after fluctuating for the next three years, at 2.4 percent in the fifth year. What caused the slow recovery of employment growth rates will be discussed after examining the behavior of real wage growth rates.

Panel (b) of Figure 3.1 portrays the change in real wage growth rates. The growth rates dropped a little in the program year and then further declined in the year following the crisis. But it increased substantially following the second year after the program. Since most IMF programs contained measures to restrain wage bills by such measures as wage freezes, reduced work hours, and cuts in fringe benefits, the initial drop in wage growth seemed inevitable (Sisson, 1986). The real wage growth in subsequent years is also consistent with the changes in output and inflation over the period of IMF involvement. Schadeler et al, (1995) shows that output growth rates declined in the program year and then subsequently recovered over the years following. The initiation of the programs was in general accompanied by lower inflation rates.[25] Higher output growth and lower inflation certainly contributed to higher real wage growth in subsequent years after IMF involvement.

Considering the strong surge of real wage and output growth, the relatively weak performance of employment growth after IMF programs is surprising. It implies that even after output growth rates, exchange rates, interest rates, etc., recover their pre-crisis level, one cannot expect the same recovery for employment. This fact, ironically, may be the result of labor productivity increases due to the adjustment program. After the crisis, program countries implement various structural reforms to enhance economic efficiency. Among them, increasing labor productivity by cutting over-employment is usually a primary objective. In other words, the reform has the same short-run effect as a laborsaving technology progress. Therefore, even after output demand returns to its pre-crisis level, labor demand is not fully recovered in the short-run. Only after positive externality from enhanced labor productivity is materialized can employment growth rates be significantly increased. In any case, the weak performance of employment growth indicates that unemployment rates can remain at a higher level for a long period after economic crises and IMF programs. This has a very important policy implication that we will discuss in section IV.2.

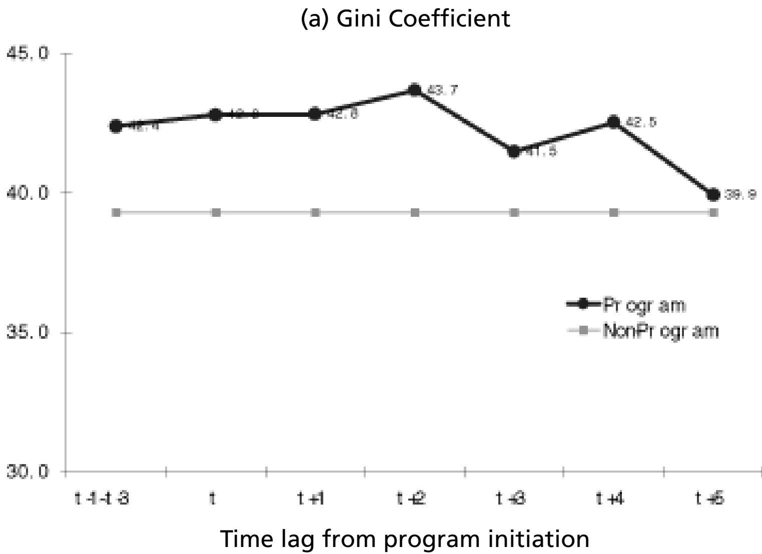
Changes in Income Distribution and Poverty

When we analyze distributional effects of IMF programs, the quality of cross-country data on income distribution raises a serious concern regarding the reliability of estimated results. A database recently constructed by Deininger and Squire (1996) considerably mitigates the data constraint faced in previous works. Deininger and Squire reviewed major studies on income distribution that had been conducted during the last 40 years and then constructed a fairly accurate and comparable data set across countries and time.

From their "high quality" database, we focus on two indicators of income distribution: Gini coefficients and the income share of the lowest quintiles. Our data set covers the period from 1968 to 1994 and consists of 322 observations of Gini coefficients and 274 observations of the lowest quintile income share for the sample of developing countries. Among total observations, 29 and 25 observations for Gini and the quintile income shares correspond to the IMF program years, respectively.

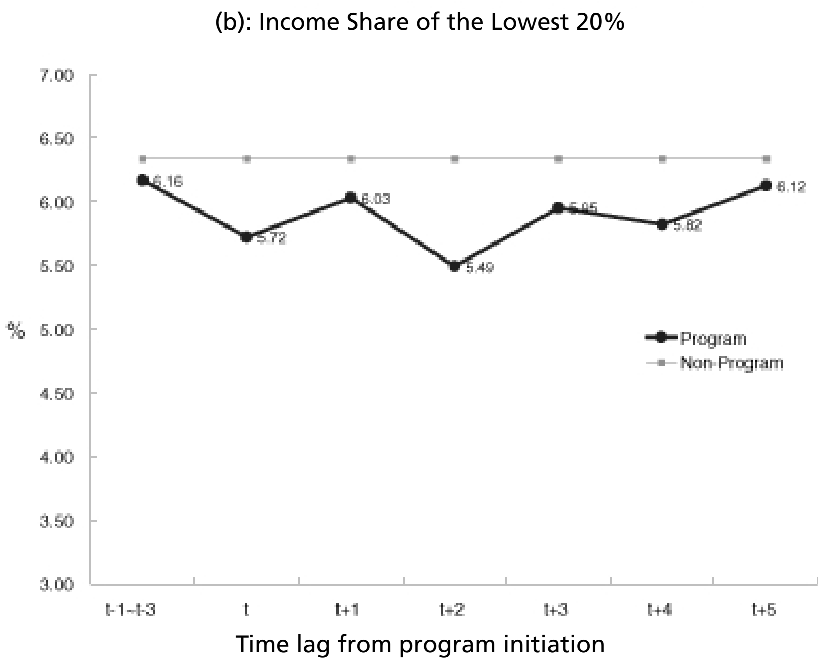
Figure 3.2 Changes in Gini Coefficient and the Lowest Quintile Income Share before and after IMF Programs

