Introduction: Challenges of Globalization

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The world economy has never been wealthier than it is today. Yet many wonder about what can go wrong. This introduction discusses three relevant areas. The first section provides a brief overview of the great economic, social, and political achievements of globalization in the last three decades, one of the greatest booms in world history. Now, however, the world is experiencing an abrupt end to this period of achievement following the eruption of a financial crisis that began in the United States and may spread to other regions. Worry dominates. The second section discusses the underlying macroeconomic imbalances in the world economy and how they contributed to the current crisis. Various aspects of these imbalances are the theme of six of the ten chapters of this book. Globalization arouses anxiety, whereas capitalism in one country is much less controversial. The third section of this introduction and the last four chapters of the book discuss how the economic model that has improved economic welfare is developing or should evolve.
A Golden Period of Global Growth

The years 2003–07 represented a golden period of growth and wealth for the world economy, which had not grown so fast since the early 1970s. The World Bank reported that, thanks to the economic boom in China and India, not only the share but also the absolute number of poor in the world diminished (Chen and Ravallion 2007).

Until World War II, the United States and Western Europe completely dominated the world economy. Ironically, after Japan’s defeat in World War II, that country rose to become a great economic power, and by 1990 people talked about the next century as dominated by Japan—until its economy just stopped growing.

The next wave of fast-growing economies were the East Asian Tigers—Hong Kong, Singapore, Taiwan, and South Korea. The Asian financial crisis in 1997–98 slowed their growth somewhat, but their march forward remains impressive.

When Deng Xiaoping launched China’s economic reforms in 1978, the country was miserably poor. After three decades of tremendous economic growth, China’s GDP per capita in current dollars is still one-quarter of Russia’s, which in turn is less than one-quarter of the US level, but China’s rise continues unabated. India started growing at a similar speed beginning around 1990. Indeed, most of the countries in East and South Asia have gained dynamism, and, led by China and India, now appear to be the prime growth engines of the world: Since 2000, nearly the whole of Eurasia, from China via India to the Baltics, has maintained an average economic growth of 7 to 11 percent a year.

After the fall of the Berlin Wall in 1989, it took almost a decade before the former Soviet bloc could join the growth feat of East and South Asia, but it has done so with a vengeance, reaching an average growth rate of 9 percent a year in recent years.

Meanwhile, Latin America has stabilized and achieved a moderate but steady economic growth of 4 percent a year. The real surprise has been Africa, which in the last few years generated 6 percent growth. The Middle East has also been quite dynamic because of large oil rents, but it remains arguably the least reformed part of the world economy, with relatively overregulated and state-dominated economies (Noland and Pack 2007).

Because of high growth in many less developed countries, the world is seeing a stark economic convergence, which has become a dominant theme in the global economy (Balcerowicz and Fischer 2006, Gaidar 2005). The focus is now on the largest emerging economies of Brazil, Russia, India, and China—the so-called BRICs. Goldman Sachs forecasts that by 2039 the BRIC economies will together be larger than the G-6 economies (France, Germany, Italy, Japan, the United Kingdom, and the United States; Wilson and Purushothaman 2003).
Economic growth does not come alone. It raises society as a whole, accompanied by extraordinary social achievements. Poverty has fallen sharply, not only in the share of the world population that is poor but also in absolute terms, even if the World Bank still estimates that about one billion people live in absolute poverty (Chen and Ravallion 2007). The major indicators of global health are improving, and impressively so. The average life expectancy in the world increased from 63 in 1980 to 68 in 2005. In the same period, global infant mortality declined from 79 per 1,000 live deaths to 52. The world’s healthier and wealthier people have invested in their human capital, so that global literacy has risen from 76 percent in 1990 to 82 percent in 2005 (World Bank 2007).

The economic and social improvements have also been accompanied by an expansion of democracy. What Samuel Huntington (1991) called the “Third Wave” of democratization, which started in Spain and Portugal in the mid-1970s, has increased the number of democracies in the world from 41 in 1974 to 123 in 2007 (Freedom House 2007, Diamond 2008). For the first time in world history, most people live in democratic countries. At the same time, there are fewer military conflicts and fewer deaths in armed conflict than ever before in recorded history (SIPRI 2007).

Thus the last three decades of economic, social, and political development in the world have been nothing short of spectacular, doubtless the finest ever. As a result, for the first time, we can seriously talk about the end of poverty. In 1989, when Francis Fukuyama wrote about the end of history, suggesting that the whole world was about to become democratic, he was widely ridiculed. Twenty years later, such a perspective appears less utopian (Diamond 2008), although still far from being achieved.

