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THE WORLD ECONOMY: THE CRISIS IN FINANCIAL MARKETS AND THE RISK OF A GLOBAL DEPRESSION

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THE WORLD ECONOMY: THE CRISIS OF FINANCIAL MARKETS AND THE RISK OF A GLOBAL DEPRESSION

S. Sideri*

'Fin de fiesta....
nasce y destrye el ritmo y continúa:
la verdad es amargo movimiento'
P. Neruda, Obras Completas, vol. II, p.435, 1968, Losada, Buenos Aires

'...for the world economy to be stabilized, there has to be
a stabilizer, one stabilizer'
C.P. Kindleberger, The World in Depression 1929-1939, p. 305, 1973,
Allen Lane, The Penguin Press, London

ABSTRACT

The risk of a new Great Depression is greater now than at any time during the last two decades. Although the immediate cause of the risk is the Asian crisis, its deeper causes are rooted in the economic system that prevails in most countries and the related global network that increasingly embraces them all. The current globalisation was preceded by a similar phenomenon at the turn of the present century, a phenomenon that ended under the forces of growing inequality and destructive competition. Both cases of globalisation are characterised by fundamentally flawed banking systems: a series of financial panics in South America and Central Europe brought to an end the first, those in Asia and Russia are undermining the second. The identification and analysis of the process that has shaped the world economy and brought it to the present crossroad is essential for moving away from the brink of a new disaster. The main instruments to achieve this objective are found to be the state, and its revamped role, and regionalism.

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CONTENTS

1. INTRODUCTION

After some scares in mid-1997, it seemed that the financial turmoil in Asia was to miraculously spare Western financial markets which, paradoxically, continued to do very well up to the end of August 1998. Then came the deepening of Japan's outlook and the dramatic worsening of the Russian situation, whose devaluation of the rouble sent around tremors that started rocking even Latin America. It started to dawn on investors world-wide the extent of the exposure of Western financial institutions and the danger this posed for the continuous well-being of the West. Particularly vulnerable appeared European banks, heavily exposed in Asia and Eastern Europe. Finally, investors started abandoning stocks for the security of triple-A-rated government bonds from the USA, Germany and few other countries - a flight to quality.

The essay attempts to understand this situation and cast some light on its impact on the future. To do so it examines the formation and evolution of the world economy, some of whose main feature were shaped even before the beginning of the current century - beginning which is anyway hotly debated as it is the duration of the twentieth century[1]. The present surge of globalisation was preceded by a similar trend in the late 19th century. In both global economic forces have caused inequality, which in the early case certainly contributed to end it abruptly with WWI, followed by the reinstatement of strict trade protection and tight restrictions on capital movement.

Today anarchic market forces are brewing a series of interconnected crises that are dangerously pushing toward a world-wide crisis. Although the craving for re-imposing some form of control

[1] From the economic point of view the twentieth century starts with the Great Depression of 1873-1896 (whose beginnings Bairoch (1993:70), however, places in the period 1869-73), as argued by Arrighi [1994], rather than in 1914, as proposed by Hobsbawm [1994]. And this because Arrighi [1994: ix-x], following Braudel's *Capitalism and Civilization*, sees finance capital 'as a recurrent phenomenon which has marked the capitalist era from its earliest beginnings'. Therefore, 'financial expansions have signalled the transition from one regime of accumulation on a world scale to another' as they are 'integral aspects of the recurrent destruction of "old" regimes and the simultaneous creation of "new" ones'. The financial expansion of the late nineteenth and early twentieth century marked the destruction of the British regime and the creation of the American one, as the current financial expansion indicates the radical transformation of the latter into a new regime. As during the current one, that period was characterised by rapid growth and globalisation, plus economic convergence as poor countries caught up with rich ones [Williamson, 1997: 117]. Since that convergence appears seriously challenged by the Asian crisis, the process of globalisation may not be halted as it happened then. Consequently the end of the twentieth century would move after the year 1991 chosen by Hobsbawm as its closing date. If, instead, one chooses globalisation as the defining characteristic of this century, then 'for the beginning of a truly global economy, one might well choose 1869, the year in which both the Suez Canal and the Union Pacific railroad were completed [Krugman, 1995: 330]. But then the 20th century's end is not in sight yet. In case, however, the present crisis continues to deteriorate, then the 20th century runs from the late 19th century's Great Depression - as suggested by Arrighi - to the incoming global one.

on the current non-system[2] is growing, it is difficult to envisage how it can be possibly achieved without resurrecting a sense of solidarity and without taking into consideration some of the objectives identified by socialist thought. Paradoxically the challenge the socialist regimes represented for the West gave it scope for greater cohesion, for better co-ordination of its economic policies, and possibly even for achieving higher growth [Ciocca, 1998: 26]. International policy co-ordination is necessary so that countries can develop expansionary policies, avoiding those competitive currency depreciations that in the long run hurt everyone[3]. The end of the Cold War has introduced, instead, political uncertainty, instability and chaos in a vast area. By destroying 'the international system that had stabilized international relations for some forty years...it revealed the precariousness of the domestic political systems that had essentially rested on that stability' [Hobsbawm, 1994: 10].

After the present introduction, part 2 of the paper identifies the main features of the world economy - the issues discusses under this sections are the subject of a huge recent literature - and their relevance for the assessment of the present situation. Part 3 considers the causes of the Asian crisis and the consequences it may have on the present world economy and its evolution into the next century. Part 4 explores the risk of a global crisis and the future of the world economy. A concluding section ends the paper. The paper was finalised by the end of October 1998, a timing worth remembering considering the dramatic evolution that presently characterises the world situation.

2. MAIN FEATURES OF THE WORLD ECONOMY

With the benefit of hindsight, it is possible to identify several features of the world economy helpful for explaining its evolution and its future directions.

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[2] Hobsbwam [1994: 559] has argued that 'for the first time in two centuries, the world of the 1990s entirely lacked any international system or structure'.

[3] Krugman [1996: 169-70] instead maintains that expectations about international macroeconomic policy co-ordination are unrealistic since the conditions for it 'hardly ever' exist. A point this that has just found confirmation. As soon as the deputy finance ministers of the G-7 hinted at co-ordinated interest rates cuts to steady markets on September 14 1998, the German and French central banks denied that there was room to lower interest rates, and Greenspan, few day later, scoffed at the idea of co-ordination. Furthermore, and regardless of Clinton insistence on the need for co-ordination in his speech at the UN also on September 14, Greenspan reminded the world that 'our actions must be focused at the end of the day on the American economy'.

2.1. Economic Growth and International Trade

Undoubtedly the development of the world economy has lately generated substantial material progress[4], but the trend does not seem sustainable forever, and economic growth may have already started to slow down. Rapid economic growth materialised principally during the late 19th and early 20th century and during the post-WWII period up to the early 1970s when the globalisation drive was re-ignited and trade started growing rapidly[5]. Yet what makes this second period 'new' is not so much the higher trade-to-income ratios, but their being combined with the widening of the spectrum of goods and services entering international trade. In this second period, trade - whose growth 'simply reflects a recovery to levels achieved before World War I' – presents the following main characteristics [Krugman 1995: 361 and 332]. (i) Rise of intra-trade, that is trade in similar goods in similar countries; (ii) possibility of segmenting or fragmenting the production process into several geographically separated steps, which has caused an unprecedented intensive growth of trade and has allowed the emergence of both (iii) supertraders, that is countries with very high ratios of trade to GDP; and (iv) large exports of manufactured goods from low-wage to high-wage countries.

Both periods have been characterised by globalisation and rising inequalities in rich countries. According to Williamson [1997: 117-18, 125], before WWI globalisation accounted for more than half of the rising inequality in the rich countries, technology contributing about 40%. In the poor countries, instead, globalisation accounted for a little more than a quarter and technology about half of the decline in inequality in the poor countries. And more than trade, it was immigration that enhanced inequality in the rich countries. If the 'globalization-induced inequality trends help explain the retreat from globalization between 1913 and 1950' accomplished by the rich countries [Williamson, 1997: 130-31], then the redistributive effects caused by trade policy become even more important.

[4] Correctly we are reminded by Ayres [1998: 189] that 'economic growth has been a relatively episodic phenomenon in human history'. The rate of economic growth of the West is estimated by Maddison [1995: 20] at 0.4% per year from 1500 to 1700 and 0.5% per year in the 18th century during which only Great Britain achieved 1.0%. More interesting the case of the US economy that for over a century after the Civil War grew at a yearly rate of 3-4%, a rate made possible by a 2% increase of output per worker. Consequently real wage could double every 35 years: the 'two-per-cent solution' on which was built the American Dream. Since the early 1970s, however, the rate has slowed down by a full percentage point as the pace of labour productivity growth has more than halved.

[5] From 1870 to 1950 the annual growth rates of the 16 richest countries in the world averaged about 1.3%. During the period 1950-70 the rate jumped to about 3.6% per year, to decline since to about 2.2% [Maddison, 1995: 23 and 188]. The latter is considered barely able to keep employment levels constant.

If the defence of free trade rests upon the consideration given to 'the question of the fairness and legitimacy of the practices that generate these consequences', it is difficult to make popular trade that 'involves exchanges that clash with (and erode) prevailing social arrangements' [Rodrik, 1997: 6]. It is sustained that the rapid growth of trade cannot be attributed to the effects of technology without at the same time stressing 'political factors to at least an equal extent'. These factors are such as the role of the GATT, of unilateral liberalising measures by the South, and of initiatives aiming at integrating regional markets as Europe's 'Project 1992' [Krugman, 1995: 336 and 1939][6]. Furthermore since globalisation generates technological spillovers and associated externalities, it also rises the need for government intervention, that is for the reintroduction of trade barriers[7].

The slow down of growth rates in the North since the beginning of the 1970s has been variously explained. One explanation reflects the observation that, in general, the overall rate of economic growth tends to follow the decline of the manufacturing share of total output. Another is related to the fact that the service sector, broadly defined, does seem no longer able to absorb workers made redundant by automation in manufacturing [Ayres, 1998: 77 and 80]. Other explanations privilege the end of the post-war 'catch up', the impact of the oil price increase, the underestimation of productivity growth in the service sector, declining national saving and investment rates[8], too-high taxes (this being mainly the European case), wage stagnation, and persistent unemployment.

The slow down, however, may very well 'reflect a continuous shift of resources away from productive investment into social security and increased consumption by the elderly and unwell', a trend that in the future should become even more pronounced because of the apparent increase in capital depreciation. Consequently it is expected that 'a larger share of total investment must go into replacing depreciated capital, especially infrastructure'. Meanwhile, the

[6] Instead 'the level and rates of growth of growth of trade intensity have led to more rapid technological progress, with some additional effects from country size' [Helliwell, 1994: 266].

[7] This argument is rather different than Gray's [1998: 194] view that the end-result of the present wave of globalisation, driven by the world-wide spread of new technologies, is 'an anarchy of sovereign states, rival capitalisms and stateless zones'.

[8] In the OECD countries the gross saving rate as a percentage of GNP has changed from 23.3% in the period 1960-70 to 23.5 in 1971-80, to 20.2 in 1981-88. For these countries as a whole the average ratio of gross national saving to GNP fell by 3 percentage points between 1960-70 and 1981-88 while the decline of gross national investment relative to GNP was about 2 percentage points [Dean *et al.*, 1990]. The decline of saving rates has continued from 21.6% in 1990 to 21.0% in 1995 [World Bank, 1997: 238-39 Table 13].

cost of fossil fuels and other natural resources cannot continue to fall, and alternative technologies are bound to be more capital intensive.

The information technology has attracted much attention because it is creating fewer jobs in the industry itself than it is destroying in the other industries[9], the first time in history that technological change 'has become a major contributor to overall unemployment' [Ayres, 1998: 79-82 and 84][10]. Heilbroner [1996: 174-76] attributes this crucial change in technology to automation, which takes many forms but always needs 'much less directly applied labor' than required previously. 'Ceteris paribus automation is unemployment-generating', whereas most of the new jobs it creates are 'located at the top of the employment pyramid, not at the bottom'. Furthermore, automation presents a more limited capacity to create new second-order industries than earlier technological advances while, like computative technologies, is more easily transplanted abroad. Hence the 'penetrative' capacity of this technology 'explains much of the internationalization of production that has been such a destabilising element in our period'. Heilbroner also underlines that the enormous 'enlargement of the capacity to amass and transmit data' brought about by automation has created 'the basis on which rests the unified world financial markets. The ensuing financial globalisation has then helped undermine the effectiveness of national monetary policies, effectiveness earlier on made possible by the relative insulation of the economies concerned.

The communication revolution is also making increasingly evident the complementary of trade in goods and services, foreign investment, and factor flows. These variables can no longer be fully understood and treated as separate entities, hence rendering very hard for governments to conduct trade policy independently of domestic competition and regulatory policies. Meanwhile, as Feketekuty and Rogowsky [1996: 168-69] point out, the segmentation of production processes is causing products to lose their national identity.

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9 This thesis is maintained also by J. Rifkin in his *The End of Work* of 1994 and is supported by the fact that 'for each 1 per cent in GDP growth in the West, employment goes up by a meagre 0.1 per cent' [Ayres, 1998: 82]. This thesis differs from the standard explanation that job destruction through increasing labour productivity is really job creation through increasing demand. Interestingly, Schumpeter [1954: 684] sustained that Ricardo 'never clearly realized the *essential* fact about capitalist "machinery" is that it does what, quantitatively, could not be done at all without it or, to put it differently, that it "replaces" workmen who have never been borne'.

10 Different is the position of Eatwell [1996: 5 and 7] who believes that 'there is no evidence that the speed of technological change is behind the growth in unemployment throughout the G7'. Furthermore, it is not clear to what extent the failure of manufacturing to create jobs as in the past is due to the slowdown of demand or to a change in the relationship between the rate of growth of demand and the rate of technical progress.

More worrisome is the rising unemployment, particularly in Europe and particularly among the young - in the industrial countries more than 36 million people are jobless, 30% of them being aged 25 years or less - and declining or stable wages, mainly in the US, that have started accompanying economic growth. Both effects appear to be more pronounced where free-market economic policies have been more strictly followed; and both have not failed to produce greater inequalities within and between countries. And the evidence produced by Alesina and Perotti [1996] suggests that since income inequality within countries creates social discontent, it increases socio-political instability that, in turn, causes uncertainty in the politico-economic environment, hence it reduces investment.

The liberalisation of international trade and capital flows are bound to 'accentuate the asymmetry between groups that can cross international borders (either directly or indirectly, say through outsourcing) and those that cannot', most of the latter being unskilled and semiskilled workers, and middle managers. Their international immobility, together with the segmentation of production processes, reduce the demand for these workers and negatively affects their bargaining power. As a result, the wage premium widens while significantly grow 'labor-market instability and insecurity, finding expression in greater short-term volatility in earnings and hours worked and an increase in inequality within skill groups' [Rodrik, 1997: 11 and 16-225][11]. The overall result is not only lower wages and benefits, but also the fundamental transformation of the employment relationship as the demand for labour is rendered more elastic by the forces of globalisation. The latter affects labour markets in the North by reducing the demand for low-skilled labour and facilitating their substitution with other workers in different countries.

The performance of market economies is also challenged by demographic change. While in the developed world a key population trend is the growing proportion of the elderly, which will add to the critical need to reform the traditional welfare state, the developing world faces an enormous swelling in the younger age groups and the daunting tasks of generating jobs for them and increasing per capita income for its growing population.

It is estimated that before the world population stabilises there will be at least 3 billion more people on the planet, almost all of them in the developing countries[12]. The impact of this growth

[11] Rodrik [1997] ascribes to globalisation a more significantly negative impact on labour markets than do others, including Krugman [1995a] who thinks that 'international trade is a secondary factor in the growing inequality of wages, with technology probably the main culprit'.

[12] The Third World has insisted that population issues must be placed within a context that is concerned with social and economic development broadly conceived, resisting Northern initiatives aimed directly at individual citizens and their efforts to make population growth an international issue, together with the promulgation of new transnational values. As in the cases of basic human need and human rights, the

on poverty, protection of the environment and food production is enormous, considering also that presently more than 800 million people go hungry and 2 billion are malnourished. Undoubtedly the required increase in agricultural production will be certainly partly provided by the application of biological sciences, particularly the revolutionary manipulation of genes that it is making possible[13].

But there lies a crucial problem. According to Serageldin [1998: 52] - World Bank's vice president for special programmes - the scientific 'breakthroughs that are coming are for the first time driven by proprietary science'. The private sector is investing between 8 and 9 billion dollars a year in biotechnology and expects to recoup them with the protection of intellectual property. And intellectual property rights presently are being greatly enhanced, particularly at GATT's Uruguay Round[14]. It is remarkable that in a period of generalised liberalisation, 'all of a sudden we are witnessing a change in the rules of the game, where the best of science is no longer freely available because it is patented'. If this situation is not redressed proprietary science 'exacerbate[s] the gap between the haves and have nots, with the risk of creating a "scientific apartheid" in the next century'. The fact is that the global market for biotech products is already large and growing fast[15].

The more recent success of most developed countries in holding down inflation has been sufficient, however, to convince some that the North, or at least the USA, has entered an era in which traditional limits to economic expansion have become irrelevant. Business cycles can be discarded as 'one of history's barbarous relics'[16] [Gray, 1998: 197]. According to this so-called

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opposition of the South is due to the simple fact that these initiatives clearly encroach upon the recognised prerogatives of sovereignty [Krasner, 1985: 274-80].

[13] Genetic engineering is reconfiguring the DNA of agricultural produce in order to transfer traits between organisms and turn ordinary crops into extraordinary crops. In principle, this could boost yields, lessen reliance on toxic chemicals, prolong the shelf life of foods while improving their healthful qualities.

[14] Not only patent rights have been strengthened but also patent coverage is being constantly extended to include even business methods [*TE*, 15.08.1998: 52]. That multinational companies largely perform the diffusion of technology is indicated by the fact that more than 70% of all international royalties on technology, estimated at $48 billion, involve payments between parent firms and their foreign affiliates [UNCTAD, 1997: 20-21, Table 1.5].

[15] According to *Newsweek* [24.08.1998: 42] Britain's Department of Trade and Industry expects this market to surpass 100 billion dollars in two years time, the European Association for Bioindustries predicts that it should reach 285 billion dollars by the year 2005.