(a) Gini Coefficient



Time lag from program initiation

(b): Income Share of the Lowest 20%



Time lag from program initiation

Figure 3.2 plots the behavior of Gini coefficients and the lowest quintile's income share. Panel (a) of Figure 3.2 shows that countries initiating IMF programs experienced gradual deterioration of income distribution over the period of the initial program year and the following two years after the programs. The average Gini coefficients increased to 42.8 in the program year from 42.4 in the preceding three years and then further increased to 43.7 in the two years after the programs. However, over the longer-run period, income distribution showed substantial improvement. Gini coefficients dropped to 41.5 in the three years and to 39.9 in the five years following the programs. Hence, on average, income distribution improved well over the level in the pre-program years and approached close to the level of the non-program tranquil period.

The lowest quintile's income share shows a similar pattern to those of Gini coefficients. Panel (b) of Figure 3.2 shows short-term deterioration and long-term improvement of income distribution in terms of the lowest quintile's income share. However, there exists an important difference. The immediate adverse effects of IMF programs on income distribution are more visible in the quintile indicator. The lowest quintile's share dropped on average to 5.72 percent at the initiation of the program from 6.16 in the preceding three years. Then it fluctuated for the next two years, eventually increasing to 6.12 in the five years following programs. Note that while in the five years after the crisis, long-run income distribution measured by Gini coefficients improved far more than the level in the pre-program years, the income share of the poor increased only close to the level in the pre-program years.

Although the estimated magnitude of the distributional impact of the IMF program may vary depending on sample countries, we think the pattern of short-term deterioration and long-term improvement of income distribution is quite a robust phenomenon.[26] The initial deterioration of income distribution can be attributed to government policy changes. The stabilization programs in general consist of contractionary monetary and fiscal policies and real exchange devaluation. Since these policy changes immediately lead to increases in bankruptcies, unemployment and the slow growth of real wage, there

is likely to be a severe deterioration of income distribution. Poverty is aggravated as prices of items such as food, public transportation, and energy, which account for a large share of the consumption of low-income households, rise. In the long run, however, distribution started to improve when successful programs led to increases in foreign capital inflows, investment, and output growth.

There are other channels through which the IMF stabilization programs can affect income distribution. First of all, fiscal constraints have significant effects on income distribution and poverty through changes in both revenue and expenditure. IMF programs typically require the government to increase its revenues and/or decrease its outlays so as to reduce its overall deficit. Increase in taxes on income or imported luxury goods would influence income equality more favorably. The distributional effects of reduction in government expenditure depend on where the specific reductions are made. Workers in the public sectors as a whole tend to experience a decline in real wage or salary earnings with the downsizing of the public sector. Reduction of social expenditures - particularly subsidies to the poor, such as food subsidies - results in more perverse distributional effects (Sisson, 1986).

Monetary and credit policy also affects income distribution in various ways. A credit crunch and tight monetary policy hurts small and medium-sized firms more severely than large firms, which negatively impacts income equality (Johnson and Salop, 1980). Increasing real interest rates has an additional effect by redistributing income from borrowers to lenders, which is likely to render relative gain for households in the richest quintile, considering their interest-bearing asset holdings. Real depreciation of exchange rates causes a relative increase in the price of traded goods, leading to increases in the incomes of producers in the export and import-competing sectors.

III.3. Impact of the Asian Crisis on Unemployment and Real Wage

For the last two decades, Asian countries enjoyed virtually full employment prior to the crisis. As shown in Table 2.1, the unemployment rates in Indonesia, Thailand, and Korea were remarkably low, at

less than 3-4% during the 1990s.[27] But their performance has drastically deteriorated since the crisis began. Bankruptcies due to credit crunches, contractionary fiscal and monetary policy, and the lift of legal restrictions on lay-offs, have contributed to a rapid increase in unemployment. Unemployment rates have been rising faster in these countries than in Mexico in 1994. According to the estimates reported in ILO (1998), the unemployment rate in Indonesia would reach 8 to 10% compared with about 5% in 1996. In Thailand, it is expected to increase from 1.54% in 1996 to 5.6% in 1998. In Korea, the unemployment rate had already risen drastically from 2.0% in October 1997 to 6.7% in April 1998. Given that Korea had not fully gone through economic restructuring yet, the unemployment rate is expected to go up even higher, to 7.5% by the end of the year. Since the extent of the crisis was so unexpected and drastic, there exists a pessimistic view that the recovery may not be as rapid as that of Mexico and Argentina following the tequila crisis in 1994. Moreover, the stylized pattern of employment changes discussed in section III.2 showed that unemployment rates are likely to remain high, if not higher, for a long time.