Two very different kinds of queries arise in the midst of this plenty. A first and natural worry is that the situation is too good to last. Time and again, the world has been hit by financial crises and depressions. The recent episode of rapid growth for almost the entire world economy resulted from the coincidence of numerous supportive factors, which will not necessarily endure at least to the same degree.

First and foremost among these factors, the world economy benefited from comprehensive and far-reaching policy reforms in a number of important countries and regions in the 1990s and early 2000s, the subject of analysis in many chapters of this volume. Second, after two or more decades of macroeconomic turbulence caused by weak, and sometimes openly populist, macroeconomic policies, the vast majority of less developed countries adopted a more prudent stance. This resulted in an impressive worldwide disinflation, a rapid increase in international reserves, and a substantial improvement in fiscal balances. Third, the successful completion of the Uruguay Round in the mid-1990s helped, with a certain time lag, to liberalize the world’s manufacturing trade and, partly, trade in the service sector. Fourth, an accommodative monetary policy of the largest central banks in the early 2000s, in the aftermath of the so-called...
dotcom bubble burst and the 9/11 terrorist attack, resulted in a strong and positive demand shock for most of the less developed countries and strengthened their economic boom.

Unfortunately, the near-term global prospects look less optimistic now, and it is not clear how the world economy and individual countries will adjust to the new, less favorable environment. Some of the factors that contributed to the recent boom are definitely over, at least for the time being. The reform impetus of the 1990s has been followed by reform fatigue in many countries. The next World Trade Organization (WTO) global trade liberalization round, the Doha Round, is paralyzed. And the accommodative monetary policy of the major central banks caused the current financial crisis in the United States and global overheating. The latter is evident in rapidly growing commodity prices and the surge in global inflation, among other indices.

A major macroeconomic concern derives from the inordinate imbalances in international payments. China, Japan, Russia, and generally East Asian and oil-exporting countries have accumulated huge international reserves, while the United States has run a large and persistent current account deficit. Most countries in Central and Eastern Europe also have large current account deficits. The first part of this book is devoted to questions concerning these deficits.

A second and very different group of worries about globalization is that its many advantages are not genuine or that other values are more important. The most obvious concern is that inequality appears to have increased in the last two decades in virtually all countries (Milanovic 2005), although Sadhir Anand and Paul Segal (2008) find no firm evidence that inequality among individuals in the world as a whole has increased during the last three decades. The very rich, however, are both more numerous and wealthier than at any other time in world history. Is this a problem? The sanguine argument contends that the flood raises all ships. As long as the poor receive more, the rise in the share accumulated by the very rich is not really troublesome. But a radical concern is that the rich are buying society lock, stock, and barrel—their wealth jeopardizes democracy by leading to the rule of the wealthy, whose goal is to make more wealth. Naomi Klein (2007) has taken this argument to its extreme by claiming that the driving force behind capitalist ideology is war and exploitation to make the richest even richer. A less radical criticism of globalization focuses on its increasing pace of social change, resulting in the frequent closure of enterprises and the transfer of jobs to other places and countries.

Notwithstanding these criticisms, the markets for goods, services, and capital, but not for labor, are arguably freer than at any other time in the world, and global economic integration is greater than it has been at any time since World War I. During the two decades before the Great War, the world saw a similar degree of international economic integration. The economic dynamism of that time was extraordinary, but this early phase
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of globalization ended with World War I, which started seven decades of protectionism and state management of national economies. The upshot was not an economic but a political failure as the old more or less authoritarian monarchies and empires were unable to keep up with the freedoms of capitalism.

We argue that the rising criticism of globalization is a function of the inherent self-destructive forces of capitalism. In itself, capitalism is not stable. Business cycles are inevitable, and we do not know whether true depressions can be avoided in the future. People must nonetheless believe in its just existence if capitalism is to survive. However absurd communism appeared toward its end, it represented a clear, anticapitalist logic, which might reemerge when the evils of communism have been sufficiently forgotten. The public rarely appreciates private ownership of large enterprises and huge fortunes. Other dangers are populism and chauvinism, which can manifest themselves in ways quite similar to leftwing radicalism.

The second part of the book, therefore, concerns the institutions of capitalism. What are they? How can they be defended? How are they evolving?

