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The Perils of Globalization

Structural, Cyclical and Systemic Causes of Unemployment

Seminar Paper 13

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Serious Economics and market economics

Joan Robinson, liked to say that economics was a "serious subject", but that is was not a particularly difficult subject if one was willing to follow the analysis through to its logical conclusions and then took them seriously. Economic development is not a particularly difficult subject, but there is an increasing tendency not to take it seriously.

Development policy has undergone a curious evolution since the introduction of the market-based structural adjustment programmes that we now know as the Washington Consensus were introduced. The structural reform measures to liberalise external trade and investment, to liberalise and privatize the financial system, deregulate economic activities and open the economy to international capital and competition were intended to create a more efficient and dynamic economy based on market signals that would promote an efficient allocation of resources and enhance the external competitiveness of the economy. It was also presumed that this would be sufficient to create the conditions for sustainable economic growth. The watchword, that was subsequently taken up in the discussion of the transformation of the Eastern European planned economies, was to "get prices right". However, after the Asian crisis, and the failure of the market to produce rapid adjustment in Eastern Europe, the importance of institutions was discovered. The watchword became "get institutions right". In particular this referred to things like property rights and prudential regulations. But, even that was apparently no sufficient, and now we have the call to "get governance right", an issue that came closer to home than most developed country economists would have liked with the Enron and subsequent accounting scandals. So in introducing "market-based" economics we have progressed from prices, to institutions, to regulations and supervision, to governance.

One wonders what will be discovered next to account for the fact that structural adjustment policies have not been translated into sustainable growth, that for regions such as Latin America they have produced two decades of stagnation in wages and per capita incomes. There is certainly one element of the market that will not be rediscovered.

When I was an undergraduate I studied economics from Paul Samuelson's *Economics.* The book made the very simple point that the market system was an

efficient means of allocating resources, of deciding "what, how and for whom", because it was patterned on the operation of the democratic process. Just as individual political preferences were efficiently expressed through the creation of majorities via the democratic voting process, economic preferences were efficiently expressed by individuals voting with their dollars in the market. But, if we take this argument "seriously", and recognise that the efficient operation of the democratic process is based on one person, one vote, then it should follow that the efficient operation of the market would require that each individual have the same

LATIN AMÉRICA: DISTRIBUTIÓN Of HOUSEHOLD INCOMES a/, NATIONAL TOTALS , 1990 – 2000

(Percentages)

Country	Year	Average Income b/	Share in Total Incomes of: 40% poorest	Next 30%	20% beforer richest10%	10% Richest	Ratio of average per capita income c/ $D^{10}/D^{(1\ a\ 4)}$	Q^5/Q^1
Argentina d/	1990	10.6	14.9	23.6	26.7	34.8	13.5	13.5
	1997	12.4	14.9	22.3	27.1	35.8	16.0	16.4
	1999	12.5	15.4	21.6	26.1	37.0	16.4	16.5
Bolivia	1989 e/	7.7	12.1	22.0	27.9	38.2	17.1	21.4
	1997	5.8	9.4	22.0	27.9	40.7	25.9	34.6
	1999	5.7	9.2	24.0	29.6	37.2	26.7	48.1
Brasil	1990	9.3	9.5	18.6	28.0	43.9	31.2	35.0
	1996	12.3	9.9	17.7	26.5	46.0	32.2	38.0
	1999	11.3	10.1	17.3	25.5	47.1	32.0	35.6
Chile	1990	9.4	13.2	20.8	25.4	40.7	18.2	18.4
	1996	12.9	13.1	20.5	26.2	40.2	18.3	18.6
	2000	13.6	13.8	20.8	25.1	40.3	18.7	19.0
Colombia	1994	8.4	10.0	21.3	26.9	41.8	26.8	35.2
	1997	7.3	12.5	21.7	25.7	40.1	21.4	24.1
	1999	6.7	12.3	21.6	26.0	40.1	22.3	25.6
Costa Rica	1990	9.5	16.7	27.4	30.2	25.6	10.1	13.1
	1997	10.0	16.5	26.8	29.4	27.3	10.8	13.0
	1999	11.4	15.3	25.7	29.7	29.4	12.6	15.3
Ecuador f/	1990	5.5	17.1	25.4	27.0	30.5	11.4	12.3
	1997	6.0	17.0	24.7	26.4	31.9	11.5	12.2
	1999	5.6	14.1	22.8	26.5	36.6	17.2	18.4
El Salvador	1995	6.2	15.4	24.8	26.9	32.9	14.1	16.9
	1997	6.1	15.3	24.5	27.3	33.0	14.8	15.9
	1999	6.6	13.8	25.0	29.1	32.1	15.2	19.6
Guatemala	1989	6.0	11.8	20.9	26.8	40.6	23.5	27.3
	1998	7.3	12.8	20.9	26.1	40.3	23.6	22.9
Honduras	1990	4.3	10.1	19.7	27.0	43.1	27.4	30.7
	1997	4.1	12.6	22.5	27.3	37.7	21.1	23.7
	1999	3.9	11.8	22.9	28.9	36.5	22.3	26.5
México	1989	8.6	15.8	22.5	25.1	36.6	17.2	16.9
	1994	8.5	15.3	22.9	26.1	35.6	17.3	17.4
	2000	8.5	14.6	22.5	26.5	36.4	17.9	18.5
Nicaragua	1993	5.2	10.4	22.8	28.4	38.4	26.1	37.7
	1998	5.6	10.4	22.1	27.1	40.5	25.3	33.1
Panamá	1991	8.9	12.5	22.9	28.8	35.9	20.0	24.3
	1997	11.0	12.4	21.5	27.5	38.6	21.5	23.8
	1999	11.1	12.9	22.4	27.7	37.1	19.5	21.6

