



**The State Versus The Market :**  
**A False Dichotomy**

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# ***"The State Versus The Market: A False Dichotomy"***

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## **I. Introduction:**

There are two striking facts about the recent history of economic thought on the role of the state in the economy. First, it seems to swing between extremes, from one set of ideas that give primacy to the role of state over markets to another that gives supremacy to markets and stresses their advantages over the state and then back again. Second, the stronger the theoretical challenge to the notion of the supremacy of the markets has become, the louder are the voices calling for stronger roles for the markets in the economy. The subject is dynamic and drastic changes can and must be expected. In this sense there are always surprises, novelties and discoveries. We are witnessing today yet another drastic swing away from market supremacy and towards a stronger and more active role for the state in the economy. This new swing augurs for far reaching consequences but it is consistent with the broad sweep of the historical perspective of pendulum swings.

Economic development policies in Third World countries have reflected this pendulum like shifts in ideas about the role of the state. In the 1950s and 1960s, most developing countries adopted development planning and gave the state a key role in economic transformation, both through intervention in markets and through the establishment of state enterprises.<sup>i</sup> The debt crisis in the 1980s gave lenders and their financial institutions, including the World Bank and the International Monetary Fund, the chance to repudiate these policies. The policy reforms of the "Washington Consensus" were informed by a minimalist conception of the role of the state which is confined to the provision of secure property rights, sound macroeconomic policies, adequate education and some infrastructure.<sup>ii</sup> The Washington Consensus policy prescriptions were heavily in favor of reducing the role of the state in the economy. The earlier optimism about what the state would be able to achieve has been replaced by excessive pessimism. The recent financial markets' crises in the west and the migration of the crises to the real economy with massive increases in unemployment, plant closures, and escalating bankruptcies of mammoth firms in many regions of the world have called into question the heavy reliance of unfettered competition, the wholesale participation in the deregulation dynamic and the dismantling of the regulatory and supervisory regimes over financial and other markets. The deepening of the crisis and its persistence are already chipping at the intellectual infrastructure of neo-liberal economics and the core ideas and beliefs of monetarists, rational expectations, real business cycle theories and other brands of neoclassical economics espousing a dominant role of the markets in the economy. In lightning speed governments almost everywhere have concocted multi-billion dollars, euros, etc bailout plans of banks and industries in an unprecedented race to shore up markets and consumers in desperate attempts to revive and resuscitate their contracting

economies. The voices of free marketers are muted and the mantra of the day is that Keynesian economics is alive and kicking and that we are all Keynesians now.

The earliest systematic thinking on the role of the government in the economy came from Ibn Khaldoun and formalized by the Mercantilists who advocated sweeping government intervention in industry and trade. Adam Smith's *Wealth of Nations* was in large part a reaction to mercantilist beliefs. The "invisible hand" doctrine of Smith was advanced to liberate markets from state interference. It became the dominant idea in economics and culminated in the 19<sup>th</sup> century "gold standard." Major counter ideas emerged with Marxism, Fascism and Keynesianism in the late 19<sup>th</sup> and early 20<sup>th</sup> century. Each contributed in a special way its specific ideas about why the state needs to intervene in order to achieve desirable socioeconomic outcomes. Until the eve of this moment the neoclassical view of the supremacy of markets was in complete sway despite severe and serious criticisms of the theoretical foundations of this claim. Today, the pendulum has swung again and will likely to continue to swing.

The rush towards globalization and a sense of triumphalism about capitalism in the aftermath of the disintegration of the Soviet Union and communism have combined to revert much of the economics profession to a new fundamentalism about the virtues of markets and the shrinking of government. Over the past three decades a stunning imbalance in ideology, conviction and institutions has emerged one that favor markets over the state.

This triumphalism has been challenged both on theoretical and empirical grounds and today by the unraveling of the financial markets and the speed with which recessionary forces have spread across the world. The pendulum is swinging back under the force of systematic and highly refined theoretical questioning of the orthodoxy, the re-assessment of the Southeast Asian experience and recent economic upheavals.