How Severe and Dangerous Are Global Imbalances?

The last serious global financial crisis was caused by the combined effects of the East Asian, Russian, and Brazilian crises in 1997–99 and the Long-Term Capital Management (LTCM) failure in the United States at the end of 1998. Argentina and Turkey faced serious crises somewhat later, but they were confined within their national boundaries. Since then, the world has seen a period of unusual macroeconomic calm and discipline, especially in emerging markets and most of all among those that were hit by the crises of 1997–99. These countries have excelled with budget surpluses (or small deficits), many with current account surpluses, and many have paid off their foreign debts, most notably Russia. As a result, China, Japan, and Russia have accumulated the largest international currency reserves in the world, amounting to a total of $3 trillion.Sharply rising oil prices since 2004 have also led to increased reserves in the oil-producing countries, which appear to have learned their lesson from the 1970s, when they squandered their (temporary) fortunes in the belief that they were permanent.

If properly accounted for, total current account surpluses must be balanced by a sum of corresponding current account deficits. The anomaly of the last decade has been that the United States has been the largest net debtor to the rest of the world economy. Another region that has experienced lasting and sustained current account deficits is Central and Eastern Europe. Six chapters in this book focus on current account imbalances, how to interpret them, and what to do about them, if anything.

In chapter 1, Susan Schadler, former deputy director of the European Department of the International Monetary Fund, asks “Are Large External
Imbalances in Central Europe Sustainable? A number of countries in this region have had lasting and large current account deficits, and seven (Bulgaria, Estonia, Hungary, Latvia, Lithuania, Romania, and Slovakia) averaged 7 to 12 percent of GDP in 2001–06. In 2007 these deficits grew even further, with Latvia’s deficit rising to as much as 24 percent of GDP, Romania’s to 14 percent, and Bulgaria’s to 21 percent (Marrese 2008, EBRD 2008). In the late 1990s, the rule of thumb was that a current account deficit of more than 5 percent of GDP was worrisome (Summers 1996).

Schadler acknowledges that “By conventional standards, the external imbalances of many of the Central and Eastern European countries are indeed large enough to justify serious concerns” and proceeds to analyze standard factors of vulnerability. In this region, exchange rate policies arouse few concerns. The Central European countries have hardly any discretionary official intervention. The Baltic states and Bulgaria have currency boards, and the others are inflation targeters with floating exchange rates. Public debt is no major concern because capital inflows focus on the private sector, going primarily to real investment. This high economic growth arises from very dynamic total factor productivity, both of which should attract foreign investment. The underlying factors are these countries’ recent accession to the European Union and their prior depression of the communist system and its collapse. Indeed, most of the current account deficits are actually covered by foreign direct investment. To that should be added some stock purchases and short-term loans from foreign banks to their subsidiaries in Central Europe.

These factors dispatch most of the conventional concerns, but not all. In some countries, the external deficits are just too large. Latvia stands out, though its small size and deep integration with the Nordic economy might save it from a hard landing. Another country with a large deficit that is only partially financed with foreign direct investment is Romania. A different concern is excessive private borrowing from abroad, which was the prime cause of the East Asian crisis. In this regard, several countries (notably Estonia and Latvia) appear vulnerable.

A further worry is currency mismatch. The governments have reduced their currency risks by increasingly selling bonds in their local currencies. Currency risks have instead landed in the consumer sector. In Hungary, half of all home mortgages are in Swiss francs. Thus, the dominant picture is one of a historic shift of savings from a region where productivity grows slowly to a more dynamic region. Yet, rather than abating, the current account deficits have ballooned, increasing fears of financial crisis.

In chapter 2 Alan Ahearne, Birgit Schmitz, and Jürgen von Hagen discuss “Current Account Imbalances in the Euro Area.” Their initial observation is that current account imbalances have widened markedly over the past one and a half decades and that these imbalances have been aggravated since the creation of the Economic and Monetary Union (EMU). The salient point is that the three poorest euro economies, Greece, Portu-
gal, and Spain, had current account deficits on the order of 9 percent of GDP in 2006, and these were financed by rich euro countries. The authors argue that this increased dispersion of current account positions reflects shifts in relative competitiveness in the euro area. As always, the source of financing is crucial, and a worrisome observation is that the large current account deficits of Greece, Portugal, and Spain are financed to a large extent through bank loans. An alternative interpretation of the current account imbalances is that they reflect capital flows in line with neoclassical growth theory.