Paraguay	1990 g/	7.7	18.6	25.7	26.9	28.9	10.2	10.6
	1996 f/	7.4	16.7	24.6	25.3	33.4	13.0	13.4
	1999	6.2	13.1	23.0	27.8	36.2	19.3	22.6
Perú	1997	8.1	13.4	24.6	28.7	33.3	17.9	20.8
	1999	8.2	13.4	23.1	27.1	36.5	19.5	21.6
República Dominicana	1997	8.5	14.5	23.6	26.0	36.0	16.0	17.6
Uruguay f/	1990	9.3	20.1	24.6	24.1	31.2	9.4	9.4
	1997	11.2	22.0	26.1	26.1	25.8	8.5	9.1
	1999	11.9	21.6	25.5	25.9	27.0	8.8	9.5
Venezuela	1990	8.9	16.7	25.7	28.9	28.7	12.1	13.4
	1997	7.8	14.7	24.0	28.6	32.8	14.9	16.1
	1999	7.2	14.6	25.1	29.0	31.4	15.0	18.0

Source: CEPAL, Panorama Social, 2001-=20022, Annex Table 22, p. 225own calculations based on household surveys of the respective countries.

a/ All households ordered according to income per capital.

b/ Average monthly incomes of households , as a multiple of the per capita poverty line.

c/ $D^{(1\ a\ 4)}$ represents the 40% of poorest households , while D^{10} is the richest 10% . The same notation is used here for quintiles (Q), representing group of 20% of households.

d/ Greater Buenos Aires.

e/ Eight Major cities and El Alto.

f/ Urban Total .

g/ Metropolitan Asunción.

number of dollar votes or, that market efficiency requires an equal distribution of income. Clearly, as shown by the accompanying Table, in Latin America the distribution of income has become less equal with the application of increased market-based policies over the last decade. But, this would imply that the market allocation mechanism is also less efficient. It is unlikely that the next step in the evolution of the Washington Consensus will be “get the income distribution right”.

Further, part of the historical development of democracy has been the extension of franchise from a system in which only male property owners, which meant landowners, could vote, to a system which allowed common freemen and then women to vote to a system that abolished slavery and allowed slaves to vote. This would suggest that an efficient market allocation would not leave some individuals disenfranchised. But this is precisely what happens when individuals are unemployed, so that a “serious” economist would also accept that full employment is a prerequisite of an efficient functioning market mechanism. But, since the “TINA” counter-revolutions of Margaret Thatcher and Ronald Reagan, the call to “get employment right” has virtually disappeared from policy discourse.

Finally, neoclassical economists usually accept the principle of diminishing marginal utility, and since Edgeworth that have accepted that this idea also applies to money. “Serious” economic analysis thus leads to the conclusion that economic welfare can be maximised by means of redistribution of income from those with higher incomes to those with lower incomes. While the neoliberal approach is presented as the only “serious” analysis of economic development it is interesting that the pressure for

increasing the role of the market in developing economies hardly ever takes the issues full employment and income distribution seriously.

Humans Learn — What have we learned from twenty years of failed adjustment policies?

