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Globalization: A view from the South

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Foreword

In this paper Professor Mohan Rao provides a strongly critical review of the neo liberal position on the distribution of the benefits of globalization. He writes from the position of poorer countries whose growth and development are unlikely to be promoted by giving free rein to internal and external markets. He stresses that productivity growth, based on increasing returns and external economies, is mainly a local process. Exploiting such potential requires extending the domestic market through public investment in infrastructure, modernizing state institutions, developing human resources and creating incentives for workers, enterprises and public institutions to cooperate in a process of learning and adaptation to imported technologies. Public action is needed at all levels. Rao accepts that globalization need not emperil local development, equitable distribution or macroeconomic stability, if (a big "if") governments face no fiscal constraints. But he notes that fiscal weakness is rooted in the political and economic structures of poorer countries. Capital controls, and "financial repression" are inevitable and mutually supportive. Furthermore reducing vulnerability in the trade balance requires public intervention in building up a threshold level of industrial development. These imperatives conflict with the tenets of globalization.

Professor Rao notes that the orthodox theoretical arguments for the static gains from trade are too weak to support the fundamentalist position which argues for trade liberalization. The evidence linking trade openness with dynamic gains is also heavily disputed. Empirical attempts to verify that exports have "externality" benefits have been mostly unsuccessful and the alleged gains from improved resource allocation boil down in practice to the advantage of specialization based on cheap labour. While liberalization in a low-wage economy may allow a nation a temporary advantage in gaining entry into tight export markets, such a policy cannot secure dynamic gains in productivity, especially in high-value-added products. There is little reason to believe that the industries or enterprises that have the most learning potential will also be the ones that a liberalized trade regime will favour; that, in other words, competitive and comparative advantage will coincide.

However, foreign trade does present opportunities as well as constraints for steady growth. Foreign exchange bottlenecks hurt both resource accumulation and utilization. Avoiding these ought to be a primary aim of trade and macro policy. In small countries, scale economies in operating many modern industries, coupled with the limited size of the home market, favour an early push into export growth. But such scale economies justify openness or export orientation only if they are specific to industries rather than to the whole economy. In fact, both selectivity and protection may be required to capture such economies, even when they are industry-specific: the one to ensure that resources are not spread too thinly and the other to provide the initial market to develop the growth momentum.

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Globalization: A view from the South
Economic reforms and poverty alleviation in Tanzania

1.0 Introduction

Any assessment of the constituents, consequences and value of globalization must depend on the theoretical framework adopted. As an outcome more than as a process, globalization may be understood to be the creation of a *market system* in which national economies are integrated with each other through international or global markets. Integration is identified with the establishment of the Law of One Price, the equalization of prices of both goods and factors. But such a description of globalization raises more questions, concerning both its constituents and consequences, than it answers: (1) Must all markets be integrated to produce a global system? There is little prospect, for example, that barriers to international labor mobility will be removed any time in the foreseeable future. Do international movements of goods and of factors have an independent significance for global integration? (2) Can relevant markets be successfully integrated? Is this merely a question of removing 'artificial' i.e. politically decreed, barriers to the free mobility of goods and factors or, are there endogenous impediments to integration? (3) If a national economy is itself not internally integrated, whether for to political or other reasons, does globalization aid or hinder such internal integration? (4) Are global market forces sufficiently strong and convergent to support market integration? If divergent and disequilibrating forces exist, how do these affect the functioning of global markets and of national economies? (5) Can a globalized economy function i.e., can integration be sustained, without global political or regulatory institutions?

The purpose of this paper is (1) to address the above issues from the viewpoint of the poorer nations of the world and (2) to draw out the implications for national and international policies that are conducive to economic development in these nations. The section that follows sketches out the causes and consequences of the growing competition in and integration of international markets and the varied responses in the developed North and the developing South. It also outlines the neo-liberal case for liberalizing domestic markets, whether in rich or poor countries, and for removing all artificial barriers to a complete integration of national and global markets. Section 3 develops an alternative theoretical framework emphasizing North-South asymmetries in the structure of internal markets and the fragmentation of international markets in goods and finance. Building on this framework, the final section analyzes the value of national autonomy in the South, develops a political economy of interests within nations and between North and South, and the policy choices required for promoting development in the periphery.

2. Integration, liberalization and convergence

Following the Golden Age of capitalism, the crises of productivity and macroeconomic stability in the North and of debt in the South hastened a process of international and national restructuring of both production and policy regimes, which is still under way. The increased mobility of capital together with a sharp rise in worldwide unemployment and in informalization in the periphery define the environment within which this restructuring has occurred. Neo-liberal theory holds that liberal policies and openness, whether for the North or for the South, are a guarantee of global economic integration and of convergence in national living standards.

2.1 Globalization

There is no consensus of views among economists or political scientists concerning the questions raised in the introduction. Such collective agnosticism seems to be especially pronounced when matters are viewed from the perspective of the South. It needs hardly be added that pessimistic and optimistic evaluations of the forces of globalization abound.

But there can be no doubt that international flows of goods and especially of finance capital have increased very sharply over the past decade or two. The costs of transactions across national frontiers - the movement of money, knowledge and materials - have been greatly reduced by the information and communication revolutions. Non-traditional manufacturing exports from the newly industrializing countries (NICs) of Asia to the advanced capitalist countries (ACCs) have reached new heights. The rapid growth of national income in China, Malaysia, Thailand and Indonesia has been accompanied by an accelerated expansion of foreign direct investments (FDI) from outside and within the region, especially Japan, Hong Kong, the Republic of Korea and Singapore. Formal processes of market integration have been initiated in North America and are reaching their culmination in western Europe. A new GATT accord has been signed which phases out important areas of managed trade and protectionist policy. Many economies of the South and eastern Europe have shifted policies, in some cases radically, towards opening up their economies to global markets.

To be sure, the movement of goods, capital and enterprises across national boundaries is marked by great unevenness. First, the ACCs, whether as sources or as destinations, account for a disproportionate share of these flows relative to their share in global income. Second, even as tariff barriers have declined, old forms of non-tariff restraint on trade persist while new ones are coming into vogue. Third, the formal and informal creation of regional blocs for trading and investment may be seen as a threat to the forces of integration across these blocs and, even more, as a factor further isolating the numerous countries and regions in the South that do not enjoy political or economic proximity with Japan, the United States or the Economic Union. Finally, there remain great asymmetries in the stability and composition of exports as between the ACCs and NICs on the one hand and the less developed countries (LDCs) on the other.

On the whole, however, the balance of forces seems to point in the direction of globalization at least in the descriptive sense of a *process* of increasing international resource and goods flows. Globalization in this sense is to be naturally distanced from globalization as an integrated market system; this usage also suspends judgment with respect to the several questions concerning globalization, in the systemic sense, raised at the beginning.

The forces driving this process were evident both during the quarter century of the Golden Age of Capitalism following 1945 and in the subsequent quarter century of slowed growth, heightened instability and widespread changes in economic institutions and policies in both North and South. Although the unraveling of the monetary arrangements of the post-war era in 1971, the productivity growth deceleration of the ACCs starting in the late 1960s and the oil price increase of 1973 have all had a definite impact on the shape of international economic relations during the past two decades, these are themselves best seen to have been effects of anterior causes. The latter are located in the crumbling of the particular political-economic regime (`Fordism') in the ACCs that maintained stable national and international regimes of rapid growth (the Golden Age).[1]

[1] Recent accounts of the constituents of the Fordist Golden Age and of the paths out of that regime of accumulation are given in Boyer (1995) and Lipietz (1995).

As Fordism successfully diffused from the United States to western Europe and Japan, albeit with important local deviations and adaptations, high growth was led and sustained by rising wages which enlarged home markets in the ACCs. The coincident growth of home demand, together with United States hegemony and the Bretton Woods institutions, also ensured the rapid growth of international trade without threatening conflicts between external and internal balance. The convergence of productivity and income levels in Europe and Japan to those prevalent in the United States accelerated the growth of intra-industry trade and investment among these regions as firms took advantage of new market opportunities and exploited the economies of scale that came with inter-penetration of each other's markets. Protectionist barriers to trade also came down in successive rounds. In other words, income convergence also produced market integration. But by the same token, the maintenance of export competitiveness began to emerge as a new imperative, rivaling Fordist concerns about maintaining real wage growth and the welfare state. The increased volume of private capital flows, Vietnam era United States expenditures overseas and the development of off-shore markets for the dollar eventually caused the abandonment of the fixed exchange rate system, a development which only served to aggravate the problem of macroeconomic imbalance and of trading uncertainty.

The new imperative arose at the same time that the internal growth potential of Fordism was petering out. This manifested itself as a fall in profitability resulting from supply-side constraints as high employment levels were maintained with rising wage and raw material prices. Attempts at fine-tuning the economy led to structural inflation and external imbalance and, in response, businesses demanded fiscal and labor discipline (Cox, 1994). Inflation control on the macro side and all-around "flexibility", including deregulation, on the supply side became the hallmarks of new conservative policy regimes. Assaults on the welfare state, more or less extensive, have followed in their wake. That the decline in profitability was not due to the supply-side squeeze alone seems to be confirmed by the failure of these policy regimes to deliver either internal or external balance: despite high unemployment, productivity growth did not recover in the United States and United Kingdom, the champions of supply-side economics.[2] At any rate, the global expansion of the Golden Age gave way to the deflationary bias of the conservative era, which accentuated competition for international markets.

Countries in the South played diverse parts in this unfolding Northern drama. Not all of them have been at the `receiving' end or, at least, not in the same sense. The expansion of world trade during the Golden Age provided ample if unexpected opportunities for commodity exports and industrialization. As a group and individually, countries in the South enjoyed respectable rates of economic growth. Growth in the ex-colonies surpassed their dismal performance during the colonial era. This difference was not simply due to the global economic environment of the Golden Age alone; rather, a large if variable share of the difference must be accounted for by the transition from colonialism to sovereignty and the developmental role of the state (not excluding a policy regime based on import substitution). The growth momentum was maintained even through the 1970s in part because of better export prices for many raw material exports. Whereas the first oil price increase had produced a severe crisis of macro management in the ACCs, the recycling of petro-dollars to the South supported their continuing growth. But the eventual crash turned out to be far more costly in the South, particularly in Sub-Saharan Africa and Latin America, than the earlier one had been

[2] Lipietz (1995: p. 351) argues that enlisting the "negotiated involvement" of shop-floor workers, particularly in conjunction with the new technologies of production, accounts for the comparative success of Japan, Germany, Austria, Switzerland and Scandinavia.

in the North. It was brought on by the crushing rise in interest rates and the sharp adverse movement in the South's terms of trade which followed the Reagan-Volcker monetary restrictiveness of the early 1980s.

In East and Southeast Asia, the crisis did not produce economic collapse. Instead, the state managed a quick if difficult adjustment and growth resumed. The East Asian NICs had enjoyed a special concatenation of external and internal political circumstances in the decade or two following the second World War. These compelled and enabled their states to launch successful land reforms (in Taiwan(China) and the Republic of Korea), invest in mass education and health, and in other ways establish a growth regime that spread the fruits of rising incomes. The unusual mix of authoritarianism and an inclusive social base for growth, by design and circumstance, allowed the state to discipline capital and labor without posing excessive problems of disciplining the state itself. Following Japan's lead, the East Asian NICs were able to give a good account of this social capital in achieving export competitiveness in manufacturing. The crisis of Fordism in the ACCs, even as liberal trading arrangements continued to grow, afforded the NICs a golden opportunity to make inroads into the ACCs' markets, an opportunity they had been well prepared to take advantage of. In many ways, China appears to have followed a similar course though lagging its neighbors by a decade or two. On the whole, the 1980s proved to be an exceptionally good decade for most Asian countries. Though eventually hit by a major external crisis nearly a decade after Mexico's in 1982, even India's per capita income grew at over 3 per cent per annum through the 1980s, which was a decade lost to development in Africa and Latin America.

The crises of Fordism in the North and of debt in the South hastened a process of international and national restructuring of both production and policy regimes which is still very much under way. In the North, the breakdown of the social accord has allowed enterprises to take the lead in their search for competitiveness and flexibility while accommodating new technologies: structural unemployment and foot-loose capital have followed. In the South, the foreign imbalances have been joined by massive fiscal crises: retrenchment in the modern public and private sectors has increased unemployment and a substantial growth of low-wage informalization. The growing internationalization of production from the North and the expanding informalization of production in the South are linked together in a hierarchical, three-step restructuring among core, semi-periphery and periphery, a hierarchy in which wages, skill levels and job security decline from core to periphery.

The phenomenon of jobless growth and skilled labor displacement associated with this restructuring is in part the result of new technological changes which demand higher physical and human capital intensities and flexibility. To this extent, it is a `Ricardian crisis' of technological displacement and/or falling average wages that the market has not been able to compensate for through accumulation and reabsorption. However, neither accumulation nor new employer strategies have been conducted in a rudderless market vacuum. In the North, as we have noted, "flexibility" has been actively promoted by conservative policies: the *political* assault on the Fordist compromise, through macro and micro policies, has permitted capital to pursue the new rationality of flexible restructuring. This political-economic environment has enabled footloose capital to wrest further concessions from both labour and the state. In the South, straitened budgets (reflecting the internal transfer problem arising from the debt crisis) have undermined state capacity to pursue indigenous models of modernization: even the pretense (in many countries of the South, it was not much more than that) to include the marginalized majorities has been all but given up. Conditionalities imposed by international creditors, in the form of orthodox stabilization and structural adjustment programs, have been the major instrument for opening up these economies to the winds of global competition. "Adjustment with a human face" appears as a "human mask" (Guhan, 1995: p. 243) for the actual adjustments carried out.

Parts of the South are faced with yet another "Ricardian crisis", a crisis of natural resource degradation and ecological destruction that have rendered subsistence production increasingly fragile. Some of this grows out of the extractive state strategies that have taxed the poor without compensatory investments to augment productive capacities. Some of it has arisen, as in parts of Sub-Saharan Africa, from destructive civil wars and extended droughts. But the economic crises and structural adjustments which forced the mining of natural resources for export have also been responsible. This fragility has delayed the demographic transition in what may be called the Fourth World, which, in turn, compounds that fragility in a destructive spiral.