The authors proceed to an econometric test and find that the EMU has changed the pattern of capital flows in Europe, increasing capital flows from rich to poor countries. Thus the current account development reflects an adjustment to capital flows rather than any flaw in macroeconomic management. The authors’ message to new EU members is that they should expect even larger capital inflows—and current account deficits—when they finally adopt the euro. Yet the question remains: How much is too much? Countries that join the EMU will face a serious challenge in managing capital inflows.

Marek Dabrowski takes this argument further in chapter 3, “Rethinking Balance of Payments Constraints in a Globalized World.” His aim is to confront the traditional framework of analysis for balance of payments with the new realities of a highly integrated world economy with great capital mobility. He finds many weaknesses in the simplifications of traditional analysis: It distinguishes transactions as “foreign” or “domestic,” but in this day and age many asset owners easily alter residency or jurisdiction. All transactions, both public and private, are summarized in balance of payments, but their purposes and utility vary greatly. Dabrowski also points out that in a world of largely unrestricted capital flows, investors seek the highest expected return regardless of national boundaries, and the movement of capital is particularly easy in a monetary union. Much of the current account deficit of the new EU members may be seen as a reflection of the new member states offering a higher rate of return on capital. Because they attract capital inflows, they have a current account deficit. But in fact, these deficits bear witness to a favorable business climate. As a consequence, Dabrowski warns against the use of stereotypical warning signals, such as the “5 percent doctrine,” as a standardized share of GDP in current account deficit.

Instead, Dabrowski proposes an alternative analytical framework. Capital movements are not restricted but free, and major sources of capital have no country of origin. Investors represent the private sector, and they seek the highest rate of return regardless of place or duration of investment. Finally, if a country has a better investment climate than others, there is no necessary diminishing rate of return in that country. Such an alternative analysis could have far-reaching policy implications. Deficit countries would fall into two categories, those with sovereign currencies
and those belonging to a monetary union, notably the EMU. In general, many large deficits become acceptable, but certainly not all. A much more differentiated, nuanced, and profound analysis of capital flows becomes necessary.

In chapter 4, “A World Out of Balance?” Daniel Gros broadens the picture to external imbalances in the world economy. His starting point is the US current account deficit that increased steadily to 6 percent of GDP in 2006. This external deficit was underpinned by rapidly rising housing prices in the United States and permissive credit markets with historically low risk premiums. Gros argues that the US external deficit was not caused by higher US growth but by the maintenance of domestic demand through foreign borrowing. The US current account deficit corresponds to the difference between US saving and investment.

Today, emerging economies maintain a savings glut, while US household savings have fallen to nil. The US external deficit has been financed by emerging-market economies, among which the biggest surplus country is China, which seems determined to maintain its export-led growth model. The other financiers of the US deficit are the oil-producing states; rising oil prices have led to substantial savings surpluses in these countries. Further oil price increases should aggravate the already great global imbalances: Gros sees the large savings of the oil-producing countries as the cause of low interest rates in the face of sharply rising oil prices.

Gros summarizes three views of the key cause of the excessive global imbalances. Washington blames China for underconsumption and manipulation of its exchange rate in order to promote exports, Europeans complain about the US fiscal deficit and the loose monetary policy of the Federal Reserve, and Asians accuse the United States of overconsumption while themselves seeing a competitive exchange rate as a necessary element of an export-led growth strategy. As China has amassed $1.7 trillion of reserves through huge surpluses vis-à-vis both the United States and Europe, a transatlantic consensus has been formed in favor of a revaluation of the Chinese renminbi. However, Gros argues that China is only one large source of global savings; the other is the oil-producing countries. He advocates that the United States accept a prolonged period of weaker growth in order to achieve a gradual adjustment of its external deficit, but he worries that US policymakers will try to escape an economic slowdown by cutting interest rates aggressively, which would cause the dollar to plummet. If the United States adjusts primarily through devaluation, the European economy will also decelerate, and the slowdown might become global. Gros concludes that the United States and some European economies have been overheated because of housing inflation, which has been financed internationally—a problem that should be resolved.