[16] The common explanation for the price stability, which seems to distinguish the American economy, is that growing international competition prevents companies from passing on increases in costs in higher prices. Yet some argue that costs themselves have increased less than one might have expected mainly because of a squeeze on worker benefits.

New Economy the adoption of the requirements of the 'Washington consensus'[17] has eliminated the fear of sudden crashes and long depressions[18] of the past. Yet the hidden productivity boom - that is a productivity growth much above the modest rate indicated by the official statistics for the previous two decades - assumed by the New Economy as the factor that should have been sustaining the US economy, 'remains purely hypothetical' [Krugman, 1998: 35]. Considering then the present crisis it seems that no many economic theories have had a shorter life!

Together with the growing inequalities, the too modest contribution of globalisation to the grave problem of unemployment in the Third World is causing, as it did during the previous era of international integration[19], mounting waves of migration towards the USA and Europe, where job markets are already tight. Among the various effects attributed to the inflow of low-skill immigrant workers there is that of sustaining low-wage productions, such as apparel in the USA. In the presence of trade substitutes from labour-rich countries, wages are effectively restrained firstly in the industry concerned and then, through the labour-market arbitrage, also in other industries [Leamer, 1996: 309]. In other words, not only low-wage areas attract jobs, but also send migrants to high-wage countries, thus further depressing the latter's wages. No wonder then that since 1990 practically all Northern countries have tightened immigration rules and the inflow of immigrants as percentage of the their populations has markedly declined [TE, November 1 1997: 97 Chart 2]. Since it is unlikely that the tightening of the rules is going to be very effective, it might be more useful to try long-term planning of these inflows according to levels of skill required by the Northern countries and immigrants' place of origin.

2.2. State and Marketplace

The relationship between state and market is a very well established topic to which, however, the collapse of the socialist regimes and the Asian crisis has given new life. Opposite opinions

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[17] The so-called Washington consensus involves ten different aspects of economic policy that Krugman [1995b: 29] has summarised in 'free markets and sound money'. Sachs [1998: 21], instead, refers to it as the 'phony Washington consensus on how to achieve shared prosperity'.

[18] Depression refers to a cumulative and uncontrolled process in which the contraction of consumption and investment over a prolonged period of time causes a decline of output, falling prices, depressed business confidence and widespread business failures and unemployment. A less severe form of business downturn is recession, that is a decline of real GNP lasting at least six months. In a recently published study (C. Dow, *Major Recessions. Britain and the World, 1920-1995*, Oxford University Press, Oxford, 1998) a recession is called 'major' when output falls absolutely one year after another, often for 2 or 3 years together.

[19] During the 19th century, between 10 million and 49 million indentured workers were sent around the world. In the second half of the same century and the first of the 20th 60 million people moved from Europe to the Americas, Oceania and South Africa [TE, 011,11.1997: 97].

on how to draw the frontier between the state and the market have dominated different periods and the controversy has really never been settled to everybody's satisfaction. The intellectual and political clashes related to the various attempts to resolve the issue have been particularly fierce during the course of this century. In fact Yergin and Stanislaw [1998: 11] maintain that 'in its entirety, the struggle constitutes one of the great defining dramas of the twentieth century'[20]. During this century 'two theories had competed for the hearts and minds of people struggling to break free of poverty - one focusing on markets, and the other on government'. The collapse of the socialist economies apparently demonstrated the non-viability of the second model [Stiglitz, 1997: 18].

The re-examination and reassessment of many root assumptions brought about basic changes in thinking about the appropriate relationship between state and marketplace, engendering a profound restructuring of economic life in the 1970s. The shift involved the state's withdrawal from the commanding heights, a return to traditional liberalism, 'indeed a reconnection - for it had its heydays in the late nineteenth century' [Yergin and Stanislaw, 1998:10-13 and 16]. Economies almost everywhere have been reordered accordingly, in some case quite radically. The reordering has been implied not only the elimination of state controls and ownership[21], but also the assignment of overwhelming primacy to private entrepreneurship; the introduction of stock markets and reliance on them for economic decision making; the rejection of the principle of the welfare state less because unsuitable than unaffordable, even by rich societies.

Soon, however the reordering starts causing 'new anxieties and insecurities...and unease about the price that the market demands of its participants'. Then in came the first turbulence in international capital markets in Latin America, followed by the even more upsetting Asian crisis which, according to Yergin and Stanislaw [1998: 12], 'turn[ed] that unease into fundamental questions about the danger and even the legitimacy of markets'. With the widening of the crisis of the global economy doubts grow, therefore, with respect to assertions widely shared until recently. It is questioned even the almost unanimously shared view that the general and 'steady move away from central planing, over-regulation, and general overreach in state intervention toward letting markets function...is indeed all to the good and promises world-wide prosperity' [Bhagwati, 1998: 11]. While hopelessly watching the mounting problems created, or at least contributed to, by the spread of liberalisation and globalisation, little by little the possibility of

[20] Let us not forget that 'the growth of the Smithian market required a strong centralist state in sixteenth-century England and seventeenth-century France, but there was still a sharp contrast with Eastern despotism' [Eichengreen, 1998: 131].

[21] The resulting privatisation amounts to 'the greatest sale in the history of the world ... for trillions of dollars of assets' [Yergin and Stanislaw, 1998: 13].

having gone too far, as Bhagwati himself admits with respect to capital liberalisation, begins to sink in.

In fact there exists what Kahler [1990: 57-58] has aptly labelled the 'orthodox paradox', namely that the expansion of the role of the markets requires a strengthening of the state and especially of its financial bureaucracy. Although the proponents of liberalisation have not seriously addressed even the paradox of using the state to change policy in a less statist direction, the reassessment of the role of the state has found its way in one of the major study of economic policy reform in the Third World. Its editors, Bates and Krueger [1993: 462], conclude that economic policy reform 'clearly leads to an increase in the power of the executive branch of government and, in particular, of its financial units'. It is possible, therefore, to 'imagine circumstances under which the advance of globalism might force governments to become more rather than less active in certain policy areas' [Arndt, 1997: 704-5]. One of these circumstances could be the creation of a safety net aiming, among other objectives, at making the effects of globalisation more palatable to many, or at avoiding tariff or fiscal competition wars, the so-called 'races to the bottom'.

The intervention of the state is becoming more indispensable not only because of the need to deal with the very social and environmental iniquities caused by the process of globalisation, but also to improve the effectiveness of the economic system's operations. At the same time, however, globalisation and increased policy competition among governments reduce the ability of government to conduct independent policy. Therefore, the problems that are making necessary to reform the welfare state have been worsened because 'the increasing mobility of capital has rendered an important segment of the tax base footloose, leaving governments with the unappetising option of increasing tax rates disproportionately on labor income' [Rodrik, 1997: 6]. Furthermore, another problem, this in the Third World, due to the implementation of policy reform has been the creation of corporatist forms of interest group bargaining, as the cases of Chile and Korea demonstrate. Furthermore, Strange [1996: 8] has pointed out that whereas in the West, and more particularly in the Anglo-Saxon world, the state authority has been progressively hollowed, the Asian state 'has in fact been the means to achieve economic growth, industrialisation, a modernised infrastructure and rising living standards for the people'.

The crucial point is that although the free market is necessary for continuing growth, it is not the only necessity and the issue of income distribution cannot be ignored for too long. Theoretically the free market distributes income to the suppliers of labour, capital and other resources according to the contribution these make to production. If this distribution is considered fair, then the argument ends there. Yet the definition of fairness is not based on economics, but rather on moral consensus and since usually the free market distributes income rather unequally, no wonder it is considered unfair by consensus in most nations. In this case, under democracy, the distribution is corrected through taxes and benefits, even though such an intervention may lower the total national product. During this century the distribution between profits and wages has remained constant and also stable [Phelps Brown, 1968]. Yet lately has moved in favour of profits in most of the Western world while at the same time taxes on wages and salaries have risen, labour being the less mobile factor of production [TE, 06.12.1997: 91]. Labour markets in the North have undergone striking developments: in the USA real wages growth has stagnated and wage differentials between skilled and unskilled labour have increased, in Europe, instead, unemployment has risen markedly while skill/unskilled differentials have been less pronounced.

The concentration of income 'has stemmed from rising wage inequality', inequality due not so much to rising real wages at the top but mainly to falling real wages at the bottom [Cline, 1997: 254]. This could be the result of either skill-biased technological change or trade and immigration[22]. After a throughout analysis of the problem Cline concludes - like Krugman [1995: 361] - that the trade effect resulted a modest magnitude [1997: 257]. The fact that 'unskilled workers have born the brunt of the poor labour-market performance in OECD countries since the mid-1970s' is not really due to these countries' trading with developing countries. It is instead much more the result of changes in manufacturing production techniques biased toward highly skilled workers and, particularly for the USA, of the declining productivity growth in the service sector [Lawrence, 1996: 119].

Together with an unequal distribution of income, the free market causes also uneven growth over time. Both effects call for public intervention[23], but by reducing the ability of government to spend resources on social programs, globalization... makes it more difficult to tax capital, and labor now carries a growing share of the tax burden' [Rodrik, 1997: 64]. And although in its 1997 World Development Report the World Bank has abandoned its endorsement of minimal government, it has done so by deriving the proper functions of the state from the economic

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[22] Among the authors stressing the impact of technological change are Berman, Bound, and Griliches 1994; Borjas, Freeman, and Katz 1992; Krugman [1995], and [1995a]; among those privileging trade, that is trade with the South, and immigration are Leamer 1992, 1995, and [1996]; and Wood 1994. The latest contributions to this discussion are to be found in *The Economic Journal* (108, September 1998), in S.M. Collins (ed.), *Import, Exports, and the American Worker*, Brookings Institution, Washington D.C., 1998.; and G. Burtless, R.Z. Lawrence, R.E. Litan, and R.J. Shapiro, *Globaphobia. Confronting Fears about Open Trade*, Brookings Institution, Washington D.C., 1998.

[23] 'Historical experience in developing countries also suggests that market intervention rather than laissez-faire price signals may be required to kick off productivity growth in the first place. This observation runs directly counter to the "hands off" industrial policy stance now recommended by agencies such as the World Bank' [Taylor, 1996: 148].

theory of public goods. In doing so the Bank fails to recognise 'the state's economic role in preserving and fostering cohesion in society' as well as 'the diversity of contemporary capitalism' [Gray, 1998: 202-204]. Yet, once it is recognised that 'the market economy could not function properly without the political framework provided by the state', it is easy to accept Strange's [1996: xii] contention that 'the necessity of the state as a public good...arose with the emergence of a developed market'.

Therefore, whereas the thesis based on the pre-eminence of the state has been discarded by the collapse of the socialist economies, the opposite thesis, that markets by themselves would provide the most effective development strategy, 'also has not been justified by economic theory or by historical experience... [since] almost all the major successes - the economies of East Asia[24], the United States, many countries in Europe - involved heavy doses of government involvement...There are few examples on the other side, of success without government involvement' [Stiglitz, 1997: 18]. Which Hobsbawm [1994: 563-64] explains with the simple reasons that 'no such purely laissez-faire society ha[s] ever existed', nor indeed there can be such a thing. That an economy in which resources are allocate entirely by a totally unrestricted market and in which unlimited competition prevails can generate not only produces the maximum of goods and services, 'but also the maximum of happiness and the only kind of society deserving the name of "freedom"', is clearly a notion based purely on a 'theological faith'.

If instead the rationale for government action is found in the theory of market failure then 'what is required is not deregulation, the naive stripping away of regulation, but regulatory redesign', while governments must 'create the institutional infrastructure that markets require in order to work effectively' [Stiglitz, 1997: 22-23]. Furthermore, as economic progress has became people's dominant expectation, so the role of economic policy has become central to most of the 20th century's life[25]. After the Great Depression, the establishment of the Keynesian economic order appeared to have completely marginalised economic liberalism, up to the 1970s

[24] The governments in East Asia 'while they achieved macroeconomic stability, they intervened extensively in the market' [Stiglitz, 1997: 22], for most of them the model being essentially the Japanese developmental state. According to one interpretation - see A. Greenspan, S. Fischer and M. Feldstein [1998] - the Asian crisis, largely the result of governments' interference in the economic and financial fields, is going to end the developmental state. Following the opposite interpretation of the crisis - a 'panic triggering debt deflation in a basically sound but under-regulated system' according to J. Sachs and J. Stiglitz, among others - Wade [1998] concludes instead that the crisis represents the beginning of the unravelling of the globalisation and neo-liberal economic doctrine.

[25] Yet in the North public spending started increasing and has maintained a persistently upward trend since the latter part of the 19th century [TE, 06.12.1997: 90].

when the new phenomenon of stagflation and the demographic trends in the North revealed the unsustainability of the welfare state.

Meanwhile, growing internalisation has been imposing constraints to national economic sovereignty, constraints that are the more severe the more democratic the countries concerned, as well as some international co-ordination of economic policies [Ciocca, 1998: 30-33]. In fact, even though capitalism and national states grew together and depended on each other, the more diffused becomes the global economy, the more difficult for national governments to intervene[26]. The first industrial revolution helped create the nation state and made it into a production unit and economic entity. The current industrial revolution is instead weakening it, 'pulled apart by the forces of a supranational or transnational economy, and by the infranational forces of secessionist regions and ethnic groups' [Hobsbwam, 1994: 10].

Besides the growing diffusion of authority to other institutions and associations, and local and regional bodies, the declining authority of the states derives also, according to Strange [1996: 4, 8-9, 82 and 190], from the 'growing asymmetry between the larger states with structural power and weaker ones without it'. The asymmetry is very much the result of the fact that the military aspects of technological change are making it increasingly difficult for the state to discharge even the primary reasons for its existence, namely the defence of the territory. The world economy, however, has further undermined the authority of the state so that 'national governments evidently lack both the power and the will to make good the deficiencies of inequality and instability that have always gone with the growth and change in market economies'. As impotence and unwillingness permeate even to the structurally more powerful larger states, it is difficult to envisage who or what could effectively intervene for correcting and redressing unacceptable outcomes of the increased power of the markets.

There is an often-neglected relationship between the growth of government and the intensification of international economic integration. According to Rodrik [1997: 50, 53] the relationship is largely due to 'the importance of social insurance and the role of government in providing cover against external risk'. The greater the risk people expose themselves, the more the protection they demand (such as more generous social programs), hence the larger becomes the government. From this the conclusion that 'social welfare is the flip side of the open economy'. But there arises a dilemma and a problem.

[26] According to Arrighi [1994: 33] there is here a contradiction between capitalism, for which power concerns the extend of command over scarce resources, and territorialism, which identifies power with the extent and populousness of their domains.

The dilemma is that while the process of globalisation increases demands on the state, it simultaneously reduces its ability to perform that role effectively. From this follows the problem: the weakening of the state undermines the social consensus necessary for maintaining domestic markets open to trade, hence 'a return to old-style protectionism becomes a serious possibility'. In its attempt to become politically more acceptable the liberal trading order is forced to offer discriminatory relief - mainly anti-dumping and countervailing duties, the so-called administered protectionism - to those most badly affected by the accelerated changes and the increased uncertainty created by the globalisation process.

2.3. Trade and Capital Liberalisation

Since 'historically, free trade is the exception and protectionism the rule' [27], 'until the early 1960 the commercial history of the developed countries was almost entirely one of protectionism' [Bairoch, 1993, xiv and 16]. Only lately international trade has been marked by a substantial reduction of controls, even though nontariff barriers have multiplied and an attempt to reverse protectionism's downward trend materialised in the 1980s. As a result, while total world's production has increased only 5.5 times, the volume of world merchandise trade has gone up 16 times since 1950. Therefore the ratio of world exports to GDP has moved from 7% to 15% during the same period.

Even though the beneficial impact of trade liberalisation on developing countries, derived from a neoclassical static framework, has been seriously questioned, particularly considering increasing returns to scale and firms' investment in productivity enhancement [Ocampo and Taylor, 1998], the process of liberalisation has been extended also to international capital flows. An extension that rests on the following propositions:

- by freely flowing across national borders private capital can be channelled towards its most effective uses on a global scale
- by fostering investment faster economic growth and improved standards of living are achieved
- their positive effects are more consistent when foreign capital inflows stimulate the broadening and deepening of domestic capital markets
- they are even more valuable for developing countries whose domestic resources are limited.

[27] Also Krugman [1995: 338] points out that 'the pre-World War I world economy was not exactly characterised by free trade. Indeed, the two largest economies, the United States and Germany, were frankly protectionist'.

Clearly private capital flows to low- and middle-income countries that have created a welcoming investment environment have greatly increased, but have also remained highly concentrated. Ten countries, representing half of the developing world's GDP, have received around 75% of the funds while, equally relevant, these private flows have not gone to all sectors of the economies that have received them [World Bank, 1998: 20-21 Table 1.8 and 1.9]. On the whole, about $350 billion have been invested in the emerging markets in the past decade.

Yet the crisis that has engulfed several Southeast Asian countries shows that the excessive borrowings of foreign short-term capital followed the loosening up of their capital account controls. Bhagwati [1998: 8-10] has then forcefully pointed out that the enormous benefits claimed for free capital mobility are not very persuasive[28]. In fact 'even a cursory glance at history suggests that these gains may be negligible' and against the eventual benefits must be set the costs of crises caused by a capital liberalisation that extends to the free movement of portfolio capital. Contrary to the largely shared notion that free capital mobility is exactly like free trade in goods and services, 'short-term borrowings under free capital mobility will be, and have been, a source of considerable difficulty'. Furthermore, the suggestion that 'crises under capital account convertibility can be eliminated' is just a myth. The move toward unfettered capital flows has, therefore, been driven by 'the ideology of markets', by the IMF and by the interests or lobbies of what Bhagwati has labelled the 'Wall Street-Treasury complex'[29].

In reality, continues Bhagwati [1998: 8], 'to ensure that capital returns, the country must do everything it can to restore the confidence of those who have taken their money out'. This is usually attempted, on IMF's prodding, together with the further capital liberalisation, by raising interest rates. As a result firms with large amounts of debt are eliminated, fire sales of domestic

[28] Long ago J. Tobin warned against capital mobility and suggested throwing 'sand in the wheels' of the international capital markets. He now considers the Asian countries, like Mexico in 1994-95, all 'victims of a flawed international exchange rate system that, under US leadership, *gives the mobility of capital priority over all other considerations*' (*Washington Post* 21.12.1997 quoted by Wade and Veneroso [1988: 18]). Even J. Williamson is reported to have pointed out that he 'never put capital mobility in the Washington consensus', since he 'never believed in it' [Elliot, 1998:24A]. Yet 'ironically, the IMF has been pushing the Asian countries towards accelerated capital market liberalization in the wake if the crisis' [Radelet and Sachs, 1998: 72].

