Globalization for all – reviving the spirit of Bretton Woods.

An examination of developments in global financial markets.

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If we cannot make globalization work for all, in the end it will work for none.

Kofi Annan

Summary and outline

Sixty years ago, in the closing days of global conflict, the world's political leaders made a commitment to global security and development. Their legacy has been a set of institutions of conflict resolution and economic cooperation – the United Nations and various economic institutions known collectively as the "Bretton Woods" institutions.

Were they to survey the world today, the architects of those institutions would be dismayed to see how many of the world's people are still in poverty. They would be pleased to see what progress has been made, but they would be shocked by the patchiness of that progress, and even more shocked to see how inequality has widened over that period.

But their prime concern would be the developments since September 2001, as governments, jockeying for influence in a "new world order", bypass the institutions of multilateral cooperation. That world order could be one defined by military and trade security for the powerful and prosperous rather than by a commitment to just and sustainable development for all. It could be one which retains the rhetoric of globalization and liberalization, but in which the reality is protectionism and disengagement, and the demise of the fragile consensus which, to date, has sustained global economic cooperation. If people do not see globalization and liberalization working for the common good, they will turn to other economic creeds.

The world has been there before.

This work is a plea not to forget the lessons of history. Its first two chapters, therefore, provide a brief description of the development of the Bretton Woods Institutions – the World Bank, the IMF and later institutions, such as the World Trade Organization, forged in the spirit of Bretton Woods – a spirit of global liberalism.

Chapter 3 surveys how well that vision has been realized. There has, indeed, been progress, particularly in East Asia, and gross indicators do indicate more widespread progress. But the vision of the Bretton Woods architects is far from realization.

These failures are analyzed in the following two chapters. Chapter 4 outlines how the practical and pragmatic economic philosophies of earlier times have given way to the "Washington Consensus" – a dogmatic reliance on simple (and flawed) economic models which remove economics from its social context, which devalue public enterprise, and which have allowed the financial sector to become decoupled from the real economy. Chapter 5 is a reminder of the realities of markets; they rarely obey the rules of simple economic models. Liberalization of trade and capital flows can work to the benefit of all, but only if they are well-managed.

The last two substantial chapters plot a path for reform – in the institutions and within developing countries. Financial market reform, while important, will do little to help the world's poorest unless accompanied by renewed commitments on aid and trade. While the institutions are flawed, they are not beyond redemption. There is some scope for developing new institutions but the greatest benefits will come from revitalizing existing institutions. Whatever the shortcomings of our institutions of multilateral cooperation, they are trivial in comparison with what may happen in a world of hegemony or beggar-thy-neighbour unenlightened self-interest.

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Preface

A note on timing

As this paper is being finalized the institutions of international cooperation are under severe stress. For almost sixty years the world has looked to the United Nations, the Bretton Woods institutions and other more recently developed bodies of global cooperation to provide stability, security and protection against a repetition of the events of the first half of the twentieth century.

The future of global cooperation is now unclear, and is likely to remain unclear for some time. There are several possibilities: superpower hegemony, bilateralism, a retreat to regional cooperation, and a reversion to beggar-thy-neighbour nationalism.

In contrast with these dismal possibilities there could arise a re-vitalized spirit of multilateralism, either through development of new institutions or re-invigoration of existing institutions.

The main assumption in this paper is that the setbacks of 2003 are temporary. Good sense can prevail now as it did in the 1940s; we have not all forgotten the lessons of history. Another assumption is that we will recognize the investment all stakeholders have made in these institutions; they are flawed but not beyond repair.

A note on terminology

This paper uses the terms "development" and "developing", but the meanings of these words are contentious. Some see "development" purely in terms of gross monetary indicators, such as GDP per capita, which take little account of environmental or social capital. Such a narrow concept can lead some to speak against the desirability of development, and others to assert that development objectives are necessarily in conflict with social and environmental objectives – that there have to be tradeoffs. It is more useful, however, to use the term "development" in a way which encompasses all resources, not just those which can be captured in monetary measures.

Similar ambiguity attaches to the word "developed", which has become synonymous with "prosperous". Is it meaningful, however, to refer to ancient civilizations, such as China and Mexico, as "less developed" or "developing", and to refer to New World countries as "developed"? What does it mean when a country with a rich cultural tradition and a thriving pre-capitalist economy is transformed into an impoverished capitalist economy stripped of its cultural wealth? Is this development?

This paper adheres to the convention of international agencies in use of these terms, while accepting that they give little weight to cultural capital and similar endowments. But that doesn't restrict these words to narrow monetary interpretations. Development is about improving all dimensions of well-being; when people are deprived of nutrition, shelter, physical safety, clean water, health care, education, connection with the community and other basic needs, it is reasonable to define development in terms of overcoming these deprivations, even if they are not always covered in monetary measures.

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Published sources are acknowledged in the bibliography. Bibliographies, however, in mentioning many sources, give no indication of the extent of influence of particular authorities. In this regard I would like to express particular thanks to Professor Dani Rodrik as a teacher and ongoing source of inspiration through his publications.

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Canberra, April 2003

1. Introduction – economic models and economic realities

From the insulated environment of Washington, Basel and Geneva, the homes of the global financial institutions, it is easy to allow simple economic models to dominate policy thinking and to ignore the economic and political practicalities which dominate the real world.

It would be hard to find anyone in these agencies, or among the politicians of their sponsoring governments, who does not believe in the importance of global development. Even conservative economists and politicians, who speak out against the debilitating effects of welfare in developed countries, find the extreme deprivation of the world's poorest to be unacceptable.

Policy differences are about means, rather than ends. While there are few who would advocate comprehensive central planning, as occurred in the former Soviet Bloc and in some African countries, there is still a strong debate about the extent to which development should be left to private markets and to private institutions. The *laissez faire* view, in support of less government intervention, tends to dominate among the policy élites of the developed (and developing) countries – and therefore among those who control funds available for development.

Market-based policies, however, such as openness to trade and capital flows, or conditionality imposed as part of a loan package, given favourable conditions, may work in the long-term. But they can have such disastrous short-term consequences that they undermine their own effectiveness.

Politicians and public officials in developing countries generally do not have the comfort of waiting for the long-term, and their experiences do not conform to the models to be found in economics texts. They will be pressed to deal with the immediate needs of their citizens for nutrition, health and safety, rather than the demands of international creditors. And even the most hard-nosed authoritarian government can hardly ignore its people when they take to the streets to protest about the effects of fiscal stringency.

International agencies, and finance departments (in both developed and developing countries), however, will not be so responsive to people's immediate needs. To their staff, raised with a near religious faith in the workings of competitive markets, phenomena such as food riots or conflicts over diminishing water supplies are no more than transitory problems.

It is easy to condemn the discipline of economics for this callousness. But economics devoid of a social context, and which does not accommodate practical experiences within its framework, is poor economics. Development economists know that markets rarely behave in the way postulated in undergraduate textbooks. Market failure abounds.

For example, global development does not follow the path of simple economic models. Economic theories of capital markets suggest that capital should flow from rich countries with a surplus of capital and a deficit of labour to countries with a shortage of capital and a plentiful supply of labour. If that were the case, Africa and India would be the major destination of global capital flows, and the US would be a net creditor nation, rather than the world's largest debtor nation.

Similarly, markets do not sustain equilibrium. Events of 2002 demonstrate that not even Wall Street enjoys the luxury of equilibrium, and equilibrium is an even more elusive experience in Buenos Aires, Lagos and Jakarta. The World Bank, in its 2000 *World Development Report*, listed macroeconomic stability as a major prerequisite for achieving the growth necessary for development.[1] It is not the only prerequisite, of course, but it is an essential one. Over the last thirty years world financial markets have been anything but stable; instability in financial markets has led to instability in the real economy. Encouraging runs of development have been brutally punctuated by currency and exchange rate crises.

Economists and financiers can be oblivious to the lessons of history, which remind us that the backlash against brutal economic reforms can be so severe that in time people reject economic reform altogether, turning away from the world and rejecting the promises of economic (and social) liberalism. It is easy to pontificate about the virtues of open markets from the comfort of an office in Washington, or even from the comfort of a hotel room in Buenos Aires; it is much harder to make a convincing case in a village of impoverished farmers.

This comfort goes beyond mere physical amenity and the conditioning of university economics courses. It is reinforced by the apparent success of western capitalism. The last thirty years of the twentieth century have seen the triumph of western capitalism over central planning. The mantra of the neoliberal regimes of Thatcher and Reagan was “there is no alternative”. The collapse of European communism prompted Francis Fukuyama to proclaim “the end of history”.[2]

History hasn’t ended; it is still being played out, as current events demonstrate. There is nothing permanent about the world order of the early twenty first century, which is starting to manifest some of the instabilities of the early twentieth century.

The economic liberalism of the nineteenth century came to an abrupt end in 1914; the following thirty years were characterized by isolationism, uncooperative and dirigiste trade policies, financial and economic booms and busts, and, of course, wars. Not until 2000 did capital achieve the mobility that it had achieved just before the 1914 war.[3] Labour mobility is now much more controlled than it was during the great migrations of the nineteenth century. The period from 1914 to 1945 saw a huge public and political reaction against markets, and, in the wake of the Great Depression, against financial markets in particular.[4] Anti-market movements, most notably fascism and communism, were nurtured by the misery of this period.

Those who lived through the turbulent first half of the twentieth century appreciated the fragility of economic liberalism. As the 1937-1945 war drew to a close the western powers – dominated by the USA and Britain – came together at Bretton Woods, New Hampshire, to establish a set of agreements and institutions that would re-establish economic liberalism. These institutions developed alongside the United Nations – first conceptualized in 1942 and

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1 World Bank, *World Development Report 2000* p. 1.

2 Fukuyama 1992.

3 Obstfeld and Taylor 2002.

4 Polanyi 1944.

formally established in 1945. Political liberalism and physical security were generally the realm of the UN, while economic liberalism and economic security were to be the realm of the Bretton Woods institutions. While some have drifted from their original purpose, these same agreements and institutions are still dominant today.

2. The creation of the Bretton Woods institutions

The agenda for the Bretton Woods conference was to ensure that the world did not slip back into the chaos which had emerged after 1918. The scene for the conference had been set in 1941, when Roosevelt and Churchill had agreed on the terms of the Atlantic Charter – to abolish colonialism, to develop a fairer world trade system, and to improve labour standards and security throughout the world. The Atlantic Charter was essentially the conditionality the US sought for its support of Britain's war effort. As the war drew to a close, the Bretton Woods Conference was the vehicle which gave practical effect to the Charter.

The liberalism of Bretton Woods was not without an ideological content; the experience of the Great Depression, the demise of fascism and the military and economic triumphs of the USSR had made communism appear a very attractive alternative to capitalism. The Americans and British were determined to ensure that the postwar order would gain widespread acceptance, not only in their own countries, but also in the war-ravaged countries of Europe and East Asia, and in the countries about to be de-colonized. Even if physical colonization was to end, contests for ideological and trade dominance were to persist for the following forty years.

Jessica Einhorn, former Managing Director of the World Bank, describes the mood of the time:

> The World Bank, along with the International Monetary Fund (IMF), was established at Bretton Woods as part of the post-World War II international financial architecture. This system was meant to avoid future world wars by ensuring an open international trading system and global financial stability. At the founding conference, the economist John Maynard Keynes called for an institution that would focus first on postwar reconstruction and then on development in poor countries. The bank was thus established, beginning the great postwar experiment of using public loans for economic development.[5]

The Bretton Woods institutions

The World Bank and the International Monetary Fund (IMF) are often known as the "Bretton Woods institutions". Both were established in 1944.

The World Bank's original purpose was to finance the reconstruction of war-torn Europe. In the postwar era it soon became a major lending and technical agency concerned with development. Over the last twenty years it has increasingly become involved in debt-management in developing countries.

The IMF's original mandate was to promote international monetary cooperation, to facilitate the expansion of international trade, and to promote exchange rate stability. While these remain key objectives of the IMF, the means it employs to achieve these ends have changed significantly, with increasing emphasis on imposing fiscal stringency on debtor nations.

While there is overlap between the institutions, the distinguishing difference is in original purpose. The World Bank's role has been concerned with economic development, while the IMF's role has been to prevent a recurrence of the circumstances which led to the Great Depression.

5 Einhorn 2000, p. 23.

The origins of the Bretton Woods institutions and related institutions are outlined below.

The World Bank

The World Bank's early mission reflected the pressing concerns of the day – in fact it was originally known as the "International Bank for Reconstruction and Development". (The IBRD is now one of the Bank's two branches, the other being the International Development Association.) Financing of physical infrastructure such as dams, highways, ports and railroads was a priority in the postwar years.

The UNDP

While the World Bank would attend to infrastructure finance, the United Nations was to have a role in non-repayable aid. Various UN programs were merged in 1959 to form the United Nations Development Programme (UNDP). (The UNDP still has a significant development role, but it is not well-financed. Its role is mainly one of research, advocacy, coordination and levering contributions for jointly funded programs.)

The IMF

The IMF had a mission complementary to that of the World Bank. Its task was to provide back-up liquidity to allow countries to ride out the inevitable swings of business cycles. The severity of the Great Depression was aggravated by countries pursuing beggar-thy-neighbour policies of competitive devaluations and fiscal contraction – policies which can provide a reasonably assured but painful path out of a national recession, *provided other countries aren't pursuing similar policies*.

The IMF was charged with preventing another global depression. It would do this by putting pressure on countries that were allowing their own economies to go into a slump, and therefore not contributing to global aggregate demand. It would help those countries (and, therefore their trading partners) by providing governments with liquidity in the form of loans to countries facing an economic downturn and unable to stimulate aggregate demand from their own resources. In recent years the IMF has come to be associated with fiscal stinginess, but its original charter was just the opposite – to provide responsible Keynesian stimulation for countries which could not afford to do so from their own fiscal resources. Joseph Stiglitz, former Chief Economist of the World Bank, outlines this original role:

> In its original conception, then, the IMF was based on a recognition that markets often did not work well – that they could result in massive unemployment and might fail to make needed funds available to countries to help them restore their economies. The IMF was founded on the belief that there was a need for collective action at the global level for economic stability – just as the United Nations had been founded on the belief that there was a need for collective action at the global level for political stability.[6]

[6] Stiglitz 2002, p. 6.

The exchange rate system

Providing liquidity, in itself, does not ensure stability. (In fact, excess liquidity in the hands of speculators can cause instability.) Much of the instability of the interwar years had resulted not only from a lack of liquidity but also from competitive devaluations. Competitive devaluations were to be prevented by a régime of fixed exchange rates – a régime which survived through to 1973. The system was not rigid; over the period that the Bretton Woods system held France and Britain, for example, devalued their currencies against the US dollar, and Germany and the Netherlands revalued their currencies, but these were carefully managed adjustments.

The Bretton Woods system was a defacto gold standard, and remained workable "as long as the US dollar was as good as gold, convertible into gold at a fixed rate".[7] Keynes and others had urged the development of a global currency as a peg for other currencies, but this was not acceptable to the Americans.

Fixed exchange rate régimes are hard to sustain; over time different rates of inflation in different countries result in divergence in real (inflation adjusted) exchange rates. When the Bretton Woods fixed exchange rate system collapsed in 1973 and the world progressively moved to floating exchange rates, the orthodox economic opinion was that market forces would lead to more stability in real exchange rates. That was not to occur, however. Since 1973 real exchange rates have been far more volatile than they were during the period of fixed rates.[8] Conventional economic theory suggests that over the long-term exchange rates should reflect purchasing power parity, but this theory is based on the notion that most foreign exchange transactions are to finance real finance flows – trade and physical investment. When foreign exchange transactions take on a life of their own, quite separate from real trade and investment transactions, long-term instability can result.

The Bank for International Settlements

Another Bretton Woods institution is the Bank for International Settlements (BIS). The BIS was established in 1930 to handle war reparations among European countries. Subsequently it was subsumed into the Bretton Woods framework. Its main role now is to act as a bank for central bankers, performing essential functions of facilitating interbank transactions, such as reserve management and gold transactions. The BIS does not have any specific role relating to economic development, but it has been an active participant in the Financial Stability Forum, a group established after the 1997-1998 Asian crisis to examine causes and consequences of global financial instability. The FSF is a consultative body only; it has no executive power.

While the IMF is truly global, with 146 members, the BIS has only 29 members, with a strong European dominance. The IMF could be classified as a development bank or a development corporation, while the BIS is more a central bank of central banks, without a specific development role. But there is a degree of overlap in the institutions' roles. Both have an interest in financial stability, and the BIS has been a lender to developing countries in various

[7] Allen 2001, p. 153.

[8] Dimson, Marsh and Staunton 2002, p. 99.

rescue packages brokered by the IMF. (It has provided some supplementary functions to the IMF, for example, in the context of the IMF stabilization programs for Mexico and Brazil.)

Another important role of the BIS is to provide secretariat and research support to the Basel Committee on Banking Supervision, a committee established in 1975 by the G10 countries. This committee established the "Basel Concordat" which specified the locus of responsibility for supervision of transactional banks. Another initiative has been the "Basel Accord", which defines minimum capital adequacy requirements. Since 1998 the Committee has been re-defining capital adequacy in a way that more accurately reflects the risk across a bank's capital base. In the context of financial stability, these new standards are designed to counter the balance sheet innovations that financial institutions used to use to provide compliance with previous "one line" standards which took inadequate account of the quality of reserves. Although initially only BIS members signed up to these requirements, other countries have joined in order to achieve market access and credibility.

The ITO, the GATT and the WTO

Besides finance, the other essential plank of the Bretton Woods orders was trade – not just free trade but also fair trade. Another proposed (but not established) Bretton Woods institution was an International Trade Organization. The draft charter for the ITO included an article which stated that:

> ... all countries have a common interest in the achievement and maintenance of fair labor standards related to productivity and thus in the improvement of wages and working conditions as productivity may permit. [...]
>
> Unfair labor conditions, particularly in production for export, create difficulties in international trade, and, accordingly, each member shall take whatever action may be appropriate and feasible to eliminate such conditions within its territory.[9]

Besides labour standards conditions, the ITO was to set out rules on restrictive business practices and international investment. Although its charter (the "Havana Charter") was endorsed by 50 national delegates in the 1948 UN Conference on Trade and Employment, it failed to be ratified by the governments of those countries, with the strongest opposition coming from the US Congress. It was not until 1994 that the World Trade Organization (WTO) was established with a much more restricted charter. But there was a reasonable commitment to tariff reductions, with the General Agreement on Tariffs and Trade (GATT) having been ratified in 1947. The GATT principles were concerned with ending discrimination in trade and with general reductions in tariff and non-tariff barriers to trade, and these principles were largely incorporated into the WTO rules. (Although they did not get off the ground in 1944, the GATT and WTO are generally considered to be Bretton Woods institutions.)

Also missing from the Bretton Woods agreements was any consideration of coordination of national taxation policies. Sixty years on, this may seem to be a serious omission, reflecting the influence of powerful lobbies. But not even Keynes raised the issue of coordination of taxation policies; it would have taken extraordinary foresight to have predicted and

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[9] Rodrik 1997, p. 33.

anticipated the growth in tax competition and the proliferation of tax havens that have occurred in the postwar era.

While trade liberalization was a high priority of Bretton Woods, financial market liberalization was not part of the agenda. Indeed, there was a view that in providing certainty about exchange rates, the constraints on the financial sector posed by having fixed exchange rates would help firms make investment plans which would facilitate trade and real economic growth. Keynes and others knew that financial instability resulting from speculative capital flows had been one of the factors contributing to the Great Depression.

The liberal spirit of Bretton Woods was summarized by Henry Morgenthau, Secretary of the Treasury in the Roosevelt administration:

> I take it as an axiom that this war is ended; no people – therefore no government of the people – will again tolerate prolonged or wide-spread unemployment. A revival of international trade is indispensable if full employment is to be achieved in a peaceful world and with standards of living which will permit the realization of man's reasonable hopes.[10]

Looking back, it's hard to recall the liberal origins of the World Bank, the IMF and the WTO. The Bretton Woods institutions were crafted by people who saw trade and investment as means to an end, not as ends in themselves. They realized that unless the benefits of economic growth could be distributed, primarily through participation in employment, their reforms would not endure. They understood that economic liberalism, particularly global economic liberalism, is fragile, and that policies have to work in concert. But that was sixty years ago.

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[10] Morgenthau 1944.

3. Global development since 1944

3.1 Income and poverty

Gross indicators of postwar development reveal that there has been a reduction in poverty. Whether this would have occurred without the Bretton Woods institutions and agreements is a matter of conjecture. So far the world has avoided the turmoil of the 1914 to 1945 period, and, while there have been some severe stresses, the legitimacy of global institutions of cooperation has been sustained. While there have been financial shocks and severe recessions, the failures in domestic monetary management which aggravated the misery of the Great Depression have not been repeated; central banks have become much more competent in sustaining liquidity in the wake of financial shocks.