2.2 Liberalization

In response to the crisis-inducing globalization of the past decade or two, there has been a remarkable convergence of formal policy regimes in the South toward a neo-liberal order. Three salient factors explain this tendency. The first is the substantial influence that neo-liberal ideology assumed in the Bank-Fund administered stabilization and structural adjustment programmes. The crises greatly weakened both official and popular resistance to the dismantling of policies and programmes that were the symbol and substance of third world autonomy. Second, neo-liberalism, of which state minimalism has been the kingpin, furnished an intellectual basis for these states to make a virtue out of necessity. In many cases, it also provided ideological cover for the political project of elite minorities to jettison social commitments. Third, neo-liberal influence has grown cumulatively: the pursuit of liberalization in individual countries not only affected their internal economies but also altered the global environment facing each of them, an alteration that made the pursuit of autonomous policies increasingly precarious or, at least, increasingly unfashionable.

Liberalization is anchored in four basic assumptions: 1) that a politically unconstrained market regime is feasible (distributional problems can be resolved without `distorting' the market); 2) that the market can fully coordinate individual decisions (the state can only get in the way); 3) that public investment is an inefficient substitute for private investment in the growth process (complementarities are negligible); 4) that the unhindered import of technology can provide an adequate basis for developing competitiveness (a level playing field imposes no handicaps in building up dynamic competitive advantage); and 5) that the free movement of finance and enterprises across the national border will produce internal and external balance (globalization is good for the South).

The agenda of liberalization in the South draws primarily on the orthodox trade-theoretical critique of state-directed development policy. As championed by the Bretton Woods institutions, structural adjustment is effected through market-oriented measures designed to improve supply-side flexibility and performance. The main instruments include trade policy reform (dismantling quantitative restrictions, reducing tariff rates and ensuring currency convertibility), openness to capital and technology flows, unhindered flow of domestic investment and labour across sectors (flexibility and free exit), financial reform to permit market-determination of investment and saving, and public sector disinvestment. It presumes that import-substituting industrialization and state interventions distort resource allocation and reduce resource utilization. Reforms seek to reallocate resources from home goods to traded goods; within the latter from import-competing to export goods; and from the public to the private sectors. Improved resource efficiency is to be secured from the exposure of enterprises to internal and external competition and through a drastic reduction in the scale and discretionary component of government interventions in enterprises and markets. The benefits of capital account liberalization derive from the full risk diversification of wealth-holders' portfolios, enhanced domestic financial market efficiency and the attainment of an optimal level of investment independent of domestic saving (Williamson, 1993). Globalization of domestic finance also imposes beneficial restraints on macro policy, which enhances the credibility of that policy. The success of market liberalization requires as a cornerstone a labour regime that is free from distortions and rigidities. At the level of state policy, this is usually defined in terms of the *absence* of 1) direct interventions in wage-setting and indexation including legislated non-wage elements of compensation; 2) exit barriers on firms in the form of job tenure legislation or restrictions on employers' freedom to lay off or retrench workers; 3) soft budget constraints or other ways of rescuing firms that fail.

Clearly, this agenda implies that external openness and internal liberalization are strictly complementary. The constraints imposed by globalization on both the state and private agents can only be benign just as internal restraints on agents are costly: the first set of constraints derives from the global market whereas the second can only be inflicted by the state. Liberalization is then both desirable in itself and necessary to capture the full benefits of globalization to an account of which we now turn.

2.3 Convergence

It needs to be emphasized that neo-liberal theory holds that liberal policies and openness, whether for the North or for the South, are a guarantee of market integration in the systemic sense. Participation in global markets necessarily benefits all: the achievement of allocative efficiency and the diffusion of technology are the bases for both absolute benefits and the equalization of productive powers. Inequalities among nations pose no impediments to any of them in deriving these benefits. On the contrary, a strict reading of the Law of One Price under full integration (the integration of product and capital markets even without global labour mobility) implies *equalization* of factor prices and living standards across the globe. The Law of One Price must hold in a self-regulating global market system in essentially the same way as it is supposed to hold within national boundaries. In sum, globalization plus liberalization equals equalization. As Sachs and Warner (1995) put it:

> "The world economy at the end of the twentieth century looks much like the world economy at the end of the nineteenth century. A global capitalist system is taking shape, drawing almost all regions of the world into arrangements of open trade and harmonized economic institutions. As in the nineteenth century, this new round of globalization promises to lead to economic convergence for the countries that join the system" (pp.62-63).

But Sachs and Warner wish to base this conclusion on the stronger assertion that *openness in trade alone* is sufficient to ensure the Law of One Price. Thet claim that technology and best practices (assumed to be wholly tradable) fail to diffuse not because of market impediments but because of social and political forces. These forces come into play principally on account of the ideological failure on the part of political leaders to accept the free rein of the market. There is, however, no warrant for this strong version of global equalization even *within* the Hekscher-Ohlin neoclassical framework. Logically, free trade in technologies and products cannot assure factor price equalization. If factor endowment ratios are sufficiently far apart (as is evidently the case between the North and the South), then, specialization without factor price equalization will hold.[3] In short, factor mobility has an independent significance in assuring full assimilation unless the economies are already similar to start with. The "convergence club" of the late nineteenth century (the United States, Canada, Argentina and Australia) were favoured beneficiaries not merely of capital flows out of western Europe. As Fischer (1995) notes, the convergence may have been largely effected through the movement of European workers to these temperate lands.[4]

At any rate, the orthodox gains from trade argument, including the factor price equalization theorem (with capital mobility as needed) implies economic assimilation but says nothing about growth rate differentials or their convergence. All that openness assures, given the liberal assumptions, is an effect on the level of income. This may appear as a growth effect but international growth rate differentials are simply too large and have been sustained over too many decades to be simply a "level" effect. Nor can it be maintained that trade liberalization produces substantial gains due to the diffusion of a large backlog of unabsorbed technologies (together with capital inflows if necessary): countries that liberalize do not go from a primeval and pure autarchy to perfect integration.

Even with capital mobility assumed to be globalized, others have drawn more pessimistic or agnostic conclusions than do Sachs and Warner. Some, like Baumol (1986), have suggested that convergence in the late twentieth century is also confined to a club: the present OECD countries plus a handful of advanced NICs. This is supposedly explained by the proposition that only those that have sufficient initial levels of human capital can benefit from their backwardness by borrowing technology to enjoy convergent growth. A variation of this argument is that although countries may not have an identical (expected) long-run <u>level</u> of income, there is contingent convergence in the sense that a country grows more rapidly the greater is the gap between its own long-run income and its initial level of income (Barro and Sala-i-Martin, 1992). Thus, convergence does not mean an absolute equalization of income levels.

Given the diversity of views about the nature of economic convergence expressed within the liberal camp, the core proposition concerning the long-run consequence of global integration boils down to the idea of gains from integration, including gains from commodity trade.

3. Localization, structures and markets

We would argue that forces of divergence, rather than convergence, in a globalized market system are inherent to that system and not exclusive and extraneous results of mis-informed interventionism by states. Structural asymmetries between North and South, the localization within national territories of major sources of growth, in the form of external economies and increasing returns, and the hierarchical fragmentation of world markets, particularly in finance, help explain the weakness of the global forces of convergence.

3.1 Uneven Development

International inequalities have risen massively during the past century. Living standards over much of the old world were approximately similar around 1600. Even as late as 1800, per capita income in Europe and North America was roughly the same as in Asia (Schwartz,

[3] Factor intensity reversals within the available technologies must also be assumed away.

[4] Labour migration itself was propelled by the opening up of natural resources through capital investment, which assured a high level of rural incomes.

1994). But by 1900, incomes in the centre were around 10 times as large as in the periphery and the gap had widened even more by 1960.

For the period 1965-1989, GNP per capita in the low-income economies increased 2.9 per cent per annum, compared to 2.3 per cent per annum in the middle-income and 2.4 per cent in the high-income economies. While this represents a very modest amount of convergence, large parts of the low-income periphery (representing nearly 40 per cent of the world population) have grown less rapidly than the high-income nations: the faster average growth in the low-income economies is heavily weighted by China's impressive growth acceleration; India and other low-income economies grew substantially less rapidly than China. Uneven development, North-South and South-South, was also manifest during the 1980s when world growth slowed. Whereas the rate of growth of per capita income in the world economy fell by 0.8 percentage points between 1965-80 and 1980-89, the decline in growth rates in developing countries was 1.8 percentage points. In the same period, growth in East and South Asia accelerated by 1.3 and 1.5 percentage points respectively but growth in Sub-Saharan Africa, the Middle East and North Africa, and Latin America decelerated by 2.6, 3.2 and 4.0 percentage points respectively (Griffin and Khan, 1993: p. 7).

In an important sense, the world today bears a much stronger resemblance to the world of a century ago than of a half century or even a quarter century ago. Trade and capital flows relative to world income are roughly comparable. Markets in the periphery were largely open then; investments in the periphery, though confined to exploiting natural resource-based comparative advantage and to the infrastructure, such as the railways, that this required, were in significant measure financed by the richer countries, especially the United Kingdom. Extensive as the globalization of the past two decades has been, the world economy in 1900 was not measurably less globalized than it is today.

The differences, though, are also notable. Most peripheral states lacked sovereignty in the earlier period and were subjected to colonial exploitation Even the convergence among people of European origins, as already noted, may have been largely secured through labour mobility in respect of which the end of this century greatly differs from the end of the last. There was scarcely any sign of convergence among non-European countries, certainly none comparable to the experience of the NICs in recent decades. India's per capita income, for example, stagnated under the Crown-imposed policy of laissez faire and virtual free trade; a modest beginning in modern industry was balanced by agricultural decline and the near-demise of artisanal industries due to the competition from cheap industrial imports. By contrast, a strongly regulated import-substitution regime after independence served to more than double India's per capita income. There were significant episodes of peripheral industrialization, in Brazil, Mexico and India among others, during the Great Depression and World War II, when the world economy had virtually ceased to be global.

These comparisons are not without value for delineating hypotheses concerning the process of unequal development under globalization. Global market forces by themselves appear to have generated substantial, even immiserizing, international inequalities. "The predatory kinds of coercion associated with colonization" (Schwartz, 1993) served to extract resources both directly and by opening up the periphery to the market. Throughout the past century, sovereign state power has been necessary, although not always sufficient, to overcome the unequalizing tendencies in global markets or at least to effect absolute economic improvements. But the historical comparisons cannot account for the effects of real, particularly, `world' time. Has catching up with the leaders become easier over the past century or more difficult? Is successful state tutelage of `late' industrialization more probable today or less?

3.2 The Gains from Trade

The neo-liberal position provides one set of answers by denying each of the above hypotheses. It claims that the global market system, in this view, equalizes national living standards if not absolutely, then, at least relative to each nation's `development potential'. Not only are protection, selective promotion and graduated linking with world markets unnecessary for catching up; on the contrary, they are the only impediments to achieving it. The history of growth failures of the past century or longer is to be accounted for by such impediments and such impediments alone.

Careful consideration shows, however, that the mechanisms adduced in favor of this position do not bear scrutiny.[5] Empirical estimates of the gains from trade liberalization rarely amount to more than one or two per cent of national income. Despite all the vaunted benefits from free trade, the latest round of GATT agreements is estimated to produce no more than $ 250 billion in gains (in the year 2000) for the world economy of which the lion's share accrues to the OECD nations, especially the United States, Japan and Germany. These small one-shot gains are dwarfed by the cumulative growth rate differences that liberal enthusiasts wish to attribute to trade regime differences. Over time, therefore, the defense of openness has shifted by invoking several other mechanisms.

One response has been to elaborate a new political economy of the state. The central claim is that interventionism (not necessarily confined to trade) breeds competition among rational market participants for the rents created which dissipate real resources equal in value to the rents themselves. Although the rents created by interventions are captured by competing agents, the competition itself entails costs that are equal to the rents. The resource cost of such necessarily *unproductive rent-seeking* can be many times as large as the inefficiency loss of the interventions themselves. For trade interventions alone, typical "estimates" of rent-seeking waste are in the region of 10-20 per cent of national income[6]. However, neoclassical political economy mis-interprets the nature of competition for state influence by mis-specifying the behaviour of private agents and state functionaries alike. If this specification is made so as to be consistent with the neoclassical premise of rational action, rents created by interventions will be conserved rather than unproductively dissipated (see Rao, 1995e).[7]

A second line of defence links openness with superior productivity, product quality and product variety. There are several aspects to this claim that may be considered in turn:

(1) Trade generates *knowledge spillovers* which, through reverse engineering, for example, are beneficial to productivity and quality. However, it can be pointed out that such spillovers are indirect, incidental and uncertain. Profit-maximizing firms will seek out profitable knowledge wherever it might be; free trade is neither necessary nor sufficient (much less is it efficient) in conveying new knowledge to producers.

[5] The discussion here is confined to the case for openness to *commodity and technology trade*; capital mobility will be considered separately below.

[6] These estimates of waste are derived by simply equating them to the estimated value of rents created by state interventions.

[7] Private coalitions that succeed in creating rents for themselves through state interventions will also successfully capture the rents: rival coalitions will have no incentive to contest this capture so that no resource-using rent-seeking activity will be realized. Rents will then constitute purely redistributive transfers and therefore will be conserved.

(2) Import competition has a *disciplining effect* on producers who are obliged to exploit cost and quality economies i.e., reduce "x-inefficiencies". If competition has such an effect, this argument does not provide any reason why it must originate in international trade; presumably, domestic competition can serve the purpose just as well. More fundamentally, such an effect is inconsistent with the basic neoclassical premise that firms maximize profits. For if they do, then, they will minimize unit cost (or the cost/quality ratio) regardless of the degree of competition.
(3) Import liberalization increases consumer welfare by *enhancing choice* in the varieties they consume. While this is true particularly in poor economies with small home markets, this link is tenuously relevant, if at all, to explaining visible measures of economic performance such as growth and export competitiveness as opposed to the invisible consumer gains from variety.[8]

If the old trade theory is too feeble to support the weight of the neo-liberal position regarding free trade, the new trade theories may appear to vindicate that position on new foundations. How far is this the case from the viewpoint of the South? The new trade theories are based on decreasing cost due to scale economies, product differentiation among firms and associated market structures of oligopoly or monopolistic competition.[9] Domestic and international firms producing similar products compete in each other's markets. Such intra-industry trade may yield gains in the form of increased product diversity or promotion of competition, the latter arising from the curtailment of monopoly power, which serves to increase output. This latter form of the gain is the one relevant for present purposes: as markets are integrated, markets shares of monopolistically competitive firms, for example, are reduced, output rises and, given scale economies, costs fall. However, intra-industry trade does not necessarily produce *net gains* for the trading countries. In the product diversity case, if goods with high fixed costs displace others with low fixed costs, the net gains from diversity may turn out negative. More to the point, intra-industry trade may also incur additional transport, advertising and selling costs while promoting competition. Once again, trade may produce net losses.[10, 11]

But the more central issue is the relevance of intra-industry trade for the South. Factor proportions remain as crucial for the new theories as for the traditional theory. Inter-industry trade based on comparative or complementary advantage takes place between dissimilar economies whilst intra-industry trade based on absolute or competitive advantage characterizes similar economies. The bulk of North-South trade is of the former type.[12] Even much of the

[8] The argument also supposes that domestic producers have no interest in making the productive or quality improvements in the first place.