One important thing to note is that the crisis had diverse impact on unemployment across different groups. In Thailand and Indonesia, the wave of lay-offs affected urban white-collar workers the most (Tambunlertchai, 1998 and Azis, 1998). In general, however, the crisis hit marginal workers such as women; young workers; the less educated; recent school dropouts; and first-time job seekers, the hardest (Kim, 1998). Table 3.1 and Table 3.2 clearly exhibits this pattern in Korea. Table 3.1 shows the changes in employment by gender, age, and schooling. Between April 1997 and April 1998, employment declined by 3.8% among men, but by 7.1% among women. Young workers aged between 15 to 29 accounted for the lion's share of job destruction, especially young female workers. Jobs for those with no high school diploma were destroyed by 11.1%, whereas the employment of college graduates increased by 7.2%. The increase is not surprising, because it reflects the deterioration of jobs. Displaced college graduates are settling for jobs that used to be taken by high school graduates. We also see that employment of older workers, particularly

Table 3.1

Employment by Gender, Age, and Schooling in Korea

(units: thousand, %)

Age	April 1996	April 1997	April 1998	D 96/97 (%)	D 97/98 (%)
Total					
All	20,743	21,219	20,127	476 (2.3)	-1,092 (-5.1)
15/19	394	398	335	4 (1.0)	-63 (-15.8)
20/29	4,775	4,811	4,162	36 (0.8)	-649 (-13.5)
30/39	6,100	6,007	5,915	-93 (-1.5)	-92 (-1.5)
40/49	4,621	4,825	4,802	204 (4.4)	-23 (-0.5)
50/59	3,000	3,161	2,973	161 (5.4)	-188 (-5.9)
60+	1,852	2,017	1,939	165 (8.9)	-78 (-3.9)
Men					
All	12,349	12,446	11,976	97 (0.8)	-470 (-3.8)
15/19	151	150	137	-1 (-0.7)	-13 (-8.7)
20/29	2,528	2,513	2,178	-15 (-0.6)	-335 (-13.3)
30/39	3,969	3,867	3,841	-102 (-2.6)	-26 (-0.7)
40/49	2,836	2,893	2,912	57 (2.0)	19 (0.7)
50/59	1,819	1,910	1,805	91 (5.0)	-105 (-5.5)
60+	1,045	1,112	1,103	67 (6.4)	-9 (-0.8)
Women					
All	8,395	8,773	8,151	378 (4.5)	-622 (-7.1)
15/19	243	248	198	5 (2.1)	-50 (-20.2)
20/29	2,248	2,299	1,985	51 (2.3)	-314 (-13.7)
30/39	2,131	2,139	2,074	8 (0.4)	-65 (-3.0)
40/49	1,784	1,933	1,890	149 (8.4)	-43 (-2.2)
50/59	1,181	1,251	1,169	70 (5.9)	-82 (-6.6)
60+	807	904	836	97 (12.0)	-68 (-7.5)
Schooling					
No HS Diploma	7,637	7,715	6,870*	78 (1.2)	-845 (-11.1)
HS Diploma	9,009	9,163	8,582*	154 (1.6)	-581 (-6.2)
College Diploma	4,098	4,341	4,675*	243 (6.4)	334 (7.2)

Note: *; projected number

Source: National Statistical Office, Korea, *The Economically Active Population Survey*, Cited from Kim (1998).

Table 3.2
Change in Employment by Industry Occupation and Work Specification in Korea

	(units: thousand) April 1997/ April 1998
Industry	(% Change)
Agriculture/Fishery	216 (8.8)
Manufacturing	-619 (-13.7)
Construction	-392 (-19.3)
Utility/Trans./FIRE	11 (0.6)
Retail/Wholesale	-234 (-4.0)
Services	-66 (-1.5)
Occupation	
Prof./Administration	15 (0.0)
Clerical	-117 (-4.5)
Sales/Service	-103 (-2.1)
Operatives/Laborer	-1,072 (-13.9)
Farmers/Fishers	186 (7.9)
Work Specification	
Wage/Salary Workers	-1,041 (-7.8)
Regular Workers	-727 (-10.0)
Non-Wage Workers	-50 (-0.6)
Unpaid Family Workers	201 (10.5)
1 to 17 hours per week	47 (14.0)
18 to 35 hours per week	96 (9.0)
36 hours or More	-1,256 (-6.4)

Source: National Statistical Office, Korea, *The Economically Active Population Survey.*

older women who were more likely to be forced to accept early retirement, declined more compared with primary workers. This pattern is consistent with the internal labor market hypothesis that marginal workers — young, female, less experienced, less-educated workers — rather than primary workers are more likely to bear the burden of adjustment to external shocks. Its policy implications will be discussed in section IV.

Table 3.2 examines the changes in employment by industry, occupation and work hours. It shows there have been substantial retrenchments, especially in manufacturing and construction indus-

tries. To a lesser degree, employment in retail and service sectors decreased, while the agricultural and fishery industries gained in employment. This implies that displaced workers and unsuccessful job seekers in the primary sector are involuntarily settling for inferior employment in the rural or the urban informal sector. No doubt this trend will increase underemployment. Underemployment will also rise due to the fact that unpaid family workers and part-time workers gained employment whereas regular workers lost it. The influx of displaced workers into the rural or the urban informal sectors and the decline of regular jobs will reduce the already low average income in those sectors even more, and are likely to increase the number of people below the poverty level.

Table 3.3
Participation Rate by Gender and Age
(units: %)

Gender	Age	April 1996	April 1997	April 1998	D96/97	D97/98
All	All	62.2	63.0	61.3	0.8	-1.7
	15/19	11.2	11.2	10.7	0	-0.5
	20/29	66.8	68.0	65.2	1.2	-2.8
	30/39	76.3	77.6	75.6	1.3	-2.0
	40/49	80.5	81.1	79.7	0.6	-1.4
	50/59	71.9	73.3	71.0	1.4	-2.3
	60+	40.1	41.7	39.3	1.6	-2.4
Men	All	76.5	76.3	75.8	-0.2	-0.5
	15/19	8.6	8.6	9.0	0	0.4
	20/29	76.6	76.3	75.4	-0.3	-0.9
	30/39	97.2	97.3	96.6	0.1	-0.7
	40/49	96.4	95.9	95.2	-0.5	-0.7
	50/59	88.7	89.4	87.7	0.7	-1.7
	60+	55.3	56.2	54.1	0.9	-2.1
Women	All	48.7	50.5	47.4	1.8	-2.8
	15/19	13.8	14.0	12.5	0.2	-1.5
	20/29	58.4	60.7	56.5	2.3	-4.2
	30/39	54.3	56.7	53.6	2.4	-3.1
	40/49	63.7	66.0	63.3	2.3	-2.7
	50/59	55.6	57.3	54.3	1.7	-3.0
	60+	29.5	31.6	28.8	2.1	-2.8