[29] Also R. McKinnon [*IHT*, 21.09.1998: 6] actually thinks 'that IMF was too pushy in going around the acceptable wisdom and encouraging countries to liberalize their capital accounts too soon. And not the least of the reasons behind this was arm-twisting from by the United States Treasury, which always wants American banks and Wall Street people to be in there, competing freely'. Even the Deputy Treasury Secretary L. Summers has recently admitted that 'the IMF has done more to promote America's trade and investment agenda in East Asia than 30 years of bilateral trade negotiations'. Yet and at the Hong Kong annual IMF meeting in September 1997 the policy-making Interim Committee gave the IMF a mandate to alter its Articles of Associations in order to extend its jurisdiction over the capital account of members' balance of payments.

assets to foreign buyers follow, and the political independence to run the economic policy is lost[30]. In fact, since greater openness implies a higher ratio of tradables to nontradables, larger parts of the economy are exposed to foreign shocks and disturbances. Hence, as argued by Gray [1998: 198], the risks of a systemic crash are further enhanced by 'the enormous, practically unknowable, virtual economy of financial derivatives'.

Nevertheless the integration of all economies into the global capital market has continued, at least until the main effects of the Asian crisis started to materialise.

Following the failed attempt to establish the New International Economic Order (NIEO) in the mid-1970s, the liberalisation drive that has dominated the 1980s and the 1990s. This has happened regardless of the fact that the liberalisation of the Third World was bound to lead to growing vulnerability since its adjustment capability lagged behind the speed at which it was being opened up. The multiplication of crises is there to demonstrate that the instability has indeed worsened[31]. In fact, the financial instability in recent decades and its consequences for macroeconomic instability are not a one-off response to financial liberalisation but rather an ongoing feature of liberalised financial markets. The recent Asian experience shows that opening-up markets to capital inflow can magnify the welfare cost of domestic distortions, overwhelming the existing capital infrastructure and leading ultimately to collapse. Hence these domestic distortions should be addressed before integration is sought.

Yet in the case of some countries in Asia as well as in Russia, it was hoped that privatisation and liberalisation would generate that macroeconomic stability that would foster the middle-class that would, in turn, insist on rule of the law, contract sanctity and the rest. Clearly, it has not worked and that 'the free market system has failed and failed disastrously', is no longer the assessment of the isolated Malaysia's Prime Minister. The capital controls imposed by the latter are an attempt to curtail the large amounts of short-term capital from abroad that are considered too disruptive of a system based on high savings rates and high level of corporate debt. Although capital controls raise the cost of doing business, this is might be more than

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[30] Krugman [1998: 44] is convinced that 'the susceptibility of an economy to financial crises and its ability to deliver sustainable growth in general have little to do with each other'. He also argues that exchange controls - those 'unsayable words' included in Krugman's [1998d: 31] desperate Plan B, to dististinguish it from IMF's failed Plan A, and from a Plan C that nobody seems to have - are needed in Asia.

[31] Following the very serious ones that ended the exceptionally favourable phase of growth of the period 1950-70, there have been the European currency crises of 1992 and 1993, that of Mexico in 1994-95 and then the crises that started in East Asia in 1997.

compensated by the possibility of containing temporary speculative attacks without having to push interest rates to stratospheric levels.

The surge of foreign capital inflows into several Asian countries in the months before the crisis represents the 'obvious common factor' with the Mexican crises of 1982 and 1994-95. Furthermore, in all these cases the inflows 'had more to do with external factors than with internal ones - specifically, the hungry search by international fund and pension managers for profitable places to put their money' [Strange, 1998: 102]. As in Mexico in the mid-1980s, the inflow of capital in Asia fuelled aggregate demand, inflated equity and real estate prices, expanded bank balance sheets and financed big current account deficits. Furthermore, financial intermediaries channelled capital inflow into risky investments with no foreign exchange cover, promoting asset bubbles. The overvalued currency[32] that follows curtails exports, leading to a weak economy which forces central bank to reduce interest rates. To hold assets denominated in the domestic currency becomes unattractive [Krugman, 1995b: 35]. Add to this political instability, rising international interest rates and a pegged exchange rate - that contributed to deteriorating competitiveness[33] while 'it create unprecedented opportunities for speculation' [Kissinger, 1998] - and the crisis became unavoidable. Capital flight duly took place. Having 'in effect gambled with other people's money', the inevitable failure of many runaway Asian financial institutions 'was hastened and reinforced by a circular process in which collapsing asset values undermined banks, and an imploding banking system not only further depressed asset values but disrupted the normal functioning of business. Meanwhile, foreign investors, whose excessive optimism had helped create the bubble, ran for exit' [Krugman, 1998: 44] following their herd mentality. In effect, total net capital flows to emerging markets have declined from $247 billion in 1997 to $ 186 billion in 1998 and are estimated to further fall to $119 in 1999 [TE, 05.09.1998: 18], while new portfolio capital seems bound to dry up.

Even Africa appears to have been drawn into this global economy by reason of the massive cash exodus that has taken place there: by 1990 some 39% of African-owned private wealth was held outside the continent. The outflow demonstrates that in most situations controls have been ineffective. Hence East Asian governments must consider, as suggested by Collier, Hoeffler and

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[32] J. Sachs [1997] point out that the strong currency that follows economic liberalisation was not due to the latter, as commonly believed, but to capital inflow chasing high rates of returns. The effect of these inflows is to start a bubble in real estate prices and in non-traded goods and services. Once the bubble bursts and share prices start falling, the currency starts to lose value in the markets.

[33] In analysing financial crises Mishkin [1996: 43] stresses 'how dangerous a pegged exchange rate regime can be for a developing country if it has a fragile banking system, short duration debt contracts and substantial amounts of debt denominated in foreign currencies'. When these institutional features apply the adoption of a pegged exchange rate regime 'is like putting the economy on a knife edge'.

Pattillo [1998], not only 'whether it is wise to permit unrestricted capital movements', and how to keep capital in, but also how to design policies for getting it back.

The relationship between Third World countries and liberalisation is very much about their choice of domestic and international regimes. The most convincing rationale for making such a choice is that offered by S.D. Krasner, even though it results in a far cry from that required and imposed by global liberalism. Krasner's analysis starts remarking that developing countries 'are profoundly weak both internationally and domestically and... want power and control as much as wealth'. Their international weakness is compounded by the internal underdevelopment of their political and social systems. Hence whereas for economic reasons they demand greater participation in existing liberal international regimes, their structural weakness will push them toward 'more authoritative regimes that would enhance both wealth and control' [Krasner, 1985: 3-4 and 270]. Consequently, also as a group they have been more interested in endorsing international regimes that 'legitimate more authoritative as opposed to more market-oriented modes of allocation'. And this also because they cannot hope to cope with their poverty and international vulnerability 'except by challenging principles, norms, and rules preferred by industrial countries', namely the prevailing international regime. No less importantly, their attraction for authoritative international regimes derives from the fact that the latter 'can provide more stable and predictable transaction flows. External shocks and pressures are threatening to developing countries because their slack resources and adjustment capabilities are so limited'. Authoritative regimes can provide to the Third World both control and wealth, which instead the market-oriented ones cannot. Which explains why the Third World has 'sought to alter existing international institutions, or create new ones that would be more congruent with its preferred principles and norms', or press for regimes that would move in that direction, such as the NIEO. The objectives of the regime pursued by the Third World 'are designed to limit the market power of the North by enhancing the sovereign prerogatives of the South. This is to be achieved either 'through universal international organizations in which each state has a single vote, or by widening the scope of activities exclusively subject to the unilateral sovereign will of individual developing states' [Krasner, 1985: 5-7]. Hence, the conclusion that 'there are fundamental differences between the international regime preferences of the North and the South which are a product of underlying disparities in national power capabilities. Since these preferences will not change, even if the economic performance of the South improves,...the conflict between the North and the South is endemic' [Krasner's, 1985: 271]. And since it seems evident that global liberalism is the international regime most antithetical to Third World's interests, its reaction to it is bound to get stronger as it does the likelihood of clashes with the North and within the South. Hence even if clashes among developing countries may assume the colours of nationalism, ethnicity or religion, the underlying reasons most likely will be economic frustrations at the constraints and instability generated by the international regime imposed to them.

2.4. Growing Instability

Another important feature of the world economy is that its expansion has been accompanied by growing instability and recurrent financial crises, particularly when liberalisation has extended to international capital flows. As a result of deregulation the financial institutions have developed at their core a volatility which makes a world economy that is organised as a system of free markets essentially unstable[34]. Radelet and Sachs [1998: 3] sustain that 'international financial markets are intrinsically highly unstable', and history confirms that free markets are highly imperfect institutions, not self-regulating or self-adjusting [Gray, 1998: 196-97], inherently volatile, and affected by speculative booms and busts.

Like all markets, to work properly the financial markets need not only regulation but also active management. In the post-WWII governments did not hesitate to intervene to maintain the stability of world markets, stability which was further guaranteed by an international regime based on fixed exchange rates and international co-operation, plus the fact that financial markets that remained regulated until the early 1980s. As soon as significant and continuos fluctuations of the exchange rates enlarged the scope for profits, the pressure against regulatory structures started mounting. Deregulation inevitably led to the explosion of speculation, that is short-term flows that seek to profit changes in asset prices. Furthermore, the need to hedge against the costs that fluctuating exchange rates imposed to the private sector strengthened, according to [Eatwell, 1996: 11], the demand for the deregulation of international capital flows. In fact, the end of the Bretton Woods system, under which foreign exchange risk was borne by the public sector, led to the privatisation of such a risk. In order to absorb and cover this risk the domestic and international banking systems have found necessary to create a series of new financial instruments. Together with the restructuring of financial institutions, became then essential to remove many of the regulatory barriers that limited the possibilities of laying off risks.

Over the last 30 years global capital flows have increased exponentially and by the mid-1990s daily currency transactions held by currency traders in the most important centres surpassed 1.2 trillion dollars. Even more relevant is, however, the enormous growth in the scale of

[34]Although *The Economist* [25.10.98: 100] does not hesitate to consider 'simply false' the proposition that financial markets have become much more volatile, the difficulties of attaining equilibrium are particularly evident in the financial markets which, as a rule, tend to overshoot. 'In reality, the idea that a free market economy is a self-stabilizing system is archaic - a curious relic of Enlightenment rationalism. It will be tossed aside when the market reminds today's investors that those who think themselves exempt from history are condemned to repeat it' [Gray, 1998: 198].

speculation, relative to other transactions, that has taken place in the foreign exchange markets over the past quarter of century. In fact, Eatwell [1996: 10]estimates that while in the early 1970s about 90% of all foreign exchange transactions related to the financing of trade and log-term investment, the reverse happens in the middle 1990s. Notwithstanding the substantial amount reached by international capital movements, a real global capital market does yet not exist[35] [TE, 25.10.1997: 99]. This is demonstrated by the fact that identical assets do not command the same returns, that real interest rates are still unequal across countries, that countries' saving and investment rates remain highly correlated (Feldstein and Horioka, 1980), and that most investment is still financed domestically. Moreover, on the whole, international flows continue to take place largely among the major industrial countries themselves, a fact that, as suggested by Ghosh [1995: 127], represents a much more real puzzle than the Feldstein-Horioka's findings.

Also the stock of FDI has increased four folds since 1982 and reached 3.2 trillion dollars in 1996. Over the past decade its rate of growth has been more than twice that of gross fixed capital formation, thus indicating an increasing internationalisation of national production systems. In fact it is estimated that international production - that is the value of goods and services[36] produced by some 280,000 foreign affiliates - has reached about 7 trillion in 1995, outweighing exports as the dominant mode of servicing foreign markets. The output of foreign affiliates almost tripled between 1982 and 1994, while its share of world output rose from 5 to 6%. This is the result of investment in foreign affiliates estimated at $1.4 trillion in 1996, of which only $ 359 billion were financed by FDI. FDI flows to developing countries have also been growing, reaching $129 billion in 1996 equivalent to a 37% share of world inflows[37], Asia obtaining about two-thirds of the total. In the same year the South's outflows grew to a record $51 bullion. Following the liberalisation and globalisation of financial markets, foreign portfolio equity investments raised by emerging markets in international capital markets reached some $15 billion in 1996, the stock market capitalisation of these countries having grown from $171

[35] The 'capital-mobility index' developed by A. Taylor shows that although capital markets' integration 'is rising, it has yet to reach the peaks of the early 20th century' [*TE*, 25.10.1997: 99-100]. Yet integration in financial markets is certainly higher than in markets for factors and products.

[36] Even excluding telecommunications and network services, between 1980 and 1995 the service share in overall global trade grew from 17% to 20%. The telecommunications revolution has increased the tradability of services by unbundling the production and consumption of information-intensive activities, thus facilitating the fragmentation not only of goods production, but of services as well. In the early 1990s the service sector absorbed one half of the global stock of DFI.

[37] Developed countries received almost 60% of these inflows, but since 1989 their share has declined [UNCTAD, 1997: xx], a trend that the much reduced attractiveness of the emerging markets is certainly reversing.

billion in 1986 to $1.9 trillion in 1995. As for FDI, this inflow of portfolio equity investment was concentrated in Asia and Latin America, its sources being the USA for 35%, Japan for 15% and the UK for 11% [UNCTAD, 1997: xvi, xx-xxi, 1-2, 16, 112-15].

The rapid increase of the flows of factors of production and production itself is rendering control over the working of the world market rather difficult, if not utterly impossible. Furthermore, short-term capital flows that respond to speculation in the foreign exchange market can be the cause of excessive current account movements because capital flows, when are not absorbed in reserves, must show up in the current account. However, the magnitude and volatility of these flows indicate that they are much larger than would be necessary to sustain consumption levels negatively affected by sudden changes of government expenditure, investment, or output. Hence the possibility that 'speculative capital flows may be wagging the current account, rather than the capital account reflecting the need for capital to... smooth consumption' [Ghosh, 1995: 127].

The crises referred to above are not the crises caused by macroeconomic mismanagement, but those due to short-term borrowing made possible by free capital mobility. Yet to avoid capital fights or ensure that capital returns, confidence must be maintained by interest rates increase. Credit crunches follow and consequently bankruptcy of indebted firms and selling of domestic assets to foreigners at a discount that, when very large, causes so-called fire sales.

So, while an agreement is emerging with respect to the graduality that ought to distinguish the opening up when financial markets are not well developed, the discussion of whether to re-impose controls in a crisis has just started. And the more courageous dare venture that 'the weight of evidence and the force of logic point in the opposite direction [i.e. away from capital liberalisation], toward restraints on capital flows' [Bhagwati, 1998: 12]. Finally, the expansion of financial innovations underlines not only the process of securitisation of the international financial markets, but also the more relevant so-called financiarisation of the world economy, a phenomenon which, in turn, reflects the real economy's loss of dynamics.

2.5. Changing Structure of World Power

While the 19th century has been by and large characterised by the pax britannica, the 20th century has witnessed several changes in the world leadership. The USA's role started growing rapidly since the second half of last century but its rise was strongly opposed by emerging powers like Germany and Japan during the first part of the next century. Only with WWII did the USA emerge in an extraordinary dominant position: its GNP three times as large as that of its main rival, the Soviet Union; a huge technological lead over its competitors in most industrial sectors; and a monopoly on nuclear weapons.

With the recovery of Europe and Japan, however, started the erosion of the American domination, erosion to which did contribute significantly the simultaneous process of decolonisation. The USA's decline seems so advanced that Krugman [1998: 45] has recently predicted that 'future historians will not record that the 21st century belonged to the United States'. For others, however, the next century was destined to Asia. In the light of what has been happening in Asia since 1997, the last prediction appears rather doubtful together with the notion, widely shared until recently, that the axis of the world economy was shifting from the Atlantic to the Pacific.

Lester Thurow in his Head to Head of 1992 has proclaimed that 'future historians will record that the 21st century belonged to the House of Europe', where already at the beginning of the present century history seemed to be centred. In this case, therefore, the next century could witness a growing competition between the Old and the New Continent. What is not yet clear is whether the European strategy will be a total imitation of the USA or will instead markedly diverse. Yet, whatever the strategy, the competition cannot be expected to stabilise the world scene. Undoubtedly, Europe would like to believe that its process of integration is paving the road to regaining its leadership, but if the various current crises become a global one it seems difficult for the EU to escape most of its depressing and devastating consequences. And then again the crucial problem is given by the evolution of its relationship with the USA. The more the global crisis affects Europe the more the USA has a real chance to retain its leadership, although much limited and diminished. According to Wade [1998: 1550], the USA's hegemonic status has been enhanced by the dismissal of the fixed exchange-rate regime. As a result the USA is allowed both 'to create enough credit to sustain domestic expansion and project military force abroad at the same time, without raising taxes or interest rates', and to exploit 'vast profit opportunities, including those of the foreign exchange markets and the derivatives markets'.

Basically unchanged appear the North-South relationship, except the growth of internal and international disequalities. Starting with the first ones, it is clear that 'growth by itself does not ensure that the fruits will be equitably shared' and then there are the costs, 'both to individuals and to society, of economic insecurity' and environmental damage [Stiglitz, 1997: 19]. The problem of inequalities is also connected to the process of globalisation - the latter type of inequalities. In both the cases of late nineteenth and of late twentieth centuries 'the trend towards globalisation was accompanied by changes in the distribution of income as inequalities rose in rich countries and fell in poor ones'. The so-called phenomenon of 'convergence', which specifically means poor countries catching up with rich ones. The globalisation that characterises both periods was marked by trade expansion[38], mass migration, and huge capital flows. Between one-third and one-half of the rise in inequalities in the then and now rich countries seems due to global economic forces. Since also the retreat from globalisation after WWI can in part be attributed to the inequalities generated by globalisation, it becomes an open question whether or not the same is going to happen with the current globalisation drive [Williamson: 1997: 117]. Or whether, instead, the Southeaster Asian crisis, by halting the convergence, is also rendering unnecessary the retreat from globalisation. This crisis may ultimately demand some changes in the modus operandi of the global economy, sufficient to make sure that the South's economic growth ceases causing growing inequalities within the rich countries while slowing down the reduction of the North-South gap.