[9] Smith (1994) provides a lucid survey of the main lines of inquiry in this mould.

[10] These ambiguities arise from the fact that intra-industry trade adds its own distortion while reducing an initial distortion.

[11] In the European Community, estimates of gains from trade integration (including competition promotion and scale economies) amount to about 5 per cent (Hine, 1994: p. 258). But even there, the home market retains its importance "with the largest part of virtually every market being taken by domestic firms" (Smith, 1994: p. 57). Similar preferences are believed to obtain even more strongly in Japan and in the Republic of Korea. In effect, these endogenous barriers allow monopolistic firms to retain substantial discretion in pricing.

[12] According to Hamilton and Winters (1992) 70 per cent of the variation in trade flows among a sample of 76 countries was explained by variables measuring national 'proximity' such as incomes rather than variables measuring national differences, a reflection of the large share of North-North trade. But exports from the South are primarily to the

export of manufacturers from the South is of standard products based on established technologies. Whereas equalized incomes drive the pattern of trade within the North, it is the pattern of specialization and trade that supports non-equalization of factor prices between North and South: primary producers are poor countries and rich countries are industrialized ones. In fact, the *absolute* difference between average wages in the North and the South has been growing ever larger for close to two centuries[13]. Hence, North-South inequality (in the sense of absolute differences) must be understood in terms of uneven development i.e., dynamic factors making for persistently or even progressively different endowments. Naturally, what is meant here by endowments has to do with physical and human capital rather than natural factors.

3.3 The gains from localization

Uneven development has to be considered outside of the standard models of trade theory. Forces producing divergence in a globalized market system are inherent to that system rather than the exclusive and extraneous results of mis-informed interventions by states. Such centrifugal forces may be located in (1) global processes (based on structural asymmetries) with or without capital mobility; (2) local processes (generating knowledge and related production advantages) despite capital mobility; and (3) barriers to the mobility of capital itself. "Localization" refers to forces that spatially fragment the development process; when these forces persist or even cumulate, uneven development is the result.

Prebisch, Lewis and Emmanuel formulated various versions of the idea that international exchange between rich and poor nations is unequal. Unequal exchange arises from structural asymmetries in product markets or in labour markets, given complete specialization. The inability of the South to catch up by accumulating capital (even if capital is mobile) is *because* of the pattern of specialization in which it finds itself. The South specializes in low demand-elasticity, primary goods while the North produces high demand-elasticity consumption goods and capital goods. Prebisch (1950) argued along this line that balanced North-South growth and trade will produce dynamic terms of trade losses for the South, owing to the lower income elasticity of demand for its exports compared to its imports. Alternatively, the South must face slower growth with fixed terms of trade. While productivity improvement in either North or South reduces its barter terms of trade, it is likely to raise the double factoral terms of trade of the North but reduce the double factoral terms of trade of the South.[14] In other words, productivity improvements in the South are liable to be lost through trade while similar improvements in the North are liable to be retained there. Deliberate industrialization in violation of the South's comparative advantage emerges as the way out of this fix.

With capital perfectly mobile between North and South, asymmetry can arise from a higher relative wage in the North. Lewis and Emmanuel assume that wage levels are given in both regions and that these govern the terms of trade between them. For Lewis (1954), wage differences derive from differences in subsistence (food) productivity between the two regions:

dissimilar North.

[13] What matters for the factor price equalization theorem are wage levels and not their long-term relative convergence (if any) so the `convergence debate' is beside the point here.

[14] The double factoral terms refer to the ratio of per capita (strictly, per worker) incomes in the two regions.

catching up hinges on raising food productivity.[15] For Emmanuel (1972), they derive from a cumulative process in which higher Northern wages induce faster growth and technical change, through higher consumption demand, which supports even higher wages. This tendency may be further reinforced by the power of trade unions and manufacturing enterprises in the centre which manage to raise wages and prices as productivity grows.

Alternatively, structural differences - in addition to the pattern of specialization - consist in different `closure rules' in North and South.[16] For example, an elastic labour supply (or widespread underemployment) at a fixed wage in the South contrast with a fixed labour supply and full employment in the North. When capital investment rises in the South, there is a disproportionate increase in the demand for the North's good, the South's terms of trade deteriorate and real wages rise in the North. The asymmetry carries over to the effects of technical improvements. Improvement in the North raises real wages there and benefits the South in the form of higher employment. But productivity increases in the South accrue to the North through a reduction in the export price of the Southern good and may even reduce employment in the South if its exports face a price-inelastic demand (Burgstaller, 1983). These arguments favour selectively ignoring the international division of labour that orthodox economics assumes to be dictated by efficiency i.e. a move towards diversification in favour of modern industry.

Inequality and unequal growth in these models hold so long as the structural asymmetries - the pattern of specialization and conditions of labour supply - remain in place. Capital mobility makes no difference because the return to capital in the South faces a market absorption constraint (through falling terms of trade). But specialization need not remain completely fixed. Either through deliberate policy or because of evolving comparative cost advantages (a rising wage differential in favor of the North, for example), industry will develop in the South with capital movements from the North quickening the process. Nonetheless, inequality may be perpetuated by two other factors not explicitly considered thus far: the first is cumulative processes of productivity advance based on increasing returns and external economies and, the second, barriers to the mobility of capital.

Adam Smith and other classical economists recognized the role of *growing* specialization as a key factor in productivity growth. Young (1928) extended Smith's idea by pointing out that as aggregate production expands, new processes, products, intermediates and sub-divisions of work come into being which reduce costs and prices. The division of labour is limited by the extent of the market which is limited in turn by the division of labour. Such dynamic external economies cannot be privately appropriated and may even be purely external to all existing industries (since the set of industries is itself variable). If the division of labour is limited by the extent of the market, then, globalization is obviously productivity-enhancing and integration through free trade will benefit North and South. To the extent, however, that capital is not perfectly mobile, the South's participation in the global division of labour will be stunted and so will be its gains.

But the dynamic economies of specialization may be disproportionately large in certain types of production, i.e. some of these economies may be specific to these types. These activities will be located in those nations that have a head-start in them. Although

[15] The subsistence good is a non-tradable in a double sense: the good itself does not enter international trade and, in addition, capital does not enter into its production. Thus, subsistence sector productivities are governed by non-tradable factors (such as land).

[16] See Ocampo (1986) for an extensive survey of theories of unequal development.

specialization is therefore national, other nations can also benefit from it by buying the relevant products from the specialized nation (assuming markets are competitive). But reaping these benefits requires that the pattern of trade equalizes factor prices (Krugman, 1987). If factor prices are not equalized (because of structural asymmetries or capital immobility), then, the gains will not accrue to the nations whose factor prices are not equalized with those of the specialized nation(s).

Modern industry appears to be the prime example of activities with dynamic external economies, as is perhaps evident from the unambiguous connection between the share of industry and per capita income across nations.[17] Since it is the principal specialization of the North, the last conclusion of the preceding paragraph broadly applies to the South and is therefore a factor in explaining why growth rates differ. Growth based on industry-specific external economies amplifies uneven development based on structural asymmetries. This is, therefore, an additional reason for fostering industrialization in developing nations.

Industry-specific productivity increases from process or product <u>innovations</u> are, of course, widely prevalent. Once again, the North, by dint of an earlier start and a large share of global research and development, is specialized in industries where process and product innovations are rapid. The South tends to lag in these industries, or what amounts to the same thing, enters them after their practices and products have become relatively standardized. The Northern lead yields higher wages and higher profits either through cost reductions (process innovations) or monopolistic prices (product innovations). This sets up a cumulative process in which structural asymmetry, in the form of unequal factor prices and unequal research effort, is maintained or exacerbated. The innovations themselves tend to be adaptive to the factor proportions of the North so that the asymmetry is reproduced over time. This reproduction is aided, to an important degree, by demand-side factors as income elasticities tend to be high in sectors the North is specialized in. As incomes rise, intra-industry trade grows rapidly but tends to be largely confined within the North. In sum the localization of productivity-leading industries in the North is itself an aspect of asymmetry. As such, capital need not flow from the North to the South: it may well gravitate Northward if the dynamic returns differential favoring the North overwhelms the static differential in favor of the South.[18]

To be sure, a quickening of the catch-up process will hurt the North by cutting into its market and technological rents.[19] Two sorts of response may arise. At a collective or national level, market and technological protectionism in the North may seek to sustain or shore up the lead. Another is that firms themselves will tend to have a structural preference for practicing a kind of protectionism in respect of proprietary knowledge. This argument is elaborated as follows. The catch-up process would be aided by the location of lead industries in the South as in this way knowledge and practices will be spread more easily, through external spillovers. However, due to the weaker enforcement of intellectual property laws and the greater incentive to produce inexpensive substitutes adapted to the local market, both factors being a consequence of unequal incomes, any relocation to the South would threaten rents both in the

[17] Traditional trade theory has no explanation for this central stylized fact of the patterns of growth among nations.

[18] If the innovation process is substantially due to knowledge spillovers (externalities) rather than being proprietary, then, this will further reinforce the localization of lead industries i.e., the mobility of capital will be of secondary importance compared to the structural asymmetry.

[19] Apart from diffusion through capital and technological markets, technological convergence may be structurally endogenous: if industrial structure changes endogenously to slow down innovation (for example, due to the rising share of services) in the North while the Southern human capital endowment converges to the level in the North, overall convergence may be the result.

local (South) market and the North. Hence, innovative firms have an incentive to practice localization to protect their monopolies.

Forms of localization in production, other than of technology-generating processes, may be even more important or at least more widespread throughout the economy, North or South. One concerns the costs, particularly in transport and transactions, attached to market integration. The costs of tapping markets or resources (including labour) decline with localization and serve as natural barriers to integration. If there are fixed elements in these costs - advertising for example - there will also be *economies of scale* within locales (agglomeration economies). Another concerns knowledge in the form of an unplanned public good. Though some spillovers of knowledge are international, they are more often confined to national or local networks of enterprises, universities and workers. Furthermore, much of the knowledge generated in such locally connected networks is embodied in workers and managers, the internationally non-traded factors *par excellence*. Localization of such *unplanned public goods* is aided also by language and nationality or cultural barriers. A third source of localization arises from infrastructure and services which tend largely to be *non-tradables*: transport, communication, power, water, publicly-funded research and even educational and financial institutions. More generally, local and national public goods or quasi-public goods are, almost by definition, location-specific. A final source of supply-side localization is *market information*. This is particularly important in the capital market where reputations and knowledge are critical to enforcement of transactions (more on this below).

It should be evident from this list that the imperative of localization and its benefits are both economy-wide and sector-specific. On the whole, economies in infrastructure appear to be very important for agriculture (where transport costs loom large, research and extension are public and skills largely home-grown and home-used owing to the preponderance of small and highly localized enterprises, particularly in the South). By contrast, knowledge and skill-based externalities are much more important in industry proper as are marketing costs.

But the connectedness of transactions and resources is scarcely confined to supply factors alone. The *home market*, as a base, is important to individual enterprises because consumer characteristics tend to be locally specific and locally `engineered' rather than global. There are also localized *joint products*: higher wages, for example, produce a demand for better infrastructure that also feeds into superior productivity. The home market matters in an even more vital sense: the level and distribution of income are important determinants of the inducement to invest. But because these vary internationally (which is itself an expression of the lack of global integration), the *investment process* itself becomes local to an important degree.

The chief implication of localization is that the forces of the global market are fragmented rather than uniform. Although competition, exchange and the size of the market are important determinants of the gains from specialization (and *vice versa*), gains also accrue from inter-connectedness, non-exchange and localization. If the economies of local connectedness are stronger than those of global market size, then, uneven development must be the result. Global market integration does not produce (has not in two centuries produced) global convergence; rather, the locally divergent development process produces the characteristic types of global integration (North-South versus North-North) that we witness. Global markets have been the conveyor belts rather than the motors of uneven development.

3.4 Global markets

Historically, free trade has been a luxury pursued by the strong; laggards have always practiced a kind of mercantilism, protecting their nascent industries or subsidizing exports.

The present world juncture appears to mark a departure from precedent. The quickening pace of global market integration in recent decades has coincided with the crisis of Fordism in the North and the crisis of debt in the South. The slowing down of growth together with the transnationalization of production has amplified international competition. Though non-tariff barriers have risen, the world as a whole has moved strongly toward a more liberal trading regime. The North, faced with the imperative of achieving competitiveness and the South, under the compulsions of debt, decline and creditor conditionalities, have both been obliged to go global. Meanwhile, the NICs, which have made significant inroads in the North's markets at home and abroad, are being held out as a model for the rest of the South to follow.

But in a world in which the growth process remains powerfully localized, openness benefits the strong and, the weak must continue to sell primary commodities or standard manufactures. Competition in the markets for the latter has been accordingly fierce. During the 1980s, the export prices of LDC manufactures have fallen in relation to the manufactures they import and, at the same time, their commodity export prices have been lower, in real terms, than at any time during the past 10, 40 or 120 years. "This deterioration is at least partly responsible for the great fall in real wages which developing countries have been experiencing." (Avramovic, 1993: preface). Their import capacity also declined substantially despite the growth rate of the volume of exports being higher than in the preceding decade and a half. The main causes were a substantial decline in the terms of trade and a reduction in net capital inflows. In fact, the 1980s also witnessed a "retardation of diversification" (Griffin and Khan, 1993). Perhaps even more damaging is the trend in price instability for primary exports which has been positive over the past four decades. The ratio of income per capita of the poorest 20 per cent of the world's population relative to that of the richest 20 per cent, when measured at purchasing power parities, has *risen* relative to the similar ratio when measured at nominal exchange rates, from 2.3 in 1970 to 2.8 in 1980 and further to 3.2 in 1988-89.[20] In other words, the price structures of poor countries have been *deviating further* over the past twenty years from those of the rich countries. Contrary to the trend toward apparent global integration, the Law of One Price seems to have grown progressively less valid.