Like astronomers, economists must rely primarily on natural and historical experiments for their data, facts and evaluation of theories and debunking ideologies. Three major experiments have unfolded recently; all are instructive for the developing world as it ponders its options, and policy formation mechanisms and strategies. The first and second natural experiments unfolded in Southeast Asia. The first covered the period 1960 to 1996 during which the state played a major role in leading development and in transforming a basically underdeveloped region into a major economic success story. The second occurred in 1996 and continues until the present. In this experiment the state failed to ward off the negative effects of a major financial crisis in some countries of Southeast Asia and succeeded in few others. In both cases, the state was at the center stage of events. The third natural experiment is unfolding at this time. It started in the United States with a major slump in the real estate market and migrated into financial and capital markets and now threatens the real economies of the world. The message in these three experiments is simple--the state when it is dynamic and committed and when it is weak and indifferent makes a whole difference to whether the economy succeeds or fails.

As important as its role in shaping the economy, the state can also frustrate and override the development of a vibrant private sector that can play a key role in sustaining a balanced and prosperous economy. The dominance of the state or its exclusive eminence could threaten and retard growth and development as it can subvert the dynamics of a propulsive and dynamic economy. It is here where the excesses of one system can undo the success of the entire economy. The real substantive issues are not about market failure or government failure but about what makes for a successful economy where both systems can work together re-enforcing each other as equal partners in the responsibility for sustainable development. The emasculation of the private sector is nowhere more real or true than in our Arab region. Even when it was not an intended objective of the state, the private sector fell victim to negligence, indifference and an over bulging state. While it is difficult to argue for a retreat of the state, there are good reasons to argue for a more visible and nuanced role for the private sector. A role that does not compete with the state but complements and cements a partnership where the duties and responsibilities of each are clearly demarcated and respected.

In what follows I will present the theoretical underpinnings of the debate about the state versus the market and then deal with the three natural experiments and the distilled knowledge gained from their implications and end with a new perspective on a more nuanced role for a vibrant public/private partnership.

## **II. Theoretical Perspective:**

At the core of the celebration of markets is a relentless tautology. If we were to begin by assuming that nearly everything can be conceived as a market and those markets optimize outcomes, then everything leads to the same conclusion that we need to further marketize.<sup>iii</sup> If, in the event, a particular market does not optimize, there is only one possible conclusion—it must be insufficiently marketized. This is a no-fail system for guaranteeing that the theory trumps evidence. Should some human activity fail to behave as an efficient market, it must logically be the result of some interference that should be removed. There is no admission anywhere that the theory could mis-specify human behavior or fail to account for deviations from its enormously rigid assumptions.

Economists were increasingly becoming dissatisfied with simple rules of thumb (such as non-intervention, simplicity, uniformity, transparency and non-discretion) that were often advocated as guides for policy based on naïve neoclassical economic models. Recent formal approaches to political economy have relied heavily on the integration of a number of transaction costs in addition to standard market failures that render the policy formation process more complex but more relevant and effective and this is way before the new crisis. Policy making and the role of the state in the economy have been theorized to contend with imperfect and asymmetric information, adverse selection problems, moral hazard, inability to monitor effort, opportunistic and rent-seeking behavior, multiplicity of principals (principal agent problems), time inconsistency, bounded rationality and incomplete markets. All of these issues constituted formidable

transaction costs that influence the policy making at both the conceptual level as well as at the implementation level and many economists are on record calling for a more nuanced role for the state in the economy, far before the panic calls for this role in today's dizzying free falls of several economies. Avinash Dixit (1996) made this point so well over ten years ago that it is worth quoting at length.

My starting points are simple to the point of being trite—one must accept markets and government are both imperfect systems; that both are unavoidable features of reality; that the operation of each is powerfully influenced by the existence of the other; and that both are processes unfolding in real time, whose evolution is dependent on history and buffeted by surprises. Most important, I will argue that the political process should be viewed as a game between many participants (principals) who try to affect the actions of an immediate policymaker (agent). What follows from these observations is orthogonal to, and perhaps destructive, of the whole “markets versus governments” debate. The equilibrium or the outcome of the game will typically not maximize anything. Any attempts to design, or even identify, the desiderata of a truly optimal system are doomed to failure, and no grand or general results about the superiority of one organizational form over another can be expected. What we can do is to understand how the whole system consisting of markets and governments copes with the whole sets of problems of conflicting information, incentives, and actions that preclude a fully ideal outcome.<sup>iv</sup>