It is difficult, however, to be categorical about the extent of poverty reduction that has occurred over the postwar years. For a start it is difficult to define poverty. The World Bank defines poverty in terms of "pronounced deprivation", a deprivation which restricts what Amartya Sen calls the "capabilities that a person has, that is, the substantive freedoms he or she enjoys to lead the kind of life he or she values".[11]

Poverty has many dimensions. The poor suffer needlessly from hunger, malnutrition, preventable illnesses, shortened life expectancy, physical violence, social and political exclusion, and economic insecurity. Many of these conditions could, theoretically, be addressed without any external funding; indeed armed conflict in many developing countries absorbs vital financial and human resources which, if redirected to other ends, could improve in people's welfare markedly. Lincoln Chen, from Harvard's Kennedy School of Government, estimates that up to 75 percent of deaths in Africa are theoretically preventable.[12] He also points to the high rates of violence suffered by the poor from a spectrum of causes ranging through wars between states, wars within states, inter-tribal conflict and domestic violence. In half of the world's 33 poorest countries there have been serious armed conflicts over the last ten years.[13] One result of such violence is that there are 11 million refugees in the world, 8 million of whom are in developing countries.[14]

Similarly there are many simple and inexpensive techniques which could be employed to improve access to drinking water and sanitation.[15]

Availability of financial resources does not, in itself, alleviate poverty, and some forms of poverty can be alleviated with very little monetary input. Monetary measures of poverty, therefore, are partial at best.

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11 World Bank *World Development Report 2000/01,* p. 15.

12 Chen 2002.

13 World Bank *World Development Report* 2003, p. 2.

14 UNDP *Human Development Report 2002*, Table 20.

15 UN *Sustainable Development* 2002.

Taking a long-term view, Amartya Sen acknowledges that there has been progress in eradicating poverty, some of which can be attributed to the benign aspects of globalization. He reminds us that:

> ... globalization has enriched the world scientifically and culturally, and has provided vast economic benefits as well. Pervasive poverty and 'nasty, brutish and short' lives dominated the world a few centuries ago, with only a few pockets of rare affluence. In overcoming that brutishness, modern technology as well as economic interrelations have been influential.[16]

Because poverty has so many manifestations and dimensions, measuring poverty is difficult. Adequate nutrition, access to education, availability of clean water, security from violence, capacity to participate in society, and freedom of mobility are some of these dimensions. Some, but only some, of these dimensions can be expressed in numerical indicators. Those for which summary comparative data are compiled in the UNDP *Human Development Report* are shown below.

Table 1. Selected indicators of well-being, percent of population, 2000

	Arab states	East Asia and the Pacific	Latin America and the Caribbean	South Asia	Sub-Saharan Africa
Use of adequate sanitation facilities	81	48	78	39	55
Use of improved water resources	86	75	85	89	54
One year olds immunised against measles	84	86	92	56	51
Adult literacy	79	97	94	70	78

Source: UNDP *Human Development Report 2002*, Tables 6 and 10

One dimension in which there has been measured improvement is literacy. Adult literacy in developing countries has risen from 63 percent in 1985 to 74 percent in 2000; youth literacy has risen from 78 percent to 85 percent over the same period. These figures mask huge gender differences, however. In most developing countries, particularly in Africa, the Middle East and South Asia, female literacy rates are much lower than male literacy rates.[17]

Less encouraging trends are emerging in environmental resources. The 2003 World Bank *World Development Report* presents many indicators relating to depletion of environmental assets, particularly in developing countries.[18] The proportion of people living in areas with water shortages is rising. Rivers are becoming overloaded with nutrients from fertilizers and industrial discharges. Forests are being cleared, the yield of croplands and grasslands are reducing in many places. Fisheries are becoming depleted; 70 percent of the world's commercial fisheries are fully exploited or over-exploited. Greenhouse gas emissions are increasing, and local air and water pollution, particularly in highly populated areas, is

[16] Sen 2002.

[17] UNDP *Human Development Report 2002*, Tables 10 and 22.

[18] World Bank *World Development Report 2003*.

worsening. Urbanization is increasing; by 2050, on present trends, there will be 59 "megacities" with populations of 10 million or more (up from 19 megacities in 2000). Environmental pressure results not only from population pressure – even if population were to stabilize there would still be excess pressure on many environmental resources. Poverty elimination is difficult if the basic resources which sustain life are becoming depleted.

While economists stress that environmental values are not absolute (the essence of cost-benefit analysis is to compare competing values), there is not necessarily a tradeoff between environmental values and other values. The World Bank points out that countries can have very different environmental outcomes while achieving the same growth rates as revealed by conventional economic measures.[19]

Apart from physical measures, which cannot be aggregated into single indicators (how can we aggregate access to clean water and education, for instance?), for measurement of poverty we have to fall back on financial data. Measures based on private monetary data don't necessarily relate to insecurity, the threat of violence or the risk of illness, and they rarely count the cost of depletion of environmental assets. They are limited, but as indicators they are all we have readily available.

The most commonly used measures are income, consumption and wealth. Most such data is presented in the form of national averages, which say nothing about distribution within nations. India and China, which account for 38 percent of the world's population and 44 percent of the developing world's population, have huge internal regional disparities in well-being. In many countries there are large economic disparities between ethnic groups. Most often aboriginal people and other long-term inhabitants are at a disadvantage with respect to more recent arrivals; sometimes, however, the more recent arrivals who have come as slaves or indentured workers are disadvantaged.

It may appear to be a reasonable assumption that we can ignore wealth, on the basis that the poor have none, but Hernando de Soto, former GATT economist and President of the Institute of Liberty and Democracy, points out that in some countries the poor do have assets, but that they lack adequate property rights over these assets.[20] It would be callous to draw on de Soto's analysis to suggest that property rights alone will alleviate poverty; the assets in question are often no more than small agricultural plots, for example.

It is notable that there is an emerging interest in individual and collective assets; the World Bank, in its 2003 *World Development Report*, stresses that for people to thrive their assets – physical, financial, human, social and environmental – must be well-managed.[21] Asset accounting is more than a question of orderly bookkeeping; proper accounting practices, including practical estimates of depreciation and depletion, are important management tools for planners and managers. Asset accounting is in its infancy, however. As historical indicators of progress we are reliant on income and consumption data.

The World Bank, in its 1990 *World Development Report* (an edition dedicated entirely to poverty), pointed out that in the twenty years from 1965 to 1985, consumption per-capita in

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19 Ibid. p. 26.

20 De Soto 2000.

21 World Bank *World Development Report 2003,* p. 1.

the developing world rose by almost 70 percent.[22] In the 2002 *Human Development Report* the UNDP reports that annual per capita GDP growth over the period 1975 to 2000 has been 1.7 percent in the OECD countries and 3.1 percent in developing countries.[23]

The gap is closing, or so it seems at first sight. But the gap between the extremes – the very poorest 20 countries and the very richest 20 countries – has widened significantly over the last 40 years.[24]

In 2001 the World Bank again devoted its annual report to poverty, using as a more robust indicator the number of people living on less than $1 a day. (Some economists suggest that the dollar a day criterion is not a robust measure of poverty, but this criticism confuses a *measure* with an *indicator*.) Between 1987 and 1998 the number had hardly moved. It had stuck doggedly at 1.2 billion – 20 percent of the world's population in 1998. The better news was that, because of population growth, the percentage of people living below a dollar a day had fallen from 28 percent of the population of developing countries to 24 percent.

These gross figures mask significant differences between broad regions. Table 2 shows, by region, the distribution of severe poverty in 1998 as indicated by the dollar a day criterion. To summarize, almost half of the world's very poor live in South Asia, and almost half of those who live in Sub-Saharan Africa are very poor. And Latin America and East Asia, which feature so strongly in news of financial crises, are not the world's poverty hot spots. This is not to overlook severe poverty in countries *within* those regions; Cambodia, Papua New Guinea, Myanmar, Viet Nam, Indonesia, Argentina, Columbia, Mexico, Venezuela, Peru, Ecuador, Honduras, Paraguay and Nicaragua all report that more than 15 percent of their population live below the one dollar a day line.[25]

Table 2. People living on less than $1 a day, 1998

Region	Million	Share of regional population %
East Asia and the Pacific incl China	278	15
Excluding China	65	11
Europe and Central Asia	24	5
Latin America and the Caribbean	78	16
Middle East and North Africa	6	2
South Asia	522	40
Sub-Saharan Africa	291	46
Total	1 199	24

Source: *World Development Report 2000-01* Table 1.1. (1993 purchasing power)

The rates of poverty amelioration are also patchy. The success story is in Asia, particularly East Asia. The bad news comes from Sub-Saharan Africa, where the proportion of people

22 World Bank *World Development Report 1990*, p. 1.

23 UNDP *Human Development Report 2002*, Table 12.

24 World Bank *World Development Report 2003*, p. 3.

25 UNDP *Human Development Report 2002*, Table 3.

living in poverty has hardly changed over recent years. Poverty in Africa seems to be more entrenched than elsewhere.

Table 3. Percentage of people living on less than $1 a day – 1987 and 1998

Region	1987	1998
East Asia and the Pacific incl China	27	15
Excluding China	24	11
Europe and Central Asia	0	5
Latin America and the Caribbean	15	16
Middle East and North Africa	4	2
South Asia	45	40
Sub-Saharan Africa	47	46
Total	28	24

Source: *World Development Report 2000-01* Table 1.1. (1993 purchasing power)

At the 2000 Millennium Development Summit, all 189 UN members endorsed a set of *Millennium Development Goals*, with targets on a number of development indicators, to be achieved by 2015. These include:

- halving the proportion of people living on less than a dollar a day;
- halving the proportion of people suffering from hunger;
- ensuring all boys and girls complete a course of primary schooling;
- eliminating gender disparity in primary and secondary education;
- reducing by two thirds the mortality rate among children under five;
- reducing by three quarters the maternal mortality rate;
- halting and reversing the spread of HIV/AIDS and malaria;
- reducing by half the proportion of people without sustainable access to safe drinking water;
- significantly improving the lives of at least 100 million slum dwellers (by 2020).

While this set of targets encompasses many dimensions of development, there are notable omissions, including labour standards. Nor are environmental goals clearly articulated. They are expressed in vague language, such as "integrate the principles of sustainable development into country programmes and policies" and "reverse loss of environmental resources". On air quality there is a strong alliance of countries, led by the USA, and including oil and coal producing countries (prosperous but commodity-dependent countries such as Saudi Arabia and Australia), opposed to global agreements to set targets for production of energy from renewable sources.

The downplaying of labour and environmental concerns has possibly been a reaction to the way in which prosperous countries, in the 1999 Seattle WTO meeting, were seen to be advocating labour and environmental standards as defacto non-trade-barriers against developing countries.

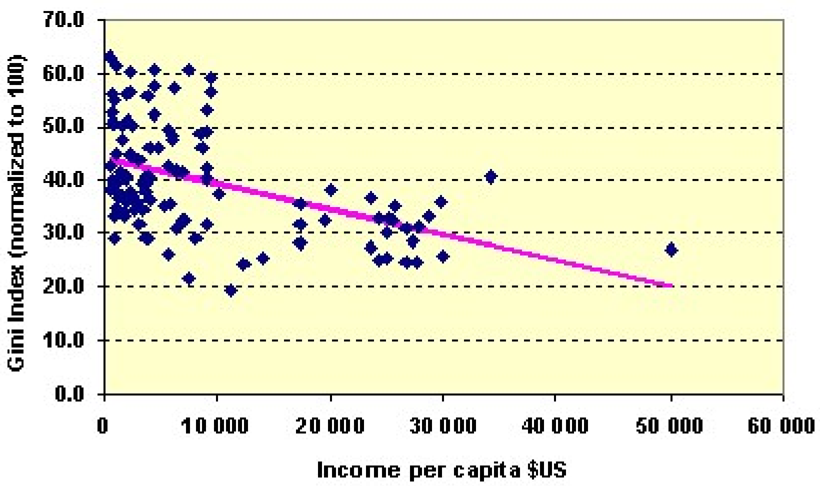
3.2 Inequality

Another measure of economic progress is inequality.

There is ample evidence that, in general, poor countries are less equal than rich countries. Figure 1 shows, for the latest year available, (generally the late 1990s) the relationship between countries' average national per-capita income and the Gini index in income or consumption. A high Gini index denotes high inequality.

The correlation is far from perfect; some high-income countries, such as USA and Australia, have high income inequalities, and some medium income countries, in particular the emerging economies of Eastern Europe, have low inequality. The coefficient of correlation between income and inequality is only 0.22. But there is a distinct cluster in the under \$10 000 countries, contrasting with another distinct cluster of the over \$20 000 countries. National poverty is associated with inequality. But is this inevitable?

Figure 1: Gini Index by Income



Source: Derived from UNDP 2002, Tables 1 and 13

Some economists hold to a strict "Pareto principle" of economics – that so long as no one is made any worse off by economic development there is desirable progress. If the incomes or wealth of the rich rise, while the incomes or wealth of the poor remain unchanged, then that is preferable to no progress at all. By such logic widening inequality does not matter.

Some economists who do not necessarily hold to such cold logic believe that inequality, while perhaps undesirable, is a collateral price for development. In time the benefits of growth will "trickle down" through the economy. The aphorism which captures this philosophy is "a rising tide lifts all boats". This theory is embodied in a notion known as the "Kuznets hypothesis", which postulates that economic growth will first lead to an increase in inequality, and later to a decrease in inequality.

This path of development is explained by a general model in which people move from low productivity agricultural activities into higher productivity activities such as manufacturing and service industries. This movement takes time – perhaps a generation or two – and over this transition period there are large disparities in earnings between the two sectors. It aligns with the history of those developed countries which now enjoy high incomes and relative equality but can look back to a time when they were much poorer and much more unequal.

The basic problem with such logic, as Keynes would have put it, is that in the long run we are all dead. Five years of poverty is enough to leave a permanent blight on a child. Nor is it inevitable that the history of today's industrialized high-income countries will be repeated in those countries now at an earlier stage of development. And, while today's industrialized countries did enjoy reducing inequality in the early postwar years, the last quarter of the twentieth century has seen inequalities open up again. Trickle down economics has not reduced inequality in industrialized countries; there is no reason it should do so in developing countries. As an economic model it assumes too much about the behaviour of the rich – that they will invest their surplus income in local industries, that their consumption will stimulate the local economy, and that they will not engage in anti-competitive activities to protect their privilege.

If the Kuznets model held, we might expect the very poorest countries to be more equal than the next poorest countries – the relationship postulated by the Kuznets model is an inverted "U" shape, not a straight line with inequality decreasing with income. There is no such cluster of countries, however; the world's poorest countries, all in Africa, all have very unequal distribution.

The Kuznets model assumes that returns in the agricultural sector are necessarily low – but this may be because of poor domestic policy, such as a lack of land reform or poor transport infrastructure, or because of a lack of access to global markets.[26] It is hardly reasonable to assert that returns to agriculture are necessarily low when agricultural markets are distorted by the policies of rich countries. And poor returns in subsistence agriculture may be no more than an artefact of measurement, for much of the output of subsistence agriculture does not show up in monetary transactions. The move from subsistence agriculture to cash cropping for export is often accompanied by worsening poverty.

Trade liberalization since 1945 has generally not extended to agricultural products. The average global tariff on agricultural products is 62 percent, compared with only 4 percent for non-agricultural products. Between 1986 and 1997 the share of world agricultural exports from developing countries decreased; Africa's share, in particular, fell from 9 percent in 1991 to 3 percent in 1996. [27]

The Kuznets model also assumes that the transition will necessarily be slow, constrained perhaps by people's inability to access opportunities to improve their lot – education and credit for new business ventures in particular. Those assumptions certainly seem to align with reality for many countries, but are these constraints inevitable or, rather, do they reflect failures in public policy?

Stiglitz points to other fallacies in the Kuznets hypothesis. He points out that development is often centred on rapid development of extractive industries, creating a comparatively wealthy élite, but not producing ongoing regenerative wealth. Even more basically, Stiglitz, Sen and others warn of the destructive tensions caused by inequality. "It is not true that 'a rising tide

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[26] Timmer 1986.

[27] World Economic Forum 2002, p. 2.

lifts all boats'", Stiglitz says. "Sometimes, a quickly rising tide, especially when accompanied by a storm, dashes weaker boats against the shore, smashing them to smithereens."[28]

Jean-Philippe Bouchaud and Marc Mezzard of the University of Paris, specialists in computational economics, have demonstrated through simulation that openness to trade does indeed reduce inequality over time. That aligns with the conventional wisdom of the benefits of globalization. But they have also demonstrated that volatility – in commodity or financial markets – can increase inequality to the extent that the equality gains from openness can be overridden.[29] That is why stability in global markets is a desirable end. Agricultural markets will always be subject to a level of instability resulting from natural causes, but this instability should not be aggravated by capricious moves to protectionism in developed countries. And volatility in financial markets arises largely from mismanagement and poor public policy which has allowed the financial sector to take far too prominent a role in influencing developments in the real economy.

The World Bank, in its 2003 *World Development Report*, acknowledges that entrenched inequality can be inimical to economic progress. A narrowly-based élite holds on to privilege by resisting the development of institutions that provide political empowerment for the masses. If élites can live apart from the general community, they have no interest in supporting civil, legal and government institutions which may protect people against the capricious behaviour of the powerful; indeed they may manipulate institutions to reinforce their own privilege. Nor do they have any incentive to contribute to public goods, such as schooling, police protection and transportation, if they can provide themselves with private schools, private security guards in gated communities, and chauffeur-driven limousines. As a result land reform and other developments that give the poor access to private and public assets, and to institutions that uphold legal rights, do not occur.

At the other end of the spectrum the poor, who have no stake of ownership in society have no interest in supporting civil institutions such as property rights (particularly when property rights protect the mansions and monopolies of the rich but not the meagre assets of the poor). Nor do the poor have any incentive to support the rule of law when they know the rich can escape the consequences of their misdeeds.

These statements of political economy are supported by research which shows, over a 300 year period, that those countries with more inequality in their early phases of development have grown much more slowly than societies with more equality.[30] There are two possible explanations. One explanation, well-established in economic theory, is that when demand is spread among the population there are likely to arise mass markets with associated positive feedback loops of increasing wealth. (This is the celebrated success of Henry Ford's model of capitalism – the spending power of a well-paid workforce provides capitalism's mass markets.) Another is that income equality is associated with equality in education, an important asset for industrialization. Yet another explanation, based on the research of Alice Amsden, is rooted in political economy. Amsden, contrasting the development paths of South East Asia and Latin America, suggests that in pre-industrial societies with high

[28] Stiglitz 2002, p. 78.

[29] Referred to in Buchanan 2002.

[30] World Bank *World Development Report 2003*, pp 53-55.

inequality there is strong political resistance to industrialization.[31] This is possibly because the path to industrialization inevitably involves some upsetting of existing class systems.

Destructive tensions associated with inequality and perceptions of unfairness may, in time, wreck the global institutions, agreements and understandings which were designed, sixty years ago, to protect the world from the misery which followed the last collapse of global economic liberalism. The tensions have resulted, in large part, from the way in which the Bretton Woods institutions have become captive to narrow interests.

David Korten, founder of the People-Centered Development Forum and former Harvard professor, refers to their failure – the way they have allowed pursuit of means (free trade and globalization) to distract them from their ultimate purpose (development and alleviation of poverty):

> In the intervening years, these institutions have held faithfully to their mandate to promote economic growth and globalization. Through structural adjustment programs (SAPs), the World Bank and the IMF have pressured countries of the South to open their borders and change their economies from self-sufficiency to *export* production. Trade agreements negotiated through GATT have reinforced these actions and opened economies in both North and South to the increasingly free importation of goods and money.
>
> As we look back fifty years later, we can see that the Bretton Woods institutions have indeed met their goals. Economic growth has expanded fivefold. International trade has expanded by roughly twelve times, and foreign direct investment has been expanding at two to three times the rate of trade expansion. Yet, tragically, while these institutions have met their goals, they have failed in their purpose. The world has more poor people today than ever before. We have an accelerating gap between the rich and the poor. Widespread violence is tearing families and communities apart nearly everywhere. And the planet's ecosystems are deteriorating at an alarming rate.
>
> Yet the prevailing wisdom continues to maintain that economic growth offers the answer to poverty, environmental security, and a strong social fabric, and that economic globalization – erasing economic borders to allow free flow of goods and money – is the key to such growth. Indeed, the more severe the economic, environmental, and social crises, the stronger the policy commitment to these same prescriptions, even as evidence mounts that they are not working.[32]

What Korten is referring to has come to be known as the "Washington Consensus".

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[31] Amsden 2001.

[32] Korten 1996.

4. From Bretton Woods to Washington

While the World Bank and IMF are known to many as the "Bretton Woods institutions", we are now likely to hear the term "Washington Consensus" to refer to the guiding policies of these institutions – and to the policies guiding the WTO, which, along with the BIS, has a secretariat in Switzerland. The terms refer to a hegemony of ideas rather than to any regional location.

There is no precise agreement on what is meant by the "Washington Consensus"; in itself it is a weird term, for it implies a consensus of one. But most economists, liberal and conservative, express it in terms of a set of interrelated norms of international economic order, underpinned by tenets of "neoliberalism".

Neoliberalism itself is not a well-defined economic philosophy: it favours deregulation and *laissez faire* operation of markets, but is reasonably comfortable with regulations, such as industrial property protection, which favour business; it is hostile to public ownership of natural monopolies but is accepting of private ownership of those same monopolies. It rejects large slabs of conventional neoclassical economics, including the theories of public goods, market failure and transaction costs.