One of the reasons that neoclassical economists consider their analysis independent of institutions is Adam Smith's idea that the "propensity in human nature to.. truck, barter and exchange one thing for another.. is common to all men, and to be found in no other race of animals, which seem to know neither this nor any other species of contracts...Nobody ever saw a dog make a fair and deliberate exchange of one bone for another with another dog." (Adam Smith, Wealth of Nations (1776), Chicago Edition, p. 17). A superficial reading of this passage appears to suggest that the "market" is part of human nature and thus not a man-made institution. But, there are alternative views of human nature available. President Abraham Lincoln also had a view on the difference between man and beast: "...Beavers build houses; but they build them nowise differently, or better, now than they did five thousand years ago....Man is not the only animal who labours; but he is the only one who improves his workmanship," (Abraham Lincoln, Speech of the 1860 Presidential Campaign). For Smith man is distinguished from other animals because he trades in a market, for Lincoln it is because he is able to learn from his mistakes.

Following the lead of Lincoln, the question that I would like to raise tonight is whether we have improved our workmanship in terms of the policies that we propose in support of economic development and structural adjustment after the experience of the last ten years from the Tequila Crisis, to the Asian Crisis, to the Russian Crisis, to the Brazilian Crisis to the Argentine Crisis. Whether we have improved our understanding of how markets operate in promoting economic development. And if we have not, to discover what went wrong, why the World Bank and the International Monetary Fund appear to be reluctant to adjust their policies to the new conditions of the globalised twenty-first century economy, to refuse to learn from their mistakes.

Let us start by considering how the adjustment polices practiced by the IMF evolved in the immediate post-war period. In the view of US Secretary of the Treasury Morganthau the creation of the Bretton Woods institutions was to keep the control of the international financial system out of the hands of international financiers who were considered to have caused the Great Depression. Keynes agreed that free private international capital flows were incompatible with a stable international financial system and this similarity of views produced a post-war system in which it was presumed that there would be virtually no private international capital flows.

Twenty-first century economies are different from post-war economies

For the structure of fiscal and external accounts the absence of private capital flows meant that the current account would be entirely composed of trading in real goods and services and its balance would be determined by domestic income levels, or what came to be called domestic absorption. The government budget would be composed of the expenditures on labour and provision of public goods and services. In such conditions a fiscal deficit due to government expenditure in excess of tax

receipts would increase income, employment and domestic absorption. Attempts by labour unions to increase real wages by pushing nominal wage growth above domestic productivity growth would also increase absorption. In either case, when domestic absorption exceeded domestic productive potential the result would be an increase in imports, a decrease in exports and this combination would eventually produce an external deficit. In such a world, adjustment to alleviate an external deficit could only be achieved by reducing the government deficit and reducing the expansion of the domestic money supply sufficiently to reduce income growth, absorption and imports, create excess capacity leading producers to seek export markets and creating excess supply in the labour market to reduce the growth of wages. The result was a concentration of attention on the impact of the fiscal balance on incomes and the creation of domestic financial assets to create financial for rising nominal wages as the main objectives of adjustment policy. Thus the standard features of IMF conditionality were targets on the fiscal surplus and creation of domestic financial assets to insure balance between absorption and domestic productive potential. In the absence of such policies, exchange rate adjustment was contemplated to bring about expenditure switching by means of changing the relative prices of imports and exports.

However, by the beginning of the 1980s this simple world, based on what was called hydraulic Keynesianism, had changed dramatically. International capital markets were actively channeling private capital across the globe and developing countries were accumulating unsustainable amounts of external and internal debt. This change had important implications. The first is that the external accounts of these countries now contained substantial and growing deficits caused not by imbalances in goods and services trade, but by factor service payments, that is, by debt service for the accumulated stock of international debt. At the same time, fiscal budgets showed increasing amounts of interest service on outstanding government debt. This has an important policy implication for it means that a large and growing proportion of external and fiscal deficits is no longer responsive to the traditional policy tools — changing the level of income via fiscal policy has no impact whatsoever on the level of debt service since debt service is determined by a number of other factors including the rate of interest, the maturity structure of the debt and international financial market conditions. Further, the ability of a country to meet these foreign interest commitments is not a function of its fiscal balance, but of its ability to earn foreign exchange via a surplus on its current account balance.