Falling real wages in many LDCs do increase "competitiveness" but do not counter the asymmetries of specialization or strengthen the local processes of learning and development. Wage costs become a crucial part of competitive advantage only in the later stages of the product life cycle when the technology is standardized, and there is little need for experience or specialized skills. Even in such a case, however, there is no assurance that a lower wage translates into a cost advantage. The ability to take advantage of transferred technologies and of trade-based gains from specialization has been highly dependent on creating an <u>indigenous</u> process of cumulative learning and utilization (Hikino and Amsden, 1993). Among these local determinants, early land reforms, investments in infrastructure and human capital, stabilization of social relations by agreement or coercion, and the nature of the state have been particularly important. Given these local effects, it is unsurprising that (a) very few among the LDCs succeeded in their late industrialization efforts; and (b) a period of rapid growth in world trade enabled the few successful ones to pull away rapidly from the rest in terms of both growth and export success.

Although many economists contend that competition from abroad is necessary and sufficient to promote industrial productivity growth, the problem frequently is the reverse: there is too much domestic competition for efficient production. For example, whereas both Brazil and Mexico limited entry to and the number of models in their automotive markets,

[20] Computed on the basis of UNDP data cited in Griffin and Khan (1993), p. 3.

Argentina's domestic car industry had as many as 15 producers in the 1950s and 1960s making for small production runs and great inefficiencies (Schwartz, 1993: p. 265). Many nations have succumbed to competitive challenges rather than been able to meet them; competitive pressure by itself fails to account for the outcome.

Contrariwise, phases of protected industrialization are necessary but hardly sufficient to achieve competitiveness. Indeed, without the careful cultivation of the above-mentioned local effects, protected industrialization becomes part of the problem rather than part of the solution. It is not easy to tread the fine line between providing excessive protection to inefficient domestic firms and dampening the inducement to invest in mass production industries that arises when enterprises cannot ensure, through the exercise of market power, that output is restricted to a level that is absorbed by stable demand. Unstable demand can be fatal to a nascent industrial sector in which scale economies are critical.

Technology markets pose a different order of challenges to the South. Few would dispute the *gross* advantage of late industrialization viz., the import of technology rather than invention *ab initio*. This, however, is not to assert that technologies are pure commodities that are simply transferred in the act of their purchase. As long as elements of technology or best practice remain tacit, the originating firm will have an incentive to invest abroad directly rather than licensing the technology.[21] Conversely, where local learning and adaptation capacities advance, the ability to convert the gross advantage of late industrialization into a <u>net</u> advantage also grows.

The diffusion of technologies and the location of trans-national corporations (TNCs) in the South must be viewed from both the supply and demand sides. On the supply side, TNCs' location decisions have been motivated by two factors: (1) deploying extraction technologies to capture rents on raw materials and (2) locating or sub-contracting standard technologies abroad to take advantage of cheap labour. On the demand side, location in the South is driven by the relative profitability of producing for the LDCs' domestic markets versus producing for exports to the North or other markets in the South. The demand side, in turn, is governed by (3) tariff barriers protecting the domestic markets; (4) the rate of growth of domestic demand; and (5) the growth of export competitiveness. To the extent that factors (1)-(3) dominate, trans-national location to the South combines the gross advantage noted above and the South's comparative advantage i.e., it builds on rather than counteracting structural asymmetry. But to the extent that (4) and (5) are the leading elements, a dynamic process may be inferred i.e., the conversion of gross advantage to net advantage.

Over the post-war decades, there has been a 2-1 margin in favour of TNC investment oriented to domestic markets rather than exports and the latter type was heavily concentrated in a few, more advanced LDCs (Kaplinsky, 1993). Although tariff-jumping was a primary factor, the experience of Brazil, Mexico and Argentina is instructive at least in regard to dispelling the notion that TNCs have been a universally effective mechanism for industrial advance. All three countries provided inducements (subsidies and protection) and imposed restrictions (domestic content requirements). Yet, for the most part, export competitiveness was not secured. Besides, TNCs tended to import much of the machinery they used, dominated strategic points in the production chain and tended to buy out the most dynamic local firms rather than start up new subsidiaries (Schwartz, 1993: p. 266). In the 1970s, all

[21] Arthur Lewis (1978) argues that it is not finance nor even technology that is the main contribution of the trans-national corporation on the premise that technology in the light industries is easily transferred through purchase. Advanced technology is far less important in cement or textiles than in computer or cars and the latter are of less interest to the least developed. Rather it is market connections and managerial expertise that is the chief contribution.

three nations shifted strategy away from a reliance on TNCs to direct borrowing in world capital markets to finance state or local private firms instead.

By contrast, East Asian economies practiced both explicit and implicit protectionism of national firms from the start. By requiring TNCs to produce mainly or only for export (in export processing zones), national industry was allowed to grow by producing for the home market. Given complementary policies to develop the localization process, domestic firms were thus strengthened and later compelled (through conditional credit and other subsidies for exports) to themselves graduate to selling in export markets as well. Contrary to neo-liberal interpretations, the `level playing field' between foreign and national firms in these countries was largely a product rather than the pre-condition of development. This model of localization with considerable state direction as the basis of success certainly describes the Republic of Korea and Taiwan (China) cases (as also in Japan earlier and in China more recently). In all of these cases, high rates of domestic saving were the primary source of financing of high rates of domestic investment. The exceptional role of TNCs in the transformation of Hong Kong and especially Singapore is explained by their being free ports from the outset; the government in Singapore spearheaded localization in all other respects.

According to neo-liberal argument, external liberalization serves to eliminate the previous home-market bias of TNC investments. This appears to be borne out by the recent success of Malaysia, Thailand and Indonesia in raising their industrial and export growth rates with the help of foreign direct investment. Chandrasekhar (1995) identifies labour costs (both skilled and unskilled) together with exchange rates as the key factors in determining the "new" FDI inflows. Exchange rate appreciation follows in the wake of FDI-led export growth and eventually pushes FDI out. There is a step-wise movement of FDI away from the earlier to later recipients driven by rising labour costs, appreciating currencies and infrastructural bottlenecks. In addition, firms in the early recipients themselves "appear to find the need to invest in production capacity elsewhere" (ibid. p. 10).

But it is not evident that this investment activity represents an entirely new kind of relocative FDI prompted by liberalization alone; that it is, in particular, different from the East Asian model. For one thing, the role of trade liberalization measures needs to be assessed relative to the weight of incentives for export-oriented investment. For another, economic proximity to East Asia together with political stability (insured by authoritarian regimes) has been a special factor. The appreciation of the East Asian currencies, especially the Japanese yen, and on-going trade frictions with the United States have created a strong economic and defensive motive for diversifying investments to new sites, of which the three ASEAN nations mentioned were the favored ones[22]. The continued concentration of FDI/TNC investments among a handful of nations at least suggests that these *follow* rather than lead growth. The limited spread of FDI is amply revealed by the fact that in the early 1990s of the total South-bound flow of $65.1 billion in FDI, China alone got $25.8 billion or 40 per cent while the top 7 recipients (China, Indonesia, Malaysia, Thailand, Argentina, Mexico and Hungary) accounted for nearly 75 per cent of the total (Chandrasekhar, 1993: p. 15). Even in these countries, FDI remains a small part of total investment.

Despite a wave of external liberalization in the LDCs during the past decade, the prospect of a significant further increase in FDI inflows or of their spread beyond a handful of favoured sites appears to be clouded by on-going changes in technology and organization. In the Fordist era, with standardized products and special-purpose machinery, production processes that had

[22] The particular fiscal and macroeconomic structures in these countries that made openness possible with economic and political stability will be considered separately below.

a large unskilled labour cost component were subcontracted out to LDCs. TNC decisions were motivated by the advantages of locating market-leading products and processes close to their markets *within* the North in order to minimize transactions costs and to spread their development costs and obsolescence risks. The new competition under post-Fordism, based more on product differentiation, flexible machinery and just-in-time production, favours proximity and supply reliability even more. In addition, the need for multi-tasking has increased the need for multi-skilling of individual workers which is liable to be more feasible in the high-wage North. These features not only increase the advantage of proximity they also reduce the advantage of low-wage, low-skill labour (Kaplinsky, 1993). In short, the dynamic economies from locating investments within the North may be growing stronger than the static advantages of sub-contracting out to the South.

At the same time, technological changes appear to be making the process of indigenous catch-up even more difficult today than it was for the NICs of yester-years. "With new technologies more difficult to copy and anticipate due to their non-linear [i.e., incorporating knowledge from largely unrelated industries and processes] and differentiated [i.e., not incremental] nature, and with higher knowledge and entry barriers and shrinking product life cycles, it may be increasingly difficult for producers in the Third World to replicate the experience of their counterparts in the first generation of NICs" (Bernard, 1994: p. 225). Nonetheless, the untapped demand for standardized, mass-produced products in the developing world should not be underestimated; the potential for industrialization remains large although the prospect for catching-up may be shrinking.

3.5 Global Finance

There is an obviously profound imbalance in the capital available per worker or consumer between the rich and poor countries. Coupled with the large differences in technologies employed, the potential economic returns to making finance available to the South are large. Though the objective need and opportunity for saving and outside finance for physical, human and infrastructural capital formation is evident, it does not follow that the market, whether internal or international, is willing and able to supply these. In the context of structural asymmetries in the growth process, the fragmentation rather than integration of capital markets is both a symptom and a cause of those asymmetries.

The neo-liberal presumption is that barriers to the Law of One Price in finance are purely policy-induced. On this argument policy reforms that secure openness to global financial markets and internal financial liberalization will both serve to remove financial bottlenecks to development in the South. A relatively closed financial system has or entails controls on interest rates, exchange rates and the capital account, and the regulation of credit allocation - in short, financial "repression" that produces inefficiencies in both portfolio holdings and in investment allocation. Internal liberalization then stimulates domestic saving and improves its allocation via financial markets. Integration permits global market forces to determine interest rates, bond and equity prices and the foreign exchange rate. Removing capital controls brings about full risk diversification on the saving side and the optimal level of investment independent of domestic saving.[23] The objective financing needs noted above will find full expression in such a globalized setting, the real interest rate will rise and capital will flow in to meet those needs. Though this is only a "level" effect, economic growth will accelerate over an extended period of time.

[23] The collection of studies in Reisen and Fischer (1993) lays out several of these arguments in detail.

Even if the fragmentation of global finance were to be dismissed as temporary and it was accepted that equalization will rule in good time, this characterization fails in terms of the `flow' variables that will presumably bring about international convergence. Even among the ACCs, saving and investment rates are strongly correlated. The real interest rates faced by LDCs on their foreign debt, which is the money rate adjusted by the rate of change in their dollar export prices, are more than three times the rates experienced by developed countries (Avramovic, 1993). Profit rates remain dispersed even if short-term rates of interest show a degree of convergence due to the enormous increase in short-term financial movements. Recent work by Epstein (1995) finds little evidence that there has been an increased tendency for investment to move in response to international differences in profit rates. While FDI is not unresponsive to relative rates of return, there is no perceptible increase in response over time.[24]

The lack of integration in the supply of long-term finance has several sources. One pertains to international economic (particularly financial and exchange-rate) *instability* that has grown since the mid-1970s. However, increased "instability" as indicated by the increased variability of exchange rates and inflation rates failed to account for the failure of profit rates to equalize or for the persistence of profit rate variability. Rather, it is the lack of third-party *enforcement* of international financial and investment transactions coupled with the decline in United States hegemony that, according to Epstein's (1995) empirical analysis, must bear the burden of explanation.

Other considerations, based on North-South distinctions, are also relevant. While the barrier of geographical distance in financial markets has dissipated over time, the global flow of finance remains constrained by real-side factors favouring localization. As noted earlier, the increased tempo of technical change together with post-Fordist imperatives has increased the *value of proximity* between production and markets in the North. Whereas technological distance has risen between core and periphery, formal and informal alliances among firms in the North proliferate with investment tending to become more inward-looking. Just as *intra-industry* goods trade preponderates among the rich countries, similarly gross flows of investment within the North are substantially greater than net flows.[25] The importance of corporate retentions in financing investment means that a large volume of saving <u>and</u> investment get recorded in the same country. Hence, enforcement and sovereign risk concerns pose a much stronger North-South barrier than within the North.[26]

As with FDI flows, long-term financial flows seem to follow development rather than lead it. This reflects not only the importance of local development processes but also of the isomorphic localization of financial markets. The location of production depends on the comparative costs of immobile factors, which are not confined simply to raw labour and land, the obvious ones. The (local) development process is also intensive in human capital accumulation and investment in infrastructure. It is not merely that the services provided by such investments are attached to the immobile factors and strongly complementary to movable

[24] Of the 21 countries in Epstein's sample, 11 were LDCs or NICs - Brazil, Chile, Colombia, India, Ireland, Mexico, Panama, Philippines, South Africa, Spain and Venezuela.

[25] The rise in the *share of services*, which tend to be non-tradable, to unprecedented proportions in the rich countries may also be relevant. To the extent that services are dominated by smaller firms whose capital and management tend to be much more proprietorial and nationally rooted than those of large corporations, finance becomes more nationally oriented.

[26] Although trade-related risks have hardly vanished within the North, the present levels of internationalization of gross corporate holdings would appear to provide a strong joint interest if not full insurance against enforcement failures.

capital investment in tradable sectors. There are also financial market failures owing to significant externalities and information asymmetries which place these human capital and infrastructure investments largely outside the scope of both indigenous and, especially, international market finance.