Actually, the economic gap between rich and poor countries has been widening dramatically starting from the early 1980s when the Third World debt crisis drained financial resources from poor countries to the benefit of the creditors in the North - between 1985 and 1992 a debt service of 280 billion dollars was paid to the North net of the new private loans and government aid received during the same period. The widening of the North-South gap as a group does hide the fact that for few Third World countries it actually started narrowing. Since these few fortunate countries were essentially the East Asian ones, the impact of the present crisis is certainly to reverse these favourable trends, at least for some time.

The growing disparity, and its consequences, are no where more evident than in the expansion of world consumption, both public and private; consumption which in 1998 showed a six-fold increase over its 1950 level and was 16 times larger than that prevailing at the beginning of the century. Yet more than one billion people are deprived of basic consumption needs while three-fifths of the 4.4 billion people in developing countries lack basic sanitation, a fifth have no access to modern health services and a fifth of the children do not attend school to grade 5. Actually, 'the average African household today consumes 20% less than it did 25 years ago' and, more generally, in 70 countries with more than a billion people consumption today is lower than it was a quarter of century ago. Whereas the poorest 20% of the world population accounts for 1.3% of total private consumption expenditure, the richest 20%, i.e. those living in the highest income countries, account for 86% [UNDP, 1998 2]. In the last three decades the income gap between these two groups has increased from 30 to more than 60 times.
Even in the richest countries, however, more than 100 million people experience under-consumption and human deprivation and are homeless. The real issue becomes not consumption

[38] Yet if the ratio of trade to output is used to measure the extent of product markets' integration, then countries like Britain and France are only slightly more open to trade today than in 1913, while Japan is less open now than then [*TE*, 10.10.1997: 103].

itself but its patterns and effects. Since, consumption is exacerbating inequalities and also undermining the environmental resource base, it is apparent that 'the dynamics of the consumption-poverty-inequality-environment nexus are accelerating', as 'pressures of competitive spending and conspicuous consumption turn the affluence of some into the social exclusion of many' [UNDP, 1998: 1-3]. Growing inequalities do also result from the fact that present consumption levels are sustained by borrowing from future tax revenues, and, of course, from increasing unemployment. If then one foresees a decline in the rate of growth of the West, as does Ayres [1998], then the call for questioning increasing globalisation becomes more urgent, together with the need to consider alternative ways to restructure domestic economic arrangements world-wide. It seems increasingly difficult to deny that the defence of the environment is 'incompatible with a world economy based on the unlimited pursuit of profit by economic enterprises dedicated, by definition, to this objective and competing with each other in a global free market' [Hobsbawm [1994: 570].

The possibility that the 21st century will be characterised by few rich countries and most of the other ones slipping further behind - an 'economic apartheid' related to the 'scientific apartheid' mentioned above - becomes more likely as we approach it. Clearly free markets and globalisation are not helping much in raising the South's standards of living, a South for which the North is showing a growing neglect. Consequently, the globalisation is integrating 'only about one-third of humanity (most of the people in the rich countries plus the elite of poor countries) into complex chains of production shopping, culture, and finance' created by Northern transnational corporations[39]. This is causing a divide between this one-third of humanity - the 'global North' - and 'the two-thirds of humanity from slums of New York to the favelas of Rio who are not hooked into the new global menu of producing, consuming, and borrowing opportunities in the "global South"' [Broad and Cavanagh, 1995-96: 25]. A 'global South' that contains between 10% to 20% of the North's population that has lost the competition race and gained little or no substantial advantage from economic progress. Because of its lop-sided effects, the process of integration is well described as 'asymmetric economic inclusion'.

Finally, it is left again to Hobsbawm [1994: 15] to underline the most disturbing effect of the process of transformation of the world. This is 'the disintegration of the old patterns of human social relationships, and with it, incidentally, the snapping of the links between generations, that is to say, between past and present'.

[39] The globalisation of production started when the early multinational companies began making complete products in various countries, often for sale in the local market. It has advanced further when they have transformed themselves, also organisationally, in the present transnantional corporations which instead make components and parts in many countries for sale in markets all over the world.

2.6. National Sovereignty and Globalisation

Strong tensions have developed between the nation-states, with sovereign governments, which continue to represent the basic units from which the world is organised and the growing cross-border economic integration which is undermining their autonomy and eroding their differences. This simply means that domestic policies cannot be conducted as if they were unrelated to what was going on in other countries that openness has brought closer and made more intertwined, while eroding their differences.

The tension has been gaining strength by the liberalisation of trade and capital that since the end of WWII has become the more pressing goal of international policy [Lawrence et al., 1996: 1]. The liberalisation was meant to be nurtured and promoted by the various international agreements reached and institutions that have been created since. During the early phase of liberalisation, namely the removal of border barriers, the role of national governments remained central and strong was their control in domestic policies. Only later did the differences in national domestic policies start to be seen as serious obstacles for maintaining the benefits generated by the process of integration.

The problem was addressed by means of some policy co-ordination, with which, however, the erosion of national sovereignty has become even hard to ignore. The increased volatility brought about by the operation of global markets, have made 'specific types of national policies very costly to maintain' and 'force[d] governments into steps that may put them at odds with preferences expressed by voters' [Lawrence et al., 1996: 17-18]. Growing economic openness has made necessary for policy makers to adjust the policy mix, but this may render more difficult to achieve particular policy objectives or make it necessary to reach them by other means.

Then technology has reduced the effective economic distances among nations by lowering the costs of moving goods, services, money, people, and information. Meanwhile the emergence of the environment issue and the increasing concern for the global commons have also contributed to make people to viewing the world as an integrated system. Consequently other countries' regulations had to be taken into account more and more if governments wanted their choices to be accepted and effective. By adding to the power of the market, globalisation forces government, not just firms and people, to obey the dictates of world-wide competition and to allow the financial markets to effectively determine their policies and behaviour.

The 'resulting pressures on national policy are especially important because national governments have assumed increasing responsibility for the living standards and quality of life of their citizens. The mismatch between the obligations assumed by governments and their ability to satisfy them while acting autonomously is growing' [Lawrence et al,, 1996: 19]. If this reveals the serious challenge that globalisation poses for democracy itself, it must be stressed that it also 'engenders conflicts within and between nations over domestic norms and the social institutions that embody them' [Rodrik, 1997: 5][40]. Hence the development of international and supranational bodies as globalisation resumed its course in the second half of the century.

It seems, therefore, that the formation of a world-wide capitalist system is bound to undermine the system of national states, the interdependence of these two processes causing instability and uncertainty. If globalisation describes the process of integration and internationalisation of economic activities and strategies, that is the growing planetary interconnectedness, globality refers to a world economy in which the traditional and familiar boundaries are being surmounted or made irrelevant.

The implosion of the Soviet system, the growth of capital markets and the continued lowering of barriers to trade and investment are further tying markets together and promoting a free flows of ideas. These flows are facilitated and accelerated by the information technology, all together making national boundaries increasingly porous and, in terms of many forms of control, increasingly irrelevant. Particularly significant is the integration of financial markets to which have strongly contributed the information and communications technology, but also the privatisation carried out on a global scale. The result is aptly described by the US Secretary of the Treasury R. Rubin who, as reported by Yergin and Stanislaw [1998: 370-1] admits that 'there is a greater risk of these markets causing instability because they are so large, and so much money is moving around in them. If it all moves in one direction, the size of the flows can be destabilising, and the impact could be substantial'.

The impact of an eventual disruption of the international financial system results from the interconnection of currency markets, interest rates, and stock markets, along with the extraordinary growth in the various ancillary markets that hinge on them. As stocks fall - reduction of the total value of US stocks since the market record high of July 1998 is estimated at about $2 trillion, while for the whole world the losses are estimated at almost $4 trillion over the past two months [TE, 05.09.1998: 17] - so does consumer spending. To the loses caused by the dramatic downturn in the securities markets, one must add the continuing fallout from the near-bankruptcy of business entities like Long Term Capital Management[41]. Plus the wild

[40] At the same time it is possible that democracy increases the power of special interests as it has happened in Thailand where the latter moved against the 'macro-economic technocrats' and eroded the independence and credibility of the central bank [McNeil and Bøckman, 1998: 1532].

[41] LTCM is a high-flying hedge fund with global investment worth more than $120 billion plus off-balance sheet derivative contracts with a likely value of more than $1 trillion. In the first ten months of

swings in the currency and bond markets as many hedge funds unwind huge speculative positions in search of liquidity. In the process, trillions of dollars of wealth are vaporised all over the world. To regulate a global financial system in which hedge funds - most of which operate offshore, managing an estimated $200 billion of investors' money [TE, 17.10.1998: 22] - can leverage themselves geometrically and with little supervision, and in which money flows are instantaneous and electronics, is definitely extremely complicated, to say the least.

According to the Bank of International Settlements (BIS) trading in foreign securities in the USA has been rapidly increasing from 2% of GNP in 1975, to 213% last year. To avoid that paper losses turn into a slump in real output, central banks could lower interest rates, which they may prefer not to do in order to defend the national currency. The 'belief that a strong currency means a strong economy, that stable prices ensure prosperity' is one of those 'rigid ideologies' which, according to Krugman [1998a: 8], represent the real risk for the world economy. Lower interest rates in the North instead present an efficient way to deal with capital flight from countries in distress which then feel compelled to increase their own interest rates - like have done, for instance, Canada and India - in order to attempt to retain capital funds. But as a result also imports and investment fall, and these countries' economic conditions worsen.

Furthermore, the distinguishing characteristics of financial innovations are the interwoveness of their rapid expansion with their high substitutability. Although they have made possible a significant reduction of financial costs, they are contributing to raise the instability of markets over which the central banks have little or no control. Since financial markets have transcended national boundaries and traditional regulation, contagion – namely the probability that a crisis in one country is going to trigger a crisis in another - can now sweep throughout the world's markets in hours, endangering the entire system. Clearly new methods need to be developed to keep pace with the growth of the global capital markets and avoid their more negative effects on the economic life of the countries involved.

The international organisations and the agreements that are joined voluntarily form entities, or clubs, that take three forms according to whether they deal with (i) single or related issues - functional clubs like ILO and BIS; (ii) several functional issue simultaneously - regional clubs

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1998 its net worth fell from $4.8 billion to just $600 million and was saved at the last minute by a Federal Reserve engineered rescue of $3.5-3.6 billion put up by 16 large banks and brokerages. Although the rescue did non involve directly taxpayers' money, it has been criticised by many, including former Federal Reserve Chairman P. Volcker. LTCM travails have revealed the extent that leverage, that is borrowed money, fuelled the great bull market of the 1990s and how much of the leverage came from speculators borrowing yen and investing the money in other countries. Now these yen are being repaid, pushing up the value of the yen and easing the pressure on Asian currencies [*IHT*, 12.10.1998: 8].

like the EU, NAFTA and APEC; or (iii) linkages among issues - global co-ordinating clubs none of which has materialised yet.

A fourth type could be the 'convergence club' envisaged by Amsden [1996: 42 and 57-58], that is a non-voluntary and de facto club grouping together the countries that present converging productivity levels in technological capabilities. The greater competition that develops among them may increase the number of innovations but also possibly lower the rate of return on investment for each innovation and the long-run growth rate of employment. Attempt by anyone of these countries to counteract these contractionary trends by stimulating demand through macroeconomic policies is 'more likely than otherwise to raise imports of innovative products from other countries rather than domestic output'. Since labour-saving technologies are rapidly transferred, 'labor requirements per unit of output also promise to fall without any offsetting rise in the total number of labor hours employed'. Hence technological convergence presents another important argument for greater co-ordination of expansionary macroeconomic policies among countries. In this case international co-ordination could take the form of 'large-scale international technology development projects, that are expanded or contracted in tune with the business cycle'. Co-ordination efforts could, however, be greatly strengthened by restraints on production globalisation and financial flows.

Among those to be eventually established, quite urgent is the creation of a type (i) club aiming at defending environmental standards and avoid that they follow the fate of jobs and working conditions and 'become bargaining chips for firms in a deregulated global economy' [Broad and Cavanagh, 1995-96: 28]. Undoubtedly, as long as the export drive in too many developing countries is likely to continue to be based on the unsustainable exploitation of natural resources, it is also going to accelerate environmental degradation and diminish the real long-term wealth of these nations. Yet most of the world's consumption, greenhouse gas emissions, ozone-depleting emission, and industrial pollution occur in the North.

As for the Asian crisis analysed in the following section, the dilemma is how governments can harness the commercial windfall of globalism while managing the domestic economic, political, and social stresses caused by increased influence from abroad.

3. ASIAN CRISIS

The Asian crisis arrived unexpectedly[42]. Yet it was preceded by the stock market crash on October 1987 (which Arrighi [1993: 3], considered the worst since 1929[43]). Plus there were by two speculative attacks on fixed exchange rates: on the European Monetary System in 1992-93 and on the Mexican peso in later 1994, which was followed by the 'tequila hangover' crises in Argentina and Brazil. There were also other signs of the impending problem - like Thailand's and Korea's collapse of export growth in 1996 [Sachs and Redalet, 1998: 18] - that only afterwards have been recognised as significant.

It is also a crisis difficult to explain with conventional economic models since in the countries affected government policies have not been particularly profligate and unemployment has not been high enough to encourage expectations of looser policy. In fact, more than in previous cases, the policies pursued seemed successful, economic growth assured - per capita income had risen several folds in three decades - and credibility was rising, yet the entire strategy unravelled and in almost no time the countries involved found themselves in deepest troubles. Contrary to many other instances, the Asian one appears as essentially a private sector crisis and, even more disturbingly, affecting highly successful economies.

In East Asia the crisis did not start in the real economy, since at its eve the economies involved were, on the whole, rather healthy. In fact their current account deficits as a percentage of GDP were modest, except in Thailand whose deficit reached 6% of its GDP in 1996, financed by substantial net inflows of foreign capital. Government budgets were relatively balanced. A high percentage of foreign investment was in tradable sectors. The percentage of non-performing loans appeared manageable. The foreign debt was rising but at the time seemed still sustainable; aggregate savings high. Fiscal positions were considered sound even by IMF and real exchange rates not seriously overvalued on a trade-weighted basis. The development strategy was based on open and outward-looking policies. Inflation appeared largely limited to the price of assets, rather than to those of goods. In most cases the current account deficits were due to a surge of foreign capital inflows rather than to excessive domestic spending drawing in capital.

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42 'In such situations, policymakers are invariably surprised by how the market can suddenly turn on them, and by the extent to which they have underestimated their vulnerability. Markets, in turn, are surprised by how little liquidity there is when all the lenders scramble to get out at the same time. The combination makes for a chaotic collapse and the disruption of finance' [Dornbusch *et al.*, 1995: 245-46]. For an earlier detailed treatment of the Asian crisis see also Sideri [1998].

43 For *The Economist* [05.09.1998: 17], instead,'the world economy's worst "recession" since the 1930s' is the 1981-82 slump.

Not justified by fundamental factors, the Asian crisis seems then due essentially to the intrinsic instability of international loan markets. These markets 'are prone to self-fulfilling crises in which individual creditors may act rationally and yet market outcome produce sharp, costly, and fundamentally unnecessary panicked reversal in capital flows' - the so-called herd behaviour in financial markets. Since solvent, but illiquid, borrowers are unable to borrow fresh funds from the capital markets in order to service debt obligations, the resulting crisis is indeed one of liquidity, not solvency [Radelet and Sachs, 1998: 4-5 and 48]. The two main views of the crisis attributed it either to a creditor panic, or bank run, or, instead, to some fundamental flaws in the economies affected. The first argue that it was a crazy scramble for liquidity that brought the various national banking systems to their knees and the region's 'economic miracle' to a standstill. The second reveals that these were just bubble economies and there was no miracle. The more likely explanation of what went wrong in Asia involves both the policies that created the vulnerability and the lenders who jumped ship [Dornbusch et al. ,1995: 245]. As to what triggered the crisis the leading role ought to be attributed to 'factors largely out of national or regional control' [Kissinger, 1998]. Such an approach does not at all diminishes the earlier success. It also allows concentrating on the real problems that accompanied it as well as on questions like the real extent of these economies' integration into the world economy and how far had proceeded their supposed adoption of free market capitalism.

Undoubtedly the inflows of foreign capital[44] boosted local economies: dollars were converted into local currencies and spent or deposited in banks. Bank lending to Asia rose - outstanding bank loans increased from $110 billion at the end of 1990 to $390 billion in mid-1997 when two-thirds with maturity of a year or less - and the region underwent a building boom of offices and factories. Imports were sustained by the easy of converting local currencies into dollars, while the increased demand for the industrial countries' exports fuelled the latter's economic growth.

A rapid build-up of private debt was a consequence of the most recent spurt in investment, and rising leverage, mostly in foreign currency. Borrowers leveraging themselves on the basis of buoyant expectations of economic growth as well as rising asset prices. The shift from a closed economy to an open one likely caused banks a and their clients to overestimate the ability to pay back loans.

[44] The hot money that entered South Korea, Indonesia, Malaysia, Thailand and the Philippines between 1994 and 1996 grew from $40.5 billion to $92.8 billion. This inflow was followed by an outflow of over $12 billion in 1997, a swing in the net supply of private capital of $105 billion in just one year, equivalent to 11% of the pre-crisis GDP of the five economies [Radelet and Sachs, 1998: 2]. In South Korea alone half of the $42 billion received in 1996 left the country the following year.

Since successful economies offer high yields and profits to international investors, and capital flows in as soon as a better access is provided by liberalisation. As a result exchange rates become greatly overvalued, prices of key assets - like shares and land - rise significantly and quickly, imports become cheaper, real income increases, and as asset prices rise so does perceived wealth. Banks wishing to increase lending lifted liquidity constraints, consumption rises and this pushes private investment to higher levels. The rapid deterioration of the current account, however, is initially hidden by the unabated inflow of loans and investment provided by foreigners anxious to move into a successful economy. When this perception changes - for internal or external causes - the shift is drastic and so are the effects which tend to be mutually reinforcing: the curtailment of bank credit depresses asset prices and further deepens the recession, which forces banks to retrench still further. The whole process - as explained by Griffith-Jones [1998] - becomes a vicious circle. Moreover, in the case of the Asian countries the loans received were largely made on the basis of either incomplete or faulty financial information. Even more crucial, however, was the faith that in case of default the lenders would be covered, that is ultimately paid by the public at large either in the South or in the North, depending on the IMF role. The actual trigger appears to have been increasing pressure from external factors, when investors began increasingly to focus on the misalignment of the Thai exchange rate. An inadequate response by the domestic authorities eventually precipitated the first crisis, which spread further afield by means of bank-run type behaviour in other economies in the region.