There is an old development theory called the “two gap” approach. It says that even if a country manages to solve the problem of deficient domestic savings by closing the “savings gap” through a fiscal surplus, it will not be able to translate these savings into increased capital investment if it does not close the “foreign exchange gap” to provide the means to purchase the imported capital goods necessary to increase investment and growth. The same argument applies *pari passu* to foreign debt service — no matter how large the country's primary fiscal surplus, this does nothing for its ability to finance external debt unless it is accompanied by a current account surplus sufficient to provide the necessary foreign exchange. The “simple” serious conclusion it that the most important variables in the adjustment process for highly indebted developing countries are the interest rate and the external balance. But rather than attempting to design policies to reduce interest rates on external debt

and means to ensure a positive external balance, conditionality associated with IMF structural adjustment packages continues to stress primary fiscal surpluses and money supply controls which tend to increase fiscal deficits by reducing income growth and thus tax yields, and to increase the burden of the debt by increasing interest rates. The policies practiced by the IMF are thus not only outmoded, they may make conditions worse, rather than better, to the extent that declining growth rates due to restrictive policies increase fiscal deficits and damage international confidence, leading to higher international risk premia. It would thus appear that we are not learning from experience, as evidence by the new Argentine IMF rollover agreement that contains explicit targets on both the primary surplus and the growth of the money supply, as well as a number of traditional IMF conditions.

Other structural changes caused by free capital flows

There are a number of other factors associated with increasing importance of international capital flows that have caused policy mistakes. By introducing its Convertibility Law Argentina was supposed to have been subject to an automatic adjustment process — since the peso was rigidly linked to the US dollar an external deficit would automatically lead to a decrease in the domestic money supply, reduced credit creation and thus reduced activity levels. This would cause a fall in domestic prices relative to external prices leading to a decline in imports, rising exports and an automatic return of the external balance to equilibrium. However, during most of the period of the Convertibility Law foreign capital inflows were larger than the external deficit, which meant that the external constraint that was supposed to set this adjustment process into action could not work. Although external capital flows impeded the external adjustment process, but there was never any consideration given to policies to control those flows.

Indeed, that external flows would cover financing needs and thus block the operation of the automatic adjustment mechanism was assumed in the structural adjustment policy designed for Argentina. The econometric model used to assess the coherence of the strategy was premised on the idea that "Because of the strong relation between public sector deficits, inflation, and poor macroeconomic performance, this model differs from most Bank models by placing the public sector at the center of the analysis. The central macroeconomic issue in Argentina, especially after the assumption of external debt of the private sector, is the internal transfer problem. The model is therefore constructed so that the primary gap is in public finances rather an in the balance of payments. While the gaps are in theory closely related, positioning the gap in the public sector allows a more direct focus on public sector financing requirements, *and allows the balance of payments gap to close through private capital flows that finance the residual savings-investment balance of the private sector*." See "Argentina — From Insolvency to Growth" The World Bank, Washington, D.C., August 1993, p.259, emphasis added.

But there is another aspect of the failure of the adjustment process to operate efficiently in the face of free international capital flows. One of the objectives of the Convertibility Law was to take control of the money supply away from the Central Bank because it was considered to be subject to influence by politicians, rather than following "serious" economic policies. But, the Central Bank Law coupled with the Convertibility Law simply took the control of creation of the money supply away

from the Central Bankers and placed it in the hands of international investors. The results of the Argentine experience suggest that international investors are no better at finding the appropriate monetary policy to ensure stability than the Central Bank. Clearly a new approach is needed — tying the hands of the Central Bankers simply leaves the determination of a crucial variable of economic policy hostage to international capital markets that have a very poor track record in economic policy matters.

Finally, a large part of the Argentine adjustment process was based on the assumption that freer trade would provide a stimulative role in increasing economic growth. But, in Argentina the policy advice was to unilaterally liberalise its markets, in direct opposition to the framework that had been adopted by developed countries through multilateral GATT negotiations or the WTO and a position which did little to ensure benefits of more open trade to Argentine exporters. This position was supported by a World Bank working paper that recommended that Argentina had much more to gain from unilateral trade liberalisation than through multilateral trade negotiations. However, the analysis was based on the assumption "that liberalization does not affect the trade balance, i.e., changes in exports equal changes in imports." See, J. Nogues, "The Choice Between Unilateral and Multilateral Trade Liberalization Strategies," WPS, 239, International Economics Department, The World Bank, July 1989. The Bank provided structural adjustment lending to Argentina to implement its trade liberalisation policy, which was started in 1978, and was in fact almost totally unilateral. But to believe that a country that had exercised substantial protection of domestic industry should be able to preserve trade balance is beyond the willing suspension of disbelief usually associated with this sort of econometric exercise.