Consider investments in human capital: in developing countries, expenditures on nutrition, health and education are major productivity-raising factors. While they are certainly privately "profitable", poverty and the lack of collateral, aggravated by moral hazard and adverse selection, render market financing either impossible or costly. Far from financing such productivity-raising expenditures, the utter inadequacy of credit markets forces a reliance upon self-provisioning and self-insurance, which detract from productivity. The lack of credit and insurance markets is a critical factor, for example, behind `accumulating' precautionary and old-age saving in the form of children. This only serves to raise the dependency burden in the form of higher current consumption requirements while also reducing current incomes (by increasing wage competition from low-paid child labour) which, in turn, aggravate the initial market failure.

The returns to human capital would hardly be fully internalized even if credit markets were perfect. As noted in section 3.3, external economies in the form of knowledge and training-based externalities are a core feature of the localization of development. Increasing returns to scale from reaching "threshold" levels with regard to the stock of human capital also appear to hold. Hence, private profitability can hardly be a gauge of social productivity. Even `perfect' capital markets must produce systematic underinvestment in human capital[27]. In sum, both externalities and imperfect capital markets shift the problem of financing human capital from the private to the public realm.

Similarly, the low levels and quality of infrastructure help explain the low overall productivity, including low rates of return to capital, in LDCs. Free trade obviously cannot enable a country to specialize away from its requirements of these non-traded goods. But the pertinent question here is whether global finance can help. Many elements of infrastructure are characterized by external benefits, if not outright jointness in consumption, non-excludability except at prohibitively high cost, increasing returns due to substantial indivisibilities and long payoff periods. Some of these features, particularly non-excludability e.g. in national highways or the supply of rural power, are peculiarly strong in underdeveloped countries due to both technical and social conditions. User charges are often limited even below the efficiency price (which itself must be below full cost) in the interest of political or price stability. On the other hand, the investment and operating costs that `need' to be recovered are also typically inflated by the malfeasance of managers, whether private or public. Hence, by rational design or institutional default, infrastructural services must be extensively subsidized. The private financing of such investments is made as problematic as public regulation (if not public ownership) is made economically necessary.

These difficulties acquire weight because infrastructure and human capital investment accounts for a sizable share of total investment in the low-to-middle range of national per capita incomes. In other words, there is a "life-cycle" bulge in infrastructure accumulation that a normal process of modernization, urbanization and development requires. In fact, while the

[27] The so-called "new" growth theory recognizes increasing returns to human capital as a cause of productivity growth. However, in the form of the "convergence club" and "contingent convergence" hypotheses, the relationship between human capital and economic potential is reduced to the status of a tautology: the failure of unqualified convergence is attributed to the inherent diversity of the long-run income potential of global participants. The argument here, by contrast, is based on localization in the context of failures in markets, whether local or global, which are correlated with achieved income levels.

capital-output ratio in tradables may be optimized over a significant range through appropriate specialization, the weight of infrastructure investment with a largely fixed and high capital-output ratio limits the value of such optimization. Financing and efficiency failures in infrastructure can thus prove costly in terms of economic growth. In many cases, these are due to *both* state and market failures rather than the one or the other.

While these considerations on the requirements of and returns to vital pieces of the local development puzzle, in conjunction with financial market failures, do suggest why their financing if not their operation spills over into the public domain, they do not by themselves pose insuperable barriers. The problem, however, is that few states in the South muster either the political will or the administrative capacity, by way of tax effort, that this spillover requires. While fiscal constraints do not arise wholly on account of the need to finance current and investment outlays for development, public investment is often the first victim of fiscal troubles. At any rate, modern states' development ambitions customarily run well ahead of their incomes or borrowing capacities. Squaring off the books has been accomplished through forced finance: by monetizing the deficit and forcing saving via inflation or by requiring domestic banks, through reserve and portfolio requirements, to accommodate government finance. Forced saving and financial repression both have their limits (and both have been used to the hilt presumably because it is even more difficult to extract taxes from the wealth-holding public).

Of immediate interest is financial repression. Observe first that this indirect route to public finance requires a captive supply which can only be arranged by limiting the exit option. This, no doubt, is the prime motivation for external capital controls. Second, following the above discussion with respect to the problems of financing development investment via markets, it is ironical that the financial market comes to be repressed in part because of its failure to voluntarily provide for these development needs. Third, contrary to neo-liberal prescription, financial repression is not in itself costly for much depends on the scope for alternative finance. Whatever political virtue there may be in subjecting state finance to the discipline of the financial markets, it is not self-evident that the missing tax effort will appear in the wake of financial liberalization. If not, political virtue will be secured at the expense of development. Going back to the premises, financial repression together with capital controls represents a second-best financial system more or less appropriate to the political economy of underdevelopment.[28]

Even within the normal market domain of business finance, however, financial markets in developing countries are far removed from the textbook model. Small-scale agriculture (which in most cases is the major part of agriculture) and small and informal firms in manufacturing and services are endemically constrained by lack of finance. They must either rely on self-finance or pay high interest rates in informal credit markets. Unlike the formal sector of large-scale industrial enterprises where the "missing" returns to capital and labour[29] (relative to the returns in the advanced countries) may be accountable to the state of the local development process, these sectors typically have *actual* rates of return substantially above the

[28] Recalling the earlier arguments, financial repression is the joint product of ineffective fiscal effort and inefficient financial markets.

[29] These are external returns that fail to be internalized by the market and which help account for the disjuncture between the evidently large gap in the capital-labor ratio between rich and poor countries and the comparatively small gap in realized returns to capital.

rates in the formal sector, domestic or global. Interest rates paid by these informal enterprises are typically 3-5 times as large as those prevalent in the formal sector[30].

Nor is the formal side of the financial market exempt from substantial imperfections. Quite apart from authority-directed priorities in credit allocation across sectors, limited inter-bank competition and market segmentation, the power of banks to set rates or channel credit to preferred customers, and the lack of supervision which allows banks to overcharge viable borrowers to compensate for bad loans to `insiders' demonstrate fragmentation even within the formal financial market. These factors are so deep-seated in fact that even with financial opening, there is little convergence of domestic interest rates to world levels: large interest rate differentials persist which cannot be explained by political or exchange risk premia (Fischer, 1993).

Although shallow securities and money markets may be a consequence, in part, of financial repression, which prevents government borrowing from becoming securitized, lack of investor confidence also arises from the poor accountability of enterprises and the inadequate monitoring and supervision of these markets by private agencies or public authority. Concentrated control of corporations allows reported profits to be understated at the expense of anonymous shareholders and bondholders.[31] Hence, private portfolios confront information constraints to diversification.

Consider now the implications of integrating such a fragmented domestic financial system into global financial markets. Even assuming that capital flows in rather than out, financial openness in the South not only provides no guarantee of macroeconomic stability but, on the contrary, adds its own not inconsiderable risks. In response to an inflow, either reserve accumulation may be maintained together with the exchange rate, or an exchange rate appreciation prevents reserve accumulation. The latter option is likely to de-industrialize by enlarging the non-tradable sector and promoting speculative investment, both of which hurt long-term competitiveness. Presumably, nations in the South will eschew such a course. Portfolio flows are also liable to conflict with foreign direct investment. The maintenance of high interest rates attracts the former while the exchange rate appreciation is apt to discourage FDI. Thus, while trade reform may encourage FDI, financial liberalization works in the opposite direction.

On the other hand, the accretion of reserves with a pegged exchange rate will be inflationary and finance a bout of consumption or, worse, capital flight, rather than productive investment. If this supports a pick up in investment, "the country is `borrowing short to invest long' which exposes it to potential crises" (Patnaik and Chandrasekhar, 1995: p. 3009). But even assuming that this problem can be got around by choosing short-gestation, export-oriented investment, what guarantees that there is an agent and a motive to undertake that investment? State withdrawal under structural adjustment, which is the very basis of liberalization, makes it an unlikely agent; inducing private investors with the carrot of reduced interest rates "can scarcely be used for fear of frightening international rentiers" (*ibid.*). Short of further fiscal mobilization, stepping up public investment must also confront the same constraint since it is the market under the liberal dispensation that will determine what a sustainable level of the fiscal deficit can be. Sterilized intervention (or managed floating) is also severely circumscribed by (a) the limited capacity of the central bank to issue bonds (given the

[30] See Rao (1995c) for a macroeconomic analysis of financial and real dualism with formal and informal sectors.

[31] "Evading corporate taxes by showing very low profits" (Reisen, 1993: p. 50) may not be the most serious source of unaccounted profits.

shallowness of the domestic securities markets); (b) negative fiscal consequences from the consequent pegging of domestic interest rates; and (c) adverse consequences for the private sector from the credit squeeze (Reisen, 1993: p. 47-8).

It is in this light that the success of relatively liberalized financial regimes in Malaysia and Indonesia since the early 1970s (and Singapore since the 1960s) must be understood. Fundamentally, it is the exceptional fiscal strength of those states that helped them avoid macroeconomic instability and the loss of competitiveness in the face of large capital inflows. The Singapore government's chief policy instruments in achieving the world's highest rates of saving were essentially coercive: the use of state monopolies to extract rents in such non-tradables as land and housing, public utilities, the port, telecommunications, etc. and high rates of compulsory savings via the Central Provident Fund, a social security scheme (Huff, 1995). Sterilization has been accomplished through transfers of excess savings controlled by the state into and out of the banking system. In Malaysia and Indonesia, a major share of export revenues came from oil and other extractive industries, which were largely state-owned as was also the banking system in Indonesia (Sen, 1995). Hence, the budget surplus tracks reserve movements as does central bank credit to the government. This frees up the interest rate from demand management so that it can be directed instead to steadying the exchange rate.

To sum up, national financial markets *within* the South present a picture of deep structural fragmentation. Finance flows unevenly between the modern industrial sector where much of the learning process must concentrate, the informal and agricultural sectors, which are the prime sources of employment and livelihoods, and the public sector, which must play the leading role in creating infrastructural and human capital. The asymmetries that underlie the lack of financial integration within nations are rooted in both political and market failures. In turn, indigenous financial markets, even when not closed by policy, are but poorly connected with global markets: the lack of integration of production and real investment is mirrored in large enforcement or country risk premia. Besides, openness itself is constrained by the weak domestic fiscal and financial structure. In short, the hierarchical fragmentation of global financial markets is both constituent of, and caused by, the localization and unevenness of development.

In this structural context, attempts at opening up place local development processes at considerable risk of rupture or slackening. Following the theorem of the second best, financial integration in the presence of structural asymmetries may cause further divergence rather than convergence. Adverse effects are not confined to the probable distortion of development priorities that will ensue. In the longer term, even net flows may tend in the "wrong" (from the perspective of the South) direction. That is, reverse flows may not be the result only of debt crises and associated capital flight. In recent years, profit rates in the ACCs have trended upward. If the uptrend is real, and not the result of reversible factors such as real wage reductions and reductions in input prices (energy and raw materials) and due to irreversible productivity advances based on technical change, then, there is a prospect of "further flight of capital from developing to developed countries and continuing and perhaps accelerated migration of both skilled and unskilled labour" (Avramovic, 1993: p. 4-5).

By comparison with capital mobility, integration via labour mobility would provide a far more reliable and powerful mechanism for reducing international inequalities. But as small as North-South capital movements are, the South-North movement of labour remains smaller still. Besides, the selectivity of immigration policy favouring the skilled is largely inimical to the interests of the South while the liberalization of labour immigration is hardly on the North's agenda.

4. Autonomy, interests and options

The value of national autonomy in the South arises from the structural and market asymmetries identified in the preceding section. Goals of national integration and locally-oriented development must, as in the past, continue to take precedence over the project of globalization. The quality of public intervention and participation is fundamental to the realization of these possibilities. But this depends on the political compromises, consensus or conflicts that each society inherits or has to contend with. We conclude the paper with an examination of the political economy of interests in or against liberalization and globalization, and of the policy alternatives that are most conducive to economic development in the poor nations.

4.1 Autonomy

States have played a pivotal role in capitalist transformations throughout the world. The development of the market system has required the simultaneous development of institutions, including the state itself, to support it. This requirement has evolved with `world time': late developers, as Gerschenkron and others pointed out, have found it necessary to fashion state institutions and policies that are more actively engaged, both qualitatively and quantitatively, in the development process. Nurturing local development against competing global forces has become a progressively more delicate affair. Strategic direction of the economy, macroeconomic management to secure internal and external balance and selective engagement in global markets to exploit the opportunities and thwart the constraints they offer have been added to the tasks of establishing new forms of property relations and associated legal and enforcement systems, ensuring order, supplying infrastructure and educational services and, above all, resolving the fundamental political conflicts which arise in the process of constructing a market system.

In the Golden Age, state-fostered development, including industrialization with protection, succeeded in an aggregate sense: output grew more rapidly in the South than in the North and the proportion of non-traditional exports in the total exports of the South rose significantly. When disaggregated, however, economic development in peripheral countries presents a convoluted picture. While some countries have managed to grow at remarkably high rates, others have been unable to develop competitive advantage fast enough to achieve industrial take-off. A few countries have been able to exploit their integration into international markets for commodities and capital to their own advantage; many others have had to contend with the debilitating effects of import dependence and export instability. A large proportion of the population in the South remains marginalized in the global economy.

The economic success of the NICs, particularly in East Asia, is the fruit of particularly propitious historical circumstances combined with powerful state direction of the economy. American help in curbing landlordism and generous financial aid and direct purchases during the Korean and Vietnam wars contrasted sharply with the forms of outside support that reactionary regimes received elsewhere in the third world. While exploiting the full potential of localized development, growth in East Asia has also required judicious and regulated use of global market opportunities by way of importing technologies, borrowing abroad and exporting goods. If other nations have been less successful, this is not because of, but inspite of, state interventionism per se. The rise in the required critical minimum effort has made success more elusive. The relevant lesson to be drawn from the evidence is that success depends not only on the particular phase of global capitalist development in which late industrialization occurs but also on the particular structures of state and society within which national capitalism evolve.

Yet, economic and ideological compulsions arising from the very lack of economic success have prompted a radically different world view: that liberalization and globalization are the way out of underdevelopment in the South. For classical liberalism, political democracy and market capitalism harmonize interactions among self-interested individuals. Globalization merely extends the sphere of interactions to all individuals in the world. For a classical liberal the reduction of "autonomy" within the national sphere that results from globalization is a loss for states, bur can only be a gain for peoples since state interventions in markets are necessarily counterproductive to individual welfare.