These neoliberal principles, when applied to the world order, are expressed in a set of norms – specifically that countries should:

- open their economies to trade;
- open their economies to foreign capital;
- maintain "sound" macroeconomic policies, with an emphasis on keeping inflation low and balancing public budgets;
- float or otherwise responsibly manage exchange rates;
- privatize government functions wherever possible and generally reduce the size of government;
- deregulate product and financial markets.

Missing from this list is any suggestion that countries may need to develop institutions and mechanisms to cope with deregulation and openness. Most developed countries have strong central banks, laws on corporations and contracts, consumer protection laws, statistical agencies which can monitor economic trends, and well-regulated financial markets. These institutions have developed over two hundred years. But developing countries are expected to cope with immediate deregulation and openness, without having had time to develop an appropriate regulatory infrastructure.

Often the first two norms, relating to trade and capital, are conflated to the single dimension of "openness" – a handy conflation because it allows financial market liberalization to free ride on the historical success of liberalized trade. And the notion of opening to foreign capital is vague, for it can range from openness to foreign direct investment, which often brings associated transfer of skills and technologies, through to short-term financial speculation.

In 1944 there had been a very deliberate collective political decision in favour of controls on financial markets. No country was criticized for keeping capital controls. While communication technologies have made capital controls harder to impose, governments in developed countries have generally been very enthusiastic about deregulating their financial sectors and reluctant to impose any controls beyond those necessary for fiduciary purposes. Financial market deregulation is one of the norms of the Washington Consensus.

These norms are an almost complete reversal of the original Keynesian vision of the Bretton Woods institutions. Over the 1980s and 1990s, in fact, it has been fashionable to debunk Keynes (even while the major economies still practice, perhaps by accident, a certain measure of Keynesian counter-cyclical management in their own countries.) The IMF, in particular, has become much more concerned with fiscal rectitude rather than economic management. Countries facing fiscal difficulties, as a condition of receiving IMF assistance, are expected to pursue contractionary policies. This generally means reining in public expenditure, arresting inflation, raising interest rates, and defending their exchange rates. If the collateral cost is unemployment and poverty, then that's an unfortunate but necessary burden; gone is the original full employment mission of the Bretton Woods institutions.

The irony is that these conditions impose most of the destructive national policies which aggravated the Great Depression – with each country pursuing its own beggar-thy-neighbour measures. And they entrench a notion that there's no inefficiency resulting from leaving labour and capital resources idle. The only policy change from the destructive practices of the 1930s is that the IMF discourages competitive devaluations; high interest rates and fiscal rectitude are designed to sustain exchange rates at high levels.

But even this policy has its costs. Stiglitz points out that it gives the rich a head start in the flight of finance out of countries experiencing troubles:

> It is understandable then why the IMF and the strategies it foists on countries around the world are greeted with such hostility. The billions of dollars which it provides are used to maintain exchange rates at unsustainable levels for a short period, during which the foreigners and the rich are able to get their money out of the country at more favorable terms (through the open capital markets that the IMF has pushed on the countries). For each ruble, for each rupiah, for each cruzeiro, those in the country get more dollars as long as the exchange rates are sustained. The billions too are often used to pay back foreign creditors, even when the debt was private. What had been private liabilities were in effect in many instances nationalized.[33]

Most often this flight is called a "flight of capital", but in reality it's a *flight of finance*. Real capital – the factories, human skills, physical infrastructure – cannot fly out of the country by computer transfer. But real capital can be left underemployed. The finance that flies out of the country goes on to fuel another asset price bubble, somewhere else in the world.

Another consequence is that the fiscal contraction following a flight of finance may actually result in contagion to other economies – the very condition that Keynes and the other designers of the Bretton Woods institutions were trying to avoid. Alfred Schipke, of the Kennedy School of Government, fears that fiscal contraction in Argentina is having a cascade effect throughout South America, for if a large regional economy contracts, then it will not be

[33] Stiglitz 2002, p. 209.

importing from or investing in other South American economies, such as Brazil.[34] Since the Argentinian crisis erupted in late 2001 there have been smaller IMF bail-outs of Brazil, Paraguay and Uruguay.

Even if fiscal stringency to defend an exchange rate is not severe enough to cause a contraction in total activity, a high exchange rate has distributional consequences, for it worsens the country's terms of trade. Exporters, often in the rural sector, find they cannot compete on already distorted world markets, and have to sell their produce in what are often over-supplied domestic markets, and domestic industries face tougher competition – often from developed countries.

But the greatest risk from the policies of the Washington Consensus is longer-term, when, after years of exposure to global financial markets and bouts of fiscal stringency, there is a political reaction. Echoing the warnings of Stiglitz and Sen on the consequences of inequality Dani Rodrik of the Kennedy School of Government points out:

> ... today the benefits of openness are oversold routinely in the policy-relevant literature and in the publications of the World Bank and the IMF. This is counterproductive both because it induces over-reliance on trade policy in national strategies for economic development, and because it increases the risk of a backlash against openness on the part of policymakers (and their constituencies) when touted benefits fail to materialize.[35]

4.1 How the Washington Consensus arose

One may be tempted to believe that the Washington Consensus is a straight manifestation of US economic imperialism, or of an attempt by US policy makers to force the rest of the world to its own pattern of economic development. But the explanation is more complex, for the appeal of neoliberal policies is not confined to the USA. Nor does the USA itself embrace neoliberalism wholeheartedly. Its trade policies, particularly in relation to imports of tropical products and clothing, are protectionist, and its budgetary support for agriculture is anything but neoliberal. Its own public budgets are generally in deficit. Its stance in the WTO, particularly in relation to trade in intellectual property (TRIPS – trade-related aspects of intellectual property rights) is distinctly unilateral.

Not only the US, but also other developed countries, have been less than enthusiastic about free trade. According to the OECD, in 2000, support for agriculture in member countries (mainly Japan, the US and the European Union) came to $327 billion – more than six times all development assistance.[36] This figure, from 2000, does not take into account the ten year $170 billion US farm bill, passed in 2002, protecting both temperate products such as dairy, wool and beef, and crops in competition with tropical countries such as rice and peanuts.

Farm support takes two forms. One is in the form of trade barriers – tariffs, quotas, and restrictions. The other is in the form of producer price support, which contributes to excess

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34 Schipke 2002.

35 Rodrik 1999, p. 25.

36 World Development Forum 2002, p. 2.

production and suppression of prices on global markets. One small benefit of distorted agricultural prices is that food prices in developing countries are suppressed, to the benefit of domestic consumers, but this is at a cost to farmers – the poorest groups in the poorest countries – and low prices discourage local production.[37] Another consequence is aggravation of the drift of unemployed rural workers to already-overcrowded cities.

Developing countries also face high trade barriers for clothing and textiles, which are often the first manufacturing operations undertaken by developing countries. There has been some progress in dismantling the Multi-fibre Agreement, under which developed countries exempted textile and clothing industries from trade liberalization, but average developed country tariffs on textiles and clothing remain high at around 12 percent.[38]

The costs of protectionism in developed countries extend beyond the immediate loss of access to markets. When protectionism is initiated by countries which can afford to lower their trade barriers, it becomes harder for governments in all countries, developed and developing, to resist calls for protectionism. Unless the world trade system is seen to be fair, it runs the risk of unravelling through retaliation, as it did in the interwar years. The durability of WTO agreements is undermined when developed countries demonstrate how they can be circumvented.

Similarly, developed countries have attempted to manipulate competition policies to their own advantage. They have sought a WTO agreement on competition policy, which would emphasize non-discriminatory access to markets in developing countries. Such non-discriminatory policies make good sense when applied between countries at comparable stages of development, such as the US and nations of the European Community.

But if such policies are implemented globally, firms in developing countries will find it difficult to compete with firms in developed countries, particularly large multinational firms with massive sunk investments in industrial property, brands and distribution networks. While they are unlikely to face strong competition in labour-intensive manufacturing, such as clothing, they would find it hard to compete in industries characterized by skills intensity, capital intensity, and investment in global brands. At best they may pick up some of the labour-intensive aspects of medium and high technology industries, but control will remain with the multinational firms.

Most developed countries have nurtured their now-competitive manufacturing sectors, particularly their locally-owned firms, behind "infant industry" tariffs and other protective measures in the past. (Japan's spectacular postwar reconstruction, for example, would never have succeeded had there been an open global competition policy.) There are sound arguments for infant industry protection; what is important is the removal of that protection as the industries concerned reach adolescence.

This is not to deny the need for competition policies in developing countries. Consumer exploitation by local home-grown monopolies, and small-business exploitation by purchasing monopsonies and cartels are serious issues. Farmers and fishers, in particular, are vulnerable to the power of fertilizer and transport suppliers, and to the power of concentrated buying

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[37] Timmer 1986.

[38] Bhagwati 2002.

firms. People in villages lack the diversity of suppliers enjoyed by city-dwellers. Governments may dispense monopoly rights as a form of patronage, and many government business enterprises in developing countries do not serve consumers well. But these are arguments for competition policies appropriate to a country's particular stage of development, not a "one size fits all" policy encapsulated in WTO rules.

Another aspect of non-symmetry in competition policy is the use by firms in developed countries of franchise restrictions and restricted licences in their offshore operations in developing countries. Regardless of price or quality, these firms are often prohibited from exporting outside a narrow geographic zone.

Unfair trading is not confined to official measures. A Transparency International survey found that the USA was the country most frequently cited by in response to a question on detecting the prevalence of unfair trade practices.[39] (The question was "Which three governments do you principally associate with practices such as those mentioned above [other means – besides bribery - used to gain unfair advantage in international trade and investment]?") France, the UK and Japan occupied second, third and fourth places.

The free trade zeal of the Bretton Woods institutions and the governments of developed countries has been confined mainly to industrial products and services. This has been of benefit to some developing countries, particularly East Asian countries, which have industrialized, but the poorest countries have not shared in the benefits of trade liberalization. If Keynes were to survey the Bretton Woods institutions now he would almost certainly conclude that they have been captured by the interests of developed countries.

Explanation for the transformation of the Bretton Woods institutions lies partly (but only partly) in terms of dominance by developed countries, particularly the US and Europe, in the governance of the institutions. Governments are represented in the WTO by trade ministers or officials, in the IMF by finance or treasury ministers or officials. Stiglitz reminds us:

> The IMF is a *public* institution, established with money provided by taxpayers around the world. This is important to remember because it does not report directly to either the citizens who finance it or those whose lives it affects. Rather, it reports to the ministries of finance and the central banks of the governments of the world. They assert their control through a complicated voting arrangement based largely on the economic power of the countries at the end of World War II. There have been some minor adjustments since, but the major developed countries run the show, with only one country, the United States, having effective veto. (In this sense, it is similar to the UN, where a historical anachronism determines who holds the veto – the victorious powers of World War II – but at least there the veto power is shared among five countries.)
>
> Over the years since its inception, the IMF has changed markedly. Founded on the belief that markets often worked badly, it now champions market supremacy with ideological fervor. Founded on the belief that there is a need for international pressure on countries to have more expansionary economic policies – such as increasing expenditures, reducing taxes, or lowering interest rates to stimulate the economy – today the IMF typically provides funds only if countries engage in

[39] Transparency International 2002.

> policies like cutting deficits, raising taxes, or raising interest rates that lead to a contraction of the economy. Keynes would be rolling over in his grave were he to see what has happened to his child. [...]
>
> A half century after its founding, it is clear that the IMF has failed in its mission. It has not done what it was supposed to do – provide funds for countries facing an economic downturn, to enable the country to restore itself to close to full employment.'[40]

Neither the pursuit of US interests nor governance limitations provide adequate explanations for the change in the Bretton Woods institutions. After all, as John Ruggie, Professor of Politics at Columbia University, points out, these institutions were largely US creations, at a time when the relative global power of the US was even greater than it is now.[41] If they are simply instruments of US interest, why were they not even more representative of US interests in 1944? And from the outset they reported through treasury and trade ministers. In terms of US power there has been no significant change; if anything the influence of the US should be less now than it was in 1944, when the US was the only significant world economy not ravaged by war.

Political and institutional explanations are inadequate to account for the transformation. Neoliberal ideas are not confined to these institutions or to any one country; they are sustained by a widespread political consensus. Their origins lie in the extreme free market ideas of some economic schools, but they have drifted a long way from the constraints of intellectual coherence to be found in the works of economists like Friedman and von Hayek. Their first national manifestations were in the governments of Reagan and Thatcher in the 1980s; their global manifestations are in the "Washington Consensus".

Neoliberal ideas have taken hold among the ranks of public policy advisers (particularly in treasury and finance departments), academic economists and researchers in think tanks. These ideas are not attached to any state or to any particular political movement. Treasury officials in developing countries are often graduates of neoliberal schools of economics, in developed countries.

Neoliberalism rejects many of the notions of classical and neoclassical economics, which, from the days of Adam Smith, have warned about the limitations and dangers of unregulated or *laissez faire* markets.

Unregulated markets, however, do not produce neat outcomes of efficient resource allocation and equilibrium. They are prone to monopolization, corruption, cronyism and instability. In developed countries there are institutions, such as competition and corporate regulators, with the function of keeping markets honest and economically efficient (though, as recent US events demonstrate, these institutions have become less effective over the last twenty years). By contrast, developing countries, particularly those with weak legal traditions and a lack of resources to enforce regulations, provide a superb laboratory for advocates of neoliberalism, because their product and financial markets are not shackled with institutions of corporate regulation, and they do not have the burden of high taxes to finance welfare systems.

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[40] Stiglitz 2002, pp 12 & 15.

[41] Ruggie 1983.

Stiglitz, commenting on the enthusiasm of the IMF and World Bank for neoliberal "trickle down economics" in their solution to the Asian Crisis of 1997, points out that treasury officials do internationally what their political masters would never let them do at home:

> Here was the U.S. Treasury pushing policies on other countries that, had they been advocated for the United States, would have been severely contested within the administration, and almost surely defeated. The reason for this seeming inconsistency was simple: The IMF and the World Bank were part of Treasury's turf.[42]

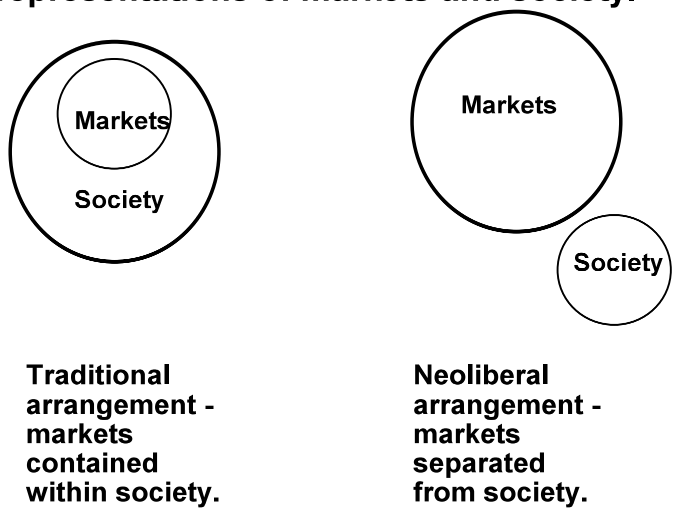
Neoliberalism champions a global market, free from the bothersome constraints imposed by nation states. It has no room for theories of market failure.

John Gray, once an adviser to Margaret Thatcher and an enthusiast of her policies, comments:

> Like the Utopia envisaged by Lenin, the global free market aims to bring about a state of affairs that has never hitherto existed in human society – and which goes far beyond the mid-Victorian English free market and the liberal international economic order that existed until 1914. In a global free market the movements of goods, services and capital are unfettered by political controls imposed by any sovereign state, and markets have been detached from their original societies and culture. This is a Utopia divorced from history, hostile to vital human needs, and finally as self-destroying as any that has been attempted in our century.[43]

Gray echoes the warnings of Karl Polanyi, who warned that through most of history markets have existed, but within societies, subject to society's norms.[44] The separation of markets from society breaks this societal primacy, and gives authority to the dominance of neoliberal policies. If the unintended consequences of market liberalization go too far – if they result in food riots or military coups – then the prevailing wisdom is that there should be some minor amelioration of policies. Perhaps non-

Figure 2 -Traditional and neoliberal representations of markets and society.



[42] Stiglitz 2002, p. 80.

[43] Gray 1998, p. 140.

[44] Polanyi 1944.

government organizations and other groups can be given a token place in the global fora. Perhaps these same fora can produce some fine-sounding press releases sprinkled with references to "environmental sustainability", "balanced development" and "social capital".

But this is as far as neoliberalism goes. There is no acknowledgement that markets should be accountable to other national policies. That economic policies should serve social ends – particularly full employment. That environmental resources are no less valuable than other scarce resources. And that representatives of community groups and non-government organizations have a legitimate place at the table and that they can make a real contribution to development policies. The rhetoric of neoliberalism is that markets have a life and purpose of their own, quite apart from society. If fiscal stringency helps produce some positive set of economic indicators, or an upgraded credit rating, then that is sufficient justification for such a policy. (The reality is that corporations are dependent on society, through government spending, for sustaining liquidity in the private sector.)

If the failure of the Bretton Woods institutions could be traced wholly to disproportionate influence by the US or other developed countries, then reform or reconstruction of the institutions could be addressed by governance and organizational design measures. But the influence of neoliberalism is more pervasive; it extends into the political and economic élites of the developing countries themselves. Indonesia's Suharto, for example, is reputed to have been surrounded by a cadre of economic advisors known as the Berkeley Mafia, because most of them had studied or taught at Berkeley. Similarly in Chile, during the years of the Pinochet dictatorship a government team of economists trained at the University of Chicago known as the Chicago Boys enthusiastically implemented a neoliberal program, dismantling state institutions, deregulating markets and suppressing trade unions. Their achievements in a brutal dictatorship demonstrate that neoliberalism bears little relationship to traditional liberalism, though neoliberalism generally uses the language of traditional liberalism to give itself political respectability.

It is easy perhaps for advocates of reform to focus on US or developed country dominance of institutions, and it is clear that they do disproportionately serve the interests of developed countries. But, because the ideas of neoliberalism have become global, so too do movements towards reform have to be global, a point taken up in Chapter 6. Reforming governance and broadening representation may be important, but in themselves they will achieve little if one set of administrators schooled in neoliberal philosophies is replaced with a similar group. Public ideas – strongly held ideologies – are hard to dislodge, particularly when they are held with sincerity, for neoliberalism has the appeal of simple nostrums to tackle complex problems.

4.2 The privatization of financial flows

One of the most profound developments of the last twenty years has been the privatization of financial flows to developing countries.

The composition of financial flows has had three phases – official aid, private loans and foreign direct investment.

Aid

The initial phase in the immediate postwar period was characterised by the dominance of official development assistance, in the form of loans and grants. Official development assistance, as a proportion of developed countries' GDP, has generally fallen over the last few decades. Only Norway, Sweden, Denmark, Netherlands, Luxembourg, Switzerland and Japan now contribute more than $100 a head to official development assistance. OECD countries disbursed 0.33 percent of GDP as aid in 1990; by 2000 this had fallen to 0.22 percent of GDP. Japan is the world's major aid donor, followed by the USA, but at only 0.10 percent of GDP, the USA is the least generous donor of all the developed countries.[45] Foreign aid is supplemented by grants by non-government organizations, but these are small, being around one seventh the amount provided by official development assistance.

Contributing to the fall in foreign aid have been the ending of the Cold War (aid was an instrument in trying to win allegiance), a public perception that aid is ineffective or misdirected ("taking money from poor people in rich countries to give to rich people in poor countries"), and a general tightening of public budgets in all developed countries.

Even within restricted aid budgets, much assistance is tied to purchases from donor countries – physical plant and equipment, and, increasingly, high fee consultancy services. UNICEF estimates that around a third of aid is tied in this way.[46] Some major donor countries, such as Japan, tie a very large proportion of their aid.

Overall, foreign aid is now not very significant in its contributions to developing country finance. According to the UNDP, foreign aid accounts for 0.5 percent of the GDP of developing countries. By contrast private flows, mainly foreign direct investment, account for 3.5 percent of the GDP of developing countries. Only the world's very poorest countries now receive significant amounts of official development assistance – 7.6 percent of GDP in countries classified by the UNDP as "least developed" (more than 20 percent of GDP in some African countries).

Private loans

The next phase was the flow of private loans, following the massive increase in bank funding which occurred after the first oil shock and the collapse of the Bretton Woods fixed exchange rate régime in 1973. (This growth was to lead to the first debt crisis of 1982-83, which had its greatest impact on Mexico and South America.)

Table 4 shows the trend in new loan commitments, with private loans progressively displacing official loans over the last thirty years. A related development has been an increase in interest rates paid by borrowers in developing countries – the premium of private over official rates is around 3 percent on average, and around 5 percent in Africa.[47] And often risk is borne by governments, even for private to private loans, because government underwriting of private loans is a common practice.

45 UNDP *Human Development Report 2002*, Table 15.

46 UNICEF *The Progress of Nations* 1995.

47 World Bank *Global Development Finance 2000.*

Table 4. Composition of new commitments to developing countries, percent

	1970	1980	1990	1999
Official creditors	61	46	51	47
Private creditors	39	54	49	53
	100	100	100	100

Source: Derived from World Bank *Global Development Finance* 2000 p 247.