The message is clear, once governments cannot be wished away and that they necessarily face multiple political pressures in an environment of incomplete information and markets, the traditional dichotomy of governments versus markets does not make sense and the simple minded advocacy of laissez-faire, even in its ideal form, becomes irrelevant.<sup>v</sup>

Perhaps more interesting is the realization that what appears to be government inefficiency and delays in decision-making and implementation are often the natural outcome of a constrained Nash equilibrium. In other words, they are a reasonable way for the system to cope with transaction costs and uncertainty.<sup>vi</sup>

Theorists over the past three decades have not been kind to the tidy story of the competitive equilibrium model the center piece of neoclassical or neo-liberal economics. The simple message of this model to decentralize, marketize and that prices would act as sufficient statistics for optimal equilibrium, have been challenged from many quarters. Equally challenged is the notion that distributional decisions can be separated from those on allocation. Below is a list of some of the salient arguments in this debate.

**First**, the lesson that competitive prices are sufficient statistics for all relevant information has been shown to be incorrect when information can be used to further an agent's own welfare or where acquiring and transmitting information is costly. The importance of this finding here is that it re-opens one of the central questions of the socialist controversy of the 1930s (Grossman and Stiglitz (1976))<sup>vii</sup> Once information

problems are introduced, the view of the world embodied in the general competitive equilibrium model does not hold. To begin with, the existence of equilibrium becomes doubtful. Even when and if an equilibrium does exist, it might not be a market-clearing price-taking one, but may instead involve other phenomena such as credit rationing. The trusty normative criterion, Pareto efficiency, becomes ambiguous with incomplete information, Holmstrom (1985).<sup>viii</sup> Thus there is no generally accepted optimality concept that may apply to the world of creative destruction rife with information costs and asymmetries. These points gain added significance on noting that informational problems are more central in developing countries than in advanced capitalist countries. The fact that the neoclassical paradigm says little about real-world institutions for dealing with transaction costs is of marked significance in judging its applicability to the design of policies and in pronouncing on the appropriate role of the state in the economy.

**Second**, entry and exit processes—the creation of wholly new sectors and activities, the weeding out of inefficient state enterprises, and the integration into the world economy—will be of crucial importance during development and reform. But to understand the costs and benefits of markets with entry and exit, it is necessary that we employ a very different perspective on human behavior than is embodied in the traditional rational actor model.

When future-oriented decisions (like entry and exit) are made in the absence of complete set of futures and risk markets, economic agents must form expectations about the behavior of other agents. In some sense, each rational actor would need a whole model of the economy. In such a conceptualization of economic behavior, as K.Arrow (1987) remarks, “the superiority of market over centralized planning disappears. Each individual agent is in effect using as much information as would be required for a central planner.”<sup>ix</sup>

What is clear here is the fact that once the assumption of complete risk and futures markets is violated, then the use of neoclassical rationality leads to the violation of the assumption of informational decentralization that is often used to propound the virtues of markets. Decision making under bounded rationality seems to be inherent in entry and exit decisions. There is as a matter of fact no theory of the comparative properties of different economic systems under conditions of bounded rationality. Nelson (1981) makes this point rather forcefully in his discussion of the relevance of neoclassical welfare economics to an assessment of the strengths of private enterprise.<sup>x</sup>

**Third**, in a world of product differentiation, consumers gain from increases in variety but lose from the suppression of economies of scale. Thus a large number of outcomes are possible when trading off between varieties and larger production facilities. The competitive economy chooses on the basis of profits and leads to different results than those that maximize consumer surplus. The superiority of one economic system over others in a world of product differentiation is not supported by theoretical considerations. It may come to depend on bureaucratic costs of organizing production versus the cost of too many varieties and the loss of economies of scale. Surely these are empirical considerations over which theory has very little to offer.

**Fourth**, the second welfare theorem implies a separation of distributional decisions from allocation decisions. When private information affects both allocation and distribution, that information can be used to improve a person's welfare, possibly at the expense of efficiency. There is a vast literature on the question of the "incentive compatibility" of economic mechanisms that developed from this observation. The literature has changed the conventional wisdom regarding the possibility of achieving Pareto efficient allocations through decentralized markets.<sup>xi</sup>

**Fifth**, the market mis-describe the dynamics of human motivation, ignores that civil society needs a realm of political rights where some things are not for sale, and prices many things wrongly.