The asymmetric information framework developed by F.S. Mishkin to explain the sudden and dramatic shift from a path of reasonable growth - a worsening of the twin problem of adverse selection and moral hazard[45] - also helps to highlight the 'principle-agent' problem. This refers to the special type of moral hazard resulting from 'the relationship between voters-taxpayers and the regulators and politicians' [Mishkin, 1996: 15]. This is the moral hazard that Krugman [1998b] has colourfully called the 'Pangloss' factor, that is the investors' belief 'that they would be protected from risk' by either host governments' more or less explicit guarantee or by an IMF bailout that the case of Mexico had made almost certain[46].

The vulnerability to shocks of East and Southeast Asia's financial structure is connected, however, to one important features of that region's economic systems, namely the much higher

[45] Because of asymmetric information riskier credit are more likely to be obtained (adverse selection) or, having obtained the loan, the debtor engages in activities that make it less likely that the loan will be repaid (moral hazard).

[46] According to Radelet and Sachs [1998: 42], however, 'foreign investors thought too little about risk because they expected rapid growth and high profitability to continue, rather than because they expected a bailout'.

corporate debt/equity ratios prevailing there than in Western economies. According to Wade and Veneroso [1998: 6-7] this is due to the region's higher savings - about one third of the GDP - mostly done by households and held in bank deposits. Since neither households nor governments have been significant net borrowers, lending to firms has been the main outlet left to the banks. The large-scale bank intermediation from household to firms has allowed firms to mobilise the huge resources required to compete internationally and continue to upgrade their capabilities. The same intermediation has, however, made 'the more likely that any depressive shock will cause illiquidity, default, and bankruptcy'.

It is because of this feature of the financial structure that the generation of rapid and sustained economic growth has required close co-operation between banks, firms, and government, restrictions on the freedom of firms and banks to borrow abroad, co-ordination of foreign borrowing by government. This arrangement, known as the 'Asian model' or 'developmental state'[47], has made possible to discipline the whole system by making investment incentives conditional on export performance or on bringing firm's prices in line with international ones. The introduction, however, of deregulation and liberalisation, encouraged by the IMF, the OECD, the WTO and some Western governments, makes it increasingly difficult for the developmental state to function properly. Removing or loosening controls on firms' foreign borrowing, abandonment of co-ordination of borrowing and investments, together with the failure to strengthen bank supervision, all undermined the working of the model. The allocation of resources, continue Wade and Veneroso[1998], becomes less rational: production over-capacity appears and luxurious projects multiply[48], projects that by their nature favours the diffusion of corruption[49] and cronyism. Furthermore borrowing abroad - a possibility that becomes appealing when domestic interest rates are higher than those practised abroad -

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[47] The main characteristics of the developmental state are the following ones: access to and state control of developmental capital, harmonious labour relations, bureaucratic autonomy, autonomy of the state, administrative guidance, and successful state supported conglomerates (C. Johnson, in Deyo, 1987). On this topic the most relevant works are: C. Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975,* Stanford U.P. 1982; C. Deyo (ed.), *The Political Economy of the New Asian Industrialism*, Cornell U.P., 1987; R. Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization,* Princeton U.P., 1990; L. Weiss and J. Hobson, *States and Economic Development*, Cambridge U.P., 1995.

[48] Although rising incremental capital-output ratios (ICOR) may 'suggest a decline in investment quality' [Radelet and Sachs, 1998: 40-41and Table 11], yet data assembled by for 1990 and 1996 only 'show some signs of a modest shift in lending away from manufacturing activities and towards construction, finance, real estate, and services. The extent of the shift differs across countries': fairly large in Indonesia, tiny in Malaysia, moderate in the Philippines [Radelet and Sachs, 1998: 36 and Table 8].

[49] Yet until recently the issue of corruption was rarely consider having a debilitating impact on economic confidence. Revealing of this attitude is Root's [1996: 163-69] treatment of the issue, under the title 'The Right Kind of Corruption. The Korean Paradox'.

exposes firms with high debt/equity rates to a dangerous squeeze of their gross profits when interest rates rise. The problem becomes even worse if also the domestic currency is devalued, raising the fixed interest payments on foreign debt in domestic currency. Since higher interest rates tend to depress demand, firms' indebtedness increases forcing into bankruptcy even profitable but high debt/equity firms.

At the core of the present crisis lies the mismatch between global capital markets and national financial systems that lack the institutional capabilities with huge and fast moving capital flows. The mistake, writes Wyplosz [1998: 8], has been 'the naïve belief that open financial markets are good for all countries'. In fact, 'when emerging markets with weak institutions link up with world financial markets, they open wide the channels of contagion that now spread like a modern plague', trade links appearing the more important source of contagion. In other words it is the combination of open capital markets, with their potential for large cross-border capital flows, and the liberalisation of previously repressed financial institutions that creates a potent brew for a currency crisis. The Asian case clearly demonstrates that the extraordinary economic growth of the region had outpaced its institutional development.

Furthermore, the institutional structure of the financial systems in Asia, as well as in other parts in the South, presents two features that make it much more difficult for them to cope with financial crises. A large share of debt contracts are not denominated in domestic currency and, due to higher inflation expectations, they are also of shorter duration. Because of these features, recovery from a financial crisis cannot be attempted by means of an expansionary monetary policy which most likely is going to produce rapid inflation, higher interest rates and sharp depreciation. With the deterioration of cash flows and balance sheets, an economic recovery becomes less likely.

If monetary policy can only be used to lower inflation - yet 'single-minded pursuit of price stability can be dangerous' - and restore confidence, then the role of foreign assistance becomes essential to economic recovery [Mishkin, 1996: 36-38]. The implications of this approach is that such assistance must be prompt and commensurate to immediate task of recovery, but also to the longer-term one of creating an adequate institutional structure that renders more difficult the repetition of such a painful experience. Moreover, it should be made clear that capital provided to countries that are unable or unwilling to build such an institutional structure should expect no bailout.

It is time, therefore, to openly acknowledge that free market capitalism implies a complex set of cultural values and stop pretending that either they are universally shared or that can be easily imported. Moreover, it ought to be recognised that a sequential approach to liberalisation is required where institutional capacity need to be developed and that liberalisation involves offering to outsiders access to the old financial system. Radelet and Sachs [1998: 22] point out that "ironically, East Asia became vulnerable to external financial shocks in part because it attempted to reform its financial markets in the early 1990s in a market-oriented manner'. Hence, the crisis was 'not the inevitable result of and "Asian capitalist model," but rather the accident of 'partial financial reforms that exposed the Asian economies more directly to international financial market instability'.

Opening up the Asian financial system, designed for the privileged channelling of credit, that is high returns with implicit guarantees, also to outsiders appears contradictory. In addition, the excessive dependence of many Asian countries on foreign capital increased their vulnerability. This was underlined by the rapidity by which huge capital inflows were followed by similar outflows the moment it appeared that much of the foreign money had been wrongly used by misguide industrial policies or just squandered through 'crony capitalism', the new name of the previous miracle-maker model. As overseas banks refused to renew their loans and foreign investors sold their shares and converted their funds back into dollars, the guest economies were left to struggle with the devastating impact of a such flight which, of course, involved local investors too. To try to stop the capital flight and depositor runs on their banks interest rates were sharply increased - following IMF 'advice'[50] - with the result of crashing the domestic economies and generating a structural economic crisis. Although lately Asian currencies are experiencing less wild swings and have stabilised enough for some Asian governments to try to cut interest rates a bit, they remain, according to Krugman [1998d: 30] 'far too high to jumpstart their devastated economies'.

In some way, all crises are 'crises of success', i.e. the initial capital inflow that ultimately proves unsustainable is both a sign and, for a time, a cause of economic success [Takatoshi Ito and R. Portes, 1998: 3]. It is likely that also the Asian crisis has been one of unsustainable bubbles in asset prices, fuelled by capital inflows to economies with weak and poorly regulated financial systems. It is clear that lenders kept pumping money into financial intermediaries in these countries by implicit guarantees[51], which made them overlook flawed policy fundamentals such as over-investment, overvaluation and under-regulation. Consequently, the inflows of hot capital

[50] For a strongly critical analysis of IMF role in the Asian crisis, see Radelet and Sachs [1998: 49-70], and also Krugman [1998d: 28-29].

[51] These implicit guarantees were perceived both in strong political connections that would come to assistance in times of financial distress - which encouraged excessive risk-taking and deteriorating loan quality - and in the government willingness to absorb the exchange rate risk of foreign borrowing - which encouraged large, unhedged positions in the books of many companies [Brooks and Soo-Nam Oh, 1998: 5].

rushed away as soon as the perception of the possibilities and advantages offered by these economies changed, i.e. when foreign depositors realised that there were not enough dollar reserves left for the guarantee to be credible [Krugman, 1998b]. In addition, local authorities made matters worse by engaging in last-gasps defences of their fixed exchange rate regimes, which made the eventual rescue packages even more costly.
It has been shown by Ha-Joan Chang [1998: 1557-60] that the two high-profile corporate bankruptcies that caused the collapse of confidence in South Korea, also signalled 'a fundamental transformation in state-business relationship in Korea' since 'the major manufacturing sectors were now not as insulated from corrupt political exchanges as before'. The transformation was mainly due to an ill-managed financial liberalisation, faulty exchange rate management, and the abandonment of the investment co-ordination and 'the tightly monitored system by which the Korean government controlled all financial flows. The abolition of five-ear planning and the 'dismantling of selective industrial policy', which investment co-ordination had made possible, led to over-capacity, hence falling both export prices and profitability, due to low capacity, but also accumulation of non-performing loans. Furthermore, it was the elimination of the 'well-publicized "rational" criteria for intervention' that made it 'easier to "bend rules" for political reasons', thus ushering in 'particularistic' or crony capitalism. But then any attempt to redress the situation 'requires strengthening, and not weakening, of the coordinatory function of the government'. Also the Malaysia's crisis is attributed [Jomos, 1998] mainly to financial liberalisation rather than excessive regulation, while it is argued [Lauridsen, 1998] that Thailand's financial liberalisation resulted in misallocation and careless investment.

The government intervention is certainly needed when capital inflows exceed the economy's capacity to absorb them, particularly in order to discourage excessive surges of short-term inflows, i.e. potentially reversible capital flows - see case of Chile's reserve requirement on a whole range of foreign credits. Instead presently portfolio flows to emerging markets are unregulated and many - including Griffith-Jones [1998] - advocate that a risk-weighted cash requirement could be levied on institutional investors.

In the Asian crisis the issue is, therefore, liquidity and not solvency or a balance of payments crisis in which problems are those of excess domestic demand and weak national competitiveness. For the latter crisis, the one with which IMF is also more familiar, the correct remedies are tight fiscal and monetary policies to curb the excess absorption, and to steer the exchange rate toward the level of depreciation required for expenditure switching so as to promote exports. If these same remedies are applied to the Asian financial crisis they can only make the problem worse [Stiglitz, 1998a] because they tend to reduce the creditworthiness of firms and cause revenues to fall.

In a liquidity crisis, when the aim is to eliminate the rationale for a run on a currency, staged conditionality can be self-defeating. By stretching out its financing over several years, strongly conditioned on structural reforms, IMF contributed little to address the liquidity concerns, instead its 'own responses added to the risks of a sharply contractionary outcome' [Radelet and Sachs, 1998: 55]. The Asian economies had then to let the exchange rates fall to restore a balance of supply and demand for their currencies, but in so doing the liquidity crisis turned into a solvency problem. The contractionary policy of IMF may have worked if only one country was involved, but with several countries simultaneously applying it, the result could only be a regional crisis[52].

The nature of financial crises has, therefore, changed with the development of a global economy. The recent phenomenon of liquidity crises in emerging markets raises new challenges for IMF, and not only because they require financial support on a much larger scale and much more promptly than has been necessary in the past. Furthermore, the supply of liquidity alone - IMF's main task - does simply finance capital flight as creditors scramble to be first in obtaining what settlement of claims they can. More difficult is for IMF to organise the necessary debt workout process, and then reconcile this task with advising and assisting indebted countries at the same time. Not to mention the fact that IMF's decisions are too often strongly shaped by US interests over-represented in this organisation, whose main objective has become to make the financial system of all countries to operate like a Western one. Furthermore, Prof. C. Goodhart maintains that the combination of devaluation and the failure to repudiate the outstanding debt has imposed a stronger burden on the Asia countries than that was the case in the crises that took place during nineteenth century[53].

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[52] As for the issue relative to the allocation of the substantial wealth losses caused by the crisis, three cases have been identified [Vines, 1998: 8-9]. First, foreign creditors are repaid, and taxpayers meet the bill. The tasks of crisis management are then both to provide sufficient liquidity to enable immediately outstanding debts to be rolled-over, and to reassure international creditors that all debts will be repaid in full. In this case a continuing orderly rollover of debts by the private sectors can then proceed - the 'Mexico solution' which, however, concerned sovereign debts. Second, foreign creditors are repaid, but within the country there remain a need for domestic debt workout, including bankruptcy proceedings to resolve the financial position of heavily indebted private firms - the 'Korean solution' when indebtedness is mainly private and also domestic debts are to be resolved. Third, foreign creditors are not to be repaid and debt workout is required domestically. Yet as there is no orderly workout procedure available to allocate the losses it is left to bargaining what proportion will be taken by shareholders, domestic taxpayers, and foreign banks, or even foreign taxpayers - the 'Indonesian scenario' and by far the most difficult case to organise. So the rescue package, particularly when debts are too large, must involve a stay on payments to private creditors, an injection of liquidity financing in the short-term, and an orderly write-down of the debts.

[53] In an intervention reported in Global Economic Institutions' *Newsletter* (October 1998, pp. 4-5) Goodhart argues that repudiation is the only alternative when a well-constructed nominal anchor is impossible. In fact it is the presence of this anchor that makes the debt workout much more easy, because

The mechanism that has rapidly transformed the crisis into a regional one has been identified in the trade patterns, which, unlike macroeconomic phenomena, are largely regional. Since standard economic models – the so-called first- and second-generation models - emphasise macroeconomic and financial fundamentals as determinants of currency crises they cannot explain why the latter tend to become regional phenomena. The relevance of trade channels derives from the simple notion that if prices tend to be sticky, a nominal devaluation delivers a real exchange rate pricing advantage, at least in the short run. It is this loss of competitiveness that exposes trading partners to speculative attacks and forces also them to devalue [Glick and Rose, 1998]. It follows that after accounting for macroeconomic and financial factors, currency crises spread along the lines of trade linkages, which often coincide with geographical proximity. This approach strengthens the argument for international monitoring as well as the need to lower the threshold for international and regional assistance. Of course, alternative possibilities to a trade channel are financial channels, due to cross-border borrowing and lending.

Since the process of globalisation is prone to generate crises and facilitate contagion, the more pressing becomes the need for better international institutions of crisis management. Currently, the contractionary macroeconomic policies and the too ambitious corporate and financial restructuring demanded by IMF are costing it severe criticism. It ranges from accusations of 'short-sightedeness' and of having become a debt collector, to suggestions that it should be abolished - as proposed, among others, by former US Secretary of State C. Schultz - or, at least, merged with the World Bank. Its managing director has acknowledged that 'mistakes' have been made [IHT, 24.09.1998: 13] and the fact that IMF is getting short of resources is not enhancing its ability to intervene. Before the international community is willing to provide the funds to create an effective global lender of last resort – which means providing liquidity on an elastic basis in order to prevent outright default - it should refrain from pressing for the opening of financial markets. It should as well accept that some sand is thrown in these markets' gears if this helps to safeguard emerging markets from the recurrence of devastating financial crises.

Furthermore, as the reform of the banking system is a process that requires many years to design and implement, it clearly goes past the time frame of IMF crisis assistance. Moreover, it is considered improper - and this is Feldstein's [1998] criticism - that an international agency intrudes so deeply into the structure of borrowing countries' economies and the jurisdiction of sovereign governments, as it has began doing in Eastern Europe and the former Soviet Union. In trying to help Russia IMF has gone further than ever before in dictating details of policies and

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everybody knows that the exchange rate will come back. The macroeconomics and the microeconomics are, in fact, very closely tied together.

insisting on comprehensive measures of structural reform than are often as political as they are economic. The promotion of a full-scale market system has forced IMF to reach ever deeper into what were previously seen as domestic policies, a micromanagement that causes greater intrusiveness. But regardless of its eagerness to assume 'functions for which it was never designed, warns [Kissinger, 1998], the IMF has failed to grasp the political impact of its actions' and 'it often weakens the political structure and with it the precondition of meaningful reform'[54].

Moreover, institutional free-market reforms as comprehensive as those imposed on Russia, in the Asian case are not necessary to restart the flow of funds [Wade, 1998: 1545]. It seems, therefore, that the effectiveness and usefulness of one of the few international organisations with a certain standing and tradition is undermined by the working of the globalisation process, which makes it even more difficult to build an institution able to manage the crises it generates.

The Asian crisis demonstrates the need for holdings far more foreign exchange reserves - to be measured against the variability of foreign capital inflows rather than months of imports - than previously expected and for avoiding fixed but adjustable exchange rate regimes. It also suggests a careful sequencing of capital liberalisation[55], if to be pursued at all, to be accompanied by the parallel development of efficient regulatory systems and improved bankruptcy procedures. Finally, it shows the danger of responding to runs on the domestic currency by raising interest rates. The currency stabilisation so achieved most likely would force many firms into bankruptcy and devastate the bank system, in other words would plunge the economy into deep recession. Considering the impact that the standard IMF package of demand restraint plus devaluation has had on the Asian economies, its inability to restore the initial macro equilibrium is becoming increasingly clear, both at the theoretical [Taylor: 165] as well as at the factual level. At the same time the financial support the IMF can offer remains rather limited, its current lending capacity being less than $50 billion.

[54] The demonstration of 'the inability of the IMF to operate where politics and economics intersect' is amply provided by its interventions in Russia and in Indonesia: in the latter 'the IMF contributed to the destruction of the political framework by excessive emphasis on economics; in Russia it accelerated the collapse of the economy by overemphasizing politics' [Kissinger, 1998].