In chapter 5 Ray Barrell, Dawn Holland, and Ian Hurst discuss “Sustainable Adjustment of Global Imbalances.” They focus on the US current account deficit of 6 percent of GDP, which has led to a negative US net
asset position of 20 percent of GDP. They argue that the deficit may be due partly to misaligned exchange rates and partly to excessive domestic absorption and that a simple devaluation would have no long-term effect on the current account. The underlying forces must be adjusted. The higher oil price since 2004 has boosted the current account deficit, but the reduction of the US effective exchange rate from 2003 to 2005 brought about a slightly larger improvement of 2 percent of GDP.

These authors argue that mere exchange rate changes driven by monetary policy would only temporarily improve the US current account. If a sustained change is to take place, the real economy must change. They advocate adjustment through a combination of actions. Critically, domestic absorption needs to fall in the United States and increase elsewhere. The authors prefer a market adjustment through a change in the risk premium on US assets. As a consequence, the US exchange rate would experience a 20 percent real depreciation. The rise in the risk premium would increase US real interest rates by over 1 percentage point from early 2007 to 2010. Then the current account balance would be 3.5 percent of GDP better than the baseline. Such a combination of exchange rate adjustments and improved current account balance would increase the US net asset position by 24 percent of GDP by 2015.

In chapter 6, “Meeting the China Challenge Is Meeting the Challenge of Comprehensive Engagement and Multilateralism,” Wing Thye Woo brings China into the discussion. He begins with the US animosity to Chinese trade surpluses with the United States, which he considers misdirected. He sees the US concern as one of increased job insecurity that derives both from enhanced globalization (not only from trade with China) and from rapid technological innovation. Rather than wanting to stop either of these forces, Woo calls for a better social safety net in the United States.

Turning to China, Woo finds that the main cause of the Chinese current account surplus is the country’s dysfunctional financial system. Total savings exceed investment expenditures, and this savings glut is the cause of the current account surplus. Simply put, China invests its savings surplus in foreign assets such as US treasuries. One reason for the savings glut is that all the banks are state-owned and the state needs to regulate their lending to keep them responsible. The Chinese people save a lot because of the poor social safety net. Because of inadequate financial intermediation, the financial system fails to reduce savings that are induced by uncertainty, forcing investors to finance more of their investment with savings than they would like.

Woo argues that the problem is complex and therefore its solution must have many parts. The United States ought to improve its fiscal balance and reinforce the dwindling Trade Adjustment Assistance program, retraining support, and medical insurance to enhance people’s sense of security. China primarily ought to speed up the renminbi appreciation that
started in 2005, not least to contain inflation, accelerate import liberalization, and pursue a more expansionary fiscal policy to soak up excess savings. Together, the United States and China should pursue multilateral trade liberalization leading to the successful conclusion of the WTO Doha Round.

In August 2007, after these chapters were written, a financial crisis erupted globally originating in the United States. Although the problems of global imbalances had been evident for a long time, as these chapters show, the dominant one was the US current account deficit, which had been growing larger until 2006. By that time, there was no doubt that it was unsustainable. The fate of the large current account deficits of small and less well-off countries in Europe is uncertain, but the old rule appears to prevail that they may have sustainable deficits for quite some time, and eventually some will grow too large and will require readjustment when the credit flow suddenly stops.

Europeans especially have long blamed loose American credit policy, which has been geared to overconsumption, for the US current account deficit. Federal Reserve Chairman Ben Bernanke has instead famously blamed the “savings glut” in the rest of the world, while others have emphasized the more attractive returns of financial investment in the United States.

The financial crisis that erupted in August 2007 also put the spotlight on poor regulatory standards evident in the acceptance of poor credits called subprime mortgages, which were packaged as securities and given excessively high credit ratings. In the wake of the mortgage crisis, the United States has landed in a housing crisis, and both have brought about an economic slowdown that is reducing growth in the rest of the world as well. Readjustment is under way, but it is guided by fear rather than an orderly process.

The long-desired realignment of exchange rates began in early 2003, and the financial crisis in 2007 gave it new impetus. The US dollar has fallen as low as anybody would have desired (Williamson 2007), while the euro and the yen have surged. Most East Asian currencies, including the Chinese renminbi, are set to rise further (Goldstein and Lardy 2008). How far the exchange rate changes will overshoot in the midst of the crisis is still to be determined. Obviously, an earlier and more orderly realignment of the exchange rates would have been preferable, as John Williamson (2007) in particular has long argued.