The market model imagines a rational agent maximizing utility in an institutional vacuum. It misses the point that real people also have civic and social selves. The act of voting can be shown to be "irrational" because the expected benefits derived from the likelihood that one's vote affecting the outcome is not worth the "cost". But people vote as an act of faith in the civic process. Self-interest is not the only motivation of people. There are innumerable instances where altruism prevails. In the absence of this notion we will be unable to explain much of human behavior. People help strangers, return wallets, do not cheat on exams, leave generous tips in restaurants they will never visit again, give donations to charity when theory predict they would generally "free ride". To conceive altruism as a special form of selfishness misses the point utterly.<sup>xii</sup>

In a market everything is potentially for sale. While the market keeps trying to invade the polity, we typically refuse to sell our dignity, public office, and our notions of fairness and justice.

Market forces left to their own device lead to lower investment levels, avoidable panics and recessions. History is rife with examples of suboptimal results generated by the exclusive reliance on markets. Intervention is quite often necessary to rescue the market from its own excesses. The state provides oases of solidarity for economic as well as social ends, in realms that markets cannot value properly, such as education, health, public infrastructure, and clean air and water.

**Sixth**, there are a number of issues about the role of the state that were inspired by the work of Friedrich List and the German Historical School.<sup>xiii</sup> The German economic vision differs from the Anglo-American view embodied in Adam Smith's Wealth of Nations in many ways. These differences are profound and the choices offered are real and substantive that no developing country can afford to ignore. Actually, to their own chagrin even developed countries have recently realized that they themselves need to rebalance their ideologically motivated policies have trumped their capacities to deal with emergent crises and challenges. It is instructive to list some of the crucial differences between neoclassical (neo-liberal) economics and the German historical school. The differences are grouped under five subheadings below.

## **2.1. Automatic growth versus deliberate development.**

The Anglo-American view exaggerates the unpredictability and unplannability of economies. Technologies and tastes change. The best way to plan in this world is to leave the adaptation to the people who have their money at stake. No planning agency can have better information than they about the direction of events are moving, and no one could have a stronger incentive than those who hope to make a profit and avoid a loss. By this logic, if each individual does what is best for him or her, the result will be the best for the nation as a whole. The German school was more focused on “market failures”. The standard illustration involves pollution. If the law allows factories to dump pollutants into the air or water, then every factory will do so. Otherwise competitors will have lower costs and will squeeze them out of the market. This rational behavior will leave all worse off. List argued that industrial development entailed a more sweeping sort of market failure. Societies did not automatically move from farming to small crafts to major industries just because millions of small merchants were making decisions for themselves. If each person invested in what gives him the best return, it does not follow that the nation will derive the most good. For it to do so, List argued it needs a plan, a push, an exercise of central power. He drew on history where Britain encouraged manufacturing (Corn Laws, tariff and physical protection of domestic industry, and subsidies) and the fledgling American government deliberately discouraged foreign competitors and built canals and railway.

List wrote in 1837 the following:

The lessons of history justify our opposition to the assertion that states reach economic maturity most rapidly if left to their own devices. A study of the origin of various branches of manufacture reveals that industrial growth may often have been due to chance. It may be chance that leads certain individuals to a particular place to foster the expansion of an industry that was once small and insignificant—just as seeds blown by chance by the wind may sometimes grow into big trees. But the growth of industries is a process that can take hundreds of years to complete and one should not ascribe to sheer chance what a nation has achieved through its laws and institutions. In England Edward III created manufacture of woolen cloth and Elizabeth founded the mercantile marine and foreign trade. In France Colbert was responsible for all the great power needs to develop the economy. Following these examples every responsible government should strive to remove those obstacles that hinder progress of civilization and should stimulate the growth of those economic forces that a nation carries in its bosom.