[55] The way reforms are sequenced 'can affect not only the performance of the economy in the short run but also the momentum for the continuation of reforms' [Stiglitz, 1997: 24]. Also Mishkin [1996: 41] insists that financial deregulation and liberalisation must be 'managed carefully' and 'slowly in order to keep a lending boom from getting out of hand which stresses the capabilities of both bank management and bank supervision'.

Beside the IMF receipt, the Asian crisis could have been tackled by other methods. One of these methods is the reduction of speculative capital flows by means of exchange controls which, however, could cut down future investment. Another is debt relief, that is foreign banks writing down loans to ease the repayment burden but also share the burden of bad loans between debtors and creditors alike. The next method is the possibility of attracting new long-term investment to replace short-term capital, with, however, the risk of fire sale. In fact, since Asian firms high debt/equity ration makes the role of debt-to-equity swaps rather limited, the devaluation enables foreign companies to pick up Asian companies at fire-sale prices. Hence the alternative, discussed by Wade and Veneroso [1998: 16 and 14], of resorting to controlled inflation as 'the least costly way to reduce' Asia's mountain of debts 'without years of stagnation, nationalist backlash, or chaos'. Together with the creation of credit, the exchange rate should be let float so that interest rates need not to be raised in order to keep the currency stable.

Clearly, the management of financial crises cannot be limited to bailout or inaction. The first carries the risk of moral hazard since, according to some, the expectation of bailouts increases the fragility of the world financial system. The second requires to accept the notion that markets left to their own devices can sort out the problem, something that many are no longer willing to accept. So 'the need to build new institutions to support a more efficient market-based resolution of debt crises and the need for new policy approaches' [Portes, 1988] or to build some new international co-operative efforts which could be based on either government or private initiatives. Market-driven initiatives would act as forces of arbitrage, by Ohmae [1993] assumed to be often strong enough to reconcile diversity and openness without further international co-operation.

Unfortunately, however, 'individual countries cannot recover until the world economy improves, and the world economy will not improve unless many individual economies do'. Yet 'the IMF and the U.S. Treasury have treated each ailing economy as an isolated case in need of "reform"' [Samuelson, 1998: 8]. Equally worrying is that effective action might come too late because of what Krugman [1998a: 8] calls the ideology of 'blaming the victim'. To deal with these two problems assumes a co-ordinated international response through which the major central banks - except that of Japan which instead must accelerate its financial reforms[56] -

[56] Based on the analysis of the liquidity trap which characterises Japan, Krugman [1998c] appears sceptical about structural reform and proposes instead 'a permanent as opposed temporary monetary expansion' to cause expectations of inflation since this is the only way to reduce the real interest rate and thus to provide the necessary boost to demand. In general, in a developed economy reflation causes the debt burden of households and firms to fall, thereby increasing their net worth. Higher net worth tends to reduce adverse selection and moral hazard problems. In addition, injecting liquidity into the economy raises asset prices such as land and stock market values, which also cause an improvement in net worth. So expansionary monetary policy causes a sharp increase in stock market prices, a slowdown in

reduce interest rates and the IMF renounces fiscal austerity in order to allow the expansion of credit before it is too late.

Yet to rely on international co-operation for restoring the conditions for resuming economic growth presents the risk implicit in any attempt to harmonise policies and structures in order to make them more consistent. The risk being, according to Lawrence [et al., 1996: 25-6], that 'stronger countries will may be tempted to use economic power or political power to achieve results most favourable to them', as for instance the USA's insistence on calling for a level playing field.

Finally, by exposing a basic incompatibility in the interaction between Asia and Western financial systems, the Asian crisis has reopen the important debate about the role of governments and markets that the neo-liberal approach considered closed.

4. RISK OF A GLOBAL DEPRESSION AND THE FUTURE OF THE WORLD ECONOMY

Toward the end of 1998 the world economy appears in serious troubles: the vaporising of trillion of dollars of wealth all over the world, an incipient credit crunch together with a flight to safety, a significant slowing down of rates of economic growth, and mounting social problems in many countries hit by the crisis. The interreletedness of the various problem areas makes the situation even more worrisome. So much so that the cautious chairman of the US Federal Reserve Board, A. Greenspan, on the 16th of September warned the US Congress that 'in East Asia, and increasingly in the rest of the world, deflationary forces are continuing to emerge' and are moving toward the USA[57]. The day after the IMF announced a downward revision of its global growth forecast for 1998 from the previous official 3.1% to 2%, against an average of

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deflationary process and, eventually, some economic recovery. However, if there is a commitment to peg the exchange rate to a foreign currency, then expansionary monetary policy may not be an available tool to promote recovery because pursuing such a policy might force a devaluation of the currency, a problem that is particular acute for small economies. A developing economy cannot use expansionary monetary policy to promote recovery from financial crisis when a large part of its debt is denominated in foreign currencies and it is of short-term type. In these countries expansionary monetary policy, therefore, may do more harm than good because it is likely to lead to rapid rises in expected inflation and hence in interest rates as well as to an exchange rate depreciation. All of which makes balance sheets to deteriorate more and the financial crisis worse [Mishkin, 1996: 32-36 and 45].

[57] Of course Greenspan's use of a highly charged word as deflation and its extension to USA and Europe have not gone unchallenged, see particularly *The Economist* [10.10.1998: 81-82]. At any rate, the day following Greenspan's testimony to Congress the Dow Jones industrial average dropped by 216.01 points, a loss of 2.67%.

4% in 1996 and 1997. Moreover, IMF admitted that even this might turn out to be overly optimistic. Following IMF forecasts the WTO's has revised from 7% to 4% the rate of growth in volume of world trade in 1998, growth rate that averaged 9.6% in 1996-97.

Most of Southeast Asia is enduring a depression that all signs indicate to be a long lasting one, also because all attempts to copy with it are made more difficult by Japan's own depression.

Although wealthy in accumulated savings and industrial might, Japan is in a prolonged slump. The worst one since WWII, the slump is causing a contraction of the economy of 2.6% in 1998, and an expected grow of merely 0.5% in 1999 or, for others, even a further 1% decline [TE, 26.09.1998: 23]. This follows eight years of diminished growth and growing bankruptcies, while its political system remains unable to tackle decisively a situation that is only getting worse by the day. Only in the first half of 1998 more than ten thousand Japanese companies went bankrupt, leaving debts totalling 7.9 trillion yen. Its banks are burdened by bad debts (officially $550 billion, but most likely close to $1 trillion [Krugman, 1998d: 28] or one third of its GDP), while a bank rescue plan has been stranded for too long in wrangling between a weak government and an uncertain opposition. No resolve is available to overcome the government's inertia - the only action having been the ill-timed tax increase of 1997- and no sense of urgency is evident for Japan to tackle its problems, for its own sake and for Asia's. Industrial output and sales are sliding, stressing the staggering over-capacity that already characterises a vast array of industries and unemployment.

Instead of providing a market for the region's exports, and so help start the latter economic recovery, Japan is reducing imports in a desperate attempt to export its way out of the turmoil. Yet an export boom of the Asian countries may not materialise because (i) their industrial export sectors are highly import-intensive and the prices of these imports have much increased; (ii) the over-indebtedness of the export sectors makes it difficult to obtain needed short-term foreign trade credits; (iii) all countries pursue similar strategies; and (iv) with the exception of the US economy, there is hardly any growth in industrial countries' markets for Asian goods.

Notwithstanding the $30 billion aid package offered at the end of September to troubled Asian economies, Japan's international isolation is palpably increasing. Yet cleaning up the banking mess and the rotten financial system is so difficult because the set up of these institutions is integral part of the Japanese capitalism - that is the developmental state - and as such they have greatly contributed to the country's past economic growth. This explains, at least partially, the resistance of Parliament to pass the legislation necessary for starting Japan's economic restructuring. Meanwhile the banks, paralysed by the attempt to meet Western capital adequacy standards in the face of declining asset values, badly need an injection of capital to resume working for the country's development. Only on October 12 the government was finally allowed to take over or shut down troubled banks and the parties seemed to have reach an agreement on a broad package of $517 billion for reviving the debt-ridden banking system. Considering that Japan is the world's leading source of savings and biggest creditor, to allow Japan's financial system to implode would cause, according to K. Curtis of Deutsche Bank Group [IHT, 14.10.1998], a global meltdown.

The disastrous deflationary spiral gnawing at the core of the Japanese economy cannot get better with a strong yen. Although a dearer yen would help those economies that compete head-on with Japanese producers, it would choke exports, which are just about the only thing that Japan has going for it, and would require an even more forceful stimulus to Japan's shrinking domestic demand. To get consumers to start spending again, massive quantities of money must be injected into the Japanese economy so as to create expectations of future inflation. The stimulus is required now since even if Japan's reform of its banking system finally starts, it will take years before the system recovers from a mountain of bad loans. To ease the suffering that its genuine deflation is causing, the only remedy is for Japan's 'central bank to "monetise" the deficit by buying government bonds itself' [TE, 10.10.1998: 83 and 18].

The weakening of the Japanese currency would help the US Treasury to fund its own deficits and avoid a credit crunch that would easily worsen the American economic climate. Yet the expansion of Japanese exports could provoke a mercantilist response from American business community [McKinnon and Kenichi Ohno, 1997: 233]. Japan's plans to restructure its banking system and strengthen domestic demand with a fiscal stimulus and an expansionary monetary policy should make the yen weaker against other currencies. If this helps Japan's recovery, it hurts other Asian economies that will have to compete with Japanese production internally, in Japan and in third countries. A growing Japanese market will, however, tend to absorb more imports while restructured Japanese banks may be willing to lend again to the Asian countries, with which Japan conducts roughly 40% of its trade. China, however, has already intimated that a weaker yen will force it to devalue its renminbi and, perhaps, even the Hong Kong dollar. And this will create even more problems to the other Asian economies struggling to survive the economic slump. So a weaker yen may result either from Japan's failure or its success in reviving the economy. Whereas in the first case China has all incentives to devalue, in the second the benefits of Japan's recovery for Asia may appear sufficient to forgo devaluation and avoid passing the regional initiative to Japan. Yet the continuous and substantial capital flight from China seems to reflect a growing fear that devaluation cannot be avoided. Another risk of Japan's expansionary policy is the eventual increase on interest rates. This would dry up the demand for loans while the lower bond prices could make it even more difficult to reduce banks' bad loans.

For the current year, according to The Economist [05.09.1998: 17], Indonesia's GDP is expected to fall by as much as 15%, South Korea's and Thailand's by 7 and 8%, respectively, Malaysia's by 6.4%, and Hong Kong's by 5%. The latter's currency is under severe pressure, unemployment is the highest in 15 years, and stock prices have declined roughly by half from their peaks. The foreign debt of the East Asian countries averages 70% of their GDP and if the domestic debt is added on, the average for the total debt rises to 200% [TE, 17.10.1998: 94]. Under the impact of the financial crisis, the imports of the five hardest-hit Asian countries fell 40%, while their exports increased 12%. Yet while the exports of Thailand, South Korea and Indonesia to Europe and USA increased, those to Japan declined sharply by about 25%. ASEAN's combined exports grew 6.3% in 1997, but their growth was almost flat in the second half of 1998[58].

Although officially China's growth rate is put at almost 8%, it is actually falling behind - 5.5% is IMF latest estimation - and the economy is effectively in recession, as also indicated by a price deflation that has presently reduced price growth at 2%. Meanwhile, the huge bank indebtedness - non-performing loans are estimated to reach some $200 billion, that is more than 20% of bank assets - is threatening the whole reform process[59]. Since the consumer demand is bound to be further reduced by the massive unemployment generated by any significant reform of the huge state-owned industrial sector, exports must remain competitive. Yet China's exports have slowed down to less than 4% for 1998 so far - 6,7% less in September 1998 from a year earlier [Newsweek, 26.10.1998: 45] - while are rising cheap imports from the region, mostly smuggled in. Hence China's trade surplus, which has remained high at $35.3 billion for the first nine months of 1998, has started to show signs of decline. Its foreign debts are not insignificant

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[58] Most recent data relative to South Korea show that while exports have been slowed down, the capacity utilisation rate keeps declining, the level of industrial production remains very low and so does that of domestic demand. With a domestic debt estimated at $500 billion, South Korea's financial system remains insolvent and not likely to improve soon. Moreover, to implement the liberalisation to which its membership in both WTO and OECD was conditioned, South Korea is going to lift its historic bans on imports of Japanese consumer products at the end of 1998. Last year Japan had a $13.1 trade surplus with South Korea, but Japanese imports from it went down by 42% in the first half of 1998, while Japan's exports to South Korea rose by 20%. Consequently it seems unlikely that the liberalisation will lessen South Korea's deficit [*IHT*: 15.10.1998]. Under these circumstances it is also unclear how Japan's engine-of-growth role can materialise.

[59] How shaky and overextended is China's unruly financial system has been further underlined by the failure of Guangdong International Trust and Investment Corp. (GITIC), one of its most prominent investment companies, with $2.4 billion in foreign debts. Yet that such a failure has been allowed may also indicate that Beijing is serious about cleaning up its act [*Newsweek*, 19.10.1998: 30].

- officially reported at $120 billion but estimated larger by at least half as much. Capital flight is reckoned to match inward flows of foreign investment, that is between $35 and 45 billion a year. As a result China's industry is probably working at about half its full capacity. Hurt by floods and concerned about deeply troubled state-owned industries and an incipient banking crisis - bad loans are estimated at $270-360 billion, equivalent to 40% of the country's GDP [TE, 24.10.1998: 30, 24, and 27-28] - China's interest in opening its markets further has declined. And this notwithstanding the fact that such an opening is a condition for entry into the WTO. Moreover, with foreign investment predicted to shrink 30% this year and the defence of the value of the yuan starting to negatively affect its exports - devaluation becomes more and more tempting, even though it makes heavier the foreign debt burden. Since such a measure will increase the downward pressure on East and Southeast Asian manufacturing prices, it will undermine the prestige that China has been gaining recently and worsen the Asian crisis. Admitting that the 'danger of an economic collapse is growing', The Economist [24.10.1998: 13] underlines that 'the biggest potential danger, however, is of economic trouble leading to political chaos'.

The reduced creditworthiness makes it harder for Asian economies to borrow abroad, while devaluated currencies and fallen growth rates affect negatively their imports. As a result their trade balances should shift towards surplus helped also by the increase of their exports stimulated by depressed real exchange rates. The counterpart to these surpluses must be current account deficits, or smaller surpluses, elsewhere. A big part of this adjustment will take place in the USA, which the Asian crisis has brought back to the region as an essential economic and political actor. The return at the centre stage of Asia demands a decisive leadership if the USA wants to deal with all its economic and security implications, a leadership that at the moment is perhaps too optimistic to expect. Meanwhile the region's problems are growing as underlined, for instance, by the continuous danger of a Korean conflict; Indonesia's fragility; migrant workers; difficult relations between China and Japan; declining defence budgets, including those of Japan and South Korea but not China's whose budget has increased by $11 billion in 1998. While Japan continues to stagnate, the balance of power in Asia is shifting and China is expected to play an increasingly larger role in Asian affairs.

Meanwhile Russia lurches from one crisis to the next, its economy expected to shrink by 6% in 1998 as well as next year. Although its economy is too small to really matter, one should not forget that its destabilising potential, backed by nuclear capabilities, amplifies its economic woes. The government has reneged on debts to foreign lenders, the rouble is all but worthless and the stock market has collapsed; in brief, the country is virtually bankrupt. Although only last December the Russian stock market was the best performing emerging market in the world, it is now clear that the reform process is dead, capitalism has failed, and Russia's attempt to

Westernise has gone astray again. The market democracy model that many thought it could be easily implanted there has not taken root since this liberal experiment was based on the questionable notion that building a middle-class only needed to add capital [Klee, 1998: 16]. The West is 'left with no effective model for making sense of Russia's predicament'. What is clear is that the possibility of its going backward is becoming more and more real, which implies 'a significant swing away from free markets to a statist economy' [Malia, 1998: 8][60]. A message this that could well received in many parts of the Third World where the search for alternative models, such as Iran's or Afghanistan's theocratic and isolationist experiments, may also be underway. And it cannot be easily excluded the possibility that a theocratic rule would prevail in Russia itself.

There is then Latin America that has already began to shake ominously. Fiscal imbalance and rising financial needs are making several of the region's countries vulnerable to a loss of confidence and risk of default, as indicated also by the low levels at which are trading their bonds. For 1998 the IMF has cut its forecasts for the region's growth to 2,8% from the previous 3,4%, while for next year Merrill Lynch has reduced it further to 2.0%. This decline is due mainly to the expected slow down of the USA, while it is to the strength of the dollar that is attributed the poor performance of the region's exports of manufactured goods and Latin America's record current-account deficit of about $80 billion in 1998. Venezuela is the most exposed economy since oil revenues have continued to decline and inflation is very high; it could then be forced to devalue its currency soon, as Colombia and Ecuador have already done[61].

Brazil presents even a larger risk with a current-account deficit equivalent to almost 4% of its GDP, a fiscal deficit that represents 7% of the GDP, heavy capital flights and losses of reserves. The low level of inflation is also the result of high - about 50% - interest rates that make more onerous the burden of the large real-denominated public debt. As a result the public-sector borrowing requirements have grown to 7% of GDP. Its currency is under pressure from a huge outflow of capital that could force devaluation and unleash another wave of market turmoil that would drag down most of the region. In effect since the beginning of August Brazil has lost about a third of its reserves which now stand at less than $50 billion. Against these reserves the government has $120 billion short-term debts coming due before the end of 1998. IMF and

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60 A sobering advise is, therefore, that Russia should no longer be judged 'by its progress, or lack of it, toward a Western model. Russia will go its own way, as it has for centuries' [Jakobson, 1998: 8].

61 Since Wyplosz [1998: 8] is convinced that for the major currencies of Latin America 'a run is in the making anyway', he recommends that Brazil, Argentina and Chile remove the exchange rate peg and declare a moratorium on external debt, while trying to convince Western creditors to provide more loans. This measure would avoid that 'a few more billions are added to [their] external debts'.

USA see Brazil as a firebreak, where the battle to keep the crisis from spreading to Latin America could be won or lost. Hence, soon after Cardoso's re-election and the presentation of a three-year plan to cut Brazil's large budget deficit, an IMF-led consortium, with the active participation of the USA that chipped in $5 billion, provided a rescue package of $41.5 billion. Meanwhile the government calculates that in the economy will shrink by 1% in 1999, following the meagre 0.5% obtained in 1998.