What will be the long-term implications of the current abrupt depreciation of the US dollar for its role as the only truly global currency and for global macroeconomic and financial stability? We foresee three impacts. First, central banks that target their exchange rates to the US dollar (even partially or in a soft way) must abandon the dollar peg immediately if they want to avoid importing an inflationary impulse via the weakened US currency. This dilemma concerns many central banks in Asia (most no-
tably China and India), oil-exporting countries (especially those in the Gulf region), the Commonwealth of Independent States (Russia, Ukraine, Kazakhstan, and others), and some countries in Latin America and Africa.

Second, the dollar is the global unit of accounting and statistical reporting, the dominant currency of trade and financial transactions, and a means of storing financial wealth, including the international reserves of central banks. All who use the dollar as an accounting unit will report rapidly increasing sale prices and revenues as well as dollar-denominated profits. This may create an illusion of money and wealth in the short term, which could lead to overly optimistic financial and investment plans if adjustments are not made for the declining international value of US currency. The same may happen on a macro level, especially in countries that continue to peg their currencies to the US dollar; they may face the illusion of increasing tax revenues, for example, as in the case of rent-type taxes linked to dollar-denominated export prices, or growing international reserves.

Third, holders of US dollar-denominated assets will lose and holders of dollar-denominated liabilities will gain. Central banks with large dollar-denominated reserves will be the major losers. Sovereign wealth funds created by oil exporters and some Asian countries in order to sterilize excessive foreign exchange inflows will be the next victims. Numerous private holders of dollar-denominated financial assets worldwide will also suffer exchange rate losses and inflation tax. On the other hand, the US private sector (especially households) and US government, the two largest debtors in US currency, will be major beneficiaries. Similar gains will be shared by all other holders of dollar-denominated liabilities. This may not be the best lesson for potential borrowers in less developed countries as it may increase their appetite for future foreign-currency borrowing.

The key question, however, is whether holders of dollar-denominated assets will quietly stay put or start a run on the US currency. Until very recently, the prevailing opinion was that, assuming a modest and gradual dollar depreciation, there would be no dramatic recomposition of at least official assets. However, this assumption may not hold true any longer, leading to further dramatic exchange rate readjustment.

Looking ahead, we must ask whether the US dollar will sustain its role as the most important global currency. If not, which currency will take over that role? Today, the euro seems the most likely successor, but whether EMU member countries and the European Central Bank would be happy with such an outcome is debatable. And a disruption of the current dollar-based trade and financial transaction system may harm global trade and capital flows.

In summary, the rising and persistent US current account imbalance proved unsustainable, and because little had been done to contain it earlier, the adjustment was sudden and abrupt following a serious financial crisis with unknown global consequences (at least at the time of this writing). As
always, an earlier adjustment would certainly have been desirable—and not impossible, as there had been clear warning signals for years.

Where does this leave the case for globalization? An immediate and broad reaction is that globalization is in danger. If even the United States, the heart of capitalism, can enter such a destabilizing crisis, what can be said in defense of globalization? Yet capitalism was considered moribund in Russia in August 1998 and in Argentina a few years later, but it rebounded with a vengeance and globalization proceeded. After all, the problem with the United States has not been capitalist orthodoxy but the leadership’s failure to abide by its dogmas. The political response will require both intellectual clarity and persuasive power.

Capitalism: A Model of Economic Growth

Curiously, the capitalist model of economic development appears less questioned today than globalization. Since the collapse of communism, there does not seem to be much of an alternative either in theory or in practice. The pillars of capitalism—reasonably free trade and prices, private ownership of the means of production, and stable money—are widely accepted. The issues are limited to how large public redistribution should be, how much regulation of various markets is optimal, and how the difficult public functions can best be organized.

In chapter 7 Leszek Balcerowicz discusses “Institutional Systems and Economic Growth.” As the title suggests, this is a broad philosophical approach to long-term economic growth as one of the most fundamental issues of empirical economics. Balcerowicz singles out innovation-based growth as potentially lasting and universal, while other forms of growth are merely transitional. Innovation-based growth must be founded in a country’s institutional system, but it can be blocked by either an information barrier or an incentive barrier. The latter is in effect when the expected utility an individual derives from a new system does not correspond to the utility to society of his or her act. Either investment is hampered or the individual returns of an investment are in danger because of official or private predation. With few exceptions, in countries where incentive barriers prevail, long-term economic growth requires a substantial change of the country’s institutions through reform.