Foreign investment

The last phase, much more significant than the move to private loans, has been a movement away from loans altogether, towards foreign direct investment and portfolio flows. This move gathered pace during the 1990s.

Table 5 shows for representative years the long-term resource flows to developing countries, reflecting these developments.

Table 5. Net long-term financial flows to developing countries, $bn

Current prices	1970	1980	1990	2000
Net flow of long-term debt	7.1	57.1	43.1	39.3
Foreign direct investment	2.0	4.4	24.3	178.0
Portfolio equity flows	0.0	0.0	3.7	47.8
Grants	2.1	13.2	28.1	29.6
	11.2	74.7	99.2	294.7
Constant (2000) prices				
Net flow of long-term debt	26.2	107.4	52.9	39.3
Foreign direct investment	7.4	8.3	29.8	178.0
Portfolio equity flows	0.0	0.0	4.5	47.8
Grants	7.7	24.8	34.5	29.6
	41.3	140.5	121.7	294.7

Source: Base data derived from World Bank *Global Development Finance* 2000. In absence of international deflator for $US, deflator is USA GDP deflator.

Notable in this table is the diminishing relative role of grants, most of which would be in the form of bilateral assistance. Annual UNDP finance, even including funding for co-financed projects, is less than $3 billion.[48]

These figures suggest a smooth pattern – a healthy upward trend of direct investment and equity replacing debt. But the period 1990 to 2002 has been anything but smooth, having been marked by four crises, which involved massive movements in short-term capital[49]:

- the Mexican crisis of 1994-95, characterized by an initial inflow of speculative capital in the early 90s, a rapid rise in the exchange rate, and a subsequent rapid collapse in the peso, resulting in a bail-out with $52 billion of IMF and other funds;

48 UNDP 2002 Annual Report.

49 The description of the first three crises is summarized from Lamfalussy 2000.

- the East Asian crisis of 1997-98, which followed large-scale capital inflows to the East Asian "tigers". The trigger for the crisis was a property boom and bust in Thailand, but the crisis rapidly spread to most East Asian countries. Indonesia has still not recovered from the crisis. (Perhaps the final contagion from this crisis has been the flight of finance to the safe haven of US equities – that is, safe until June 2002.)
- Russia in 1998, with rapid reversals of net capital inflows, aggravated by falling oil prices. (Russia recovered from this crisis in 2001 when oil prices rose steeply. It was also helped by devaluation of the rouble, which meant its agricultural sector was able to compete against dumped European produce.)
- Argentina in 2001-02, resulting from the collapse of the attempt to fix the exchange rate to the US dollar, so far largely contained but with early evidence of contagion to other South American countries.

One feature common to all these crises has been the dominance of the private sector. We may have an image of profligate borrowing by national governments, but this is not a general pattern. In all cases the lenders were mainly private banks or investment funds, and in both the Mexican and East Asian crises the borrowers were mainly corporations and banks. These crises were the consequence of the workings of private finance, particularly speculative finance; financial liberalization occurred before there were the domestic institutions in place to regulate the financial sector. And instability was aggravated because private lenders and borrowers tend to behave in a pro-cyclical manner. (See Part 5.2.)

The World Bank describes these developments in short-term borrowing:

> Short term borrowing by developing countries from international banks nearly tripled between 1990 and 1997, with especially fast growth in East Asia and Latin America. Some of this rapid rise was associated with significant benefits: it helped finance trade and financed faster economic growth. However, policy-induced distortions also contributed to the boom in short-term borrowing. These distortions stemmed in part from the rapid liberalization of domestic banking systems and the opening of capital accounts in developing countries without adequate supervision and risk management in place. Other factors included the sterilization of capital inflows seeking to defend pegged exchange rates, and capital adequacy regulations in source countries that favoured short-term lending. Cyclical influences, such as lower interest rates in source countries, also stimulated more risky and rapid growth in short-term borrowing. Short-term lending to developing countries also tends to be highly procyclical, rising during favourable times and falling even more sharply following adverse shocks. As a result, such lending often amplifies booms and busts rather than helping to smooth consumption. Policy-induced risky borrowing and procyclical behavior have meant that excessive short-term borrowing (relative to reserves) in developing countries has been strongly associated with sudden reversals and has induced or amplified financial crises.[50]

The language of the World Bank is guarded, but in essence it is saying that the practices advocated by the Washington Consensus – financial market liberalization, reliance on the

[50] World Bank *Global Development Finance 2000.*

private sector, and deregulation – have contributed to instability. To the extent that the World Bank criticizes government policy-makers, its criticisms are concerned with inadequate regulation, particularly asymmetric regulation, with crises resulting in part from the interplay of regulations in the source countries and the absence of regulation in the destination countries. Capital adequacy rules, for example, require banks to maintain a certain level of liquidity; that makes good sense, but an unintended consequence is that it encourages short-term lending to developing countries.

The accountability of financial markets, in fact, is not to national governments or their electors, but to investors, whose interests are represented, often very poorly, by fund managers whose outlook is very short-term and whose knowledge of the real economy (as opposed to the financial or paper economy) is limited. In responding to the question "to whom are economic policymakers accountable?", Rodrik explains:

> The implicit answer provided by the globalization model is that they will be accountable to foreign investors, country-fund managers in London and New York, and a relatively small group of domestic exporters. In the globalized economy, these are the groups that determine whether an economy is judged a success or not, and whether it will prosper.
>
> This would not necessarily be a bad thing if the invisible hand of global markets could always be relied upon to produce desirable outcomes. The reality is considerably more murky. It takes too much blind faith in markets to believe that the global allocation of resources is enhanced by the twenty-something-year-olds in London who move hundreds of millions of dollars around the globe in a matter of an instant, or by the executives of multinational enterprises who make plant location decisions on the basis of the concessions they can extract from governments.[51]

Nor would it be a bad thing if financial markets were completely de-linked from the real economy, for all that would be occurring in financial markets would be a series of offsetting transactions between rich speculators.

But that is no more than a theoretical proposition. Financial markets do have an impact on real resource allocation, for two reasons. First, they tie up otherwise valuable human resources, in that they absorb some of the world's top graduates, who could otherwise be working in the real economy. And, second, they have more direct and devastating effects on countries' currencies and the cost of finance capital for real investment projects.

It may not be rational that the fortunes of the real economy are influenced by the performance of the paper economy, but through the actions of speculators, and the reactions of governments influenced by the sentiment of ratings agencies, the effects rapidly flow through to the real economy.

Martin Khor, Director of the Third World Network, links the 1997-98 Asian crisis directly to the irresponsible actions of America's hedge fund Long Term Capital Management – which, with a capital base of no more than $5 billion, was able to place positions of $1 300 billion in financial markets.[52] That's equivalent to around one half of the total debt outstanding in

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[51] Rodrik 1999, p. 151.

[52] Khor 1999.

developing countries. With the capacity to raise such an amount of hot money through extreme leverage, there is huge potential for mischief. And, of course, when the hedge fund's creditors themselves get edgy, that money has to be withdrawn from financial markets.

When LTCM collapsed it was bailed out by a consortium of banks, in a scheme organized by the Federal Reserve Bank of New York. Had LCTM not been bailed out the knock-on effects on the banking system would have been devastating for the US economy. But it had already done huge damage to Asian economies, and there was no such haste to rescue their economies. Conservative economists are critical of bail-outs of developing countries, because they contribute to moral hazard in financial markets. They have a point, but it would be more convincing if they levelled the same criticism at the US domestic bail-outs – the bail-out of the stockmarket in 1987 and the bailout of LTCM in 1998. (The issue of moral hazard in lending practices is covered in Part 5.4.)

Stiglitz, too, is critical of the faith placed in private markets. Advocates of liberalization, he points out, argued that liberalization would enhance economic stability by diversifying sources of funding. But, he says:

> Surely they must have known that bankers prefer to lend to those who do not need their funds; surely they must have seen how it is when countries face difficulties, that foreign lenders pull their money out – exacerbating the economic downturn.[53]

It is easy to place the blame for financial crises on borrower profligacy, but lenders are no less responsible. Over-borrowing is the flip side of over-lending; a willing borrower cannot borrow without the cooperation of a willing lender.

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[53] Stiglitz 2002, p. 67.

5. Financial market failure

Misplaced faith in the workings of private markets should not be sheeted home to the discipline of economics. Economic research has identified several ways in which private markets fail. Rather, the problem is a simplistic neoliberal notion of economics which pervades institutions like the IMF. Stiglitz sums up the situation:

> Today, however, market fundamentalists dominate the IMF; they believe that markets by and large work well and that governments by and large work badly. We have an obvious problem: a public institution created to address certain failures in the market but currently run by economists who have both a high level of confidence in markets and little confidence in public institutions. The inconsistencies at the IMF appear particularly troubling when viewed from the perspective of the advances in economic theory in the last three decades.[54]

There is, indeed, a simple economic model of the role of private capital markets in development – sometimes known as the "Solow model". Capital should flow from developed countries, where labour is expensive and where capital, at the margin, is comparatively unproductive, to developing countries, where capital is scarce and labour is plentiful and low cost. It's an attractive, logically consistent, two-factor model of economic optimization,

If it held, we would expect the greatest flows of capital from rich countries would be to the poor countries of Africa and South Asia, followed by flows to the medium-income countries of East Asia, followed by flows to other rich countries.

In fact, this is practically the reverse order of present capital flows. Most flows are between already rich countries. In 1999, the latest year for which aggregate data is available, of $913 billion of global foreign direct investment, $727 billion or 80 percent was to countries classified by the World Bank as "high-income", and of the remaining 20 percent, four countries (China, Brazil, Argentina and Mexico) accounted for 12 percent of foreign direct investment. The USA received more foreign direct investment than all low and middle income countries, and Norway received as much as all of Sub-Saharan Africa.[55] In fact, over most of the 1990s there have been private capital outflows from Africa. High quality capital flows – foreign direct investment – have generally bypassed developing countries, but they have not escaped the ravages of more volatile speculative capital flows.

It is important to distinguish foreign direct investment from other forms of capital flows. Direct investment can involve patient capital, with an associated transfer of skills and technologies, and often access to global markets. Not all foreign direct investment involves establishment of new enterprises, however. Some foreign investment is in privatized government enterprises. Sometimes this results in resurrection of moribund enterprises, but often it is no more than a transfer of a business from local to foreign hands, at times with distributional consequences as water, electricity and telephone utilities raise their prices to provide a high return on investment to foreign owners.

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54 Stiglitz 2002, p. 196.

55 World Bank *World Development Report* 2002, Table 4.

Alice Amsden of MIT points out that there are many conditions to be met for foreign direct investment to be beneficial. Often it involves transfer of dated technology, locking the recipient country into a dead-end path of declining markets rather than growth. Often it is associated with franchise restrictions, which place limits on exports. Amsden points out that foreign direct investment is most likely to be beneficial if the recipient country has a well-educated population and a reasonably well-developed industrial base, so it can exercise some power in the relationship with the investors.[56]

The poorest countries receive very little foreign direct investment, apart from investment in extractive industries. Political stability, reliability of infrastructure, the absence of corruption, and availability of a well-educated workforce are all important factors influencing firms' investment location decisions. Increasingly, foreign direct investment is in industries with strong domestic markets rather than in export industries; this means a reasonably well-distributed domestic income providing a mass market is an attraction for foreign investors. These conditions are not found in the world's poorest countries. And if widening inequality is a result of misguided development policies, opportunities for development of local markets will be limited.

While foreign direct investment is usually committed for at least the medium-term, other forms of capital transfers, even if they are in long-term instruments such as loans, can be shifted easily. Portfolio investments can be bought and sold at the click of a mouse; loans can be sold in secondary markets. And some forms of foreign direct investment can be footloose; it is not uncommon for recipient countries to provide fixed facilities such as buildings and infrastructure, while the foreign investor provides machinery which can easily be shipped out.

The distinction between foreign direct investment and other foreign capital flows is important in terms of policy. Advocates of market liberalization often use the benefits of foreign direct investment to argue the case for financial market liberalization generally. But foreign direct investment and other forms of capital can have very different effects on developing countries.

We cannot make general claims about the benefits (or costs) of capital flows simply by looking at the benefits of foreign direct investment. If all capital flows were of patient capital, and if capital and labour were the only relevant factors of production, then the Solow Theory would hold, and there would be a global balance of capital and labour resources through direct investment.

But there are many failures in private capital markets, which make them behave in ways very different from those suggested by the Solow Theory. Four aspects of financial market failure, covered in the following parts, are:

- the importance of human capital and other factors of production;
- the behaviour of speculators;
- pecking order and other knowledge limitations;
- moral hazard.

[56] Amsden 2001.

5.1 Human capital and other factors of production

Table 6 below shows the distribution of long-term financial capital flows in 2000. They tended to flow to countries which already have reasonably high income or growth. Capital does not flow to countries which have nothing to offer but raw labour resources. The flow to Europe and Central Asia is particularly striking – accounted for largely by Poland and the Czech Republic (formerly centrally planned economies, which have had programs of privatization) – and by investment in extractive industries in Russia and Kazakhstan.[57] Tables of financial flows need to be interpreted with caution, for they do not differentiate between transfers of ownership (as occurs with privatization) and finance for new capital such as machinery and infrastructure.

Table 6. Long-term financial flows to developing countries, 2000, $bn by region

	Net flow of long-term debt	Foreign direct invest-ment	Portfolio equity flows	Grants	Total	Populat-ion (million)	$/head
East Asia & Pacific	3.5	58.0	28.6	2.8	92.9	2 108	44
Europe & Central Asia	12.9	28.8	5.5	7.6	54.8	383	143
Latin America & Caribbean	13.3	76.2	9.9	3.1	102.5	624	164
Middle East & North Africa	0.5	4.5	0.9	3.4	9.3	333	28
South Asia	8.4	3.2	2.1	2.5	16.2	1 762	9
Sub Saharan Africa	0.7	7.3	0.8	10.2	19.0	866	22
All developing countries	39.3	178.0	47.8	29.6	294.7	6 076	410

Source: World Bank *Global Development Finance* 2002, population from UNDP (2000 figures).

Similarly, there has been a strong flow to Latin America. The figures are too heavily aggregated to show what is happening in East Asia, but China and the developed countries of East Asia have had strong inflows of foreign direct investment.

Africa and South Asia, by contrast, receive very little long-term financial capital. There is some flow of foreign direct investment into Africa, but that is mainly into South Africa.

India is a special case. By comparison with China, a country with roughly the same population, India has received only a trickle of foreign direct investment. (In 1999 India received only $2.2 billion of foreign direct investment; by contrast China received $38.8 billion.) India is the last large country to embark on opening its commodity and financial markets; the process began only in 1991. India, with 17 percent of the world's population, accounts for only 0.7 percent of the world's trade in goods. (China accounts for 3.3 percent.) Average import duties in India are 34 percent – but this is down from 87 percent in 1990.[58] India is poor, but it is large enough to have a significant well-educated high-income middle class, making it a very attractive destination for foreign investment. Unless there is a significant policy reversal in India, foreign investment should grow strongly from its low base.

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[57] United Nations Economic Commission for Europe, Press Release 14 November 2002, Table 4.

[58] "A survey of India's economy" *The Economist* 2 June 2001.

The productivity of capital is a function not only of the amount of labour that is available. It is dependent on many other factors, the most important being the quality of that labour, as indicated by workers' endowments of education and skills. The former communist countries of Eastern Europe perhaps illustrate this point most strongly, for whatever the deficiencies of communism in terms of entrepreneurship, innovation and incentives, the communist countries did invest strongly in education, and the workforces of those countries have experience of working in industrialized (if not modernized) economies. By contrast the only people who seem willing to employ the plentiful labour of Africa are the warlords who, for 65 cents a day and with the capital investment of an AK47 (available for $150 in Egypt), can buy the services of an infantry soldier.[59]

Another other important factor influencing capital productivity is business confidence, and to a large extent this depends on the quality of public administration. Availability of physical infrastructure, a régime of commercial laws, an independent judiciary, protection of property rights, sound business regulation, absence of corruption, and physical safety are all factors which have a bearing on business investment.

These factors, in turn, depend on the performance of government. To attract investment governments have to be willing and able to invest in education, public health and physical infrastructure – the public goods often taken for granted in developed countries. They have to have the human resources to enact and enforce sound business regulations. One necessary (but by no means sufficient) condition for overcoming corruption is to have a well-paid and professional civil service, so that public servants, inspectors, police and other officials are paid enough to remove the temptation of corruption. Professional standards have to be supported by courts, regulators and audit bodies independent of the influence of executive government. As has been demonstrated in US corporate scandals, particularly the Enron collapse, even in developed countries there are strong interest groups who try to make sure such institutions don't work effectively.

All such institutions make high demands on public budgets, particularly in countries where well-trained labour is scarce, but their absence is costly. Petty corruption by officials, in which all transactions are accompanied by "facilitation payments" may not be as outrageous as high level corruption, but it is corrosive in its effects, slowing down business transactions and adding to business complexity.

But, too often, the dictates of the "Washington Consensus", as spelled out in the conditionality of IMF support, require governments to cut expenditure.

Of course, some economists will say this is a simplistic interpretation; the IMF generally doesn't ask governments to cut spending on regulatory agencies, education or physical infrastructure (although there are instances where structural adjustment programs have called for cuts in education outlays). Governments make the wrong cuts, or they fail to raise taxes. But governments in countries seeking assistance often have little latitude; their hold on power is delicate. A foreshadowed cut in military expenditure may precipitate a coup. A decision to increase taxes on the wealthy, or to collect resource rent tax, may initiate a revolt of the rich – perhaps even a counterproductive flight of private finance. That is one of the reasons why many development economists stress the need for development and strengthening of civil

[59] Fishman 2002.

society, democratization, and establishment of institutions for conflict resolution as preconditions for successful development.[60]

Another limitation of the Solow Theory is that it is based on only two factors of production. A third factor is natural resources. Many of the present high-income countries received a development kick start through foreign capital invested in mineral and other natural resources.

Natural resources do still attract foreign investment, but it is questionable whether they contribute to economic growth, particularly if resource depletion and environmental damage are taken into account. (They are not covered in national accounting systems.) Jeffrey Sachs, of the Harvard Institute for International Development, points out that being resource rich probably uses up one to two percent per year of economic growth potential compared to being resource poor.[61] Korea, Japan and Taiwan are blessed with resource poverty; Russia, Zaire, Venezuela, Saudi Arabia and many other countries are cursed with resource abundance.

Development economists do not know the precise reasons why resource abundance impedes development. One possible reason is that resource abundance generally leads to a high exchange rate which impedes the development of local industries in trade-exposed sectors. There may be other factors at work impeding development. Perhaps resource abundance results in rent-seeking behaviour or even armed conflict. Perhaps access to easy sources of revenue discourages countries from developing tax bases and other policies which will provide for long-term growth.

5.2 The behaviour of speculators

Orthodox economists are quick to defend the behaviour of speculators in financial markets. The basic theory is that speculators seek out minor market imperfections and, in trying to capitalize on those imperfections, they bring markets back to equilibrium through their arbitrage transactions. Markets are kept perfect by well-informed people believing markets are imperfect.

It's a theory based on the neat assumption of negative feedback loops and perfect, or near-to-perfect, information. Speculators may not be benign, but in trying to exploit weaknesses in markets they bring markets to equilibriums.

If this model were accurate such arbitrage transactions would simply be minor transactions on the margin of markets, but the volume of speculation is far from marginal, and the feedback loops are not stabilizing. In reality the feedback loops are often characterized by destabilizing positive feedback, resulting from actions such as short selling. If it were accurate real exchange rates would be more stable, but financial market deregulation has been accompanied by greater exchange rate volatility.

Citing John Eatwell of Cambridge University, Rodrik points out the basic shortcoming of the orthodox model:

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60 Rodrik 1999.

61 Sachs 1996.

> If the financial markets are simply enforcing the logic of real economic efficiency, strengthening the self-adjusting powers of competitive markets, then the "disciplining" of governments would be benign, but if markets are pursuing the rules of a beauty contest and imposing self-fulfilling prejudices on the workings of the real economy, then the outcome may be very damaging .... When [markets'] influence is combined with the persistent search for government "credibility", defined in terms of "sound money" and "prudent" deflationary policies, then the [low-growth, high-unemployment equilibrium] is the most likely outcome.[62]

Eatwell's reference to the "beauty contest" is a reference to Keynes's observation of a particular form of beauty contest, in which people were asked not to vote on their own perceptions of pulchritude, but on how they believed others might vote. "Who do you think will be voted Miss Midlands?" People were essentially being asked not to express their own views, but to speculate on the views of the herd. To do so, they would rely on simple, observable criteria.

Similarly, speculators, particularly when they are under pressure to produce short-term results, invest not in their judgement of long-term fundamentals of markets, but in their expectations of short to medium-term movements in prices, based on what they think other speculators will be doing. If prices are moving away from equilibrium (wherever that may be), then the speculator will try to chase the movement, thereby aggravating the movement away from equilibrium. Far from being a negative feedback function making for stability, speculation is a positive feedback function making for instability.

In fact, stable markets, slowly adjusting to fundamentals, would provide poor pickings for speculators, who have a vested interest in instability.