Neo-liberalism in the guise of neoclassical political economy augments the liberal case for state minimalism with a novel theory of state action. This theory seeks to extend the harmful effects of state autonomy beyond just the subtraction of the gains from trade. The idea is that states, when not bound to a minimalist agenda by the market system, are liable to be captured by special interests (either in civil society or within the state apparatus itself). Much economic harm ensues from the mere possibility of state intervention and takes the form of unproductive rent-seeking. In other words, quite apart from any economic virtue the state may have vis-a-vis the market (or any subtraction of gains from mutually beneficial private exchange), the very process of market-like competition for state influence renders state autonomy an economic liability rather than an asset. Globalization is not merely useful for *extending the gains* from trade; it is in fact the most effective means available to achieve the minimalist state, thus also *avoiding the much larger losses* from rent-seeking.

There are fundamental difficulties with these arguments. The classical view simply ignores the social embeddedness of markets (see Underhill, 1994, and the discussion below). Conflicts generated by the development of markets and their on-going transformation necessarily play out, at least in the first instance, at the national level, and states have been crucial players in resolving or suppressing them, at least in the last instance. Neoclassical political economy, on the other hand, suffers from two internal contradictions. One is that, within its own premises of the rational actor model, coalition conflicts over state policies can and will be rationally resolved; thus, the idea that the process of political competition wastes the very rents it creates is fundamentally wrong. As a positive proposition, it is fallacious. Yet, while recognizing the "embeddedness" of markets, neoclassical political economy fails to acknowledge that socio-economic conflict must inevitably engage the state. On the contrary, this is wished away via the mythical construct of the minimal state (Rao, 1995e). The call for globalization as the economic means for clipping the wings of political autonomy is thoroughly unpersuasive because globalization has got to be politically constructed and regulated. As a normative proposition, it is without foundation.[32]

This is not to say, of course, that global integration does not reduce political autonomy. The national choice of goals as well as of means is liable to be strongly compromised. The South differs from the North in this respect not so much in the goals pursued but in the means necessary to realize them: the imperative of local development is far greater while, at the same time, local development is much more vulnerable in the face of globalization. That is, the gross value of autonomy is greater while the gross cost of its loss is also larger. Contrary to the neo-liberal promotion of internal liberalization and global integration, the preceding section

[32] A variant of the neo-liberal argument - that globalization is necessary to minimize the autonomy of `predatory' states - illustrates this point. The argument tells us nothing about the social basis of the predatory state; without such an understanding, it is not evident that the `cat can be belled'. Nor does it say anything about the potential of non-predatory states to become predatory. The argument supposes that autonomy lost through globalization cannot be regained.

has argued why, in a world of strong and weak economies, unregulated global integration cannot be in the best interests of the weak.

The point is best illustrated in regard to financial markets and public finance: Despite the `natural' barriers to financial integration posed by uneven development, financial opening threatens to sever finance from the domestic development effort.[33] Local development priorities will be inadequately represented by market forces and therefore underfunded. By forcing state finances to the `discipline' of the market, integration will weaken the financing of human development and infrastructure. Complementarities between rooted and mobile capitals and their growth-inducing economies, operating on both demand and supply sides, will thus be sacrificed. Instead, finance is liable to be preempted in favor of luxury consumption, TNCs and speculative activities[34]. Apart from the macroeconomic difficulties of managing capital inflows, there is also the danger of capital flight when nations carry out "institutional, legal or political changes which call into question the enforcement power of creditors" (Epstein, 1995: p. 328).

However, it does not follow, merely from demonstrating the national value of autonomy, that the state will exercise its autonomy successfully. Constraints originate both from conflicts in civil society and from failures within the state. The tasks of modern state-building would appear to be the first order of priority in organizing local development. The nation state, after all, is `the mother of all' public goods and, being itself a local institution, must thrive on localization. Indeed, state formation and local development are strongly complementary to each other.

National competitiveness relative to the global economy proceeds from a base of national integration. The intra-national division of labour, as Adam Smith observed, is limited by the extent of the market: specialization is a public good producing external benefits that are jointly consumed. In addition, public infrastructure investment (in transport and communications, education, research, extending the land frontier, major irrigation, etc.) raises productivity both directly and by extending the home market while the development of state institutions (enactment and enforcement of laws, tax collecting machinery, maintaining order, etc.) serves to expand the state's revenues. As the market expands, the costs of running the state and delivering infrastructure services fall and state revenues increase at the same time. These make possible an increased supply of infrastructure which further extends the home market. Hence, the expansion of the home market and modern state formation feed on each other in a cumulative fashion and add to national competitiveness.

While external trade certainly can be a major source of revenue, its contribution to local development, as argued in section 3, is limited, given the international division of labour. In addition to the factors mentioned there, it should also be noted that traditional exports, in the form of mining and plantation complexes dating from colonial times, are poorly integrated into the domestic economy. Indeed, infrastructural investment in colonial times was primarily intended to serve the colonial project (including raw material extraction) rather than local economic development (MacEwan, 1995). The gains from such trade, such as they might be,

[33] Many borrowers and lenders in the South cannot undertake the transactions required to achieve arbitrage gains. While institutions may be capable of doing so on their behalf, it is far from obvious that the portfolio preferences of the wealth holders will lead to this outcome - especially as lending opportunities with high interest rates, as in the informal sector, are precisely those that cannot be so arbitraged either by borrowers or by lenders.

[34] Integration favors TNCs which "enjoy far greater possibilities than smaller local concerns of raising money wherever they operate ... They have longer pockets and far, far better market access certainly in the affluent markets of America, Europe and Japan, and often even in the local markets of their Third World affiliates" (Strange, 1993: p. 105).

do not diffuse widely or accrue as external benefits. Instead, they tend to be concentrated in rentier elements, within or outside the state apparatus, who are likely to resist taxation or diversification away from these exports. Thus, state building and local development go together while external integration is limited by state policy in a mercantilist fashion.

But modern state formation has been no less problematical than the process of economic modernization or development as the history of western Europe demonstrates.[35] In many parts of the South, the four or five decades following the retreat of colonialism have seen intense state-building activity and attempted modernization. The complementarity between these processes noted above does not imply that they will be successfully prosecuted. The failures and reversals (as also the successes) in this effort cannot be understood except in *political* terms i.e., in terms of the conflicts generated by the social embeddedness of both state and economy.

4.2 Interests

If drawing empirically-based inferences about the goals of states seems difficult, distinguishing the goals of the North and the South would appear to be positively unsustainable. Apparent differences in goals may simply be a reflection of the varied structural contexts or the different phases of the "life cycle" of development in which nations find themselves. Much the same statement could be made about the differences in interests among individuals and groups that activate intra-national conflict and politics. A further difficulty, that looms especially large in the case of the South, arises from the historical, ethnic and geo-political contexts of nations, even those that have similar income, demographic or human development indicators. Above all, nationality questions that challenge the nation-state at its roots do not seem to have any particular relationship to "structural and life-cycle" economic circumstances. But then again, these may be correlated with the vicissitudes of state formation which, as we have seen, has an important economic dimension.

Following the approach of the UNDP's *Human Development Report*, it seems reasonable to suppose that the ultimate *goal* of human development is common to all individuals and peoples. Drawing a line of distinction between this goal and its manifestation as *interests*, the latter will differ systematically - among individuals, groups and nations - depending on the aforementioned structural or positional differences. In this light, local development as well as global opportunities or constraints, breed conflicts of interest, not of goals, within and between nations. For convenience of exposition, the characteristic forms of intra- and inter-national interest conflict are discussed separately.

Although agriculture has been at the centre of the political economy of development, the agrarian question has been analyzed in radically opposed terms. Many see it as a conflict between rural (represented by the `peasant' producer) and urban interests (including industrial workers, urban capitalists and the military-bureaucratic combine). In this view, the state rigs the entire policy framework - taxes on agricultural exports, protection of industrial import substitutes, subsidized credit for industry, infrastructure oriented to urban areas, etc. - to promote urban interests. One difficulty with this thesis is that the policy package that putatively embodies such "urban bias" can be viewed instead as critical to diversification and local development i.e., a bias for development, not a bias against agriculture.[36] A second

[35] Modern state formation in Europe was spread over a few centuries. It is no accident, as the above argument suggests, that this history coincided with the age of mercantilist protectionism. The late modernization and development of Italy despite an early start with city-state merchant capitalism reflects the failure of state formation and internal integration.

[36] See Rao (1989) for a detailed critique of the urban bias thesis and an alternative analysis of the allocative, distributive and growth impacts of agricultural price and fiscal policies.

difficulty is that it does not differentiate the structural circumstances that have produced varying degrees of success from a broadly similar policy package. The package is associated with major failures in Sub-Saharan Africa, success in East Asian development and lost opportunities in Latin America and South Asia.

In the latter regions, the failure to carry out land reforms kept `feudal' agrarian relations mostly intact while leaving large proportions of the population, urban <u>and</u> rural, vulnerable to high food prices. The state was unable to tax concentrated rural incomes and property and had to compensate through commodity price and tax policies. At the same time, vigorous promotion of agricultural development was resisted by landlord interests for fear of being dynamically squeezed by falling terms of trade. This in turn limited the growth of the home demand for industry which could have come from rising non-food expenditure by both rural and urban workers. By contrast, early East Asian land reforms eliminated landlordism and left the state free to squeeze out agricultural rents through terms of trade and other policies without food output growth itself being held back. Apart from land reforms, the early shift from agricultural to manufacturing exports facilitated and required an industrial growth process based on productivity increases. In Latin America, the availability of cheap food imports and the incentives for raising export commodities on large estates delayed a shift away from a "vent-for-surplus" model of growth.

The case for "urban bias" would appear to be on firmer footing in Sub-Saharan Africa. The relative abundance of land and absence of feudal structures on the one hand and the burgeoning formal sectors of well-paid government and industrial employment on the other lend credence to the notion that interest conflict revolves mainly around the rural/urban axis. But there are other structural factors that seem at least as important. African nations' greater and continued dependence on a few cash crop exports left their economies among the most vulnerable externally. Living standards and production capabilities have suffered from the multiple onslaughts of the debt crisis, terms of trade losses and declining competitiveness arising from an extremely fragile import capacity (Shaw and Inegbedion, 1994). Superpower rivalry overlaid on arbitrary political divisions inherited from the colonial era have fractured Africa's young polities. Coupled with many ethnic divisions and the lack of democratic participation, this has not merely limited the state's ability to resolve conflict but wounded the process of modern state formation itself. Urban bias (together with development failure) emerges more as a fallout of these structural constraints than as the prime mover of rural or economy-wide stagnation.

State finance in poor countries is the focal point - both as source and destination - of many of the dilemmas and conflicts posed by development. Fiscal mobilization is hostage to conflicts of interest arising from inequalities and from a weakly developed state apparatus. Though much is made of the influence of tax rates on tax compliance, lax enforcement allows ample scope for evasion of both direct and indirect taxes whatever the rates. Most taxable incomes in the informal sectors simply escape the tax net, agricultural incomes and wealth are typically exempt from taxes, and corporations and the well-to-do in the formal sector get away with legal concessions and artful subterfuge. Official corruption imposes its own tax on the state's rightful take. Taxation in poor countries has modern designs but pre-modern machinery. Not surprisingly, real reform to make the machinery effective meets stiff opposition. On the fiscal expenditure side, a similar alliance of private contractor and official interests takes its cut by overstating expenditure and eluding quality requirements.

The conflict of interests between haves and have-nots affects not merely the outcome of growth but also growth itself. These effects play out through both markets and government policy.[37] Trickle-down theory, which is the basis of policies of liberalization, takes conflict between growth and equitable outcomes to be axiomatic. Inequality is alleged to promote faster growth by providing incentives for elite savings, effort and enterprise: for the rest, this is supposed to mean gains in future employment and consumption that more than compensate for the current sacrifice. This argument is employed to justify low taxes, low wages and labour repression. Policies to utilize surplus labour by promoting labour-intensive techniques are viewed as detracting from profits and saving. Public spending or subsides for health, education, employment, food consumption, social security and poverty alleviation programs are also considered inimical to growth. On the other hand, expenditures on defense and on the repressive apparatus of the state, tax give-aways and public sector employment for the middle class are overlooked as areas where fiscal economies might be effected and savings raised.

The poor, the unemployed and the marginalized, who bear the current burden of such policies, all too often find that the future never arrives. In many countries, these top-down growth policies have failed to overcome serious problems of low life expectancy, poor health, illiteracy or even low private purchasing power. Meanwhile, the increased inequality of wealth that they promote and the wider participation of people that they inhibit frequently detract from growth itself. Nor have they always yielded political liberation from diverse sources of oppression. Trickle-down growth also delays the demographic transition, shrinks the resources available for subsistence activities and engenders environmental degradation from above and below (Rao, 1995b).

If local development effort under the cloak of state direction and external protection is riven with conflict, the process of liberalization and globalization can hardly be otherwise. Attempts at liberalizing domestic economies and integrating them with world markets impose costs on some groups while benefiting others; hence they pose political problems. In many countries, political resistance to integration has been overcome only because of political and economic pressure from the outside. Structural adjustment with proliferating conditionalities (trade and financial liberalization, devaluation, deregulation, privatization and cuts in public investment and social sector outlays) has sought to reduce national autonomy. Nevertheless, market-oriented reforms have remained incomplete in many cases because they face inherent economic barriers or because the transition has run into rough weather. More to the point, global integration is apt to be stymied or reversed by national political projects. In Sub-Saharan African countries, for example, which have had to bear the brunt of structural adjustment programmes, a reviving civil society is making demands for new forms of local, national and continental self-reliance (Shaw and Inegbedion, 1994).

The redistributive effects of trade liberalization in the South weigh much more heavily than any gains from trade that might ensue. Even within neoclassical trade theory, when trade arises from factor endowment differences, some factors gain while others must lose absolutely. A great deal of trade between North and South still remains complementary (with specialization predicted by comparative advantage). The call for trade liberalization in the North does not resonate in the South. Whereas the North derives benefits in the form of variety and lower costs from the dominance of intra-industry trade, inter-industry specialization in the South produces only negligible net gains but large redistributions. But the net effect also turns negative once structural asymmetry is recognized.

[37] Adverse effects on growth here must be distinguished from the costs of rent-seeking in neoclassical political economy. In the latter, rents are secured through government policy but dissipated in the very process of seeking the rents. By contrast, the adverse growth effects referred to here obtain when the rents produced by counter-productive policies are captured and conserved for the interested parties.