In a similar vein, Jacek Rostowski (since appointed minister of finance of Poland) and Bogdan Stacescu consider “The Impact of the ‘Legal School’ versus Recent Colonial Origin on Economic Growth” in chapter 8. The target of their scrutiny is papers by Rafael la Porta and colleagues (1997) arguing that the origin of a country’s legal system is decisive for economic growth. Rostowski and Stacescu conduct an econometric test that fails to verify that a legal system based on the English common law system is more conducive to growth than one founded on French civil law. Instead,
their regressions support the view that the problem lies in a wider complex of institutions that are associated with having been a British or a French colony. They find that former British colonies evidence better economic performance than former French colonies. It may be added that this is only a matter of relative performance, not an absolute obstacle; as Raghuram Rajan and Luigi Zingales (2003) noticed, France had a relatively larger stock market capitalization than the United States in 1914.

The last two chapters in this book discuss the possibilities for the European Union to compete and adjust in relation to East Asia’s Tigers and China, respectively. In chapter 9, “Does the European Union Emulate the Positive Features of the East Asian Model?” Anders Åslund arrives at a surprisingly positive answer. In a comparison between key features of the East Asian and EU economic models, he finds that East Asia has excelled in four regards: small transfers and public expenditures, low taxes, freer labor markets, and strong education. He focuses on the first three, which are all prominent goals of the EU Lisbon Agenda of 2000.

The Lisbon Agenda has not been very effective, however, because it was a top-down approach. Instead, fiscal and regulatory national competition on the unified European market seems to be doing the trick. Tax competition is pervasive. The average highest personal income tax has fallen by 5 percentage points in Eastern and Central Europe in the last decade and by 4 percentage points in the 15 old EU members. The corporate profit tax has slumped by 11 percentage points in Eastern and Central Europe and by 9 percentage points in the old member countries. These tax cuts have been accompanied by stricter fiscal discipline. Even so, from 1995 to 2000, average public expenditures as a share of GDP declined by almost 6 percentage points, with three countries recording declines of 10 percentage points or more. In addition, labor markets are being deregulated in small steps. Many factors have contributed to this steady liberalization, but the dominant force is competition among the nations belonging to the European Union. This competition has been reinforced with the enlargement of the European Union and the strengthening of competition within the Union.

In chapter 10, “Eight Potential Roadblocks to Smooth EU-China Economic Relations,” Jean Pisani-Ferry and André Sapir consider the dilemma of relations with China from a European perspective. Their main concerns are that Europe will not reform fast enough to keep up in the competition and could be squeezed in intensified competition between the United States and China, in which the former would be more innovative and the latter more cost effective.

A number of factors contribute to the challenges for Europe vis-à-vis China. Chinese integration into the world economy may not help but interfere with European integration. Similarly, European privileged trade relations may be destabilized by Chinese competition. China’s great demand for energy and other raw materials will boost their prices and affect import-dependent Europe. Dysfunctional European labor markets are a
particular handicap. With regard to policies on climate change, Europe and China take opposing positions, which may harm control of greenhouse gas emissions and cause trade disputes. At present, the euro has shot up, while the rate of the renminbi is lingering (as a consequence of its continuous peg to the US dollar), further squeezing EU trade. And ultimately, China’s rise in economic power will reduce Europe’s weight not only in the world economy but also in international organizations.

But along with these international shifts and concerns, something curious is happening. Globalization, rather than capitalism, is being questioned because of its huge force that does not seem sufficiently well managed by existing governmental institutions. At the same time, capitalism is developing ever further in most countries. Deregulation, privatization, and the reduction of state financial intermediation are proceeding in line with the Washington Consensus (Williamson 1990). Public expenditures are declining and converging, possibly toward one-third of GDP as Vito Tanzi and Ludger Schuknecht (2000) advocated. Similarly, democratization is proceeding with economic modernization, as Seymour Martin Lipset (1959) taught us.

The exceptions to this increasing adherence to the rules of normal capitalism are few, essentially some of the most resource-rich countries (such as Russia and Venezuela), which can afford poor economic policies as long as the oil price keeps reaching new peaks.

Yet the victorious Washington Consensus is not popular. It has even become a bad word in populist leftwing discourse (Klein 2007; Stiglitz 2002, 2006). The situation is somewhat reminiscent of the 1960s. As the world improves in almost all conceivable regards, tolerance of the few elements that are not improving—inequality and security—is steadily declining. The economic success of capitalism and globalization may appear to be as good as anybody could have hoped, but capitalism also has to be politically sustainable, which is an important topic for another book.

References