Source: National Statistical Office, Korea, *The Economically Active Population Survey.*

Table 3.4
Distribution of Unemployment by Age and Schooling in Korea
(units: thousand, %)

	Number of Unemployed Workers (Share in Total Unemployment)		Unemployment Rate	
	April 1997	April 1998	April 1997	April 1998
All	603	1,434	2.8	6.7
Age				
15/19	41 (6.8)	75 (5.2)	9.3	18.3
20/29	277 (45.9)	527 (36.8)	5.4	11.2
30/39	141 (23.4)	359 (25.0)	2.3	5.7
40/49	84 (13.9)	272 (19.0)	1.7	5.4
50/59	46 (7.6)	156 (10.9)	1.4	5.0
60+	15 (2.5)	45 (3.1)	0.7	2.3
Schooling				
No HS Diploma	141 (23.3)	391 (27.3)	1.8	5.4
HS Diploma	308 (51.1)	731 (51.0)	3.3	7.8
College Diploma	155 (25.7)	311 (21.7)	3.5	6.2

Source: National Statistical Office, Korea, *The Economically Active Population Survey.*

Table 3.3 shows the changes in participation rates by gender and age. Between 1997 and 1998, participation rates declined by 0.5 percent among men but by 2.8% among women. Age differences do not seem to exist even though the decline is slightly more visible among older workers. Considering the extent of gender discrimination in the Korean labor market, it is no wonder that participation rates among female workers, who were more likely to be second-income earners in a family, dropped significantly more than among male workers. Table 3.4 reports the distribution of unemployment and unemployment rates. We can see that the unemployment rates of young workers (15-29 years old) are the highest and that they account for 42% of total unemployment in April 1998. But it is important to note that primary workers, not just marginally attached workers, are also losing jobs on a large scale, indicating the severity of the crisis. In terms of growth rates, unemployment rates increased faster for primary workers. For example, unemployment rates of workers aged between 40 to 49 tripled from 1.7% to 5.4% within a year.

Table 3.5
Changes in Real Wage in Korea

Note: percentage change compared with the same period in the previous year.

	1997					1998		
	1/4	2/4	3/4	4/4	Annual	1/4	April	May
Nominal Wage (All industries)	11.6	9.7	6.8	0.9	7.0	0.0	-	-
Inflation (CPI)	4.7	4.0	4.0	5.1	4.5	8.9	8.8	8.2
Real Wage Growth	6.9	5.7	2.8	-4.2	2.5	-8.9	-	-

Source: Data for Indonesia are from Statistical Yearbook of Indonesia; for Korea, Chanyong Park and Meesook Kim, Current Poverty Issues and Counter Policies, Korean Institute for Health and Social Affairs, recited from ILO(1998); for Thailand, UN(1998).

Table 3.5 reports the changes in real wage in Korea. It is noteworthy that the growth rate of nominal wage, which used to be about 10% per year, dropped sharply after the crisis. In the first quarter of 1998, nominal wage did not increase at all. On the other hand, the inflation rate increased significantly following the substantial currency devaluation. As a result, real wage decreased by 8.9% in the first quarter of 1998. In section III.2 we see that the growth rates of real wage should recover soon after the sharp initial fall. At this moment, it is premature to tell whether real wage in Korea will follow this general trend. The freeze in nominal wage that Korea achieved in the first quarter of this year was not only due to the decline in labor demand after the crisis. It was mainly a temporal outcome negotiated in the Tripartite Committee, which consists of representatives from the government, workers and employers organizations. Whether the Tripartite Committee can fully accomplish its mission is very uncertain. As the restructuring goes on and mass lay-offs begin, it is likely that labor unions will protest against their unfair suffering. Then labor strikes and nominal wage hikes will follow.

III.4. Impact of the Asian Crisis on Income Distribution and Poverty

The rapid economic growth in East Asia significantly reduced the number of people living under the absolute poverty line. However, even before the crisis began, there had been widespread concern that the accelerating trend towards globalization in the 1990s could exacerbate the prevailing income distribution. This concern is now being reinforced. The current crisis may reverse the trend of equitable distribution in the region. In this section, we provide a summary of trends in income distribution in the three worst-affected Asian countries and then discuss the impact of the present crisis on their income distribution.

Trends in Inequality and Poverty

To see the changes in income inequality from before the crisis, we look at the data on Gini coefficients and the quintile shares of total national income. Though methods of collection, degree of coverage, and specific definitions of personal income may vary among counties, Tables 3.6 and 3.7 depict a general trend of income inequality in Indonesia, Korea and Thailand.

Table 3.6 shows that Indonesia made steady progress in reducing income inequality during the past two decades. Gini coefficients increased a little in the 1970s, reaching a peak in 1978. From then on, they declined consistently until 1993, the year up to which data is available. In the Republic of Korea, Gini coefficients showed an increasing trend from 29.8 in 1969 to 39.1 in 1976, and then continued to drop to 29.5 in 1996. Hence, according to the data, Indonesia and Korea have succeeded at least in preventing serious deterioration in income distribution over the last three decades. In contrast to the good performance of Indonesia and Korea, Thailand experienced a persistent deterioration in income distribution despite high-income growth. Gini coefficients steadily increased from 41.7 in 1975 to 51.5 in 1992. The share of income of the lowest quintile decreased from 0.049 to 0.037 during the same period. According to the UN (1998), the deterioration of income distribution can be attributed to a widening income differential between the urban and rural poor.