Liberalizing agricultural prices, for example, will produce large real transfers from poor consumers (for whom food is the overwhelming part of private expenditure) to agricultural rentiers and traders.[38] With the South as a whole under compulsion to get its agricultural prices "right", this will also produce a net transfer of resources to the North. These effects are apart from the permanent increase in the variability of producer prices and export earnings that openness entails and from the transitory costs of de-industrialization and unemployment that adjustment requires.

Although financial repression serves local development by channeling scarce credit at low rates to priority sectors, it also engenders special interests. Credit subsidies accrue especially to those who gain access to government-owned or -regulated commercial and development banks. These are mostly large enterprises in the formal sector. The subsidy is a transfer from wealth-holders who make deposits into these banks. While repression promotes formal sector investment and overall growth, it may also have deleterious effects on informal investment and overall employment. Internal financial liberalization, by discouraging formal investment, may well reduce informal interest rates and thus help informal sector investments, which are normally excluded from the formal financial system. Since the capital-labor ratio tends to be considerably smaller in the excluded sectors, overall employment is also promoted as a consequence (Rao, 1995c). To the extent that high informal interest rates are induced by regulation or repression, the non-wage share in the informal sectors is raised and so is income inequality. Conflict between present and future generations is therefore correlated with the conflict between haves and have-nots.[39]

External financial integration, for which internal liberalization is necessary, also has strong political implications. The likely constraint on finance for infrastructure and human capital investment, and the cutbacks in food subsidies and social security expenditures entailed, will hurt mass incomes and employment expansion. On the other hand, higher interest rates chiefly increase rentier incomes while the beneficiaries of any capital inflow, including FDI, will be rich consumers and high-skill workers.[40] Even under conditions of a labour surplus and internationally immobile labour, wage relativities are not immune to globalization. The demand for skilled workers may grow faster than general labour demand if trade and financial liberalization serve to expand skill-intensive low or intermediate technology industry. A relative expansion of skilled employment and a rise in skilled workers' wages may also feed domestic demand and investment in the skill-intensive sectors in a spiral that deepens wage inequality. Meanwhile, the aforementioned retrenchment and cutbacks will make it more difficult for the equitable distribution of such employment opportunities. The burden of increased fragility produced by liberalization and openness will also rest disproportionately on the general mass of workers, whether employed or underemployed.

[38] Higher agricultural prices will also lower the real wage of labour to the extent that agricultural (food and raw material) goods figure heavily in labour's consumption bundle even though agriculture is labour-intensive. `Peasants', on the other hand, gain as owners of land but may lose as food consumers or labour suppliers.

[39] An earlier literature argued that, with surplus labour at an institutionally fixed wage, the inability to tax wages prevents the choice of maximally labour-intensive techniques and the direct optimization of *saving*. Instead, saving is optimized indirectly by promoting and subsidizing techniques that are labour-intensive relative to the market-governed ones (Marglin, 1976 and Sen, 1968). In the present argument, it is the market's failure to capture *dynamic productivity gains* that prompts intervention in the form of taxing savers for the benefit of investment in dynamic sectors. With saving determined by the needs of investment in the subsidized sectors, the intervention actually raises overall saving but promotes techniques that are capital-intensive relative to the unregulated sector.

[40] Haggard and Maxfield (1993) discuss the politics of financial integration based on several cases studies from North and South.

The central point of the above discussion is that policies are endogenous. Markets and production systems are sustained by policy interventions which are not neutral to varied interests within the economy. In turn, changing markets and production structures drive political evolution. Policy endogeneity does not, however, rule out a role for democratic determination, structural shifts or ideological innovation.[41] But unless the endogenous political forces are understood, the possibilities of meaningful and effective reforms cannot be delineated. Contrary to neoclassical suppositions, the market system cannot be disembedded from society. Market integration is a solved political problem neither in its foundation nor in its ongoing transformation.

These propositions continue to hold in the global arena with one important difference: the virtual absence of global institutions analogous to the nation state. This has two implications. First, as the focal point of political conflict, the nation state's legitimacy hinges on its ability to resolve such conflict. But globalization dilutes its power to do so. At the same time, however, globalization strengthens the hand of those who will gain, which can be especially damaging in the South. Second, the global market transmits influences into participant nations which may not be in the interest of any of them. Attempts to resolve such anarchic tendencies create new arenas of political conflict in which nation states remain the key actors and which require institutional solutions transcending the market. While the model of hegemony in which the dominant nation state ensured coordination by means of its economic and military power and by securing a measure of consent from other states appears to have been superseded, it has not been replaced by any coherent alternative. At the present moment at least, the anarchic potential is being increasingly realized; the fulfillment of the particular interests of the Southern have-nots and of democracy generally are in greater jeopardy than ever before. Areas of international conflict may be conveniently discussed under three heads: macroeconomic coordination, markets and standards.

The growth in globalized market transactions has not taken shape within the institutional framework which was established immediately after World War II. The imperative of competitiveness together with global economic crises, has rendered macro policy coordination more difficult and the failure of the wealthy nations in this respect more destructive. In the liberal view, labour cannot lose everywhere under globalization, even though this is fundamentally driven by the increased mobility of capital in a world of essentially immobile labour. In fact, however, the impact has been anything but distributionally neutral. Worldwide crisis and deflationary bias have limited global gains while producing asymmetric losses among nations and between capital and labour. Capital mobility makes national policy financially orthodox and even austerity-oriented. Within such an environment, the "discipline of states" by a global financial order that neo-liberals applaud does not translate into a symmetric discipline of capital and labour. As capital seeks wage concessions from workers worldwide, the deflationary bias of policies is reinforced by the global market.

The disciplining of states promotes market-seeking in passive and capital-friendly forms rather than the activist or regulatory forms of mercantilism, reflecting continuing unemployment in both North and South and the failure of global institutions to evolve. This is displayed quite clearly in the unilateral dismantling of capital controls. With cooperative controls having been effectively vetoed by the United States in the 1970s and 1980s, other OECD nations followed the United States lead in removing capital and exchange controls in a scramble to find a niche in the financial markets and for fear of otherwise losing footloose financial business and capital to the free centres in New York or London (Helleiner, 1993).

[41] Nor should interests be narrowly construed either in material or egoistic terms.

Not surprisingly, the commitment to trade liberalization in the North has remained shaky and suspect. Illiberal policies had been pursued in the North to cater to particular national interests even where, or especially when, Southern interests were liable to be damaged reflecting the importance of inter-industry exchange in North-South trade. The pursuit of the Common Agricultural Policy in the Economic Union turned self-sufficiency into subsidized food exports and rendered agriculture less profitable in the periphery. The latest GATT accord phases out the Multi-Fibre Arrangement which imposed quotas of textile imports from the periphery, but only over a ten-year period. The proposal in 1982 to include trade in services as an element for GATT negotiation drew widespread opposition from third world states including India, Brazil and Egypt. Yet, ten years later, this opposition had completely evaporated. Sound arguments, from the Southern view, that had been made for protecting their immature service industries were abandoned in the changed climate of the 1990s. In India, a leader in the earlier opposition, changes in material conditions (external and internal debt crises), social forces (the growing consumerism of the middle class) and policy shifts (towards liberalization) during the 1980s and early 1990s all helped shape the *volte face* (McDowell, 1994). Similarly, all discussion of regulating the brain drain from the less developed to the developed nations has ceased while new anti-immigration moves (aimed primarily against the unskilled) continue to grow in the North. The loss of mostly publicly-subsidized investment that the drain represents for the South provides added reason for fiscally-strapped states to dismantle investment in the tertiary sector of education (Griffin and Khan, 1993).

The drive for competitiveness in a globalized economy has heightened international conflict over *standards* in such areas as labour relations and the workplace, the relations between trans-national corporations and nations and environmental impacts. Tensions have emerged between globalized capital and national interests. Concern about fraud in global securities markets, the security of banks, the unruliness of exchange markets, the lack of standards in telecommunications, safety, health and environment has grown apace. Some of these areas are clearly beyond the control of individual nation-states; attempts at control can only damage whatever benefits they may derive from the operation of the relevant enterprises or resource flows. In regard to trans-national enterprises, even the assignment of profits to subsidiaries or other nodes in their international networks, is resolved internally and must therefore reflect the powers and interests of its managers, an arbitrary element that has significant implications for taxation and other policies (Vernon, 1993). Competition for foreign capital in the form of lowered tax rates and other forms of fiscal concessions must follow with particularly adverse effects in the South.

In the North, where intra-industry trade among similar countries predominates, low-wage competition from the South nevertheless remains a serious and growing threat to aggregate employment even if not to competitiveness in the lead sectors or to overall productivity growth. Political repression in the NICs has served to maintain both wage growth behind productivity growth and low workplace standards. The relocation of labour-intensive processes has been a factor in widening income inequalities and in the growing assault on the Keynesian welfare state in the North. Competition in labour standards (including wages) may also help to undermine cooperation between workers and employers: the short-term gains secured will erode the "negotiated involvement" that alone can secure durable productivity-based gains (Lipietz, 1995).

The development of the *maquiladora* zone of export-oriented industries on the US-Mexico border, though fueled above all by low wages in Mexico, has also benefited from the "neglect of corporate social obligations" in the form of tax concessions (which undermine the capacity to provide public goods), dangerous working conditions, the use of child labour and the degradation of the surrounding environment (Greider, 1993: p. 325). Wages in the North have fallen due to the decline of well-paid industrial jobs; wages in Mexico, because of the inability of public action to maintain minimum wages and other conditions of work under the twin pressures of repaying global debts and reducing domestic fiscal deficits.

Conflicts over labour and environmental standards have centreed on the North-South divide. In regard to the environment, the South has asserted the following principles: (1) pollution sinks to be assigned taking into account past emissions: full rather than marginal pro rata shares requires major reductions in the North only; (2) national autonomy to exploit natural resources unless financially compensated; (3) compensations and subsidies to be controlled by full representation of the South nations (Glover, 1994). In recent years, Trade-Restricting Environmental Measures have grown to include eco-labeling, bans on the use of tropical timber in municipal construction (in Germany) and the like. The inclusion of environmental issues in the agenda of the World Trade Organization (WTO) "despite the near unanimous opinion among environmental groups that liberalisation of global trade would itself be ecologically damaging" is seen as a generalization of the present misuse of such issues to protect the trade interests of the industrialized nations (Sahai, 1995). Environmental standards may be enforced internationally through trade measures for example; but besides requiring micro-management of the particular standards concerned, such measures impose enormous monitoring costs in developing countries where producers (leather tanneries or peasants or small manufactories) are numerous and dispersed.

The linking of labour standards, as defined by the ILO conventions, with international trade was unanimously rejected by developing countries in early 1995. Following this rejection, the WTO has decided to temporarily delink the social clause from trade. The ILO conventions include freedom of association, right to organize and bargain collectively, prohibition of child labour, non-discrimination in employment, equal pay for men and women and freedom from forced labour. Although most developing country states have endorsed these conventions, they are very far from implementing and enforcing them. Many countries, including some in the North, have also rejected the new proposed convention regarding home-based workers (Bhowmik, 1995).

At least *prima facie*, the international conflict over standards is not over markets but over the social and external effects of production arrangements; not about market ends (the volume and value of goods produced and sold through freely entered contracts) but about social ends (enforced through the collective regulation of such contracts). What the market treats purely as means, society sometimes chooses to treat as ends. The social embedding of markets within a national context involves state or other collective action to enact norms or standards for regulating markets. Absent the wherewithal for similar action in a globalized economy, the increasing mobility of capital is capable of producing a kind of Gresham's Law whereby socially acceptable standards are driven out by the sole criterion of cost advantage; or rather, standards are reduced to the internationally lowest common denominator by that criterion. This is effected through the actual or threatened relocation of production: thus, either capital will move to where costs (including those pertaining to local standards) are lowest or national standards are lowered to sustain competitiveness.

However, given income and production asymmetries among nations, this Law of the Lowest Common Standards, like the Law of One Price, is apt to have asymmetric effects between rich and poor nations and to be politically resisted. Indeed, if prices of goods and factors actually converge, then, it might be argued that standards would regress not to the minimum across nations but to the mean unless social preferences regarding standards vary across nations even with identical material living standards. But while the competition in standards is itself a force for convergence (after all, the poor nations cannot catch up overnight through learning and productivity improvements but they can certainly seek to catch up through lowered standards), it is probably considerably weaker than the forces of localization and divergence discussed in section 3. A divergence in standards is therefore to be expected.

This is not to say that the competition in standards will have no effects; nor to say that it will not be resisted in other ways. With their higher incomes and generally higher standards, Northern nations will seek to maintain their social and environmental standards without losing competitiveness by (a) specializing in industries where those standards are a smaller element in competitiveness; (b) accepting lower incomes or employment levels; and (c) pushing for internationally regulated standards closer to their own levels. They may also lower their standards of course. It does not follow, however, that the responses in the South will be the exact opposite of these Northern responses. To be sure, economic diversification in the South will be facilitated by maintaining low standards or lowering them further and thus serve to raise incomes and employment. Internationally imposed improvements in standards will also be resisted. But social and political counter-resistance to such actions has also gathered pace in the South.

Conflict over international standards is not alleviated by the suspicion and mistrust generated by competition in global markets. Empirically, it is difficult to draw a line of distinction between a Northern concern for Southern workers' rights or for environmental quality from disguised mercantilism (the erection of subtle non-tariff barriers including imposed standards to weaken competition from the South). Politically, structural adjustment programmes that have elevated openness in trade and finance virtually to the position of an all-consuming end have strengthened export interests which, together with the calls for state minimalism, are important factors opposing the indigenous demands for enforcing standards within the South.[42]

4.3 Choices

Though the world economy provides valuable opportunities for economic development in the South, poor nations cannot realize their full development potential by giving free rein to internal and external markets. Productivity growth based on increasing returns and external economies is, for the most part, a local process. Exploiting this potential requires extending the domestic market through public investments in infrastructure, modernizing state institutions, developing human resources and creating incentives for workers, enterprises and public institutions to cooperate in a process of learning and adaptation to imported technologies.