There is an inherent herd mentality in financial markets. Money managers are risk-averse. If the performance of their funds goes awry, it is easy to explain poor performance to depositors if they can cite the authority of the herd – even if this goes against their better judgement.

As George Soros points out, financial markets, in the short-term, are reflexive.[63] That is, they can create the conditions for their own price movements. Asset prices are determined by expectations of future earnings, including the earnings expected from speculative gains. At some point, of course, expectations have to give way to reality, but a great deal of damage can be done on the way.

Economic theory is based on the assumption that speculators operate only at the margin of markets. But speculators, particularly in the USA, can take positions which are far more than marginal. One of the market failures most frequently overlooked is the huge accumulation of speculative capital in the USA. As pointed out in the introduction to this part, by straight economic theory the USA, as the world's richest country, should be exporting capital to the rest of the world. In fact, the rest of the world is financing a huge trade deficit; the US has been running a deficit on current account for twenty years. This deficit has been financed largely by Asian countries, particularly high and middle-income countries such as Japan, Korea, Singapore, and Malaysia, and by China.

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[62] Eatwell 1997, p. 246 cited in Rodrik 1999, p. 51.

[63] Soros 2000.

This phenomenon is explained, in part, by the damage inflicted by speculation itself. Individuals, businesses and governments, until recently at least, have had a preference for holding US dollar accounts because the US dollar is seen as a "safe haven", particularly in the light of financial crises in other parts of the world. In that way they have (unwittingly) financed the US trade deficit. The US dollar is the currency of world trade. Indeed, the problem of "seigniorage" – that is, one country's currency becoming the world's trading currency – was the main reason why Keynes advocated a global currency for the IMF in 1944. For reasons more to do with national pride than with economic good sense the US resisted Keynes' suggestions. As a result the US is unable to control its own money supply or exchange rate; a high US dollar has had devastating effects on many US manufacturing and other trade-exposed industries, and has led to the growth of a strong domestic protectionist lobby. More fundamentally, the funds which have financed that deficit have found their way into asset speculation – a stockmarket which (until recently) has been very much over-valued and an inflated real-estate market.

If these funds were flowing into real investments, US and world markets would be more stable. But, because financiers correctly perceive markets to be unstable, they put a high premium on liquidity and on ventures with short-term gains. A body of investment theory, known as "real options theory", puts a premium on flexibility and liquidity – in effect the capacity to enter and exit from markets quickly. It is much easier to invest in (and divest from) shares and derivatives than it is to invest in real assets. Financial instability creates its own feedback loops which foster instability. Instability is also fostered in cycles of psychological exuberance and gloom, which result in pro-cyclical activities in financial markets.[64]

Even in the absence of speculation there would still be instability in financial markets, because of stickiness in financial and product prices. Simple economic equilibrium models assume all adjustments are rapid, but, in fact, many prices (including wages, exchange rates and interest rates) are slow to respond to changes in fundamentals, and, when they do, they tend to overshoot. MIT Economics Professor Rudi Dornbusch demonstrated how overshoot occurs in currency markets as a form of compensation for stickiness in other markets. Overshoot is well known in physical systems, such as motor vehicle suspension and steering systems, and engineers have means of compensating for overshoot – basically by dampening (slowing) the response mechanisms. It has taken the economics profession much longer to recognize this phenomenon in financial systems and to design appropriate regulatory mechanisms.

The financial sector has been one of the few growth industries in the developed countries in the late twentieth century. While traditional industries, such as manufacturing and farming, have declined, the financial sector, spurred on by new technologies and deregulation, has gained in strength, giving it powerful political influence. The notion that the role of the financial sector is simply to serve the real economy has been forgotten. There is little recognition that the fortunes made in the financial sector are mainly transfers from other industries and individuals (often in other countries), rather than the creation of new wealth.

The financial sector is likely to defend the behaviour of speculators; they have helped the sector become prosperous. But relying on speculators to bring stability to markets is akin to

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[64] Crockett 2000.

having a fire brigade throw flaming torches into buildings to make sure that fire protection mechanisms are working. That may be irresponsible enough; when they also throw in enough accelerant to burn the buildings to the ground the practice is even more absurd.

5.3 Pecking order and other knowledge issues

Investors have a home bias. That is, they prefer to invest in familiar territory. The phenomenon is well-researched in relation to corporate investment; corporations prefer to invest, in order, in their own enterprises, in local markets, in nearby foreign markets, and in markets further afield. Economists know this bias as the "pecking order" effect.

The explanation of home bias is in terms of information and other transaction costs. Information is hard to acquire; the more local the easier it is to acquire.

This bias is likely to favour countries already well integrated into the channels of global finance. In spite of the spread of development to countries such as Korea and Singapore, and the growth of communication technologies, financial markets are still physically concentrated in London and New York.[65] Investment communities are still regional, to a certain extent. They are never far from the business schools and economic faculties of American and European universities. Furthermore, developed countries have better public and private information and statistical services than poor countries.

A related bias is the description of problems by broad geographic generalization, such as the "Asian crisis" of 1997, or the "South American" crisis of 2002. What happens in Indonesia or Argentina is perceived to be a problem throughout Southeast Asia or South America, and affects investor confidence accordingly. No German or British banker would describe a problem in Romania or Albania as a "European crisis" (although they may wrongly generalize about "Eastern Europe"). But broad descriptions are readily applied to other regions.

Defenders of economic orthodoxy accept that markets fail, often because of incomplete knowledge, but they point out that government failure can be worse, because governments may have incentives to suppress knowledge. George Fane, a development economist at the Australian National University, draws on the experience of governments in commodity price stabilization to argue the case against their involvement in capital market stabilization:

> The long history of government-organised commodity price stabilisation schemes which have lost money, despite being given subsidies and monopoly powers, suggests that any economies of scale in information gathering and processing are usually dwarfed by the incentives that lead to cost-padding in government agencies or to hidden subsidies for politically influential lobby groups.[66]

Fane argues that if governments have information not held by private markets, they should release it, so that private markets can use it. This is sound advice, in line with the general call for more transparency and accountability, but it doesn't overcome some of the basic problems in leaving global finance to the whims of the private sector. The private actors in global

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65 Sassen 1999.

66 Fane 2000, p. 87.

financial markets are not accountable to those to whom they lend money, and they are often acting within a set of incentives which gives prominence to the generation of impressive short-term results rather than the dissemination of useful information.

5.4 Moral hazard

When there is a likelihood of bail-out, then there is moral hazard in markets. Lenders are less cautious than they would otherwise be.

One of the paradoxes of institutions like the IMF is that, in its capacity as lender of last resort, it can add to the moral hazard of lenders. The IMF's main function in crises has been to try to provide borrowers with the capacity to repay loans. That's quite a different function from the one originally envisaged by Keynes which was concerned with liquidity generally and the capacity of governments to keep their economies stimulated at times of downturns.

More significant are the domestic bail-outs which occur in the wake of financial crises. Following the 1987 stock market crash the US Reserve Bank immediately came to the rescue of markets, with a massive injection of liquidity into the markets. (Because a key role of central banks is to sustain liquidity, such moral hazard is unavoidable.) Similarly the US Government had little hesitation in facilitating a bail-out of LTCM when that huge hedge fund collapsed in 1988. Each bail-out looks wise and pragmatic when it happens, but as they recur they result in a more cavalier and irresponsible attitude on the part of lenders.

Moral hazard does indeed exist, but even if the IMF were adhering to its original charter it does not have the resources to allow anyone to believe it could go on bailing out defaulting creditors. Moral hazard results from the actions of sovereign governments – usually well-heeled governments – which have underwritten the excesses of the financial sector. The USA has the resources to bail out imprudent financiers, and has done so at various times, resulting in less care and less risk aversity by lenders. Governments of developing countries, other than those living off natural resource incomes, generally do not have the resources to finance morally hazardous interventions.

6. Reforms – global financial architecture

Financial systems are complex. The first loan crisis of the early eighties, for example, had its origins ten years earlier in the collapse of the Bretton Woods currency and defacto gold pegs, and the associated rapid oil price rises. With the wisdom of hindsight we can see how events unfolded: a massive increase in bank deposits as petrodollars were recycled led to a boom in financial markets. Financial flows took on a life of their own, delinked from the real economy of trade and investment. New financial instruments – derivatives, swaps, junk bonds – made a mockery of traditional monetary measures and controls. (While derivatives had been around for some time, they had previously served as hedging instruments for commodity traders and investors; they were not "investments" in their own right.) The conditions for instability were established. Few financial or economic analysts were able to predict the shock or its consequences at the time.

But the more recent crises have a generic pattern. The crises of the 1990s have a depressing similarity to those which occurred in the first half of the twentieth century. These were the very problems Keynes and the other designers of the Bretton Woods institutions were determined to prevent. In 1978 Charles Kindleberger, a professor of economics at MIT, who had worked in central banking in the interwar years, warned that panics and crashes were still inevitable. The Bretton Woods institutions had not been equipped with the means to carry out their original mandate. In particular, claimed Kindleberger, the IMF's role was too much concerned with last-resort finance; its role had become one of allowing countries to pay off creditors. It lacked the resources or the mandate to carry out its original mission of providing counter-cyclical finance.[67] In short, it was primarily serving the interests of the international financial community. Both liberals and conservatives, from different perspectives, have criticized the IMF – liberals for being too concerned with the interests of creditors, conservatives for fostering moral hazard.

By the time the 1997-78 Asian crisis occurred, even the most conservative economists had to admit that the policies of the "Washington Consensus" weren't working. This crash had occurred in a group of countries which generally had star ratings from the global financial community. If it had started in some region with socialist governments, or with governments with wildly irresponsible fiscal policies, the response would have been "I told you so". Stiglitz records the reaction:

> In the aftermath of the East Asian crisis, and the failures of the IMF policies, there was a general consensus that something was wrong with the international economic system, something needed to be done to make the global economy more stable. However, many of those at the U.S. Treasury and IMF felt that only minor changes were needed. To compensate for the lack of grandness in the changes, they conceived a grandiose title for the reform initiative, *reform of the global financial architecture*. The term was intended to suggest a major change in the rules of the game that would prevent another crisis.

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[67] Kindleberger 1978.

> Underneath the rhetoric, there were some real issues. But just as those in charge at the IMF did everything to shift the blame away from their mistakes and away from the systemic problems, they did everything they could to curtail the reforms, except to the extent that they result in *more* power and money to the IMF and *more obligations* (such as compliance with new standards set by the advanced industrial countries) on the emerging markets.[68]

Those who, like Stiglitz, call for more substantial reform, can be categorized into two groups, with complementary ideas. Those in the first camp are concerned with reform of the global institutions themselves, or the possible development of new institutions. Those in the second group are more concerned with changes in the policies and institutions within developing countries.

This is not to suggest a fundamental tension between the groups. It's more a question of priorities for research and direction of influence. Nor are the two areas of reform separable – quite clearly many of the policies pursued inside developing countries have been at the behest of the global financial institutions.

One issue which tends to constrict debate is that advocates of reform often focus on one factor. For example it is correct that countries with restrictive trade policies tend to suffer from low growth. It is also correct that no country with a democratic government has ever suffered a famine.[69] (It is not correct however, to assert, as Tom Friedman does, that no two countries with McDonalds diners have gone to war; in 1999 US bombs came close to destroying a McDonalds diner in Belgrade.[70]) But to suggest that any one of these, or of other conditions, is adequate to ensure sustained growth or the elimination of poverty is to commit a basic logical error – the fallacy of affirming the consequent. There is a complex set of conditions, all or most of which must be satisfied. The absence of any one may be enough to impede development; those who focus on one or a narrow set of conditions tend to forget the complementarity of other conditions. This limited way of thinking seems to have impeded participants from all sides in the current debate on globalization and development.

Reforming financial institutions won't, in itself, promote just or enduring development, unless other preconditions are met. The most that can be expected from financial reform, perhaps, is relief from the burdens of debt servicing and of currency and interest rate instability in debtor countries.

The limited benefits of financial reform should be borne in mind, for the problems associated with debt and instability are most strongly manifest in certain Central and South American countries. Reform of financial architecture therefore is possibly of concern more to the US and its trading and investment partners in the Americas than globally. Table 7 lists the twelve countries with the world's highest debt burdens (as indicated by the ratio of debt to exports). Seven of these countries are in the Americas, and they include the large economies of Mexico, Brazil and Argentina. (A similar table, prepared in the late 1980s, would have

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68 Stiglitz 2002, p. 233 (emphasis in original).

69 Sen 2002.

70 Cosgrove 2002.

placed many African countries among the world's biggest debtors. Ethiopia, Madagascar, Burundi and Nigeria all had high debt service ratios in the late eighties.)[71]

Table 7. Debt service as a percentage of exports, 2000

Brazil	91
Argentina	71
Sierra Leone	48
Peru	43
Bolivia	39
Turkmenistan	32
Sao Tome and Principe	32
Mexico	30
Uruguay	29
Kyrgyzstan	29
Colombia	29
Pakistan	27

Source: *UN Human Development Report 2002* Table 16

Financial stability is also of concern to Asian countries, not so much because of debt burden, but because of the ineptitude of the IMF interventions in the 1997-1998 crisis, a crisis which resulted from too rapid liberalization of financial markets and inappropriate contractionary fiscal policies in response. For the world's poorest, however, in Africa and India, financial stability is not necessarily a prime concern, because those regions are somewhat isolated from the global financial system.

This Chapter, therefore, deals with institutional reforms, but it goes beyond financial reforms, into other issues which may be of concern to the world's poorest. It covers general philosophies, aid, trade, investment, and institutional reform, with emphasis on the Bretton Woods institutions. The final Chapter deals with reforms within developing countries.

6.1 General philosophies

Whatever institutional charters are written, there won't be a great deal of progress towards reform until there is a changed way of thinking about problems of growth and development. This is particularly important in bodies like the WTO, where decision-making rules are imprecise.

Stiglitz comments on the way in which trade and finance ministers see the world:

> The greatest challenge is not just in the institutions themselves but in mind-sets: Caring about the environment, making sure the poor have a say in decisions that affect them, promoting democracy and fair trade are necessary if the potential benefits of globalization are to be achieved. The problem is that the institutions have come to reflect the mind-sets of those to whom they are accountable. The typical

71 World Bank *World Development Report* 1990.

> central bank governor begins his day worrying about inflation statistics, not poverty statistics; the trade minister worries about export numbers, not pollution indices.[72]

James Scott, Professor of Political Science and Anthropology at Yale University, warns of the policy consequences of "thin simplification"[73] – the reductionist practices adopted by policy-makers and planners, who develop simplified mental models of the systems with which they are working.

National economies are complex, and it is understandable that bureaucrats working in trade and financial portfolios spend much of their time analyzing aggregated statistics on trade, the balance of payments, exchange rates, capital flows, and budget data. But these are all *financial* aggregates, often far removed from the real entities to which they refer. Bureaucrats need to appreciate the fact that such data is a purposeful reductionist representation of a complex system. Economic systems are far too complex to allow for representation of their health by a few financial metrics. (Those who criticize economics often misdirect their criticism, for the issue of their concern is more likely to be the way in which the simplified discipline of *financial* analysis has displaced the far richer discipline of *economic* analysis.) Economics is about real resources and human welfare; finance is largely about bookkeeping.

For illustration, Table 8 below shows some of the differences between financial and economic considerations.

Table 8. The contrast between financial and economic considerations

Financial considerations	Economic considerations
Size of government expenditure and of deficit – net public sector borrowing requirement.	Composition of government expenditure (health, education, defence etc), effectiveness of programs. Quality of physical infrastructure. Capacity to mobilize tax revenue. Quality and independence of regulatory institutions. Absence of resource misallocation resulting from official corruption.
Balance of payments.	Sustainability of agricultural and mining industries and of ecosystems generally. Composition and quality of foreign investment inflows. Capacity of financial institutions.
GDP growth.	Distribution of growth. Capacity for growth to be self-sustaining. Incentives and rewards in the economy. Full use of resources – accountability for costs of unemployment.

No institutions illustrate the problem of "thin simplification" better than the ratings agencies. Their clients, the banks and investment houses, are interested only in financial aggregates. In turn they are under pressure to provide simple letter grades to their investors.

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72 Stiglitz 2002 p. 216.

73 Scott, 1998.

This is not to denigrate the importance of financial accounting and proper bookkeeping. They are vital instruments of budgetary control, they provide audit trails, and they help protect against corruption. But, contrary to the faith of those who work in ratings agencies, they provide only partial measures of economic health.

A related problem is means-end confusion. The objective of those who met at Bretton Woods in 1944 was to see fair economic growth. "Our dream is a world free of poverty" adorns the banner of the World Bank website. The World Bank and IMF have had liberal and humane senior managers and research staff. But it is easy for concern about means to replace concern for ends, and for simple nostrums to replace carefully-designed policy solutions. Liberalized trade, for example, is a means to achieve fair economic growth, but only if it is combined with other conditions – conditions which will be different in each country.

Echoing Scott, Joseph Nye, Dean of Harvard's Kennedy School, stresses the need for pragmatism in the policies of these institutions:

> Most important, perhaps, is to try to design multilateral institutions that preserve as much space as possible for domestic democratic processes to operate. The real policy challenge is making the world safe for different brands of national economies to prosper side by side. The answer involves multilateral procedures, modest barriers, and rules of the game that allow countries to reimpose restrictions when not doing so would jeopardize a legitimate national objective.[74]

Ruggie refers to the "embedded liberalism" that dominated the immediate postwar order.[75] The bureaucrats and politicians of 1945 were not any more competent, left-wing or humane than their counterparts of 2002, but, having lived through the Depression and its aftermath they were more aware of the consequences of economic mismanagement. They knew that financial rectitude, if pursued as an end in its own right, could prove economically ruinous. They understood the immense waste associated with unemployment and under-employment. They had faith in Keynes' analysis and prescriptions. And they understood the political consequences of economic collapse.

6.2 Aid

The world's poorest in South Asia and Africa remain outside the world financial system. Reforms which may result in stability in global financial systems could be of help to countries like Thailand, the Philippines, Mexico and Argentina which, for better or worse, are integrated into the world financial systems, but they will do little to improve the lot of people in Pakistan or Chad. India, so far, is reasonably immune from shocks, having operated as a relatively closed economy until a few years ago; India's external debt is only 16 percent of GDP, compared with figures around 40 – 60 percent in many South American countries and more than 100 percent in the most troubled countries of Africa and Asia.

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[74] Nye 2002, p. 165.

[75] Ruggie 1982.

Famine, drought, war, disease, floods, earthquakes and other pestilences call for immediate humanitarian aid, quite unconnected with any commercial returns or even cost-benefit consideration. (Although the economic case for action on AIDS is pressing because it is taking so many otherwise active victims and their carers out of the productive workforce.)

After humanitarian aid, the next most pressing need is aid for development. In some cases this means traditional infrastructure, such as transport and communications infrastructure, clean water and waste disposal. In most countries there is a need for technical assistance in agriculture. And, in almost all developing countries, there is a need for investment in education. Globally there are 125 million people who have never seen the inside of a schoolroom or its equivalent. In sub-Saharan Africa 40 percent of primary-age children have no opportunity for schooling.[76]

Education has pervasive and system-wide effects on development beyond the immediate transfer of skills and competencies which are relevant to workplaces. Education of women, in particular, also has benefits in terms of nutrition, public health and the passing on of values to children. Furthermore, there is evidence that a more educated population is more willing to accept change, and is therefore more willing to adjust to the demands of a more open and globally connected economy.[77]

Investment in infrastructure – hard infrastructure such as roads and ports, and soft infrastructure such as education – pays dividends which accrue to society rather than to private investors. When these investments result in higher incomes governments may be able to recoup the outlays through taxes; indeed that is the conventional theory of public finance, and it is the general justification for public investment where there is "non-excludability" of benefits. That is, because the benefits accrue to all, there are no mechanisms which allow non-payers to be excluded. Market mechanisms which restrict supply to those willing and able to pay do not hold. When there is non-excludability there is usually no alternative to public provision.

Dividends from infrastructure investments take time to accrue, and when higher taxes start to flow there are other pressing priorities. There is a strong case therefore, particularly in the poorest countries, for such infrastructure to be financed through grants to provide the long-term working capital for infrastructure investment.

Liberals and conservatives alike can become over-concerned with the operations of private financial markets, overlooking the essential role to be played by official non-repayable aid.

6.3 Trade

There are several major trade issues relating to development, including trade in agricultural and other products of poor countries, labour and environmental standards, trade in knowledge-intensive goods and services, treatment of current account surpluses and trends towards bilateralism.

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[76] Sen, Amartya "To build a country, build schools" *International Herald Tribune* 28 May 2002

[77] Maglen 1993.

Before covering these issues, it is useful to recognize that trade is not a panacea for development, and that calls for "trade liberalization" can be loaded with assumptions about what such liberalization means. Often, from the perspective of manufacturers or farmers in developed countries, "trade liberalization" means no more than lowering tariff and quota barriers in developing countries. The concept often does not extend to the abolition of production subsidies, export finance subsidies and non-tariff barriers in developed countries.