Table 3.6
Gini Coefficient and Quintile Income Shares
for Three Asian Countries

Country	Year	Gini	Income (Expenditure) Share				Data Characteristics		
			Bottom 20%	Bottom 40%	Top 20%	Top 20%/ Bottom 20%	Inc[1]	Pers[2]	Gross[3]
	1964	33.3					E	P	
Indonesia	1967	32.7					E	P	
	1970	30.7					E	P	
	1976	34.6	0.080	0.196	0.425	5.3	E	P	N
	1978	38.6	0.080	0.181	0.453	5.7	E	P	N
	1980	35.6	0.073	0.196	0.423	5.8	E	P	N
	1981	33.7	0.077	0.204	0.421	5.5	E	P	N
	1984	32.4	0.083	0.208	0.420	5.9	E	P	N
	1987	32.0	0.080	0.209	0.417	5.2	E	P	N
	1990	33.1	0.092	0.213	0.420	4.6	E	P	N
	1993	31.7	0.087	0.210	0.407	4.7	E	P	
Korea, R.	1965	34.3	0.058	0.193	0.418	7.2	I	H	G
	1966	34.2	0.065	0.184	0.406	6.3	I	H	G
	1968	30.5	0.086	0.214	0.392	4.6	I	H	G
	1969	29.8	0.084	0.214	0.382	4.6	I	H	G
	1970	33.3	0.073	0.196	0.416	5.7	I	H	G
	1971	36.0	0.072	0.187	0.434	6.0	I	H	G
	1976	39.1	0.057	0.169	0.453	8.0	I	H	G
	1980	38.6	0.051	0.161	0.454	8.9	I	H	G
	1982	35.7	0.070	0.188	0.430	6.2	I	H	G
	1985	34.5	0.068	0.205	0.419	6.2	I	H	G
	1988	33.6	0.074	0.197	0.422	5.7	I	H	G
	1993	31.0	0.074	0.204	0.392	5.3	I	H	G
	1996	29.5	0.076	0.212	0.374	4.9	I	H	G
	1962	41.3	0.080	0.166	0.498	6.2	I	H	G
Thailand	1969	42.6	0.051	0.152	0.501	9.8	I	H	G
	1975	41.7	0.049	0.150	0.484	9.8	I	H	G
	1981	43.1	0.043	0.137	0.511	11.9	I	H	G
	1986	47.4	0.042	0.129	0.531	12.6	I	H	G
	1988	47.4	0.041	0.126	0.542	13.2	I	H	G
	1990	48.8	0.040	0.123	0.552	13.8	I	H	G
	1992	51.5	0.037	0.113	0.585	15.8	I	H	G

Note: 1) Inc = Whether the Gini coefficient is calculated based on income(I) or expenditure (E)
2) Pers = Whether the recipient unit is the person (P) or the household(H).
3) Gross = Whether the income reported is gross(G) or net of taxes(N)

Source: Deininger and Squire (1996); and for the Korean data of 1993 and 1996, National Statistical Office, *Social Indicators of Korea 1997.*

Table 3.7 presents cross-country comparisons of income distribution. In general, countries in Asia appear to be more egalitarian than those in Latin America. The relationship between growth and equity is not clear. Countries such as Taiwan and Korea have successfully combined the reduction of inequality with high-income growth. The

Table 3.7
Gini Coefficients and Quintile Shares for Latest Available Year in Selected Economies.

Country	Year	Gini	Income (Expenditure) Share			Data Characteristics		
			Bottom 20%	Top 20%	Top20%/ Bottom20%	Inc	Pers	Gross
Bolivia	1990	42	0.056	0.482	8.6	E	P	N
Botswana	1986	54.2	0.036	0.589	16.4	E	H	N
Brazil	1989	59.6	0.025	0.652	26.3	I	P	G
Chile	1994	56.5	0.035	0.609	17.3	I	P	
China	1992	37.8	0.06	0.416	6.9	I	P	G
Colombia	1991	51.3	0.036	0.544	15.1	I	P	G
Gabon	1977	63.2	0.029	0.663	22.9	I	H	N
Hong Kong	1991	45	0.049	0.494	10.1	I	H	G
India	1992	32	0.088	0.411	4.7	E	P	N
Indonesia	1993	31.7	0.087	0.407	4.7	E	P	
Japan	1982	34.8	0.059	0.418	7.1	I	H	G
Korea, R.	1988	33.6	0.074	0.422	5.7	I	H	G
Malaysia	1989	48.3	0.046	0.537	11.7	I	P	G
Mexico	1992	50.3	0.041	0.553	13.4	E	P	
Nigeria	1993	37.5	0.04	0.493	12.4	E	P	
Philippines	1988	45.7	0.052	0.525	10.1	I	P	G
Taiwan	1993	30.8	0.071	0.387	5.4	I	P	N
Thailand	1992	51.5	0.037	0.585	15.8	I	H	G
USA	1991	37.9	0.045	0.441	9.8	I	H	G
Zimbabwe	1990	56.8	0.04	0.623	15.7	E	P	N

Note: See notes to Table 4.1.
Source: Deininger and Squire (1996).

superior performance of these countries is in contrast to that of countries such as Hong Kong, Mexico and Malaysia, all of which had high economic growth rates but failed to reduce income inequality.