Internal markets do not provide an adequate mechanism of coordination and incentives to effect these tasks. Market failures arising from wealth-related inequalities, externalities, information asymmetries and the paucity of infrastructure have to be remedied through an appropriate choice of policy interventions in markets, institutional design and direct public action.

Opening up the economy to external market forces is not the optimal route to promoting local development processes as this will not remedy the aforementioned internal market failures but, on the contrary, will jeopardize the policy, institutional and direct actions required. Nor is unrestrained globalization the avenue for making the best use of global market opportunities. Global markets remain fragmented with their weakest links being in the South. Attempts to

[42] The defense of "cultural" specificity has, in this context, served as a new subterfuge for the violation of human rights or workers' rights while the long-established double standards in applying rights clauses or boycotts continue.

freely integrate weak local economies with the global economy will increase their internal disintegration and external fragility. Openness also detracts from the ability of states to pursue locally appropriate policies for equity, poverty alleviation and conflict resolution. National autonomy is functional in the South for both productive and distributive purposes. In purely economic terms, therefore, the projects of national integration and national development must, as in the past, continue to precede the project of globalization.

The quality of public interventions and participation is fundamental to the realization of any of these possibilities. But this depends on the political compromises, consensus or conflicts that a society inherits or has to contend with i.e., on the structure of interests. While a society may not be free to choose the sort of state or other public institutions it will have, the desiderata of good politics (in effect of valuable structures) seem quite clear. A basic requirement for an inclusive and participatory regime of development is democracy. But formal democracy is insufficient. The biased representation of interests and implementation of policies that must inhere in unequal societies with both political and economic power heavily concentrated, cannot be remedied by voting alone. A broadly egalitarian distribution of wealth, effective decentralization of public (including state) decisions and their implementation, and agile mechanisms for the accountability of such concentrations of public and private control as remain provide the most complete set of sufficient conditions for human development.[43]

In most poor countries, stepping up domestic capital accumulation is a key priority. However, this is not just a matter of tapping sources of saving; the inducement to invest may be held back through a lack of factors complementary to directly productive capital or access to finance or insufficient demand. Both structural factors and desirable policies (as discussed below) render investment dependent on the strength of the home market. For the modern industrial sector, the strength of demand from the rural hinterland (typically infrastructure-limited) and from the informal sector (typically finance-constrained) is often more important than demand from its own incomes. Hence, public investment in supply-constrained sectors and channeling credit to finance-constrained sectors can relieve both supply and demand bottlenecks simultaneously and boost industrial investment and growth (Rao, 1993 and 1995c).[44]

This said, it is still necessary to know the conditions of saving supply and the mechanisms of its allocation. Is financial liberalization likely to promote saving and improve investment quality? Is financial openness desirable to increase financing for investment? Following the discussion in section 3.5, financial openness (for which internal liberalization is necessary) promises little benefit and potentially large losses in terms of both development and autonomy. Given market fragmentation, there is no assurance that openness will deliver either more finance or more financial stability. Countries that have good policies and, more important, good performance are rewarded by the international capital markets; those that do not are not. FDI flows largely to LDCs which have high rates of domestic saving anyway. The mere removal of barriers to its flow does not appear to make much difference to the rather perverse pattern of global flows. That is, foreign finance follows development. The fast-

[43] This is not to say that authoritarian alternatives are non-existent. Indeed, authoritarian but socially inclusive regimes appear to provide the most successful instances of late industrialization. But inclusiveness under modern authoritarianism is rare indeed. By contrast, democratic polities seem to have a better chance of achieving a broad-based economic regime. At any rate, viewing regime types merely as alternative means for achieving arbitrarily defined ends such as industrial competitiveness is unwarranted.

[44] The view of wages solely as an element of cost and the neglect of the rural-urban demand nexus is only encouraged by the obsession with competitiveness in a globalized setting, often taken to mean perfectly elastic global demand.

growing developing economies all managed to achieve high rates of domestic saving and investment without notably liberalizing or opening up their financial systems.

Nor will openness ensure that local priorities are met. In the absence of fiscal constraints, globalization need not imperil *local* development, equitable distribution or macroeconomic stability. Yet, fiscal capacity tends to be inherently weak relative to the demands placed upon it. This forces a heavy reliance on proxies for strong fiscal policies, which directly conflict with globalization. So long as the fiscal take remains inadequate to meet development priorities, the trade balance remains fragile owing to volatile export earnings and inelastic import requirements, and the means to ensure price stability are limited to monetary controls, capital controls must remain in place. Fiscal weakness is rooted in the political and economic structures of these economies while development demands go unmet by fractured financial markets. Besides a bureaucracy with high levels of competence and honesty, strong public finances will require structural reforms or already high levels of income (or both). Reducing trade vulnerability requires an adequate industrial or other non-traditional export base, which cannot be established unless the country has already reached a threshold level of development. But if the state is deficit-prone, domestic financial regulation (or `repression') becomes essential for inflation to be tolerable. At the same time, without the resolution of the deep-seated development constraints, low-income economies in the South can scarcely afford to weather the storms that capital account liberalization must inevitably produce. Indeed, without steady and stable development of the home market, periodic capital flight cannot be stemmed. Contrary therefore to the neo-liberal mantras of liberalization and globalization, repression and capital controls become mutually supportive. A financial playing field that is level is not the basis but the result of development success. None of this is an argument for relaxing fiscal effort. Indeed, the best policy for the private financial system is high fiscal effort which will also permit borrowing from abroad to finance the `life-cycle bulge' of public investment.

Apart from the macroeconomic framework, selective credit policies can serve as a powerful device to correct for specific market failures and for the strategic direction of development. Deregulation, in the orthodox view, is aimed at widening access to finance throughout the economy, increasing the competition for finance and promoting efficient intermediation and greater capital mobility. Wider access to finance is predicted to have a major impact on the capital intensity of development by permitting labour-intensive but capital-starved firms, that have hitherto been excluded from the formal financial system, to grow rapidly. But unequal access to finance is not an artefact of regulatory constraints alone. The segmentation and fragmentation of financial markets are largely the product of technological and organizational differentiation of enterprises and sectors typical of late industrialization, and exacerbated by inequalities of wealth (Rao, 1995a). Liberalization, under the circumstances, may well contribute to a further deepening of unequal access by pulling even more resources into the formal financial and real sectors.[45]

The mobilization of a rural surplus for investment and the expansion of the rural market, characteristic of the early stages of East Asian development, require the reorganization and restructuring of the agrarian economy. Apart from land reform (giving the land to the tiller), local cooperative institutions to create and manage productive infrastructure, supply credit, purchase inputs and market outputs will facilitate increases in rural productivity. The

[45] Deregulation also risks diverting resources to unproductive and speculative uses. Strict restraints on funds allocation, over and above those required for maintaining prudential norms, are required to hold this tendency in check.

relationship between town and country must be viewed in dynamic terms - ensuring that agriculture is not squeezed to the point that it stagnates is critical for generating dynamic growth of both internal savings and of the home market.

Financing local public investment can also be efficiently arranged by impositions on tradable goods particularly when user charges are either difficult to collect or will cripple demand for externality-producing services. Liberalizing food prices can be costly in distributive and productive terms. A crucial component of food security, especially in a fiscal context of declining food subsidies, is keeping the price of foodgrains low. This, however, is not incompatible with sustaining incentives for farmers. But the latter is ensured not by a high output price but by cost-reducing, yield-raising technologies that enable farmers to improve their income terms of trade along with a reduction in real food prices. In other words, a double distortion of prices is needed with input subsidies on the one hand and low output prices on the other.

Economic development hinges crucially on improving the *utilization* of resources that are accumulated and allocated. Apart from dynamic external economies, productivity growth under late industrialization accrues largely from improved learning and from scale economies. In other words, growth involves moving from low levels of utilization of mostly purchased technologies to high levels rather than developing new technologies or new products. The exploitation of this potential is by no means automatically assured by accumulation and allocation. Nor is it simply the product of coordination by domestic and external market signals. East Asian success, for example, came from the combination of (1) an interventionist state which frequently got the prices wrong and intervened heavily in resource allocation, but disciplined enterprises to move continuously up the learning curve; and (2) technologically diversified conglomerate-type of industrial enterprise (Amsden, Kochanowicz and Taylor, 1994). Failures in this respect account for the slow advance of productivity in many less developed countries despite the mobilization of capital and foreign technologies.

Cooperation in production is crucial to effective resource utilization. The learning and adaptation process is a social one which is not promoted by state repression of labour, managerial authoritarianism within the enterprise or conflict-prone industrial relations at the firm or industry levels. A contented and secure workforce and cumulative productivity growth are not mutually antithetical: as argued in section 3.3, learning embodied in labour is a central instance of localized development. Nor are they inherently incompatible with enterprises' ability to respond quickly and flexibly to market changes. In the dynamic sectors of industry with a few large firms in each industry, indeed with large industrial combines of the East Asian type, and relatively secure product markets, "flexible rigidities" combining job security and dynamically responsive production systems promote growth while rapid growth facilitates rent-sharing between firms and their workers. Job security appears as an obstacle to efficiency most when firms are atomized, labour regime norms - whether spontaneous or legally enforced - are suppressed and the employment relationship becomes a pure commodity transaction.

Unfortunately, the rhetoric of liberalization limits labour regime restructuring to the demand for a submissive and easily dispensable workforce without the protection of legislation or collective action and subject to the arbitrary rule of management prerogatives. `Flexibility' in this sense may provide short-term gains but, by sacrificing job security and commitment within enterprises, it erodes the gains that come from learning. Unbridled competition from external trade is liable to disrupt industrial relations with damaging effects on utilization.

Labor regimes also affect economic performance through their impact on the relative importance of the formal and informal sectors of production.[46] The persistence of dualism and the widely prevalent employment lag in the formal sector are both related to the trajectory of late industrialization, caught between competition based on cheap labour from the informal sector on the one hand and a tenacious technology and utilization lag in relation to industrialized countries on the other. By and large, the scope for productivity growth is significantly more limited within the informal sector than in the formal sector. The implementation of minimum wage laws and of the ILO's labour conventions in the formal and informal sectors is necessary not merely to improve worker well-being and prevent exploitation but also to ensure that the learning process is promoted. Tighter implementation of labour standards obliges firms not to take the path of `flexibility' and cheap labour and hence permits the formal sector to expand at the expense of the informal.[47] An essentially unregulated labour market, to the extent that any real world labour market approximates this liberal ideal, also exerts a powerful downward pressure on wages, demand and hence accumulation.

Whereas the search for alternative paradigms of work and industrial organization in industrialized countries is driven by the saturation of growth potential of the Fordist model, in poor countries it is not the exhaustion of Fordist potentials but their frustration that appears to have held back growth. Market liberalization does little to address this frustration. At best, it increases the scope for changing the mix between Fordist mass production on the one hand and, on the other, informal and small-scale modes thriving on cheap labour. There is need and scope for shaping new labour relations and forms of work organization that maximize utilization. Apart from persisting with the Fordist or Taylorist model of mass production, new organizations based on the development of cooperative networks of small enterprises in "industrial districts" would enable developing countries to combine high employment with productivity growth (Rao, 1995a).

The orthodox theoretical arguments for the static gains from trade and non-interventionism, as pointed out in section 3.2, can hardly support the fundamentalist position for trade liberalization. The evidence linking openness with dynamic gains is also heavily disputed. Apart from the usual benefit of allocative efficiency, export orientation is alleged to be decisively more advantageous than import substitution in capturing learning and external economies. But empirical attempts to verify `externality' benefits from exports have been mostly unsuccessful.

The putative gains from improved resource allocation boil down in practice to the advantage of specialization based on cheap labour. While liberalization in a low-wage economy may allow a nation a temporary advantage in gaining entry into tight export markets, such a policy cannot secure dynamic gains in productivity, especially in high-value-added products. There is little reason to believe that the industries or enterprises that have the most learning potential will also be the ones that a liberalized trade regime will favor; that, in other words, competitive and comparative advantage will coincide. The concentration of non-traditional exports in a few Southern countries despite their relatively higher wages than other less-developed countries is not explained just by specialization in labour-intensive industries

[46] This argument is developed for the Indian case in Rao (1995d).

[47] For example, legal labour standards are similar in both Costa Rica and the Dominican Republic while implementation is effective in the former and lax in the latter. Yet, the informal sector is significantly smaller and overall economic performance better in Costa Rica than in the Dominican Republic.

with mature technologies. It is explained instead by their success in achieving high utilization through learning both in production and in market penetration efforts.

Foreign trade presents opportunities as well as constraints for steady growth. Foreign exchange bottlenecks hurt both resource accumulation and utilization. Avoiding these ought to be a primary aim of trade and macro policy. In small countries, scale economies in operating many modern industries coupled with the limited size of the home markets favor an early push into export growth. But such economies warrant openness or export orientation only if they are specific to industries rather than to the whole economy. In fact, selectivity and protection may both be required to capture such economies, even when they are industry-specific: the one to ensure that resources are not spread too thinly and the other to provide the initial market to develop the growth momentum.

The value of avoiding foreign exchange constraints and the opportunities of export orientation also justify intra-South trade on a preferential basis. Global import substitution within the South is beneficial just as intra-North intra-industry trade is, though the source of the benefit is not the same. Generalized overvaluation in developing countries together with intra-South preferences is a strategy for diversification away from traditional goods while rationing foreign exchange for the import of capital goods for industrialization. It will also help improve the terms of trade for LDCs.

While autonomous development in Southern countries, both severally and jointly, remains valuable, the need for collective action for Southern interests in particular and for the joint interests of all nations has grown in a globalizing world. Globalization has increased the scope for damaging forms of competition which also circumscribe autonomy. A South-oriented "working international order" must fulfill four key functions: (1) a centre that generates balance of payments surpluses to sustain deficits in the periphery; (2) financial institutions that can convert surpluses into loans and investments and the centre as a lender of last resort; (3) the development of industrial and technological capacity to produce capital and intermediate goods for industrialization; and (4) strong military power to enforce contracts and keep the peace (Streeten, 1995). In a multi-polar world, these conditions are best secured in a pluralistic rather than a hegemonistic framework to avoid the undersupply of global public goods (financial stability for example) and the oversupply of global public bads (competitive lowering of social and environmental standards for instance). As much as the nation state is a critical element for industrial growth and human development in the third world, unabridged sovereignty, North and South, has nonetheless become an obstacle to a better world.

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