Similarly, the notion that developing countries will be better off if they can expand their exports needs careful qualification. Exports are not desirable as an end in themselves. Exporting always involves a cost, for it involves sending real resources out of a country. Only if the benefits from exporting those resources exceed their cost, and exceed the benefits from using them domestically, is exporting economically justified. If exporting involves depletion of scarce and undervalued resources, which could be better preserved or used in domestic production, then exporting will be very costly for the country concerned. (This point is illustrated most strongly where land has been diverted from food production to crops for export.) There are many corporations ready and willing to take advantage of under-priced mineral and forest products from developing countries.

Growth in exports may involve economic diversification; if so it tends to reduce vulnerability to external shocks. That has been the experience of successful East Asian countries. But in some cases export may simply involve an expansion of an existing industry base, in line with a simplistic economic notion of "comparative advantage". (The shortcoming of comparative advantage theory is that the world is not static. Neither climates nor commodity speculators respect the constructs of market equilibria.)

Whatever the incentive facing individual firms, the main national purpose of export is to provide finance for imports. In developing countries, however, the composition of imports often has little relation to countries' basic economic needs. Industrial plant and equipment, medical supplies, transport equipment and other products of industrialized countries may be necessary for improving living standards, but if precious foreign exchange is spent on Mercedes cars for the ruling classes, Italian tiles for the rich, or Czech small arms for the generals, then all of a country's export effort has probably counted for nought. In fact, the benefit is probably less than nought, for the resentment associated with conspicuous consumption in the midst of poverty will eventually build up into a destructive force.

Trade in primary products

Subsistence agriculture is a vital part of the economies of most developing countries. Asymmetric liberalization of trade in primary products, in which developing countries have lowered trade barriers while developed countries have sustained production subsidies and trade barriers, has often had devastating effects on subsistence agriculture. Production surpluses in developed countries, supported by subsidies, have depressed prices. Sometimes with encouragement from development agencies, subsistence farmers have often turned to crops designed to earn cash incomes rather than supplying local food needs, with serious consequences for income and nutrition when the terms of trade become unfavourable.

Countries at an early stage of development, wishing to earn export income, have few options other than the export of agricultural and other primary products. (One unattractive option, which is very socially disruptive, is the export of labour as temporary migrant labour to more prosperous countries.) The East Asian countries are the only large bloc which has broken this dependence on export of primary products. Countries classified by the UNDP as "low human development", however, depend on primary products for 69 percent of their exports.[78]

In the longer term it is important for developing countries to diversify their export bases away from dependence on agriculture, but in the medium term agricultural trade issues are important. For agricultural products there are not only trade barriers, but there are also the effects of over-production, stimulated by production subsidies in developed countries. Contrary to what notions of economic comparative advantage may suggest, in cereal trade developed countries are net exporters while developing countries are net importers. In meat, while trade is not quite so distorted, there is still a huge imbalance in favour of developed countries.

The main offenders have been the European Community and the USA, which between them provide around $150 billion a year in direct budgetary support for farmers – around $100 billion in Europe and $50 billion in the USA.[79] Total farm support in OECD countries, including the consumer tax equivalent of import restrictions, is about $360 billion a year, with heaviest support going to rice, dairy products and sugar[80].That's around five times the level of official development assistance provided by all developed countries. Development economists often use these figures to point out that the average cow in a developed country is supported by three times the level of income of a poor person in Africa.[81]

There has been some recent progress in Europe, with proposals to change farm assistance away from production subsidies to income-support assistance – which should remove incentives for over-production. But at the same time there are significant new barriers being erected in the USA where the government is enacting a new and expanded round of agricultural production subsidies; James Wolfensohn's criticism of the US Government's pre-Congressional election protectionism fell on deaf ears.

The first step away from agricultural dependence into economic diversification is usually into labour-intensive manufacture, in particular clothing, footwear, and basic consumer products such as toys. But for clothing, as for agricultural products, there are still significant trade barriers in developed countries.

Trade liberalization has to begin at home – that is, in the developed countries. This is important not only for the immediate benefits of developing countries, but also as a means of legitimizing existing international trade arrangements. Trade liberalization would be easier, particularly in the US, if the US dollar were permitted to fall to a more reasonable level, because an over-valued dollar has strengthened protectionist voices in the USA.

In turn a more realistic level of the US dollar requires development of global confidence, so that US financial markets are no longer seen as the world's only safe havens. Of course a lower US dollar would have a general effect on the competitiveness of countries competing with the US, but these are not the world's poorest countries. A devalued US dollar coupled

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[78] UNDP *Human Development Report 2002,* Table 14.

[79] "Cleansing the Augean stables" *The Economist* 11 July 2002.

[80] "A not-so-perfect market" *The Economist* 23 March 2000.

[81] "The Progress Report" www.progress.org.

with free access to agricultural products would be a much fairer and more stable trading system than one resulting from an over-valued dollar and capricious imposition of tariff and quota protection. But recent falls in the US dollar have not been accompanied by any lessening in domestic protectionist pressures.

Labour and environmental standards

Labour and environmental standards in trade are another source of conflict. These issues boiled over at the WTO meeting in Seattle in 1999 and environmental issues have been at the core of the 2002 Earth Summit.

There is at least some acknowledgement of the importance of environmental protection in the WTO preamble, but it appears that the main practical application of environmental standards has been to allow developed countries to block the import of products which, on the basis of scientific evidence, may cause health or environmental problems in the importing countries.[82] These safeguards are encompassed in the Agreement on the Application of Sanitary and Phytosanitary Measures.

These do not relate to environmental standards within developing countries. In the Seattle negotiations there was great sensitivity among the representatives of developing countries, in the belief that developed countries were using environmental standards as non-tariff barriers against developing countries. Perhaps that is a reflection of the extent to which unilateralism, particularly US unilateralism, has undermined trust in the WTO processes.

Although the issue has been researched extensively, there is little evidence that lax environmental standards are a significant factor in attracting industrial development, in either developed or developing countries.[83]

There are two economic arguments for incorporating environmental standards into trade rules. One relates to environmental externalities; the other relates to establishing global contracts.

The case on environmental externalities is reasonably clear-cut. If one country's pollution, of air or a shared water resource, has spillover effects on another country, then there is a case for some cooperative agreement requiring industries in the offending countries to clean up. If the cost of cleaning up the processes is less than the cost resulting from the pollution, then there is a fairly straightforward case for requiring those industries to improve their standards. If regulations are imposed without discrimination, no-one will be disadvantaged – except, perhaps, consumers who will have to pay a price which includes the cost of environmental protection. If it is not possible to find a technical fix to improve production processes, then some industries in developing countries (and in developed countries for that matter) may become unviable. In such cases there is a reasonably strong case for compensation or adjustment assistance from the rich countries. There is a precedent for using aid as an incentive to switch production. In many cases aid has been given to farmers to switch from

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82 Weinstein and Charnovitz 2001.

83 Rodrik 1997, p. 46.

opiate production to other crops, and within developed countries there is precedent for farmers being paid not to produce certain crops, in the interests of stabilizing prices.

Similarly, if negative environmental externalities are global, then there is a case for multilateral action. This applies in particular to greenhouse issues and depletion of fish stocks – both vital aspects of the global "commons". If trade agreements are to encompass such externalities, the developing countries have a reasonable case for compensation. The developed countries may now be working to improve environmental standards, but they have generally benefited greatly from rapid depletion of their own and the planet's environmental resources in the past. Many developed countries have accumulated their capital for development from non-sustainable exploitation of resources; if they do not want developing countries to follow their example they should be much more generous in giving developing countries access to capital.

When governments don't account for environmental costs and don't sheet them home to the firms which are causing pollution or paying too little for depleting natural resources, they are, in effect, subsidizing their industries, and, through not accounting for the full cost of production, are causing a misallocation of resources. The situation is no different from dumping, which is recognized and generally prohibited in WTO rules. It is incongruous that when dumping can be associated with certain subsidies, the WTO can take action, but when dumping is associated with under-payment for environmental resources, the WTO considers it to be outside its charter. The case for covering environmental costs in dumping action is reasonably straightforward within conventional economic theory.

The more complex cases are concerned with avoiding a race to the bottom in relation to environmental standards. People in developing countries may not want to over-exploit their forests or coastal fisheries, but if every other country is doing the same they would be foolish not to join in. It's a typical case of what has come to be known as the "tragedy of the commons"[84], a problem in social cooperation where all parties know that their individual and collective interests align, but because there is no binding contract among them they over-exploit their shared resources.

Those who argue that such issues are outside the brief of global economic institutions forget, perhaps, that one of the prime purposes in establishing the Bretton Woods institutions was to stop destructive beggar-thy-neighbour competition. The consequences of competitive devaluations and competitive exploitation of environmental resources are similar to those of other forms of beggar-thy-neighbour competition. They have effects damaging to the interests of all countries.

But there are practical problems in embodying environmental standards into formal trade rules. In part this is because of the mechanics of the WTO, where it is very easy for strong lobbies in developed countries to press for the use of environmental standards as non-tariff barriers. Even though the WTO theoretically has equal representation from all countries, it has inherited the consensus model from the GATT, in which there has always been an asymmetry in effective negotiating power. Many argue that to have the WTO take on the role of environmental enforcement would result in too great a concentration of power.

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[84] Hardin 1968.

Also, even in a world of perfect institutions, not all environmental issues could be resolved through imposition of trade rules, for not all environmental violations relate to trade or give a country a trade advantage. For example, use of ozone-depleting chlorofluorocarbons does not necessarily impart a trade advantage on any party; this particular issue has therefore been handled by the Montreal Protocol on Substances that Deplete the Ozone Layer, a program administered by the World Bank. Similarly there are many other multilateral environmental agreements within the United Nations Environment Program, covering matters such as migratory species, transport of hazardous waste, organic pollutants and, most significantly, the United Nations Framework Convention on Climate Change (the "Kyoto Protocol").

The issues concerning labour standards are very similar. (The only labour-related condition set by the WTO relates to prison labour.) The added complication with labour conditions is that when there are imports from developing countries which compete with domestic production in developed countries, debates on labour standards become intertwined with debates about protection. It is easy for lobbies in developed countries to define poverty as "unfair competition".

The arguments against incorporating labour standards into the WTO generally rest on the proposition that workers in developing countries cannot expect the same standards and wages as those in developed countries. That is a simplification of the issue, however. No reasonable person is asking for equality; rather, they are seeking a basic set of standards relating to issues such as freedom of association to form independent trade unions, freedom from involuntary servitude, basic levels of safety, and prohibitions on child labour.

In economic theory, violations of labour and environmental standards can be treated in the same way as other subsidies. When goods trade at a price that does not account for the cost of depletion of non-renewable natural resources, or the cost of ruining a young person's life, that is a subsidy. Countervailing duties, paid into the WTO (to avoid the risk of importing countries becoming addicted to the revenue) could be collected on non-complying imports. Such duties would ensure that no country, developed or developing, obtains an unfair advantage from lax standards, and would give those countries a strong, market-based incentive to lift their own standards so that the countervailing duties could be withdrawn and the revenue could be captured in the form of higher prices. (The fund of collected duties could be hypothecated to technical assistance to developing countries to improve their environmental and labour standards.)

But, as with environmental standards, there are practical problems with using the WTO as the main vehicle for enforcement of labour standards. Application of rules is bound to be asymmetrical between rich and poor countries. There are fears about concentration of power in the WTO, and many violations of labour standards have no bearing on countries' trade-exposed sectors. Ideally the International Labour Organization should have the prime carriage of labour-related standards. It has established expertise in labour-related issues, and probably has a wider basis of legitimacy than the WTO. Because of its more modest presence it is less likely to become carried away with high profile emotive issues which, while important in themselves, are not the main concerns of workers in developing countries. That said, however, the ILO, like all UN bodies, suffers from a poor funding base, and from the failure of many developed countries to ratify its core conventions.

There is also a role for non-government organizations in monitoring and raising public awareness, with measures such as "fair trade" marks on products from establishments and industries which do comply with reasonable standards. As Rodrik points out, very few people in developed countries would consider it reasonable to employ a maid in the conditions that many workers suffer in developing countries. They would be appalled if they knew of some of the environmental and other consequences of the production processes that go into the goods they import.[85] Rather than the punitive approach of boycotts and sanctions, it may be far more effective, and be accepted as less heavy-handed in developing countries, if consumers' attention could be drawn to complying products.

Knowledge-intensive goods

One of the most topical trade issues relates to pharmaceutical products, and in the 2001 Doha negotiations there was considerable progress on that issue, thanks largely to the pressures exerted by the non-government organizations. But the Doha solution was only partial and fragile. Rather than the adoption of a general set of rules, the WTO solution was to permit case-by-case arrangements involving drug patent-holders and specific manufacturers and importers in developing countries.

As Larry Summers points out, there is nothing special about pharmaceuticals. The issues in pharmaceuticals are the same issues that are appearing in all knowledge-intensive goods and services.[86]

Such goods have strong public good qualities. The fixed cost of production is high; the variable or run-on cost is low – extremely low in the case of goods such as pharmaceuticals and computer software. Similarly many biological technologies are becoming proprietary. George Soros outlines the development:

> Intellectual property rights raise both conceptual and practical issues. The very expression "intellectual property" is misleading because it rests on a false analogy with tangible property. An essential feature of tangible property is that its value derives from the use that the owner makes of it, but intellectual property derives its value from the use that others make of it: Authors want their works read, inventors want their inventions used. Patents and copyrights serve to ensure that the creators arc rewarded, but money is not necessarily the only kind of reward they seek. For instance, pure science has traditionally belonged to the public domain, and scientists have sought intellectual recognition rather than financial rewards. The establishment of patents and intellectual property rights has helped to turn intellectual activity into business activity, and business is of course motivated by profit. It can be argued that the process has gone too far. Patent protection is of course necessary to encourage investment in research, but something is lost when science, culture, and art become dominated by the profit motive.[87]

The issue in such goods is what economists refer to as "non-rivalry". Summers, quoting Jefferson, put it elegantly when he said "He who receives an idea from me, receives

[85] Rodrik 1997.

[86] Summers 2000.

[87] Soros 2002, p. 46.

instruction himself without lessening mine; as he who lights his taper at mine, receives light without darkening me".

Somehow the fixed costs of such goods have to be paid for. Someone has to pay for Jefferson's education and matches; someone has to pay for drug companies' research, development and clinical trials. But should the provision of such goods be left to unregulated markets, in which producers have a clear incentive (and, to an extent, a commercial need) to charge far more than the variable cost of production? Ad hoc arrangements may work in the most pressing cases, but, as the case of AIDS drugs illustrates, it can take a gargantuan effort to get even a partial solution within the constraints set by the TRIPS agreement. A more general framework is needed.

Soros compares the commercial appropriation of knowledge to the enclosure movement in agriculture in England in the twelfth to fifteenth centuries, when previously common land was fenced off and incorporated into the estates of manorial lords.

Stiglitz acknowledges that "knowledge is a global public good requiring public support at the global level".[88] We need a means of contributing to the global commons – in short a set of contracts between those who can finance public goods and those who can share from the benefits of public goods. Such arrangements can take the form of price discrimination – "Ramsay" pricing in economic terms – by which those who can afford to pay more towards the fixed costs make a greater contribution than those who cannot. For example, firms may sell pharmaceuticals in prosperous countries at prices which include a contribution to their research and development, but in poorer countries at a price just above marginal cost and which does not contribute to these fixed costs – thereby achieving widespread distribution and providing little incentive for piracy.

The alternatives to such agreements are very unappealing – widespread piracy, parallel imports of drugs of dubious quality and ugly trade wars, or monopoly pricing, in which millions are deprived of life-saving drugs even though they are cheap to produce. (The economists' term for such deprivation is "deadweight loss" – a term with a particular savage irony when it comes to drugs for fatal diseases.) An even stupider option is to finance purchase of high-cost drugs at developed country prices with precious private or official aid money – it would be more efficient to pass the funds directly to the pharmaceutical manufacturers.

Again, it's a case for global trade cooperation, similar in spirit, if somewhat different in detail, to the issues which motivated those who established the Bretton Woods institutions.

One particular need which may lie outside the capability of even a well-intentioned pharmaceutical firm is the development and production of unique drugs, for particular conditions unique to certain regions, or for vaccines which, if effective, would not have an ongoing market. For such drugs, particularly if there is no significant market in developed countries, there is not the opportunity for Ramsay pricing. Financing of development of such drugs through a global fund appears to be the only realistic option. An adequately funded World Health Organization would be the obvious body to carry out this function. A further advantage of WHO involvement is that, where there are alternatives to drug therapies, it would have no incentive to promote the commercial medicalization of health.

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[88] Stiglitz 1999, p. 320.

Dealing with surpluses

To suggest no country should have a deficit on current account is to commit a fallacy of composition. Globally, deficits and surpluses should balance.

One of the basic principles of the Bretton Woods institutions was to prevent countries getting into serious difficulties on current account. It is generally easiest to conceptualize such difficulties in terms of deficits, but, by definition, there will be deficits in some countries if there are persistent surpluses elsewhere. Indeed, it was the accumulation of huge petrodollar surpluses that eventually set off the 1982-83 currency crisis.

The surpluses of European countries are largely contained within the European zone, and China's surplus is small in relation to its population and its capital needs. The greatest problems lie with the Japanese surplus and the US deficit. To the extent that they may not be sustainable, both have the potential to destabilize global markets. So far the world has been content to allow the US to absorb excess production, on the basis that its economic fundamentals are strong, but that is not necessarily an enduring perception. If the US had been unable to depend on the inflow of global capital seeking a safe haven, it would long ago have had to go cap in hand to the IMF, who would have imposed very strict conditionality. Until there is the same confidence in the Brazilian real and the Malaysian ringgit as there is in the US dollar, this "flight to quality" will persist.

Ideally, what is required is confidence in all the world's major currencies. This requires some stability in the relationships between the world's major trading currencies – particularly the US dollar, the Yen and the Euro – a stability which could be achieved through more modest means than those originally applied in the Bretton Woods mechanisms. Trilateral negotiations, resulting in agreements to use economic levers to achieve soft pegs (e.g. bands of ± 10 percent), would be a useful first step in restoring global stability. The financial sector, with its stake in instability, would not necessarily be supportive of such a move, but governments need to realize that the aim of economic management is to support the real economy, not the paper economy.

There is a risk, however, that rather than confidence in other currencies increasing, confidence in the US dollar will fall because of lax regulation, unsustainable deficits, and corruption in the US. If this happens too quickly it could have severe effects on those individuals and small businesses in developing countries who have stashed away US dollars as savings. When there is no perceived safe haven, the result is a steep rise in gold prices, as occurred in 1974, 1980, 1987 and 2003 – a defacto return to the gold standard, with the risk of reversion to the pre-Bretton Woods era.

Bilateralism

One of the core principles of the GATT was that trade liberalization should be global. In the pre-GATT world, bilateral trade preferences had resulted in many countries, particularly poorer countries, being locked out of world markets.

Bilateral deals of the past were generally centered on exchanges of preferential tariffs. With tariffs on most goods now much lower than they were in the pre-GATT days, the benefits of mutual tariff reductions have now been lessened. But there are many non-tariff barriers which can form the negotiating coin between countries in bilateral trade deals. Recent trends towards bilateralism, and restricted deals within trade blocs, could once more undermine the prospects for more open world trade.

6.4 Finance and investment

There are two interrelated issues relating to finance and investment. One is the role of the IMF, in particular its funding. The other is the potential to deal with the destabilizing effects of rapid movements of speculative capital.

The IMF's role and funding

The IMF has drifted further from its original objectives than any other Bretton Woods institution. Its charter, however, still has echoes of its original purpose. It includes the following statements of aims:

- to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
- to promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
- to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
- in accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

But institutions are judged not by reference to their mandates. They are judged by their actions, and through the perceptions of their stakeholders – funders and recipients in the case of the IMF.

To the financial establishments in the countries which provide the IMF with hard finance, it is judged as a banker would be judged, accused of contributing to moral hazard among debtor nations and of "mission creep" when it moves into policy areas such as poverty alleviation.

To the recipients of IMF finance it is seen as heavy-handed, imposing solutions from outside, using the power of the purse to impose unconscionable conditions on developing countries. Unlike a commercial banker's lending to a business, IMF lending comes with a strong message of paternalism – a point acknowledged by former CEO Michel Camdessus himself, when he admitted that countries tended not to have ownership of IMF solutions.[89]

The IMF seems to be neither a banker nor a development agency. If it is to survive, perhaps it needs to become one or the other. Its pure banking functions could be taken over by a body

[89] "Le monde sans Michel" *The Economist*, 15 November 1999, p. 79.

such as the BIS. Its development functions may require dramatic reform, amalgamation with the World Bank, or development of a completely new institution.

One problem with the IMF is that it lacks the capital to carry out its original mission. There is no way in which it could achieve global stability from its small capital base. Keynes' vision for the IMF was that it should have funds equal to around one half of the world's imports.[90] That rule of thumb, if applied to the world's $7 000 billion annual trade, would indicate a capital base of around $3 500 billion.