It is generally believed that trade liberalisation can act as an engine of growth if it promotes domestic manufacturing activity and manufacturing exports. In 1980 Argentina accounted for 0.2 percent of world manufacturing exports — in 1997 the figure was exactly the same. If it be thought that the failure of trade to act as an engine of income growth in Argentina was due to the failure to expand its manufacturing exports more rapidly, compare Argentina's performance with Mexico which had a massive expansion in its share of global manufacturing trade from the same level as Argentina in 1980 to 2.2 percent in 1997. However, trade increases per capita incomes only if it increases domestic value added, and in Mexico the share of global manufacturing value added declined from 1.9 per cent to 1.2 per cent between 1980 and 1997 while in Argentina the share remained constant at 0.9 per cent. (These data come from the 2002 *UNCTAD Trade and Development Report*, Chapter 3). This is not to say that Mexico did not benefit from its increased trade, but it does say that simply increasing trade is not an engine of growth, unless it does provide substantially increasing value added.

Further, as noted in the 1999 *Trade Development Report*, the impact of trade liberalisation in developing countries has in general produced conditions in which external deficits of developing countries are now higher for any given level of growth — that is, liberalisation has made the external constraint more rather than less binding on growth in developing countries.

Finally it is often forgot that according to international trade theory, the gains from

trade that accrue form opening an economy to trade only fully accrue if domestic resources are already fully employed. This means that liberalisation of trade cannot be seen primarily as a means of providing full employment, but rather requires full employment if it is to provide the greatest benefits.

Why don't we learn — what is to be done? Partial proposals for the Doha Round

What conclusions can we draw from this failure to learn that a globalised world responds differently from a world without capital flows and thus requires a different approach to economic policy? In a world dominated by debt, reducing interest rates and ensuring that increasing trade increases domestic value added and ensures a sustainable current account balance are crucially important. There are many who argue that in the current international policy environment it is impossible to introduce policies to achieve these goals. That may be the case, but every economist knows that as long as real interest rates remain above real growth rates debt will be growing as a share of GDP and make it more difficult to operate policy and to support growth. If interest rates cannot be brought down, eventually the debt will have to be restructured or default will take place. So some kind of formal mechanism for restructuring or bankruptcy at the international level will be required if it is impossible to act to reduce interest rates.

It is also important to remember that the Bretton Woods system and the GATT were originally set up to ensure the preservation of a free multilateral trade negotiations system. For this reason safeguards were built into the Articles of Agreement of these institutions that allowed countries to suspend their free trade commitments when they faced certain types of external difficulties. For example, Article VII of the IMF charter allows countries to impose exchange controls and trade restrictions against a country whose currency is declared to be scarce.

Under the GATT the balance of payments provisions of Article XVIII:B allow a country to suspend its trade commitments in order to address temporary payments imbalances caused by “expansion of internal markets and instability of the terms of trade”. Further, Article XVIII.A allows measures to promote “a particular industry with a view to raising the general standard of living of its people”. However, in conditions of large capital flows, these measures are no longer solely in support of the multilateral trading system but in fact provide means by which trade commitments are subordinated to financial commitments to foreign creditors created by international capital flows. After Doha the WTO is supposed to be following a Development Agenda. Some of that Agenda should thus address how the balance of payments safeguards should be revised in order to place trade commitments and meeting commitments to foreign creditors on an equal footing and to ensure that they reflect the new global conditions faced by the highly indebted developing countries. These issues are the subject of discussion in the WTO Working group on Trade, Debt and Finance. Developing countries should argue forcefully in the working group that Article XVIII:B should be rewritten to allow consideration of problems associated with instability in financial flows, financial contagion and increasing debt service, since these factors are now as, in not more, important that problems created by volatility in goods and services trade on the sustainability of trade measures in the face of external disequilibrium..

In order to address the question of the benefits from trade, the conditions under which measures could be taken to restrict imports for balance of payments purposes must be redefined. Article XVIII:A deals with a single industry, but many countries require restructuring of entire sectors if they are to achieve value added increasing trade. Thus, the article must be made general in order to allow for full scale industrial reconstruction with a view to alleviating the balance of payments constraint and ensuring that this is done in conditions of increasing value added. This article should be applied more generally to a country that seeks to reduce its dependence on primary export earnings by promoting structural change, upgrading and diversification, processes which typically involve more than one sector or industry but it must be pursued. Furthermore, the provision regarding compensation conflicts with the need to raise financing for development through higher export earnings. It is not appropriate for the international community to ask for compensation from developing countries trying to deal with what is acknowledged to be a global problem.

These are only some of the issues that must be considered if we are to learn from our mistakes, to improve our workmanship and formulate "serious" policies that will allow for structural adjustment that is compatible with growth in per capita incomes in developing countries. If we continue with the outmoded policies then the nearly two decades in which per capita incomes have barely increased will be followed by another lost decade and continuous financial crisis.

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