## **2.2. Consumers versus producers.**

The Anglo-American approach assumes that the ultimate measure of a society is its level of consumption. Competition is good because it kills off inefficient producers with high prices. Cleansing the system of inefficient producers is good, because more efficient producers will give the consumer a better deal. Foreign trade is great because it means

that the most efficient suppliers in the whole world will be able to compete. It does not matter why competitors are willing to sell for less. They may really be more efficient (large economies of scale, the advantage of first comers, etc.); they may be determined to dump their goods for reasons of their own. In either case the consumer is better off and that is what counts. The consumer will have the computer and the car he wanted plus the money he saves by buying foreign goods.

List believed this logic leads to false conclusions. In the long run List argued a society's well-being and its overall wealth are determined not by what the society can *buy* but what it can *make*. This is the corollary of the adage—Give a man a fish and you feed him for a day. Teach him how to fish and you feed him for life. List was not interested in the morality of consumption. Rather, his interests focused on a strategic concern. In strategic terms nations ended up being dependent or independent according to their ability to make things for themselves. Why were Latin Americans, Africans and Asians subservient to England and France in the 19<sup>th</sup> century he asked? Because they could not make the machines and weapons Europeans could. He argued that in material terms a society's wealth over the long run is greater if that society also controls advanced activities. That is, if you buy the ton of steel or q ton of wheat at bargain rates this year, you are better off, as a consumer, right away. But over ten years, or fifty years, you and your children may be stronger as both consumers and producers if you learn how to make steel and wheat yourself. Because if you can make steel, you may be able to make machine tools too. If you are able to make machine tools, you will be better able to make engines, robots and airplanes. If you are able to make airplanes and robots your children and grandchildren will be more likely to make advanced products and earn high incomes for decades ahead. The German School argued that emphasizing consumption is self-defeating. It would bias the system away from wealth creation and ultimately make it impossible to consume as much. List wrote.

The tree which bears the fruit is of greater value than the fruit itself. ...The prosperity of a nation is not greater in proportion in which it has amassed more wealth (values of exchange), but in the proportion in which it has more developed its powers of production.

### **2.3. Process versus result.**

In economics or politics the Anglo-American theory emphasizes how the game is played, not who wins or loses. If the rules are fair, then the best candidate will win. If you want a stronger economy you need to concentrate on reforming the rules by which economic success is measured. Make sure every one can bring products to the market. The role of government in this system is not to tell people how they should pursue happiness or grow rich. Rather, its role is that of a referee—making sure no one cheats or bend the rules of “fair play”. The government is basically involved in guarding the process, not to steer the results. It requires corporations to publish detailed financial reports, so that investors will have the same information. It takes companies to court—Microsoft—whenever they seem to be growing too fast and stunting future competitors. The market will always

price correctly things and will ensure that scarce resources are allocated to where they produce the largest returns.

The German view is more paternalistic. People might not choose the best for society. The market may be myopic and will not price correctly things. Returns may not be optimal. According to this view the state should be involved in both the process and the results.

#### **2.4. Individuals versus the nation.**

The focus of the Anglo-American view is on individuals. It does not care much about communities and nations. These are no more than a sum of individuals. If you care for individuals, communities and nations care for themselves. As for nations, outside the narrow field of national defense they are not presumed to have economic interests. The German view is more concerned with the welfare and indeed the sovereignty of people in groups. List fulminated against “cosmopolitan theorists” like Adam Smith, who ignored the fact that people lived in nations and that their welfare depended to some degree on how their fellow citizens fared. In the real world happiness depends on more than how much money one takes home. If the people around you are also comfortable, you are happier and safer than if they are desperate. List wrote...

Between each individual and entire humanity, however, stands the Nation, with its special language and literature, with its peculiar origin and history, with its special manners and customs, laws and institutions, with the claims of all these for existence, independence, perfection, and continuance for the future, and with its separate territory; a society which, united by thousand ties of mind and of interests, combines itself into one independent whole.

Within this view economic policies are judged as good or bad depending on whether they take into account the national interest which is more than the sum of the individual interests within the group.

The German view contrasts rather markedly with that of the Anglo-American. Instead of being grouped horizontally on a flat field, nations have always been organized vertically in a hierarchical division of labor. The structure of the world economy more accurately resembles a pyramid. Nations that industrialize and organize their development will rise; the rest will be condemned to a destiny of submissiveness. The state has a major role to play in the economy and development. The theoretical foundations of this role are solid and profound. The historical record is clear and blatant. The empirical evidence is equally compelling and persuasive. The Anglo-American view of economic ideology, organization and institution is being foisted on the world in the name of globalization. It runs counter to theory, history and evidence. But this is not an argument for emasculation of the private sector. Rather, it is an argument for balance and the mutuality of interest and responsibilities.