In fact, IMF credit outstanding at April 2002 was $52 billion[91]; even in 1999, when it was supporting nations hit by the Asian crisis, its credit outstanding was only $79 billion.[92] The IMF's total assets are around $220 billion. That's around 6 percent of the funding envisaged by Keynes, and at least half of that amount is not really useable because of a lack of confidence in member countries' currencies. According to David Driscoll of the Hoover Institute:

> Because member countries pay 75 percent of their quotas in domestic money, and because most national currencies are rarely in demand outside the countries issuing them, approximately half of the money on the IMF's balance sheets cannot be used. Although there are occasional exceptions, only 20 or so currencies are borrowed from the IMF in the course of a typical year, and most potential borrowers from the IMF want only the major convertible currencies: the U.S. dollar, the Japanese yen, the Deutsche mark, the pound sterling, and the French franc.[93]

With its present small capital base the IMF can do no more than carry out a limited role of helping countries in financial crisis settle and re-schedule their debts. It is incapable of providing the much stronger counter-cyclical function envisaged by Keynes.

George Soros proposes re-capitalizing the IMF with the transfer of IMF special drawing rights (SDRs) from wealthy countries to be used by developing countries.[94] The wealthy countries generally have adequate reserves and generally don't need SDRs. (The IMF is akin to a company with a much higher authorized capital than its issued capital.) Some would be directed to aid, the balance would provide an addition to the monetary reserves of developing countries. Soros estimates that $18 billion could be made available straight away, and much more if developed countries could extend credit through the SDR mechanism.

The risks of such a proposal, as in any proposal to increase the liquidity and capital of the IMF, are that the IMF will still not revert to its counter-cyclical role, that the extra credit may be splurged by the developing countries, that it will continue to impose harsh and counter-productive conditionality on borrowers, and that it may provide even greater moral hazard to international speculators. These concerns are valid; they highlight the problem of trying to combine the functions of banking and development within one agency. There would be little

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[90] Jonathon Power "G-7 should give Keynes new look" *San Francisco Chronicle*, 19 June 1995.

[91] IMF Balance Sheet April 2002.

[92] World Bank *Global Development Finance 2002.*

[93] Driscoll 1998.

[94] Soros 2002.

point in injecting $18 billion or $3 500 billion into the IMF if the only result were to make life more comfortable for the world's financial sector or for incompetent and corrupt governments who fail to collect taxes and who waste public money.

Another useful reform, proposed by the IMF itself, and supported by Richard Cooper, Professor of International Economics at Harvard, would be to allow countries to go into the national equivalent of receivership, with orderly and controlled debt restructuring. The US "Chapter 11" procedure, which gives debtors breathing space and which allows them to carry on business, provides a model.[95] The main benefit would be protection against a rush of panicking creditors who, just as in a business collapse, hasten and worsen the situation by their actions – all trying to protect their individual interests but, in so doing, acting against everyone's interests.

While there is a strong case for separating the banking and development functions of the IMF, there is a countervailing case for retaining its present structure. The combination of banking and development could give it a reasonably large capital base. If global confidence can be established, the capital base of the IMF will grow, as the financial community gains more confidence in the IMF member state currencies and the IMF is able to transcend the limitation of having a large amount of its deposited funds in weak currencies. Also, those who argue for strengthening the IMF point out that just as national governments try to coordinate monetary and fiscal policies, there is a case for keeping these functions under one roof in the IMF. The counter-argument is that this would give the IMF too much power; it was never meant to take over the economic role of sovereign governments.

John Eatwell, President of Queens' College Cambridge (UK), and Lance Taylor, Professor of International Cooperation and Development at the New School for Social Research in New York, are in favour of development of a new oversight and regulatory authority – a World Financial Authority. Eatwell points out that just as it has long been accepted that national financial markets require regulation, so too do international financial markets, now that finance no longer respects national borders. He draws on the positive experience of the BIS in its (so far) limited role:

> The WFA is needed because three decades of international financial liberalization have removed almost all distinctions between national and international capital markets. If liberal finance is to thrive, the same regulatory tasks required in national markets are now needed internationally. That is why the BIS pioneered international financial regulation with the formation of the Committee on Bank Supervision and Regulation in 1975. It was that Committee which formulated the capital adequacy requirements for banks in the 1980s to which all 13 then BIS members agreed to observe, and to keep out of their markets foreign banks not adhering to the requirements.
>
> The result was that more countries signed on to BIS standards in order to achieve market credibility.[96]

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95 Cooper 2002.

96 Eatwell and Taylor 1998.

Eatwell sees the BIS as taking over the role of regulation and surveillance – on a global basis. Much of his argument is institutional – the IMF has failed, and its neoliberal culture is so embedded that it is beyond redemption. Most observers, liberal and conservative, consider that the IMF was inept in not forecasting the 1997-98 Asian crisis, and was inept in its interventions. Eatwell and Taylor are impressed by the competence of the BIS, and they point out that it has a strong research role in its secretariat support of the Financial Stability Forum. If there is to be a WFA the BIS is a natural body to take on that role.[97]

Capital movements and instability

World trade is around $7 000 billion a year; turnover on foreign exchange markets is more than $1 000 billion a day. (This figure relates to cross-border transactions; $6 000 billion a day clears through the payment systems of the G10 countries alone.)[98] Transactions on current account have become almost completely de-linked from trade or long-term investment. Even when there is not an identified crisis, currency and financial markets are vulnerable to speculative runs and sudden reversals.

There is a robust debate on whether countries can, or even should, take measures to insulate themselves from these forces. While direct capital controls were fashionable up to the early eighties, they have generally not been used by high and medium income countries. The only significant exceptions have been Chile and Malaysia. From 1991 to 1998 Chile required banks to maintain reserves against external liabilities, at 30 percent of the value of those liabilities, for periods between three and twelve months. Malaysia imposed capital outflow controls in the wake of the 1997-98 crisis. Both initiatives were successful in achieving stability.

There are several measures available to try to achieve the objective of stabilization. In fact, a valid question is "stabilization of what?" Economists refer to the "trilemma" of conflicting policy options. Governments can control two, but only two, of the following three financial variables:

- foreign capital flows;
- the exchange rate;
- domestic money supply controlled by fiscal or monetary policy.

If governments do not have control of foreign capital flows, then they have to choose between:

- fixing the exchange rate, and letting domestic money supply vary;

  or

- controlling the domestic money supply and letting the exchange rate float.

97 Eatwell and Taylor 2000.

98 Crockett, 2000.

Of course, there are compromise positions, but these are becoming less popular. Countries are choosing either hard currency pegs (e.g. to the US dollar) or floating exchange rates, as shown in the following table.

Table 9. Currency management arrangements – percent of countries (unweighted)

	1990	2001
Hard pegs	15.7	27.7
Intermediate (e.g. currency boards)	69.2	37.7
Floating	15.1	34.6

Source: Schipke June 2002

Those countries which use hard pegs, as Argentina did, can maintain exchange rate stability so long as the exchange rate is judged by the financial markets to be sustainable. If sustainability of the peg is in question, however, then there is a high incentive for financial manipulation. If the exchange rate is believed to be too high, then there can be a run on the banks and capital flight (as happened in Argentina). Collapse of the currency becomes a self-fulfilling prophecy. Conversely, if the exchange rate is judged to be too low, there can be massive financial inflows, often leaving domestic policy-makers powerless. If they raise interest rates they may absorb excess liquidity, but they attract even more finance and penalize local businesses, and if they fail to raise interest rates they run the risk of high inflation. Even if currency stability is preserved, it can be at the cost of very high fluctuations in interest rates.

The hardest peg of all is to replace one's own currency with another country's currency. That may work within a block of countries which have well-developed mechanisms of coordination (in particular the European Union). When a country with a small economy, however, adopts the currency of a large country – typically the US dollar – it loses control over its instruments of economic stabilization.

Those countries which use floating exchange rates generally have more control on their money supply than those which peg, but they can import inflation when their exchange rate falls heavily, requiring a monetary adjustment, which may have a severe impact on economic growth. In such countries macroeconomic management is similar, in theory, to that which is pursued by developed countries, which (apart from the EU) generally have floating exchange rates. But developed countries generally have strong reserves to protect themselves against speculative attack.

One factor which limits countries' exchange rate and fiscal flexibility is the prevailing neoliberal view that budget deficits (other than those of the US), are indicative of poor economic management. Ratings agencies and financiers do not judge kindly any country which puts full employment ahead of fiscal rectitude, even though, in the medium to long run, full employment is likely to result in an economy which is stronger than one in which potentially productive resources have been left idle. The ratings agencies have an obsession with one side of the balance sheet only; they do not consider the value or quality of assets which have been purchased with public debt.

The important aspect to note about the fiscal choices open to developing countries is that they depend not on a country's economic fundamentals, but, rather, the judgement of those in the world's financial markets. At one extreme that judgement is based not even on financial measures, but on a military-style assessment of the country's capacity to resist a sustained attack. Developing countries may have to fortify themselves with high levels of liquid reserves to fend off speculation. These reserves, often paying very poor rates of interest on global markets, come at a very high opportunity cost, for they commit funds which could be applied to physical and social infrastructure.

In a study of the determinants of financial instability, Assaf Razin of Tel Aviv University found several factors which may predict sudden reversals of capital flows[99]:

- a persistent current account deficit (the situation is not symmetrical – a persistent surplus is unlikely to lead to a reversal, presumably because in such situations the central banks can accumulate sufficient reserves to defend their currencies);
- a lack of openness – reversals being less likely in more open economies;
- a low level of reserves;
- a low level of concessional debt in relation to private debt – official lenders tend to pursue stabilization goals;
- diminishing terms of trade;
- a high level of public sector deficit.

There are measures countries can take to insulate themselves against speculative inflows. These include a buildup of reserves, negotiation of private credit lines, and economic strengthening and diversification. But these are generally not available to developing countries – not in the short-term anyway. All require many years of successful economic performance, until the countries in question can be judged by the financial markets as being too hard to take on.

It is not surprising, therefore, that the option of capital controls is appealing. These can take two forms. One form is the imposition of direct capital controls, with regulations allowing only specific types of transaction (associated with trade or real investment). The other is the use of general capital taxes.

India and China both have strict controls on capital flows, generally imposed by linking approvals for foreign exchange transactions to presentation of invoices, as evidence of real (rather than speculative) transactions. Such controls have to be accompanied by general prohibitions on residents and non-residents holding foreign currency accounts and on changing money outside the controlled system.[100] The IMF believes that such controls have protected these countries from the Asian financial crisis; they also point out, however, that such controls require well-developed administrative systems, available in China and India, but not available in all countries.[101] (In this light it is ironic that IMF conditionality often

[99] Razin 1998.

[100] Applegate 2002.

[101] IMF 2000.

requires a cut in government expenditure, which reduces the capacity of governments to finance the staffing of regulatory agencies.)

While there are cases of successful specific controls on capital flows, such as direct linking to invoices, there is a body of economic opinion suggesting that there should be a general worldwide régime of capital transaction taxes designed to discourage speculation. General capital taxes, known as "Tobin taxes", would be imposed on short-term capital flows, but eased on longer-term flows which may be associated with investments in the real economy.

There are three variants of such taxes. The simplest is a small tax on each foreign currency transaction. At one percent that would equate to an effective 730 percent annual interest rate premium on an overnight currency round trip, but only 0.2 percent on a five-year investment. Another variant is a real interest rate equalization tax – a tax based on the deviation of market interest rates from some base measure, such as the interest rate implied by the purchasing power parity of the exchange rate. Such a tax is difficult to administer, but it works to avoid any gain resulting from exploitation of countervailing monetary measures to protect the exchange rate. The third is a deposit requirement, requiring the investor to make a non-interest bearing deposit with the central bank for a specified period – as was used by Chile. A variant on Tobin taxes is to raise the rates in times of high financial sector volatility.

While the mechanisms vary, all have the object of removing rewards from short-term speculation, without discouraging long-term investment, and without the administrative burden of imposing direct controls on foreign capital.

Tobin taxes are supported by many economists with experience in international financial markets, including Paul Krugman, Larry Summers, Robert Rubin and Joseph Stiglitz. From the conservative side of the economic debate they are strongly opposed, mainly on the grounds that they would be ineffective, and, even possibly, may worsen financial crises.

Tobin taxes would probably be ineffective if they were imposed by only one country, although Chile was able to use deposit taxes for a period. Evasion through offshore banking and use of tax havens is too easy. That's why the advocates of a Tobin tax seek universality, and the closure of tax havens. Opponents of Tobin taxes cite ease of evasion through tax havens as a reason for their opposition, and even many who support the notion of capital controls suggest that the level of international political cooperation required to make Tobin taxes work is unachievable. But if international cooperation can work to enforce trade rules, it can work to close down tax havens – the worst havens (Andorra, Liechtenstein, Liberia, Monaco, Marshall Islands, Nauru and Vanuatu) are all very small countries. Until the attacks of September 11 2001, the USA was uncooperative in any international moves on tax havens and money laundering. The US refused even to participate in OECD talks in May 2001, on ways to crack down on offshore and other tax and money-laundering havens. Its enthusiasm post September 2001 relates only to money-laundering by terrorist organizations.

Opponents also point out that, based on experience with other markets, taxes or fees which raise transaction costs do not stop speculation or reduce volatility. As evidence, stock markets, in which there are stamp duties and commissions, show high volatility. Some opponents go so far as to suggest a Tobin tax would result in no change at all in activity.

These arguments have been seized on by supporters of Tobin taxes, for by almost any normative criteria of tax policy, a tax which raises revenue without changing business activity is a good tax, and a by-product of a Tobin tax would be the collection of revenue for global development. But advocates are not as confident about the “no change” hypothesis. They would be delighted if a 0.1 percent tax could raise a billion dollars a day, but the whole purpose of such taxes is to stop short-term financial speculation, and to allow exchange and interest rates to be determined by markets which take into consideration countries’ economic fundamentals.

The claim that Tobin taxes, or any measures to slow capital transactions, may result in worse instability than they are intended to correct, has some superficial validity. Actions to defend currencies which are effective in the short-term may result in much more dramatic change when the pressures for adjustment become overwhelming. A metaphor is a small flood levee around a town: it may be better to dispense with the levee and allow a steady rise in the water level than to allow a sudden and destructive gush of water.

But this objection is based on two assumptions. One is that there will go on being huge speculative surpluses looking for a short-term shelter or a long-term home. It’s almost an admission that the developed countries (including the oil-exporting countries) cannot manage their finances and cannot tame their financial sectors. The other assumption is that monetary authorities and finance departments in developing countries lack the ability or willingness to manage their exchange rates or money supplies.

Basically, there are two sources of opposition to capital controls. One is from those who favour their use but who point out practical problems in implementation – particularly broad-brush controls such as Tobin taxes. The other source of opposition is from those who fear that capital controls would work; any reduction in speculative capital flows would hurt the financial sector, already bruised by the financial crises of the last two years.

No sensible advocate of the Tobin tax or other more flexible forms of capital controls has suggested they can compensate for mismanagement. That’s too tall an order. Like other reforms to financial systems, they have to be considered in the context of wider reforms, in the global financial systems and within developing countries themselves. Reform of financial systems is addressed in the final part of this Chapter, and reforms within developing countries are addressed in the following Chapter.

6.5 Institutional reforms

The IMF

Many political scientists and economists call for changes in the governance of the IMF. Stiglitz has reminded us that the voting power in the IMF is a historical anachronism, based on the power of the wartime victors in 1945. The G7 countries between them control 45 percent of the voting power at the IMF. (By contrast, the formal voting power of the WTO, with a “one country one vote” constitution, is much more representative of the interests of developing countries.)

Stiglitz reminds us also that the path of accountability of the IMF is through finance ministers. Senior public servants from finance ministries, because of the very structure of bureaucracies and social stratification in poor countries, may be preoccupied with immediate financial issues and quite detached from the poor in their own countries. Similarly for the WTO, the concerns of trade ministers and senior public servants may be a long way removed from the interests of the poor.

The club of finance and trade ministers, the location of secretariats in Washington and Geneva, and the capacity of the US to manipulate the policies of these bodies are all factors which make the institutions somewhat more sensitive to the needs of financial markets than to the needs of people and their governments striving to overcome poverty.

These problems of location and perspective are replicated, to an extent, among non-government organizations. While non-government organizations within developing countries usually have direct links to the poor, they have little influence in finance and trade ministries. And non-government organizations which have taken on a global presence are often over-represented by members from developed countries, and many of their secretariats are located a long way from the poor of the world.

The WTO and the World Bank

It is often tempting to lump all global financial institutions together. But each institution has its own background. In both the WTO and the World Bank, the chief executives (James Wolfensohn of the World Bank and Mike Moore when he was head of the WTO) have indicated a public willingness to adopt policies more in the interests of the world's poor.

Similarly, it is somewhat simplistic to lump all "liberalization" as desirable or undesirable. Trade liberalization should be less contentious than financial liberalization. Trade liberalization, if it includes not only tariff reductions but also abolition of production subsidies, quotas and similar protective mechanisms, should be of benefit to all. Complete financial liberalization, on the other hand, can be destructive.

Mike Moore, and his successor, Supachai Pannitchpakdi, are both enthusiastic about reform of agricultural trade. The Doha round saw some progress on intellectual property issues. The shortcomings of the WTO are more of omission than of commission.

The World Bank is showing signs of reform. More attention is being given to modest projects with community participation, such as microcredit. Its rhetoric is changing. In the 2000 *World Development Report*, the World Bank acknowledged that growth does not trickle down; development must address human needs directly.[102] The 2003 *World Development Report* acknowledges that economic growth in itself is not adequate to ensure the alleviation of poverty or the reversal of environmental damage. It stresses institutional development, the health of public goods and property rights for the poor as preconditions for just and sustainable development:

> For their livelihoods and well-being, people depend on assets – natural and human-made; communal, individual, and public. All these assets need protection and encouragement in order to thrive. The institutions that provide these safeguards range from the social capital and norms governing grazing and shared maintenance to such modern institutions as property rights, fishing quotas, and forestry agencies. The soils, fish, and forests that benefit the poor directly can be wastefully degraded when people lack security and a long perspective. In the same way, investment in machines and human capital needs the support of such institutions as credible laws and property rights to enhance confidence. The restraint required involves important

[102] World Bank *World Development Report 2000*, p. 1.

> commitment problems, since thriving assets are tempting targets for appropriation by individuals, firms, and governments and their officials. No set of actors is perfect. Institutions must compensate.[103]

The UN and global public goods

Even if the present institutions were to reform themselves, there is still a gap in terms of provision of global public goods – goods which do not necessarily warrant investment by any one government, but which are justified on a world basis. The UNDP has identified several such goods, such as research into drugs for tropical diseases, development of vaccines, protection of fisheries, environmental protection, preservation of world heritage assets, communication infrastructure for remote regions, and mechanisms to prevent financial instability.[104] Reform of global financial systems will address only the last of these shortcomings.

All will take funding, and, because of the global nature of these public goods, there is a case for funding from prosperous beneficiaries, not necessarily via "aid" agencies, but out of appropriations directly to existing or new global agencies concerned with global issues. The provision of global public goods should not be seen or accounted for as aid; because public goods benefit all, their funding by prosperous countries is simply an affirmation of sound economic self-interest.

It has become fashionable, particularly in the US, to downplay the role which can be played by the UN – to portray it as a moribund and bureaucratically top-heavy organization. Jeffrey Sachs, calling for global investment in "weapons of mass salvation", points out:

> The truth is almost the opposite of what the UN bashers say. Despite a decade of criticism and budget cuts, the specialised UN agencies have far more expertise and hands-on experience than any other organisations in the world. Even the World Bank, with its knowledge base and ability to disburse and monitor funds in some of the most difficult settings in the world, can address problems of health or environmental or other specialised concerns only in partnership with UN agencies that have expertise in these specific areas. No bilateral donor agency can substitute for the scale of UN expertise and engagement, though these agencies can be important partners in a global effort.[105]

Sachs's "weapons of mass salvation" are mainly public goods, including vaccines, medicines, and farming technologies.

His faith in the UN is unfashionable. But, he points out, the US has called on the UN when it has suited US interests. He quotes from George Bush's speech to the General Assembly in September 2002, when (in relation to Iraq), he said he wanted the United Nations "to be effective, and respectful, and successful." Bush asked whether "the United Nations will serve the purpose of its founding, or will be irrelevant".

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103 World Bank *World Development Report 2003*, p. 3.

104 Kaul et al 1999.

105 Sachs 2002.

The benefit of the UN over other agencies is its inclusiveness, and therefore its legitimacy. In development issues its role is not restricted to the operations of the UNDP. The Economic and Social Council of the UN can also provide a forum for cooperation on economic issues. (Part of the strength of ECOSOC is that unlike banking institutions it embraces economic and social considerations within one agency.)

Finally, it is necessary to acknowledge the role of regional financial institutions, such as the Asian Development Bank and the Arab Development Bank, and regional trade associations, such as Mercosur in South America. Where there are high regional disparities (as in Asia), these institutions can serve a very useful role. Because they have a limited number of national members they can avoid the representational problems of global institutions, which have to choose between small and unrepresentative governance structures, or inclusive and unwieldy structures.

A global tax treaty

The failure to deal with taxation was an understandable oversight in 1944. In 2003 the absence of action on tax is a major impediment to global development.

The conventional wisdom of the Washington Consensus is that developed countries already have bloated governments, and that developing countries will do well to keep their public sectors slim.

But this conventional wisdom is not supported by evidence. There is a need for strong, accountable, competent and open government, providing infrastructure, health care, education, and, increasingly, welfare safety nets (see Chapter 7).