In addition to income distribution and relative poverty, another important issue focuses on the extent and magnitude of absolute poverty. Until the recent crisis, all three countries enjoyed improving living standards as the population living in poverty fell substantially. Table 3.8 demonstrates that all three Asian countries reduced poverty as a result of remarkable growth rates. In Korea for instance, the level of absolute poverty decreased from 21.5% in 1975 to 8.5% in 1995.[28] However, despite the impressive success of these countries in reduc-

Table 3.8 Trends of Poverty in Indonesia, Thailand, and Korea Headcount Index(percentage of the poor)

(number of poor, millions)

Indonesia	1976	1981	1987	1993	1996
Total:	40.1	26.9	17.4	13.7	11.3
	(54.3)	(40.6)	(30.3)	(25.9)	(22.5)
	38.8	28.1	20.1	13.4	9.7
	(10.0)	(9.3)	(9.7)	(8.7)	(7.2)
Rural	40.3	26.4	16.1	13.8	12.3
	(44.2)	(31.3)	(20.8)	(17.2)	(15.3)
Thailand	1975	1981	1988	1992	1996
Total	30	23	22	13	-
	(12.4)	(11.0)	(11.9)	(7.5)	
Korea	1975	1980	1985	1990	1995
Urban	20.0	14.4	14.2	10.5	7.4

Note: Poverty estimates are based on country-specific poverty lines.
Source: Data for Indonesia are from *Statistical Yearbook of Indonesia*; for Korea, Chanyong Park and Meesook Kim, *Current Poverty Issues and Counter Policies*, Korean Institute for Health and Social Affairs, recited from ILO(1998); for Thailand, UN(1998).

ing income distribution and poverty during the past two decades, a substantial body of the population still lives below the poverty line, particularly in the rural areas of Indonesia and Thailand. Some 22 million Indonesian people were still living below the officially defined poverty line in 1996. The poor in Indonesia are predominantly located in the rural and agricultural sectors. Similarly in Thailand, though the absolute population living below the poverty line continued to decline, poverty is much higher in the rural areas, particularly among less-educated households, agricultural workers, and large families.

Distributional Impact of the Asian Crisis

Although we do not have precise statistics or information on the evolution of poverty and income distribution at this stage, the current economic crisis is considered to have already had significant adverse effects on equitable growth in this region.

The immediate impacts of economic crises and IMF programs on

income distribution were increases in unemployment and inflation. The increases in unemployment and underemployment directly aggravated poverty. The total number of unemployed has increased in unprecedented numbers in this region and will continue to pile up. The newly unemployed are obviously suffering a drastic drop in income and living standards. Loss of jobs or reallocation to low-wage occupations has led to a sizeable increase in the number of people living below the poverty line. Hence, the decline in job opportunities has definitely contributed to increased poverty.

Price increases lowered the real wages of those still employed, exacerbating poverty even more. Average annual inflation reached 44 percent in Indonesia in May 1998, and around 11 percent in Korea and Thailand. Because nominal wages did not adjust to offset the effect of price increases and social income compensation from social safety nets was minimal, real income of a typical household declined almost by the full extent of the price increases. The price increases of specific commodities also had a great impact on household consumption. They had a differentiated impact on households, depending on the shares of food and necessary items in a household's consumption basket. Because the price increases concentrated on the items that account for a large share of the consumption of low-income households, they further adversely affected income distribution. For example, food constitutes 70 percent of the total expenditure of the households in the lowest income in Indonesia and 55 percent in Thailand. The corresponding expenditure shares for the top decile households are 35 and 21 percent, respectively (Gupta, et al, 1998). Thus, price increases in these countries would have more significant adverse impacts on the consumption of the poor.

In addition to the severe adverse effects of rising unemployment and inflation, poverty could be further aggravated by "social income poverty" (Ranis and Stewart, 1998). During a crisis, higher prices and fewer employment opportunities deprive people of primary (or private) income. Moreover, a crisis reduces secondary (or social) income from the state via public works or income transfers (e.g. unemployment benefits). Although it is not clear whether total government expenditure itself was reduced after the crisis, social expenditure for

education, public health, and social services was negatively affected. In Thailand for example, the government budget in 1997 was reduced by 32%, 15%, and 11% for social services, public health, and education sectors, respectively, after the crisis (Siamwalla and Sobchokchai, 1998). The cuts in social expenditure have had an immediate, adverse effect on social incomes of the poor, and will also have long-run consequences on the private incomes of all economic agents. Since it is expenditure for education and health care that has a significant effect on human capital formation, the cuts in these social sectors can hurt long-run growth potential and prolong the adverse poverty situation over a long period.

The combined effects of higher price increases, job losses and reduced social expenditures indicate that the crisis will have a deep adverse effect on (absolute and relative) poverty in these Asian economies. However, its impact on overall income inequality is rather ambiguous. The impact of job losses on income inequality is hard to predict: it depends on the composition of job losses. If the crisis hurts urban middle class workers more severely than those in the upper and bottom quintiles, how the Gini coefficients will change is not clear.

Moreover, not all population groups lose from the crisis. Some households will gain from exchange rate depreciation. Incomes of those engaging in export and tourism sectors can improve. The sharp increase in interest rates can benefit those holding a larger stock of interest-bearing assets. Diverse impacts of the crisis on income distribution imply that the increase of Gini coefficients during the crisis will be marginal. The cross-country evidence of Section III.2 confirms this prediction. It shows that income inequality tended to increase immediately after the IMF programs but that the degree of deterioration was not substantial. Individual country experience also supports the prediction that the crisis aggravates poverty significantly, but that the change in overall income distribution is relatively small. For instance, according to Hernandez and Mayer (1998), the Gini coefficient in Chile worsened only marginally during the 1982-83 economic crisis (from about 52 in 1980-81 to about 55 in 1982-83) even though poverty indices deteriorated significantly. The share of

population below the poverty line increased from 33 percent in 1981 to about 58 percent in 1983. This finding has an important policy implication for building a social safety net during a crisis. In view of the significant deterioration of poverty and the minimal rise in overall income inequality, welfare policy should be targeted to the core group of the poorest and hardest-hit victims instead of trying to maximize the number of beneficiaries.