### III. The Role of the State in the Asian Miracle :

The remarkable success of the Southeast Asian economies in the early 1960s and beyond raises a fundamental question: what explains this success? It is an undeniable fact that in the eight economies that are part of the “Southeast Asian Economic Miracle”—Indonesia, Thailand, Japan, the Republic of Korea, Malaysia, Taiwan, Singapore and Hong Kong—the state was responsible for economic growth.<sup>xiv</sup> The real question is which policies and what actions taken by the state contributed to the success these economies, and why?

There is a general consensus about the main ingredients of this success. The ingredients cannot be separated as they form a complete interacting package. Among the most important ingredients are the following:

- High rates of savings
- High rates of investment in human and physical capital
- High levels of exports
- Equitable distribution of income and wealth
- Stable governments
- Macroeconomic stability

Each country in the region is unique and different. Some, such as Hong Kong and Singapore are city-states. Others are large. Many are racially homogeneous but Indonesia and Malaysia are culturally diverse. It does not make sense to attribute the success of each of these countries to special and specific factors; it makes more sense to look at common factors and explanatory variables.

Why were saving rates so high? This was not always the case. In the 1950s and 1960s many of these countries had much lower savings than developing countries elsewhere, for example Egypt and many Latin American countries. The Republic of Korea annual domestic savings rate between 1955 and 1965 averaged only 3.3 per cent of GDP compared with 14.8 per cent in Mexico, 16 per cent in Brazil and 21 per cent in Peru. Between 1990 and 1994 Korea recorded an average domestic savings rate of more than 35 per cent of GDP. The corresponding rates for Mexico, Brazil and Peru during the same period were 17.2 per cent, 20.4 per cent and 18.9 per cent, respectively.<sup>xv</sup> But again who was responsible for this shift in the savings function. It did not come by compulsion, but then how did it come about?

If there were a sort of a propulsive force driving the East Asian economies, it surely was capital accumulation both in physical and human terms. But again who revved up the engine to encourage a higher rate of capital accumulation. There are more metaphors than the engine one that has been advanced to explain the growth miracle in these economies. Stiglitz uses two other metaphors—the chemical metaphor where the government acted as a catalyst without being consumed in the process. He also uses a biological metaphor where he shows that governments in these economies were adaptive systems. Their

policies were flexible and responsive to change. The East Asian economies demonstrated that governments could be highly adaptive and seem to have learned quickly from mistakes. The real question remains, what set these countries apart from other developing countries?<sup>xvi</sup>

The East Asian experience points out clearly to the visible hand of government in promoting and accelerating development. The state in East Asia did not replace the market but complemented it and ensured that it has a place but it kept it in the right place. These governments recognized the limitations of markets and their failures to generate desirable outcomes and pursued deliberately a specific set of policies, which involved the following:

- Gave Precedence to economics over politics.
- Generated overall macroeconomic stability.
- Regulated markets to ensure that they function properly.
- Created markets when they did not exist.
- Directed investment towards high growth and high export sectors.
- Created a conducive environment for private investment and private initiative within publicly defined goals.
- Reversed market inequitable outcomes and distributed resources more equitably.
- Minimized rent-seeking behavior.
- Created a merit-based civil service system.

The government intervened in all markets, but its intervention was measured and carefully balanced. They made sure that government does not suppress the markets. They also worked to intervene in a way that reduced the likelihood of rent-seeking behavior and increased their ability to adapt to changing circumstances. They designed a novel system of Performance-Based Reward structure that provided strong export and growth oriented incentives and formed the basis for allocating government subsidies. The application and design sought to minimize corruption. What worked best for them is that they were able to develop a meritorious civil service system which compensated employees well and built safe-guards against corruption.

State lead development manifested itself into five major areas, I will discuss each in details.