This involves collecting public finance; the IMF falls far too easily into the assumption that the only way to avoid deficits is to cut expenditure. But strengthening national revenue bases is a clear alternative. Tax collection is not easy – taxing capital is difficult because it is mobile, taxing the rich is difficult because they have the political influence to avoid tax, and taxing the poor is futile because they have no capacity to pay tax. But unless developing countries can increase their revenue bases they will be unable to invest in public goods and to accumulate reserves to stabilize their currencies. There is no reason conditionality couldn't extend to a requirement to collect taxes from the rich and to channel public expenditure into necessary public goods.

If individual countries find it difficult to collect taxes from companies and from the rich, and if conditionality is limited in its effectiveness, then a World Financial Authority or a similar body with a specialization in taxation could specify minimum tax rates, and impose sanctions against non-complying tax havens. Obviously different countries will have sound reasons to use different mixes of taxes; the appropriateness of any tax régime depends on many factors, including a country's distribution of wealth and income, its endowments of natural resources, and its administrative capacity to collect taxes. Therefore it is important to avoid any "one size fits all" approach.

Some conservative economists defend tax havens and international tax competition because they exercise a desirable discipline on otherwise high-taxing governments. Tax havens, however, rob all countries (not just developing countries) of taxation revenue, and, because only large firms and very wealthy individuals can make use of havens, they result in domestic tax systems being less progressive than they might otherwise be. It is understandable, perhaps, that corporations may defend the use of tax havens and tax competition, but it is inexcusable for the IMF to harangue countries about the need to join in tax competition.[106]

Those who complain that regulation of taxation deprives nations of their sovereignty over tax matters fail to understand the nature of the "prisoners' dilemma" in which countries presently find themselves. Tax competition has already resulted in a loss of sovereignty. Even within the European Union, which has a high level of cooperation on many economic matters, tax cooperation has been elusive, as countries accuse one another of allowing different national tax systems to favour particular industries.

Just as within the nation state individuals need binding contracts (i.e. compulsory taxes) to finance necessary public goods, so too are such contracts needed on a global basis now that finance is internationally mobile. The IMF was founded to protect against destructive beggar-thy-neighbour competition in fiscal and trade behaviour; the same logic should apply to taxation behaviour if a race to the bottom is to be avoided.

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[106] E.g. "Cut taxes or lose skilled workers - IMF" *Australian Financial Review* 20 September 2002.

7. Reforms within developing countries

Even a well-functioning and well-informed global finance system, and a well-managed and accountable set of institutions, will not guarantee the alleviation of poverty. These conditions may be necessary for development, but they are hardly sufficient.

Rodrik stresses the need for development of a set of complementary global and local policies:

> In reality, economies that have been successful have been those whose governments have done a whole host of things not only well but simultaneously. Successful economies have combined a certain degree of openness with policies that are conducive to investment, macroeconomic stability, and prudent management of capital inflows. Countries that have relied on any one of these policies alone typically have seen their national economies falter over the longer run.[107]

Within developing countries conditions have to be supportive of development. Such support does not equate to a set of "business friendly" policies. Far from it. Economic development is a means to a set of social ends, primarily concerned with alleviating poverty and more broadly raising living standards. Crony capitalism serves neither purpose.

The governments of developing countries cannot be held entirely responsible for their own shortcomings. They generally have the historical legacies of arbitrary colonial boundaries and régimes of law unsuited to local conditions. Populations of most developing countries are much larger than they were when the colonial powers departed; declines in infant mortality preceded social changes in reproductive practices. Many countries have borne the cost of wars among neighbours, which have added a huge burden of refugees to already overstretched food supplies and health care systems.

Many of the problems of developing countries arise from the international economic system itself, with its massive power asymmetries. As pointed out in Chapter 6, these include a lack of international agreements and a lack of international contracts on labour, tax collection and environmental standards, forcing many countries to a race to the bottom. The behaviour of major powers shows a degree of hypocrisy; the US has shamelessly manipulated the rules of the WTO to serve the interests of nations with advanced industrial structures and large corporations, and both the US and Europe maintain high tariffs on clothing and support for agricultural products. The US and its uncritical allies are trying to stymie moves to reduce fossil fuel dependence.

And many structural weaknesses in developing countries arise from policies and practices of the very institutions which have a brief to promote development. Carlos Diaz-Alejandro explains how South America, in particular, has been largely shaped by a dynamic in which countries have moved through cycles of fragile populist democracies and harsh military régimes who have imposed fiscal rectitude, to the delight of the IMF.[108] To the people in those countries, rightly or wrongly, the perception of the IMF is of a body which is opposed

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[107] Rodrik 1997, p. 19.

[108] Diaz-Alejandro 1981.

to democracy and human rights and which wishes to see public health and education abolished.

A further constraint on developing countries is that in world financial markets they are judged not on their economic strength, but on their capacity to generate a set of financial indicators which conform to the standards of the world financial sector. Policies directed to achieving full employment have to take second place to policies directed to achieving balanced and small public budgets.

In many cases adjustments to openness – liberalization of capital markets in particular – have occurred prematurely. Policy makers in developed countries forget that in their own countries they have a legacy of institutions which have developed over two hundred years or more – institutions to contain and control the excesses of capitalism. These include strong and democratic governments, régimes of commercial law, well-regulated financial markets, competent central banks, competition policies and regulating authorities, and a well-functioning civil society with norms governing business deals.

Nowhere has the effect of sudden change been so noticeable in its effects than in the former Soviet Union, where the main effect so far of financial and trade openness has been rapidly widening inequality and the growth of mafia-style capitalism.[109] Corruption, criminalization, capture of regulatory agencies by vested interests, and widespread rent-seeking are general problems impeding development. Corruption, particularly when at a high level, results in resource misallocation, creates perverse incentives, and increases transaction costs.

Corruption in the former Soviet Union and in many other countries, is not only at the top; it exists in all spheres of economic activity. When it is not possible to earn an honest living without violating the rules, corrupt behaviour is a perfectly natural survival tactic. People who would prefer to live and transact business in a rule-bound society have no choice but to engage in corrupt practices themselves. Corruption can be eliminated only if there are strong, independent, publicly accountable and well-staffed regulatory agencies, and if their operations are seen by all to be even-handed and fair.

There is a negative correlation between corruption and development. The poorest countries, and those which have gone through the most severe transitions, in all regions, tend to have the lowest corruption perception scores in Transparency International surveys.[110]

It is not possible to conclude whether corruption results from poverty, or, in impeding development, corruption contributes to poverty. The causality could even be in both directions. It is reasonable to assume that businesses, domestic and foreign, will tend to avoid investing where corruption is rife, and that financiers will reasonably place a premium on their cost of capital calculations in countries with a reputation for corruption.

The association between poverty and corruption leads many to believe that corruption is entrenched and unavoidable in poor countries; foreign businesspeople have no responsibility or role in corrupt practices. Foreign businesspeople, however, are active participants in corruption. They generally take great care not to leave a trail of their activities; slush funds for "facilitation payments" are built into the inflated commissions for local agents who are

[109] Intriligator 1994.

[110] Transparency International 2002.

left with the dirty work of bribing officials. Politicians in developed countries often turn a blind eye to the foreign operations of their firms.

Poverty itself, particularly when it co-exists with inequality, promotes and sustains mistrust. But, as Fukuyama stresses, trust is a vital asset in the creation of prosperity.[111] Unless there is trust in capital markets and financial institutions it is very hard to get the not-so-poor to invest their money productively. (Who has not had the experience of finding people of modest means with hoarded wealth in the form of gold bars or US dollars?) Without trust in regulatory institutions and legal processes it is very difficult for people to enter into long-term business contracts, or to exchange assets.

Economic development isn't just about the actions of large corporations – it is also about the myriad of small daily transactions which are part of everyone's life, particularly the small and micro businesses which are characteristic of most developing countries. Hernando de Soto points out that there is no shortage of entrepreneurial energy in developing countries. Further, he stresses, in many developing countries there is a great deal of capital which the poor have accumulated, particularly in the form of improved land and buildings, but, without proper title, property rights and systems of mortgages, there is no way that they can mobilize that capital to their benefit (rather than to the benefit of their landlords).[112]

Dani Rodrik questions the basic economic assumption that poor countries have a low capacity to invest.[113] He points to the savings culture in East Asian countries – even when these countries were very poor there was a strong culture of saving. This is confirmed by the World Bank, which finds that gross domestic saving, even in the poorest countries, is reasonably high – it is 20 percent of GDP in "low-income countries", 26 percent in "middle income" countries, but only 23 percent in "high-income" countries. Even in Sub-Saharan Africa it is 15 percent. Where poorer countries are set back, however, is that reasonably high gross financial savings are offset by high rates of energy, mineral and forest depletion.[114]

An assumed shortage of domestic saving is often used as a justification for countries opening up to foreign investment. But what developing countries may need more than finance is access to technology, markets and institutional assistance, which can allow them to turn their modest savings into productive investments. That's why direct foreign investment is generally much more useful than portfolio investment. Even if domestic savings are low, financial resources for investment can be generated with sound domestic credit mechanisms.

A sound business culture isn't about laying down a red carpet for foreign investors; it's about ensuring all businesses, domestic and foreign, have a reasonable set of business rules, sound infrastructure, honest and open government, transparent and fair business regulation, and an effective tax system. But there is little reward for saving or investment when financial institutions are weak, infrastructure is crumbling or non-existent, governments are corrupt, property rights apply only to the rich, tax collection is arbitrary, and when the poor have no incentive or means to lift themselves out of poverty.

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111 Fukuyama 1995.

112 De Soto 2000.

113 Rodrik 1999.

114 World Bank *World Development Report 2003*, p. 17.

Many development economists, including Rodrik, stress the importance of investment in human capital. But, under the IMF stringency programs, public services such as health and education are often the first casualties of government cutbacks. There is a simplistic notion that this does not matter; the future of poor countries lies in basic low-skill labour-intensive manufacture. The transition from rural occupations to urbanized industrial employment does not require much investment in human capital.

This should be no more than a short transition stage in development, however. The successful East Asian economies have moved on to more skill-intensive activities, supporting higher returns to labour and capital. This does not happen by accident, but through a deliberate public investment in human capital.

Just as global financial institutions can get bogged down with concern for means rather than ends, so too can national governments, particularly when their policies are driven by the orthodoxy of the "Washington Consensus". Trade, as already pointed out, is a means to an end, not an end in itself. Rodrik points to economic research that shows trade is a *consequence* of economic development; it is not such a prime driver of economic development. (Once trade is established, however, its suppression through denial of access to markets in developed countries can stymie development.)

Similarly with privatization. In many developing countries there have been large government business enterprises, operating at low levels of technical efficiency. These have included port authorities, airports, and water, power and telecommunication utilities. But privatization, in itself, may do little or nothing to improve the performance of these utilities, and may open up new opportunities for corruption. There is no virtue in converting a state-owned monopoly into a private monopoly, particularly if there is not a set of competition laws in place backed up by a well-resourced regulatory agency. And if the entity in question is a natural monopoly, privatization will bring no competitive benefits at all. The newly privatized telecommunications firm may be very responsive to the needs of well-heeled foreign businesses, but may be no better than the old government enterprise in serving the needs of domestic small businesses.

If privatization results in widespread labour shedding, then the labour productivity of the utility or business enterprise will almost certainly rise, but if the displaced workers remain unemployed, national labour productivity may fall. Advocates of reform often take too narrow a perspective, viewing productivity from a corporate perspective rather than a national perspective. In general, shedding labour from overstaffed enterprises, through privatization or other means, improves national productivity only when those workers can find other, more productive employment.

Reform of government enterprises, without change in ownership, is another possibility, often overlooked entirely by foreign advisors. Provided the governance of such institutions is kept at arm's length from executive government, such enterprises can be reformed.

Privatization of health care financing, as has occurred in Chile, can be particularly iniquitous. There is a reasonable case for allowing the private sector to operate hospitals and clinics under contract to public health authorities, particularly if they can be well-regulated, but privatization of health care financing is very inefficient and unjust. Private insurance mechanisms can result in comfortable arrangements between insurers and health providers, to the detriment of users of the system. And, however undeveloped the tax system is in developing countries, it is still a much more inclusive system than private insurance, which almost inevitably locks out the poor.

Much can be achieved in health care with cost-effective interventions in public health and basic health care, particularly with measures directed to sanitation, immunization and simple treatment of common diseases. Unfortunately, health budgets are not always effectively directed to where they are most needed.[115] In prosperous countries misdirection of health budgets generally results in waste but not catastrophe; in poor countries misdirection can result in a great deal of preventable suffering and a great many early deaths.

In utilities and public services, particularly health care and education, priorities should be directed to improving performance within the constraint of a nation's taxation capacity. That may read like a gratuitous statement, but is a necessary reminder when objectives of budgetary contraction and privatization have displaced more orthodox and common-sense public policy objectives. And we tend to forget that, while there are winners and losers from privatization, the financial sector is always a winner, for it benefits from the fees and commissions from the process. There are strong vested interests in the privatization debate.

Reforms in economic institutions and public service delivery do not occur in isolation. They are a part of more widespread institutional reform and democratization. Rodrik generalizes the need into a requirement for conflict-management institutions.[116] Democratic institutions which can channel conflict productively, such as a free and open press, independent legal systems, elected parliaments, and accountable governments, clearly fall into this category. Rodrik stresses that even if societies at an early stage of development get by without such institutions, development creates new and heightened distributional conflicts. Régimes of law, particularly those which protect the weakest, are crucial. Overcoming political constraints to democratization is a precondition for successful development.

So too is is necessary to develop other, less formal, institutions of civil society. Globalization, through its dislocations (such as rural to urban movements) damages civil society. The state needs to nurture civil institutions, even if they are bothersome at times, for they are usually the only channels through which the voices of the poor can be heard.

One practical conflict-resolution mechanism is a clear set of bankruptcy laws. Stiglitz points out that the misery caused by crises has been extended by the absence, in many countries, of clear provisions for bankruptcy.[117] One of the strengths of the US economy, he points out, lies in its capacity to reassemble resources after a business collapse, so that the damage to the real economy inflicted by financial failure is not long-lived. Fast resolution of bankruptcy is in the interests of all stakeholders – employees, governments and creditors.

Domestic financial-market reform is crucial for development. Accountability, transparency, and independent fiduciary and prudential regulation are essential. (Stiglitz says that even the IMF seems to be regretting its push for rapid financial market deregulation.[118]) A related reform, which can mobilize local resources, is the creation of microcredit institutions.

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[115] "For 80 cents more" *The Economist* 17 August 2002 p. 20.

[116] Rodrik 1997.

[117] Stiglitz 2002.

[118] Ibid.

One basic reform is in central banking. An extreme version, advocated by Rudi Dornbusch, is that countries should "disarm their central banks". A good central bank, according to Dornbusch, is "a central bank that has been closed".[119] This is the case in the Euro zone, where countries have given up domestic currencies, and have agreed to tight budgetary controls and inflationary targets specified in the Maastricht Treaty. The Maastricht Treaty, however, has 50 years of regional cooperation behind it, starting with the Marshall Plan. A more modest reform is to establish independent central banks – which would be easier if they were under the supervision of a World Financial Authority or a similar agency. Developed countries have established central bank independence only recently. A precondition for such independence is a political culture which accepts and respects the separation of powers and removes key institutions from the direction of executive government.

Perhaps the most contentious reform, advocated by Rodrik and Sen, is for development of welfare safety nets.[120] Conventional wisdom suggests that welfare safety nets can be afforded only by developed countries; in developing countries priorities for government spending have to be infrastructure and education. Rodrik, however, uses the experience of developed countries to argue for welfare. As the developed countries have opened to globalization the demands made on public budgets by welfare payments have increased, because of the need to compensate for the dislocations resulting from the transition to openness.

In developing countries successful development will result in a rapidly ageing population, which will put demands on health and welfare services. At the other end of the age spectrum, even if the proportion of young people falls, the smaller cohort of young people will need to spend more time in education to prepare themselves for the demands of a globally competitive economy. (But the demands of fiscal rectitude have often been in the opposite direction. Public budgets have not been expanded; the more usual response has been to cut other important services such as health and education.)

Sen is more specific about the need for welfare. Economic openness brings benefits, but it also brings volatility, which, as Bouchaud and Mezzard point out, increases inequality in the short to medium term. Gross nation-wide volatility can be reduced through economic diversification, but firm-specific or industry-specific volatility is an inescapable consequence of exposure to global markets. Workers who have become used to a certain standard of living, and who have ongoing commitments, can suffer severe reversals if they lose their jobs and if there is no safety net. Sen's argument for safety nets is not so much out of concern with the welfare of the emerging middle-classes; rather, it is out of concern for the political consequences of middle-class insecurity. If there is to be a backlash against globalization it will probably be led not by the very poorest, who lack political resources, but from the urban unemployed. (The unrest in Argentina and Venezuela provide current examples.)

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[119] Dornbusch 1999.

[120] Rodrik 1997, Sen 2002.

8. Conclusion

There is no one path to alleviation of poverty. Reform of the "global financial architecture" is certainly desirable, but, in itself, would go only some way towards achieving that task.

This paper has been written more for discussion rather than as a blueprint for action, but there are some tentative conclusions that can be drawn from the foregoing analysis.

> First, developed countries should increase their *official development assistance* contributions, particularly through the UN and other multilateral institutions. At the Johannesburg World Summit on Sustainable Development all delegates (including the US) agreed to urge the developed countries to make concrete efforts towards a target of 0.7 percent of GDP. Declarations do not ensure action, but they do remind us of the legitimacy of calls for increases in aid.
>
> Second, the *original charters of the Bretton Woods institutions* are still valid. Finance for development, fair and open trade, currency stability, and contracts to prevent beggar-thy-neighbour practices are still pressing requirements. These institutions, particularly the IMF, have drifted a long way from their original missions. The question of whether there should be reform of the Bretton Woods institutions, upgrading of other institutions, or development of new institutions, is more contentious.
>
> Third, there are still significant gaps in necessary global cooperation, in particular in the arenas of *labour standards, environmental standards, intellectual property and tax collection*. One view is that labour and environmental standards should be included in trade agreements; such inclusion would be in keeping with GATT and WTO principles of discouraging subsidies. Another view is that environmental standards can be handled with specific multilateral agreements, and labor standards should properly be the responsibility of a strengthened ILO. After all, not all environmental and labour problems involve trade.
>
> Fourth, the world trade and financial systems still contain large asymmetries in rules and practices applying to developed and developing countries. The principal asymmetries apply to *trade in agricultural products, textiles, clothing and knowledge-intensive goods and services*. Unless the world trade system is made fairer there is a risk of severe damage to the consensus which has so far underpinned the GATT and the WTO. While many may criticize the WTO, the need for a powerful multilateral trade body is no less pressing now than it was sixty years ago; the alternative is a retreat into destructive bilateralism and beggar-thy-neighbour protectionism.
>
> Fifth, while *reform of financial institutions and practices* will be beneficial, particularly in East Asia and South America, such reform will still have little effect on the world's poorest in Africa and South Asia. In some cases direct capital controls may help stabilize currency and financial markets, but an overriding cause of instability is the large amount of speculative capital that has found refuge in the US. There has to be a clear distinction between long-term investment and speculative transactions.
>
> Sixth, developed countries need to re-direct their economic management to *benefit the real economy, rather than the paper economy* – that is, the economy of the financial institutions. This will take a degree of political courage, for the institutions, having been

the beneficiaries of privilege, have amassed wealth and political power, but unless economic policy can be re-directed the economic damage inflicted by the financial sector will be severe.

Seventh, there is no "one size fits all" set of development policies. In particular the *ideology of neoliberalism* fails to recognize the reality of market failure, particularly financial market failure and the proper role of economics as a servant of social ends. The neoliberal hostility to public expenditure is inimical to long-term sustained development. Public provision of education, health care and physical infrastructure, and policies which keep inequalities in check, are necessary conditions for development.

Eighth, the pace of countries' exposure to world financial and commodity markets needs to be managed. There has to be *time for development of laws and regulatory institutions to cope with globalization*. There is a case for transitional policies, for example, to nurture infant industries.

In attending to these needs, national governments and international institutions have to work in harmony and to seek practical, pragmatic solutions. The elimination of poverty is too urgent a task to be left to the simplistic dogmas of neoliberal economics. Those who witnessed the wreckage of the 30 years following 1914 understood the limits of markets and designed practical (if not always perfect) institutions to protect the world from a repeat of the experience. They understood, all too well, that when the benefits of financial and trade liberalization were not shared, when social divisions widened, when even the well-off became anxious and uneasy, political energies could be drawn to hideous ideologies.

Those who now live in developed countries, who have enjoyed sixty years of peaceful growth, owe a large debt to the wisdom, generosity and foresight of those who gathered in New Hampshire in 1944. It is time to share that spirit globally. The liberal spirit of Bretton Woods was right for its time; it is right for our time when the problems and threats are no less pressing.

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About Consumers International

Founded in 1960, Consumers International (a non-profit organisation registered in The Netherlands as the International Organisation of Consumer Unions, registration number S1 49999) is a federation of consumer organisations dedicated to the protection and promotion of consumers' interests worldwide through institution building, education, research and lobbying of international decision-making bodies. An independent, non-profit foundation, Consumers International has more than 260 members in almost 120 countries.

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