In sum, although the short-term deterioration of poverty and income distribution is inevitable, the longer-run impact of the crisis on income distribution is less clear. It surely depends on the nature and implementation of government policy in handling the crisis. The cross-country evidence in section III.2 shows the possibility of income distribution improving with the recovery of economic growth in the long run. However, without adequate government policies, we cannot expect the level of income equality to soon recover to what it was before the crisis in Asia.

V. Concluding Remarks

The unexpected financial collapse in Asia has been followed by massive economic and social collapse. Millions of people have lost their jobs, and the problems of poverty and income inequality have been rapidly aggravated. A substantial part of the gains in living standards that have accumulated in the last decades have evaporated in one year. The lack of adequate social safety nets in the midst of the crisis has led to disastrous social consequences in these countries.

This paper analyzes the social impacts of the crisis in the most-affected Asian countries, including Indonesia, Korea, and Thailand, and tries to draw policy implications for effectively containing its social costs. The paper begins with a general overview of the cause and the evolution of the Asian crisis and highlights the differences as well as the similarities among the Asian countries. It also reviews IMF adjustment programs and analyzes their social impacts. In particular, we analyze the impacts of IMF programs on unemployment, poverty and income inequality using a cross-country data set that consists of all the countries that have received financial assistance from the IMF from 1973 to 1994.

The stylized pattern of employment growth in the previous IMF program countries indicates that employment growth takes more adjustment time compared with other macroeconomic variables. It implies that unemployment is unlikely to be alleviated in the near future in the Asian countries. Also, the paper finds that the crisis exacerbates poverty for a significant period even though it does not have a long-run effect on overall income distribution. This pattern arises because the burden of the crisis tends to be distributed unequally. The poor, less-educated, less-experienced, young and female workers are most severely affected. They are more likely to become the long-term unemployed and to remain below the poverty level even after the economy recovers from the crisis.

This fact has an important policy implication in building social safety nets in Asian countries. In view of the significant deterioration of poverty with the minimal rise in overall income inequality, welfare policy should be targeted to the core group of the poor and the hardest-hit victims instead of trying to maximize the number of beneficiaries. In particular, this core group does not belong to a union and has little political power to represent themselves. One has to be aware that oftentimes, policies adopted under the name of social consensus place an unfair burden on them.

The key features of the Asian crisis are large inflows and sudden withdrawals of foreign capital. It is therefore understandable that the call for restricting international capital flows, especially short-term capital flows, is gaining more support and sympathy. However, this paper argues that unilaterally raising a barrier to international capital flows is not the policy lesson to be learned from the Asian crisis. There is no doubt that managing erratic and volatile movements of short-term capital flows is an important policy challenge. But that goal cannot be achieved by one countrys unilateral effort. The Korean case is a good example: It is fantasy to think a small country can effectively control the extent and the speed of globalization once it opens its financial market partially or indirectly. If one country tries to restrict capital mobility unilaterally, it either has to pay a higher cost for financing or foreign capital will leave that country and flow into another country. Effective regulation of short-term capital flows

is possible only through international policy coordination. Until a global financial governance system is developed, improving the domestic financial infrastructure rather than trying to control capital flows seems to be the more practical policy option.

The Asian crisis presents extraordinary policy challenges not only to the affected countries but also to their trade partners and the international community. International partnership among the affected Asian countries, advanced countries, and international institutions is essential in overcoming the current economic and social disaster, in preventing it from spreading to the world, and in ensuring stability in the global capitalist system.

NOTES

22. For discussions on the methodology of evaluating the effects of the IMF programs, see Khan(1990), Killick(1995), Killick and Malik(1993), Killick, Malik, and Manuel(1993), and Corbo and Fisher(1995).
23.The 455 programs approved during the sample period consist of 345 stand-by arrangements, 42 extended fund facility (EFF) arrangements, and 44 arrangements under structural adjustment facility (SAF) or enhanced structural adjustment facility (ESAF). The remaining 21 cases were combined programs of more than two arrangements.
24.We have excluded some extreme observations such that annual growth rate of employment or real wage is higher than 50 percent or lower than 50 percent. The results are basically identical when these observations are included.
25. The stabilization effects of IMF programs appear depending on exchange rate regime: in countries with nominal exchange anchors, which could add a strong credibility to the stabilization packages, inflation rates fell dramatically from the first program year. See Shadeler et al, (1995, part I) for more details.
26. Garuda (1998) claims that distributional effects of IMF programs may depend on a country's pre-program economic situation. He finds evidence of a significant relative improvement in income distribution in the program countries in which external imbalance prior to the program initiation is not severe, while countries that experienced the most severe pre-program external problems showed deterioration in income distribution relative to non-program countries with equally severe conditions. We have not tried the same experiment because the sample size becomes too small with the further classification of data.
27. On the labor market front during the pre-crisis period, the performance of

Indonesia had been less impressive among these countries. But it is widely pointed out that the underemployment problem is most severe in Thailand and therefore, her unemployment rate is significantly underestimated.
28. See Whang and Lee (1997) for detailed analysis of changes in income distribution and poverty in Korea.