### **3.1. Industrial Policies**

This relates to an elaborate selective industrial policy that sought to encourage high growth sectors, develop domestic technological capabilities, promote exports and build domestic manufacturing capacity in a range of intermediate goods (steel and plastic). This overt state policy which started in Taiwan in the late 1950s and in Korea in the early 1960s took many forms from the support of technical education particularly that of science and engineering that provided a solid intellectual infrastructure that facilitated the transfer of technology to the discouragement of investment in real estate through financial repression (which practically meant more capital was available for industry and

technology) and increased profitability of investment . As well, the state directly promoted exports and developed science centers and industrial parks that offered services directly to both private and public firms that did not have research and development facilities of their own and allowed firms to reap external economies and reduce barriers to entry. The state also nationalized banks and financial institutions and provided credit at concessional terms (negative real rates of interest) to selected industries it wished to promote while keeping high interest rates to encourage domestic savings. It also promoted higher rates of profits for industry to levels unknown in the west (e.g., the Statute for Encouragement of Investment in Taiwan).<sup>xvii</sup>

While not all countries promoted foreign investment, a prevailing non-xenophobic and accommodating attitude towards foreign investment prevailed in most of the East Asian countries (Korea is an exception here.) All promoted capital flows and tried to ensure that technological and human capital would accompany the capital inflows. All of the countries in the region sought to maintain stable and credible macroeconomic policies, stable political environments, and well managed labor and capital markets. The government participated fully in the negotiation of foreign investment contracts to wrestle more concessions from the competing foreign parties (Japanese, European and American) and to raise more capital, empower domestic entrepreneurs and speed the transfer of technological know-how. They did well by discouraging competition among buyers of the foreign technology and increased the competition among sellers. The state succeeded in appropriating more of the surplus associated with the transfer of technology than could have been captured otherwise.<sup>xviii</sup>

Market failures played a significant role in justifying state interference. East Asian governments recognized quickly that their capital markets are weak, incomplete and inexperienced. They also recognized that these market failures bias prices and make them inadequate signals for investment allocation. They moved quickly to build new institutions. In the rural areas they established and promoted postal savings banks, they also created development banks to extend long-term credits. They developed bond and equity markets. They went beyond the development of financial and capital markets, they directed the allocation of capital to industries and activities they deemed desirable for growth and social objectives.

Private markets in developing countries do not have much incentive to allocate funds for technological development and large industries. The risks are often too high. Markets are typically myopic and in developing countries the legal systems often prevent private firms from appropriating adequately the returns on adoption and adaptation of new technologies. Government interference is required to complement the market and to ensure that the legal deficiencies do not thwart private investment in this field. Besides marketing spillovers are rampant, and public involvement is critical for the provision and sustenance of this strategic activity. In Singapore marketing of exports is left to the all powerful Economic Development Board and in Hong Kong the government levied a special tax and allocated its yield to promote Hong Kong exports. In Taiwan, the government promoted the production for exports under recognized brand names. In all of

the countries their embassies were instrumental in marketing their exports in foreign markets.

It is almost axiomatic that firms in developing countries are typically too small and that the large number of these firms typically reduces the profitability of all. From Japan to Thailand, governments encouraged the formation of clusters and condoned and cajoled concentration. Japan promoted rationalization of the steel industry and at one time tried to discourage Honda from entering the car market. In both Korea and Taiwan a significant number of public enterprises in basic industries were established in the 1960s and 1970s. These enterprises received generous budget allocations and favorable credit terms. The public enterprises accounted for a large share of manufacturing output and investment in each country and their importance actually increased during the take off years in the 1960s.<sup>xix</sup>

Economies of scale and capital shortages can easily stunt the growth of small firms in the industry. These small firms simply cannot expand to take advantage of increasing returns either because they cannot raise capital or because the only capital they have access too is very expensive and risky (credit). Government help was necessary to reduce the cost of capital by socializing risk and increasing access to capital.

Increasing return to scale and imperfect markets lend support to the necessity of government interference and government subsidies. This is at the heart of the infant industry argument of List, which the East Asians applied unabashedly.