Few doubt that Brazil's eventual financial debacle – the most controversial part of the plan is the assumption that Brazil's external accounts can improve much without a devaluation[62] - would have serious repercussions on the rest of the region, starting with Argentina. Since Brazil absorbs one third of Argentine total exports, a reduction of this trade would deepen Argentina's own recession and strain the country's currency board that pegs the Argentine peso to the US dollar. The freely floating currency of Mexico seems to be helping this economy to hold against mounting pressures, yet the fall of the peso and the ups and downs of the stock market are pushing upward interest rates. A worrying situation made even more threatening by the obscure case of the Fobaproa bank and its expensive bail-out. The increasing interest rates and declining stock prices prevailing in the region 'risk doing severe damage to the Latin economies' [Stiglitz, 1998: 9]. The problems will only intensify as soon as their governments and companies will try, and likely fail, to refinance themselves because northern banks are in no mood to increase their exposure.

Africa's quite modest economic relevance does not make it less problematic for the northern countries, considering the actual and potential migratory flows it can generate.

In the Middle East the political situation has further deteriorated, increasing the danger of a new war between Israel and Palestinians supported by a certain number of Arab countries. Given the region's instability such a war could easily degenerate into a wider conflict with unpredictable results also for the oil industry. During the next two decades the world will become much more dependent on oil originating in the Persian Gulf region whose output after all remains the most economical one.

Plunging oil prices and the continuing decline of other commodity prices are squeezing many of the emerging market in Asia and Latin America already at the centre of the current global crisis, and causing havoc among commodity producers in Africa, Australia, Canada plus American

[62] According to Weisbrot [*IHT* 17.11.1998] 'there is little reason to believe that the IMF's bitter medicine will help Brazil any more than it helped Indonesia or Russia'. Furthermore, he argues that in a country that has the most unequal distribution of income in the world, 'the IMF-engineered economic contraction therefore will have terrible consequences even if it ''succeeds'' on its own terms'.

farmers. The Economist all-items commodity-price index – as well as both the Goldman Sachs Commodity Index and the Commodity Research Bureau Bridge Index - has declined by 30% since mid-1997, reaching its lowest level in real terms for over 25 years. Meanwhile the oil-exporting countries' trade balance has deteriorated by $62 billion. Furthermore the fall of commodity prices represents an important link connecting Asia and Russia to the rest of the world, thus giving further substance to the spectre of contagion. Since the fall of commodity prices is expected to cause bigger bond defaults in Russia and budget cuts in many countries in Asia and Latin America, it is contributing significantly to spreading the Asian crisis around the world. It is also worth it reminding that the collapse of commodity prices, together with the financial crisis, played a crucial role in bring to an end the first case of globalisation.

Only the USA and Europe appear to be still prospering, but even though they produce more than one half of global GDP, they cannot expect to be spared the impact of the crisis that is mounting elsewhere.

In the USA, unemployment is below 5% and interest rates are at their lowest levels since the 1960s. Yet the USA's economic growth has started to slow down to a mere 1.4% in the second quarter - which may be only due to an inventory correction and the General Motors strike - and IMF expects it to be 3.5% in 1998 but just 2% next year, while J.P. Morgan expects the country to move into recession next spring. For the first time in a decade corporate profits fell in the second quarter of 1998 compared with a year earlier [IHT, 05-6.09.1998]. Also exports are weakening. Furthermore, in the USA the rate of saving remains alarmingly small - the personal saving rate has declined from 5.7% in 1992 to 2.1% in 1997and to less than 1% in the April and June 1998 – and consumer debt has reached roughly two third of the GDP. Furthermore, the US current account deficit is expected to grow from the $155 billion of 1997 to about $230-250 billion in 1998 – equivalent to 3% of American GDP - and hit $300 billion in 1999. During the first half of 1998, US imports from Asia rose 9.5%, while US exports contracted 14.5%. More than a third of August trade deficit came from trade with China. It is true that exports account for only about 12% of the country's GNP, and those to Asia for about 4%, yet exports to Asia and Latin America represent one half of total American exports. Moreover, foreigners own over $1.3 trillion more in American assets than American own in assets abroad.

As long as the country's continues performing the function of 'buyer of last resort', its rising trade deficit contributes to global economic recovery. It can also be argued that, in principle, as long as the US economy can absorb additional resources without inflation, interest rates do not need to be increased. Hence, until domestic saving remains low, it is more convenient to keep borrowing from abroad and run a deficit than avoid the deficit and forgo the investment, correctly maintains [Lawrence, 1998: 34-35]. In this way the allocation of global resources results also optimal. Yet the presence of a deteriorating balance of payments tends to move the interest rates upward. In the opposite direction pushes the capital flight from emerging economies seeking the more secure USA. If interest rates are raised, this will certainly discourage consumption - consumer-spending being more than two thirds of GDP, from 60% in the 1950s - and consequently depress investment and ultimately economic growth. The more recent sharp decline of the dollar against the Japanese yen and against the currencies that make up the euro[63] certainly reflects the unwinding of positions by hedge funds that had borrowed in cheap yen to finance purchases of higher-yielding dollar assets. More importantly, however, it reflects also a shift in perception about economic fundamentals. The growing trade deficit is contributing to the slow-down, which could be accelerated by the fall in consumer confidence and capital spending that many expect soon.

There are, however, other complications that might make it unlikely for USA's domestic demand to remain the engine of growth. One is the eventual decline of stock prices[64], the stock profits having contributed no little to the expansion of the American demand in the more recent years. Another is the federal budget that, having just registered its first surplus since 1969, cannot contribute to prop up the private demand. If then the slowdown, as expected [TE, 17.10. 1998: 56], materialises, it is going to be led by a credit crunch and weaker confidence in the private sector. This will make it 'different from other post-war recessions, and possibly harder to correct' without cutting interest rates which, in turn, may weaken the dollar, thus bolstering exports and equity markets. Yet, while a strong dollar has dampened inflation in the USA, a falling one will tend to revive it, thus making it more difficult for the Fed to keep reducing interest rates. This is, however, a measure that is crucial for restoring the liquidity whose current 'drying-up in many markets is in part a consequence of the credit squeeze being inflicted on hedge funds by banks' [TE, 17.10.1998: 15 and 22]. Growing interest rates tend, instead, to attract foreign capital, hence helping financing the American trade deficit, but hindering the economic revival of the countries from where it flows.

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[63] Yet the 10% decline of the dollar against the European currencies since August has put added pressure on European exporters and complicate the move to the euro. Although extra-EU exports represent only 11% of EU's GDP, a 20% decline may cause a 2% drop in EU's GDP.

[64] According to Toporowski [1993: 142-43] the link between stock prices' decline and consumption has been rather tenuous in the past. Yet there is no doubt that as result of the fact that 'the measured wealth of American households has doubled over the past three years' they have saved less and consumed more. Furthermore, rising share prices also made it cheaper for firms to raise equity finance, thus strongly contributing to the expansion of investment. Therefore, quite real appears 'the risk now that this could all go into reverse' and The Economist [05.09.1998: 18] argues that a 40% drop in share prices could trim consumer spending by 4-5% over two years.

Much more disturbing is, however, the growing realisation that the USA may also be a 'bubble economy', i.e. an asset price inflation not much dissimilar than that took place in Japan in the late 1980s with disastrous consequences for that economy. As total household saving turned negative in September for the first time in more than half a century and the total private saving rate has fallen to abysmal levels. However, the high equity market valuations have allowed Americans to feel richer, hence to save less and spend more. High share prices have attracted foreign capital and so pushed up the dollar. Although it seems that lately consumer spending and corporate investment have started declining - also because excess capacity has become substantial - any further reduction of the interest rate could simply inflate the bubble, while any increase could burst it. Therefore, it seems that the 'American miracle' is explained less by the New Economy, i.e. sound macroeconomics and flexible labour market, and rather by the overvalued stock market, cheap world commodity prices, and the growing pauperisation of large sectors in the American society. If share prices fall so does the dollar, while also a sharp drop in the dollar could itself burst the stockmarket bubble.

In Europe, inflation and interest rates are low and growth is still positive. Furthermore, eleven countries if the Old World are preparing to merge their currencies into one beginning January 1st 1999. The euro's launch should provide the European economies with an effective buffer against global economic turmoil. So far, the Monetary Union bulwark has held up reasonably well, whereas Norway and Sweden, which decided to stay out of it, have not been able to avoid the destabilising effects of exchange rate volatility. This supports Krugman's contention that 'true monetary union is one answer to the problem of currency crisis' [1998b: 14]. Yet global uncertainties have started to weigh on Europe, beginning with its largest economies. Due to the financial troubles in Asia and Russia, the European Commission has revised downward its forecasts in mid-October: the EU's GDP is still expected to growth by a healthy 2.9% in 1998, but it will be only 2.6% next year, down from the 3.2% predicted in March 1998. In the second quarter of 1998 the German economy stagnates, its growth rate pegged at 2.6% in 1998 and 2,5% next year. Britain is expected to move to mild recession next year, its rate of growth declining from 2.5% in 1998 to 1.3% next year. France's growth rate should decrease from 3.1% this year to 2.8% in 1999, and Italy's is expected to be reduced from 2.4% to 1.7% in 1998 and from 3.0% to 2.1% in 1999. Similar slow down are predicted for the remaining EU countries.

Exports to Asia and Russia are a relative small part of total EU's exports. Russia absorbs only 1.3% of EU's, a percentage that even for Germany remains lower than 2%. Yet German banks hold $30 billion in short-term loans to Russia. Since the German government guarantees nearly all, the losses represent a great liability for German taxpayers and a depressing force on the country's consumption levels. It is becoming clear, however, that if Russia is unable to raise fresh money or delay payments, sometime during 1999 will have to default on as much as $200 billion in foreign debt - the largest default by any government in history. Meanwhile the devaluation and the repayment moratorium - a de facto default - on its domestic debt in August 1998 has already cost Western financial institutions an estimated $100 billion, compared to the $60 billion losses due to the Latin American debt defaults in the 1980s [Powell, 1998: 31]. Therefore, a recession in Europe may be avoided only if Asia's predicament does not get worse and a new round of currency devaluations does not follow suit.

Whereas untractable levels of unemployment remain in Europe, the whole North faces a redistribution of income in favour of capital and the crisis of the welfare state. The latter can be essentially explained by the dilemma relative to the sustainability of the general practice of increasing public sector borrowing to pay for rising public sector deficits. The situation becomes unsustainable as soon as economic growth starts to slow down, then the public debt accelerates. The unavoidable result of increasing life expectancy, which makes health service costs to levitate, and of labour productivity rise, which causes higher unemployment rates, is that the rising tax burden will fall on fewer and fewer people up to the point that eventually tax revenues will start declining. One must consider also the possibility that dissatisfied with either higher taxes or less services, citizens would not buy enough government bonds. Clearly in the North, and particularly in Europe, a situation is emerging in which 'the imperative of cutting future costs is in conflict with the present political imperative of cutting unemployment' [Ayres, 1998: 41-43 and 46].

Even though a lot has been done recently to reduce public indebtedness, the problem remains acute because it is always politically easier to finance present welfare with future resources, that is by borrowing from future generations that have no voting right yet. The other two alternatives to growing indebtedness, namely raising tax rates or cutting government spending, are measures politically unpopular and economically recessionary. An alternative suggestion - advanced also by Krugman [1998a] - which is obtaining some support to further reduce interest rates, even in the USA where they are already quite low[65]. Such a decrease not only would ease debt burdens and help sustain consumer spending and home buying, thus strengthening the national economy, but would also hinder the capital flight which is now causing so much economic hardship in so many countries. Of course low interest rates, by fostering personal borrowing and spending, may also create resistance to taxes. This explain why so many hopes have been placed on renewed economic growth, hopes that now are being dashed away under

[65] To oblige could be a mistake, according to *The Economist* [05.09.1998: 18], because the Fed 'needs clearer evidence of a slowdown in demand, or the prospect that a further plunge in the stockmarket might threaten to choke future spending. There is little sign of either' yet.

the impact of the Asian crisis and the Russian disaster. In the absence of such an economic growth, inflation may appear, at least temporarily, 'politically preferable to dismantling a luxurious but unaffordable social security system' [Ayres, 1998: 47].

Yet to avoid private money outflows, international capital mobility must also be curtailed immediately, together with international openness in trade and other services. Capital markets bear a significant portion of the responsibility for the present situation and for the coming slump and it is imperative to make more difficult for international funds to push asset prices sky-high before suddenly dumping stocks and moving away, thus making the entrepreneur the serf of the financier. Furthermore it is equally important to understand that since the 'monetarists abolished Keynesianism they conjured up the trade cycles inherent in capitalism'. Moreover, by extending the application of 'the doctrines of competition and enterprise... to banks and financial institutions, cycles in financial markets become extreme' [Toporowski, 1993: 147-49. In other words, the liberalisation of trade and services and capital flows has certainly greatly enhanced markets' competition but it has also profoundly changed the nature of competition in these markets. Which, explains 'the emergence of competition policy as an issue related to international trade for goods and services' [Lloyd, 1998: 161]. Furthermore, C. Primo Braga's (quoted in [TE, Survey, 03.10.1998: 14]) underlines the close link between goods trade and service trade when argues that protecting service industries can undue the benefits of liberalising goods trade.

The approaching of the slump is made more likely by the income inequality already present even in the North, inequality which, among other effects, is eliminating 'the middle class bridge from poverty into the comfort zone' [Ayres, 1998: 48]. The austerity policy, principally wage cutting, that dominates Western thinking and policy-making world-wide has been promoted by the same 'upper-income groups in most industrialized nations [that] have used it to reap substantial financial gains' [Taylor, 1996: 172]. The matter might be further complicated by the apparent saving scarcity that has developed at world level, since to the availability of savings are connected the timing and the manner of the economic restructuring of the former socialist countries. The phenomenon may be due to the fact that, since the early 1980s, investment is increasingly directed to financial services rather than the industrial sector, thus disrupting the keynesian mechanism according to which a high level of savings is generated by a high level of investment.

At any rate, if public expenditure is not cut down, taxes cannot be reduced and the economy can only start a downward spiral that may easily end up as a serious depression. The substantial drop of the prices of most raw materials since the middle of 1997 is devastating the export sectors of many countries in the South. This reduces their imports from the North, curtails the profits of the multinational companies, therefore negatively affecting stock markets and prosperity in the North. Generalised austerity builds up a process that feeds on itself and thus is bound to cause a world-wide slump. As 'global capitalism is now destabilising the economies of poor countries and inflicting large losses to on investors in the rich countries' [Samuelson, 1998a: 18] it also demonstrates that globalisation causes crises and at the same time creates conditions that block the crisis' resolution.

To all these problems one must add the growing menace of terrorism, even if purposely exaggerated, and the proliferation of nuclear arms and other weapons of mass destruction. The last threat becomes more real as Pakistan joins Russia on the list of nuclear powers with disintegrating economies. The growing inequality and all these menace are generating forces that are undermining the social cohesion of Western societies and transforming the world's economic problems into a moral malaise. Unfortunately, 'the prospects of violence and wreckage anywhere on the globe' has been greatly facilitated by 'the democratisation or privatisation of the means of destruction' raising 'quite dramatically...the costs of keeping unofficial violence under control' [Hobsbawm, 1994: 560-61]. Related to this point is the often forgotten role that defence spending has plaid in sustaining the North's economic growth[66] while representing a drain on the South's meagre resources.

Given the rapid advances of the process of integration, three alternative options appear to lie before policymakers for trying to shape the future course of the world [Lawrence et al., 1996: 28-29 and 33-4].

- Maintaining open borders for trade and capital but engage in little international co-ordination, the so-called shallow integration, or Tinbergen's 'negative integration'. In its most optimistic version of this option, 'market forces could spontaneously produce global convergence in economic policies, gradually rendering national political and cultural considerations irrelevant'. In this 'world of the invisible hand' international governmental coordination results quite unnecessary.

- Harmonising and reconciling national differences, the so-called deeper integration, or Tinbergen's 'positive integration', which represents Europe's choice for itself.

[66]A phenomenon that started with the Italian city-states' early practice of 'military Keynesianism'. A practice through which military expenditure boosts income, thereby increasing tax revenues and the capacity to keep expanding military expenditures [Arrighi, 1994: 38], which was enshrined in the economic process by the creation of standing national armies brought in by the French revolution.

• Reversing liberalisation and reasserting national autonomy. Clearly, the risk of global fragmentation increase during periods of poor domestic economic performance, when greater becomes the temptation to resolve domestic problems by penalising outsiders, and particularly developing countries because of their lower wages and weaker labour and environmental standards.

The first option may be difficult to obtain since competition in trade and international capital markets would produce strong pressures for harmonisation. Moreover, Lawrence [et al., 1996: 106] explains that 'the argument that shallow integration would produce internationally the best results depends on two assumptions. The first is that markets operate efficiently, in other words that there are no international market failures. The second is that political systems are legitimate, that is national governments reflect the interests of their citizens and thus no constraints need be imposed on their actions, an assumption analogous to consumer sovereignty'.

If a global, relatively open trading system cannot result from a spontaneous market-led process, it may then be achieved - and this is the second option - by the active intervention of various nations willing to assert their economic and political power. Through this international co-operation countries should be able to internalise and deal with market failures, use profitably international scale economies, supply international public goods, and 'police opportunistic national actions' [Lawrence et al., 1996: 58 and 106]. The risk of the second option is that it may come about essentially from the imposition of one major economy such as the United States or the European Union, the so-called 'imperial harmonization'. Although probably less threatening than global fragmentation, the imperial harmonisation nevertheless 'would increase global political disparities' and 'permit only some nations to fully realise the gains from international cooperation and would suppress diversity'. It may also give rise to the formation of few blocs - 'hub-and-spoke networks of deeper integration agreements', likely centred on the US and EU. Such an arrangement presents at least two problems. It removes Asia as a potential hub, while leaving unclear the position of part of the former Socialist area. And it seems to ignore the possibility that the most serious tensions could develop primarily between these the US and EU blocs and consequently 'capitalism versus capitalism' replace cold war's capitalism versus communism.