SOURCE

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Part 6
Important Terms

APEC The Asia Pacific Economic Cooperation forum, founded in 1989 to promote open trade and economic cooperation among 21 member countries on the Pacific Rim.

ASEAN The Association of Southeast Asian Nations, established in 1967. Member nations include Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam.

Bretton Woods Site in New Hampshire of 1944 conference, at which 45 governments met to agree on a framework for economic cooperation. The World Bank and the International Monetary Fund were established at this conference, and are sometimes referred to as the "Bretton Woods institutions."

Currency Speculation The buying and selling of national currencies in accordance with their shifting value. One strategy is to borrow in a currency that is at risk of being devalued. For example: say that a speculator borrows an amount of Thai currency that is equivalent to $10,000 U.S. dollars. After borrowing, he converts the currency into dollars. Shortly thereafter, the Thai currency is devalued by 40%. He then uses his dollars to buy Thai currency in order to pay back the loan — but he is able to buy a sufficient amount for only $6,000. He is left with $4,000 U.S. dollars as his profit.

FDI Foreign Direct Investment refers to ownership by foreigners of physical capital (e.g., a factory) in a given country.

Free Trade Unrestricted foreign trade policy, with no tariffs or quotas on imports and exports.

General Agreement on Tariffs and Trade (GATT) An organization founded in 1947 to promote international trade. The Uruguay Round of negotiations in 1994 led to the replacement of GATT by the World Trade Organization.

Gini coefficient Named after the Italian statistician Corrado Gini, this coefficient is a measure of income inequality in a society. It is a ratio that measures the difference between given data and perfect equality. The coefficient is a number between 1 and 100; the higher the number, the greater the degree of inequality in income. (If a country registers a Gini coefficient of 65, it means it has more inequality than another

country measuring only 50. If the Gini coefficient of a given country goes from 60 to 65 over the course of 10 years, it means that inequality in that country has increased.)

Globalization Increased mobility of goods, services, capital and technology throughout the world.

HIPC Aid A shorthand abbreviation for the Debt Initiative for the Heavily Indebted Poor Countries (HIPCs). The objective of the initiative is to reduce a country's debt level to something that can be sustained over time. It is believed that if debt, and debt servicing costs, remain high, there is a negative impact on both economic reform and social services.

IMF (International Monetary Fund) Founded in 1944 in order to ensure the stability of the world economy in the post-war world. The IMF's mandate was to promote economic stability, primarily by lending money to countries going through economic downturns – the founders wanted to prevent a recurrence of the widening downward economic spiral that marked the Great Depression of the 1930's. Today, the IMF provides loans to developing countries, and works to establish stable exchange rates.

Invisible Hand A term (ascribed to 18th century economist Adam Smith) to describe the working of markets. It implies the absence of central regulation; rather, each individual, acting through self-interest (synonymous, in practice, with rational choice), helps to create an equilibrium of production and consumption (i.e., supply and demand).

LDC For many years, the acronym LDC has stood for Less Developed Country, which was more or less the same as developing country – that is, a country whose per capita income is low by world standards. However, in recent years LDC has also been used for Least Developed Country, which is defined as a country designated by the UN as least developed, based on the criteria of low per capita GDP, weak human resources (life expectancy, calorie intake, etc.), and a low level of economic diversification (share of manufacturing and other measures). (From Deardorff's Glossary of International Economics.)

MAI The Multilateral Agreement on Investment was a proposed agreement to liberalize rules on international direct investment. In response to negative public reaction, negotiations for the agreement were dropped.

Neoliberalism Economic philosophy that promotes the expansion of markets in time and space, the maximization of transactions and privatization, and the reduction of government involvement in the market.

OECD The Organisation for Economic Cooperation and Development was founded in 1961 as a successor to the Organisation for European Economic Co-operation (OEEC), which was formed to administer American and Canadian aid under the Marshall Plan for reconstruction of Europe after World War II. The OECD aims "to build strong economies in its member countries, improve efficiency, hone market systems, expand free trade and contribute to development in industrialised as well as developing countries." Most of the 30 member countries are in Europe, but the OECD also includes Australia, New Zealand, Japan, Korea, Canada, Mexico and the United States.

NAFTA The North American Free Trade Agreement, which created a free trade zone encompassing Canada, the United States and Mexico in 1994.

PNTR Permanent Normal Trade Relations, the granting of most favored nation (MFN) trading status to a country that is not a member of the WTO. (From Deardorff's Glossary of International Economics.)

Protectionism Economic policy that protects domestic businesses against foreign competition through the use of tariffs, quotas, voluntary export restraints, and other non-tariff barriers to trade.

Sahel Sahel comes from the Arabic word meaning "border" or "shore." The Sahel countries are the African nations — Burkina Faso, Chad, Gambia, Mali, Mauritania, Niger, and Senegal — that line the southern border of the Sahara desert, in a semi-arid region north of the savannah.

Structural Adjustment Program (SAP) Conditions imposed on borrowing countries by the IMF and World Bank. Typically, these programs promote foreign trade, reduce government spending, devalue currency, and decrease the government's role in the market.

Washington consensus A shorthand phrase for the neoliberal economic policies that have been promoted by the World Bank and the International Monetary Fund offices in Washington, with the support of the U.S. government.

World Bank Founded in 1944 in order to ensure the stability of the world economy in the post-war world. The World Bank's mandate was to promote reconstruction and development and to combat poverty. Today, it provides loans to developing countries.

World Trade Organization (WTO) The successor of GATT, the WTO is an organization designed to promote international trade. It monitors trade policies and mitigates trade disputes between member nations, with the overarching goal of promoting free trade through the reduction and/or dissolution of tariff and non-tariff trade barriers.