Furthermore, the open international system achieved by means of imperial harmonisation would be 'one achieved at the expense of national diversity and autonomy'. Undoubtedly the Cold War strengthened a solidarity that helped to paper over some of the conflicting interests and values within the Western world[67]. Its end has increased the importance of economic sources of

[67] This does not contradict Sakakibara's [1996: 8] correct perception of the Cold War as 'nothing but another civil war within the West or, more precisely, within the Western ideology of progressivism'.

frictions, while the spread of democracy that has follow it becomes a source of conflict whenever democratic practices are abandoned. Apparently the end of the Cold War has convinced some that a minimum amount of solidarity is no longer needed. Lawrence [et al., 1996:21, 41, 43, 105 and 107], however, considers unlikely an outcome involving 'a world community of nations marked by openness, diversity, and cohesion'. He even argues that such an outcome might not seem necessarily 'desirable', since 'taken to extremes, any one of these attributes could undermine the others'.

Since vulnerability remains 'the defining characteristic of the Third World polities' and 'has not been reduced by economic growth' [Krasner, 1985: 313] or by globalisation, one should dare 'thinking the unthinkable'. That is simply reducing the level of involvement between the North and the South, together with an increase in South-South interaction, a measure has already been suggested in the past by both mainstream scholars and others[68]. Krugman [1998d: 30-31] suggests a somehow similar course to the Asian countries hit by the crisis. His Plan B, mentioned also in footnote 30, recommends to give up for a time attempts 'to regain the confidence of the international investors and forcibly breaking the link between domestic interest rates and the exchange rate'. The introduction of exchange controls is essential for obtaining 'the policy freedom that Asia needs to rebuild its economies'. This freedom 'would clearly come at a price, but as the slump gets ever deeper, that price is starting to look more and more worth paying'.

Therefore, rather than quickening the pace to compete in an increasingly deregulated global economy, serious and co-ordinated attempts should be undertaken to temper economic integration's socially and environmentally destructive effects upon that global South that spans across poor and rich countries. Evidence is also revealing that 'most people attach values to processes as well as outcomes', which means the norms and regulations that related to the environment in which goods and services are produced, like workplace practices, legal rules, and social safety nets. Similar efforts should apply to trade which 'becomes contentious when it unleashes forces that undermine the norms implicit in domestic practices'. Also the demands for fair trade can be ascribed, following Rodrik [1997: 5], to 'this sense of unease', while 'much of the discussion surrounding the "new" issues in trade policy - that is, labor standards, environment, competition policy, corruption - can be cast in this light of procedural fairness'[69].

[68] It is, instead, the subjective communality of all Third World states that 'has been provided by a movement of thought that sees the poverty of the South as a function of the workings of the world capitalist system; in particular, a series of mechanisms that inevitably produce unequal - that is, inequitable - exchange' [Krasner, 1985: 308].

[69] Rodrik [1997: 80-81] goes further when insists that 'nations have the right - and should be allowed - to restrict trade when it conflicts with *widely held* norms at home or undermines domestic social arrangements that enjoy *broad* support'. He also finds 'not acceptable to unilaterally threaten retaliation

The increasing contentiousness of the relationship between trade and health, safety and environmental regulations reflects the ambiguities of the globalisation process. On the one hand, trade liberalisation tends to undermine national regulatory sovereignty, thus the opposition of consumer and environmental organisations' hostility to globalisation. On the other hand the expansion of environmental and consumer protection undermines trade liberalisation, thus the fear that trade barriers be justified on environmental ground, the so-called eco-protectionism. Furthermore, it has became apparent that environmental and consumer regulation cannot be cast any longer simply in national terms [Vogel, 1995: 3]. Although trade liberalisation can push national standards either down - the 'race-to-the-bottom effect' - or up - the 'California effect'-, until now the second effect has dominated. This result is simply due to the fact that, as Vogel [1995: 5] puts it, 'the impact of trade liberalization on regulatory standards is primarily dependent on the preferences of wealthy, powerful states and the degree of economic integration among them and their trading partners'. Furthermore, trade expansion causes direct environmental damage as well as it makes it more difficult for governments to protect the health of their citizens exposed to a growing variety of foreign goods, including food.

Another reason for reconsidering the drive towards more globalisation is that globalisation is weakening the nation state and undermining existing political structures. Yet to realise scale economies and internalisation, the scope of government should be increased; to achieve a more precise matching of taxes and choices and enhance accountability, governance should be localised. Moreover, the knowledge that the assignment level of governance should not be the same in all cases, does not solve the problem of being neither able nor willing to move to new levels of governance at continental or global levels. In this case there is no alternative but to try - if still feasible - to savage the nation state by slowing down its involvement in the process of globalisation.

Already the following events are reported. Malaysia has imposed draconian exchange controls looking as much as $9 billion in stocks into the country and hence striking 'at the heart of 100 years of Malaysian economic history'. Tokyo is considering 'a trial step towards nationalising

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against other countries because their business practices do not comply with domestic standards at home *in order to force these countries to alter their own standards*. Using claims of fairness to advance competitive aims is coercive and inherently contradictory. Trying to "export" norms by asking other countries to alter their social arrangements to match domestic ones is inappropriate for the same reason'. Moreover, 'enforcing labour standards may not always have the desired effect. If trade unions are recognised, wages in unionised sectors might rise but employment might fall. Displaced workers might be pushed into worse-paid jobs than they were before'. At any rate requests for the deregulation of labour markets, actually to make them more flexible, stop short of open migration. Finally, imposing the same environmental rules on every country, backed by trade sanctions, would destroy the comparative advantage of many countries, especially developing ones' [*ET*, *Survey*, 03.10.1998: 31 and 28].

troubled big banks'. Burma has detained foreign-exchange dealers in order to try to stern a fall in the national currency. Hong Kong has been throwing huge amounts of public money - more than $15 billion - at the stock market in an effort to lift prices and punish speculators who may now be thrown in jail. Taiwan and Japan have also been resorting to government-backed stock purchases. And Russia has effectively nationalised its banking industry, after defaulting on its foreign debt and is imposing unilateral controls on capital. These interventions are considered sufficiently isolationist and destabilising to justify C.F. Bergsten's [IHT, 07.09.1998: 13] conclusion that there is 'a backlash against globalization' and F. Zakaria's [1998: 19] predictions that 'the crisis in Russia may prove to be the high-water mark of the age of globalization'. Prime Minister Mahathir bin Mohamed is already convinced that 'the free market system has failed and failed disastrously'. The Malaysian action has lent authoritative support in Thailand, The Philippines and even in China where officials have declared it 'understandable and permissible under international covenants'. The just released UNCTAD Trade and Development Report maintains that capital 'controls will remain an indispensable part of developing countries' armoury ...against international financial instability'. Paradoxically it is the countries that retained capital controls, like India and China, that by being not vulnerable to a sudden exodus of capital, have weathered the financial crisis much better than those which had liberalised the capital sector. Because its currency is inconvertible, China has been able to cut, not raise, interest rates, while maintaining a fixed exchange rate, 'a degree of policy leeway that the rest of Asia desperately wishes it had' [Krugman, 1998d: 32]. A similar trend is emerging with respect to trade in goods. Some Asian countries have already introduced supposedly temporary tariff to protect threatened industries. Even in Europe quiet moves are afoot to prolong the voluntary export restraints on Japanese car sales beyond next year, when they are due to end, while the EU Commission has attempted to impose anti-dumping duties on unbleached cotton imports from China, Egypt, India, Indonesia, and Pakistan.

Whereas the erosion of nation state power is real, the theory seem still unable to determine either that policy management must necessarily move to the global level or that policy conflicts must necessarily be reconciled at supranational levels. Regional clubs may offer a rather effective and more pragmatic way to deal with such difficult issues [Arndt, 1997: 706]. Originally the spread of regionalism - lately more than one hundred such arrangements have sprung to life granting countries preferential access to each other's markets, thus the label 'new' or 'second' regionalism[70] - was viewed as a response to, but not an action to thwart, growing

[70] While the 'first' regionalism dealt with static issues concerning the welfare effects of unions with defined membership, the 'second' regionalism concentrates on dynamic time-path questions, such as whether preferential trading agreements represent stumbling blocks or building blocks for multilateral trade liberalisation.

globalisation [Sideri, 1997]. More recently, however, regionalism has been seen as a way of dealing with the current crisis[71]. This last possibility is strengthened by the difficulty of clearly establishing (as also demonstrated by the symposium in the July issue of The Economic Journal) whether globalisation and regionalism, or regionalisation, are conflicting (as maintained by J. Bhagwati) rather than complementary (as maintained by the USA). Although they may cause some trade diversion, regional arrangements may also aim at achieving deeper integration of international competition and investment. The real, and very delicate, problem with regionalism is that - as the construction of the European Union demonstrates - its progress is conditional to decisive and continuos leadership by one or two partners, a leadership that must also be not too oppressive as to alienate the remaining partners. A problem somehow similar, but still quite different than the one explored by Lawrence [et al, 1996] according to whom when there are major regional arrangements other nations are forced either to accept the rules of one of them or remain out in the cold, that is the 'imperial harmonisation'.

Notwithstanding that against the reversal of globalisation militate new technologies and the greater relevance of both multinational and multilateral institutions- see The Economist [18.10.1997: 104] - the negative impact of a severe economic downturn cannot be ignored. To avoid the second reversal of the globalisation process, there must take root the globalisation of solidarity. This seems necessary in order to attempt to tame, also in the sense of making it sustainable, wild, chaotic, anarchic capitalism at the global level. Presently neither the design nor the feasibility of such an action is clearly defined and it is easy to view it as a revival of the old keynesian solution now to be extended to the world level. Yet the situation is grave and something must be done since the capitalism's instability might undermine the market's democratic foundations.

Only the active intervention of the state, that is its economic policies, can correct the instability of the capitalist system. Therefore, 'reform begins with a rehabilitation of the modern state' which 'in many parts of the world has not taken root, or else it has collapsed', and is now being undermined by the process of globalisation, creating a real threat to peace and economic progress. Moreover, 'most actually existing states cannot hope to reconcile the imperatives of global markets with the needs of social cohesion and environmental conservation' [Gray, 1998: 201-02]. The task of the state becomes then to provide the right type and amount of social insurance needed to counterbalance the predominance of global markets, while that of

[71] The suggestion recently made that 'the new regionalism is, in good part, a direct result of the success of multilateral liberalisation' [Ethier, 1998: 1160] is quite different from that advanced in this paper, namely regionalism as a refuge from globalisation.

economics to developing a system for a more appropriate assessment of new technologies' impact on scarce resources.

From these state interventions - such as the regulations of currencies, capital movements, trade and environmental conservation - should materialise a regime of global governance in which 'world markets are managed so as to promote the cohesion of societies and the integrity of states'. Yet 'the replacement of global laissez-faire by a managed regime for the world economy is, at present, nearly as Utopian a project as a universal free market'. Furthermore, 'the regulation that is needed in a truly global economy must promote a modus vivendi among species of capitalism that will always remain different' [Gray, 1998: 199-200 and 203].

Instead of inaugurating a universal civilisation 'as both Marx and Smith thought it must', the growth of a world economy 'creates regimes that achieve modernity by renewing their own cultural traditions, not by imitating western countries'. In the world economy as it is presently organised 'there is now no alternative to capitalism, only its constantly mutating varieties...diverging from the ideal free market and from each other'. The overall result is that 'sovereign states are locked in competition not only for markets but for survival', societies are fractured and states weakened, while peoples 'become rivals for resources while instituting no methods for conserving'. Consequently 'peace is continually at risk' [Gray, 1998: 195-96], a risk heightened by the fact the globalisation has 'weakened, or even removed most instruments [like income transfers] for managing the social effects of economic upheavals' it generates [Hobsbawm, 1994: 572]. The argument is more forcefully put by Rodrik [1997: 70-71] who attributes to globalisation the deliverance of 'a double blow to social cohesion - firstly by exacerbating conflict over fundamental beliefs regarding social organisation and secondly by weakening the forces that would normally militate for the resolution of these conflicts through national debate and deliberation'. Effects these to which 'many developing countries [are] perhaps even more exposed than the advanced industrial countries'. Hence, to gain wider acceptability the world economy must make international economic integration 'compatible with domestic social and political stability', so that it 'does not contribute to domestic social disintegration' [Rodrik, 1997: 2].

Another problem is the recognition that, 'like the pre-1914 international liberal economic order, a global free market functions only so long as its institutions are underwritten by an effective global power. The USA today lacks the will, perhaps the capacity, to assume the burdens of an imperial power comparable to that of Britain during the belle époque'. Yet based on their 'assumption that, sooner or later, the countries of the world will all accept "democratic capitalism"' the same USA 'is engaged in a revolutionary make-over of the world economy... in the terms of the American free market' [Gray, 1998: 198 and 204]. In other words, while not accepting imperial responsibilities, including the fundamental one of guaranteeing some stability, the USA's actions are such as to strengthen many countries' resistance to the jointly intervention required for regulating the world economy.

Yet the extent and pervasiveness of a world economy largely operating across state frontiers has enhanced the possibility of a global crisis. A crisis that, though in different ways and degrees, would affect all countries, irrespective of their political, social and economic configurations, as already demonstrated by the Great Depression of the 1930s. Meanwhile, it is dawning on many that, aside from whether or not economic growth is good, there are no more simple receipts - as the Washington consensus - for making the world economy grow, not to speak of making it a better world to live in. Clearly the world economy urgently needs fixing and nobody knows what to do and in which direction to move. No less frightening is the realisation that no one is in charge since the leadership is in serious troubles in the USA, Russia, Japan and Germany[72]. As world leaders' concern grows as one country after another catches the contagion, they seem equally unable to fully understand the nature of the problem and even less able to act upon it. The vacuum is intellectual as well as political.

If also the second internationalisation drive is to end, its defeat can be attributed principally to the inequalities and the economic crisis it has generated. Furthermore, a hasty liberalisation clearly could not be expected to generate only positive effects. While the absence of a global government makes it impossible to take care of the negative effects of liberalisation, the excessive optimism, complacency, and a dose of self-deception prevailing in the North as well as in the international institutions[73] are rendering unsustainable the process of globalisation.

As the world economy advances into a global slump, the retreat from globalisation could lead to growing regional integration which allows the achievement of sufficient economies of scale and liberalisation, while also making it possible to control and reduce the negative effect of world-wide globalisation. Regionalism allows retaining some of the logic underlining globalisation. Because of the higher level of homogeneity that is likely to characterise regional partners, regionalism finds less daunting the task of building up an adequate governance system. Adequate in the sense that it allows the pursuit of trade liberalisation and production

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[72] No wonder that international public opinion surveys show declining confidence in government not only in the USA, but also in Canada and Europe [*IHT*, 31.08.1998: 4].

[73] Writing before the Asian crisis began, Krugman [1995b: 30-31] characterised the first part of the 1990s, the period of the reign of Washington consensus, 'as a sort of speculative bubble', that is 'a more subtle political process through which the common beliefs of policy-makers and investors proved mutually reinforcing'. As all bubbles must eventually burst and 'the Mexican crisis marks the beginning of the deflation of the Washington consensus'.

rationalisation, as well as the reduction of uncertainty and risk which extra-regional forces are bound to foster. No less important is the fact that regionalism allows a more equilibrated sharing of responsibility and control in the common governance together with the defence of the national identity of the partners. It is the 'human face' of regionalism that makes it the only space where liberalisation is sustainable economically as well as politically. In this perspective the retreat of globalisation can also be considered the victory of Europe.

5. CONCLUSIONS

The analysis so far developed can be summarised in the following main points:

- although the present globalisation is deeper than the previous one of late 19th century early 20th century, they are both rooted in the laissez faire notion that emerged in the middle 19th century; the main problem of the current globalisation being the type of technology that has spurred;

- the present globalisation is characterised by a South that is wider and it extents itself into a North that, consequently, has become relatively smaller. Hence development must be redefined in terms of less material and less material-intensive production, that means dematerialization of growth[74];

- a slow down of growth in the North highly increases the risk of a global depression, the beginning of which is rooted in the current predicament of East Asia, its crisis being 'as much a crisis of Western capitalism as Asian capitalism' [Radelet and Sachs, 1998: 3];

- even with no global depression, 'continued globalization cannot be taken for granted' [Rodrik, 1997: 9]. In fact signs of a retreat from free market capitalism are already appearing in several countries, inclusive in some of those that have been notably its most successful practitioners;

[74] Dematerialisation is a strategy aiming at obtaining economic growth by continuously increasing the productivity of natural resources rather than the productivity of labour through the use of material capital and energy. Although since the industrial revolution increasing labour productivity has been the road to economic growth, a better guide for the future could be 'to increase the *value* of the outputs and reduce the physical resource - material and energy - inputs'. The standard theory of growth instead fails to reflect the role of energy and natural resources, notably 'the role that increasing availability of cheap fossil energy ...has had in driving the substitution of machines for human labor over the last 200 years'. Furthermore, this theory makes allowance neither for resource depletion and cost replacement of these resources nor for the environmental damage caused by their use. Consequently resource costs are significantly undervalued [Ayres, 1998: 202-03 and 196-98].

• the importance of establishing global institutions that can ensure an appropriate and sustainable growth of the world effective demand which does makes contagious overall development rather than depression;

• the effectiveness and usefulness of IMF is undermined by the working of the globalisation process, which makes it even more difficult to build an institution able to manage the crises it generates. Yet if many advocate a 'new financial structure', the prevailing intellectual vacuum prevents even its description. Among the principles to be reconsidered is certainly that of central banks' independence, starting with that of the newly established European Central Bank, plus the opportunities and dangers - higher volatility among the latter - that the emerging monetary duopoly - dollar and euro - is bound to create;

• the difficulties faced by unfettered globalisation could represent a powerful boost to the drive towards the creation of a series of diverse and discrete economic groupings. These blocs could become the distinctive feature of the 21st century world economy, an economy more variegated and multifaceted within which Western liberalism and its model of globalisation are just one of the available options. Until now globalisation has been essentially a process of Westernisation.

Recent developments seem to underline 'the end not of history, but progressivism, the belief that there is only one ideal end, the unique path to which human beings can recognize' [Sakakibara, 1995: 8]. The 21st century could then be not only an age of multiple civilisations but also of different socio-political systems. Various types of capitalisms could proliferate from the neo-classical capitalism that many consider the sole model, while regionalism could become the antidote against the excess of unfettered globalisation. Whether such an evolution of the world economy will be more environmentally friendly than it has until now, it remains, however, rather unclear. Yet, the race for resources would certainly become a major source of confrontation.

Therefore, while it is easier to agree with Hobsbawm [1994: 6 and 10] that the 'unknown and problematic' future we are entering does not need to be 'necessarily apocalyptic', it is difficult to envisage this century to end with T.S. Eliot's 'whimper'.

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