The absence of markets in developing countries by necessity implies that prices not only fail to reveal the true scarcities of resources and products, they also fail to perform their coordination role. This means that government must take over this role. This has been manifested well by government undertaking up-stream and downstream investments at critical junctures in the development process when markets failed to create them. From balanced growth theory, it does not make sense to develop a steel industry if there isn't a steel using industry. If both wait, nothing happens.<sup>xx</sup>

If a large steel industry is required and with it a large steel using industry to take advantage of increasing returns to scale, market failures will preclude the possibility of establishing these industries. For one there does not exist in the developing countries markets that can divest the inherent risks in these industries. No single entrepreneur or a collection of entrepreneurs could raise the kind of capital to undertake these projects in most of the developing countries. Indeed, these problems can be dealt with through trade, but there are many industries where trade may not be the answer. Consider the set of sectors in the East Asian countries that represented the take-off sectors, such as textiles, footwear, sporting goods and toys—these were the sectors in which economies of scale and/or coordination failure were not evident and trade solved most of their growing pains. But consider the intermediate sectors that supplied the inputs to these sectors. There is no question that these downstream activities played a significant role in supporting and engendering the take-off industries and in promoting the deepening of industrial experience in these countries. Importing these inputs would have been a poor substitute,

as it would not have supported all the backward and forward linkages that sustained the manufacturing development effort. The suppliers of intermediate goods are often unable to capture all the benefits that their greater availability provides. It is here where state interference has improved the user-producer interface and the advantages to proximity prevail. In Malaysia it is believed that the production of cars provided significant spill over effects to the parts manufacturers that ultimately made the car industry more profitable and encouraged and promoted other manufacturing activity.

These industrial policies have been unsuccessfully used in many developing countries; they ended up financing infra-marginal investments and succumbed to rent seeking activities and corruption. So why were they successful in the East Asian countries? They certainly had some very powerful initial conditions working in their favor such as a highly educated labor force and a cohesive society. But one cannot exaggerate the importance of these policies and the way they were implemented and the overall environment that these countries have so doggedly ensured. There is also a number of contributing factors. These include the fact that most investment decisions were left to the firms but influenced heavily by government intervention. Second, the government instituted an elaborate network of consultation between business and government. Third, the government made mistakes, but seems to have been open and flexible. It made major changes and was not heavy handed. It did not force its opinion on business. Fourth, the government did not literally pick winners, it instead picked a winning development strategy. Fifth, it avoided micro management of the economy. Even when the government identified industries for support, it typically left it to the discretion of banks whether or not to support the chosen industry. Sixth, the industrial policies seem to have focused not on picking winners as much as on dealing with market failures—where social benefits and social costs diverge from private ones. Encouragement of technology transfers and underwriting of training are examples where the government felt that the market would under-invest in these activities because private concerns cannot appropriate the returns to their investments. Picking winners conjures the image of a government picking from a fixed pool of applicants. It fails to appreciate the entrepreneurial role of government when it stepped in to fill the existing gap in these skills in the early stages of development.

### **3.2. Encouragement of Cooperation**

When market failures are rampant, individual pursuit of self interest does not lead to public good. The government must step in to reconcile private interest with the public good. The East Asian countries recognized early on that firms have better information about investment than they do, but that this information base can be expanded and improved. Japan, for instance, developed formal and informal business councils that brought business and government together. These functioned well because they were long term and depended on developing sustainable relations and reputation that raised the long term returns on cooperation over the short term gains from pursuing self interest. Few tried to cheat and free ride knowing that they could be ostracized. Many cite cultural factors here as the main reason for the success of the cooperative effort. This Stiglitz argues is not true because many countries with similar cultures to Japan have not been equally successful. <sup>xxi</sup> The government rewarded honesty and punished dishonesty.

Cooperation created rents that the government appropriated and distributed as rewards to cooperative behavior and reduced bankruptcies giving businesses long-term security. Restricting credit raised the value of credit to those who could access it. The stability of the political system gave more value to long term associations and to reputation and the effectiveness of incentives. The “recession cartels” that the government created during recessions to avoid the problem of excess capacity in capital-intensive industries, are excellent examples of using cooperation to deal with difficult problems where individual action could produce disastrous outcomes for all.

The labor and capital markets provide other examples of the importance of cooperation. Long term employment prospects and bonuses created the necessary cooperative framework that allowed workers to feel as if they were co-owners of the enterprise, which reduced shirking and monitoring costs. Besides, basing wages on group performance instead of individual performance allowed each worker to monitor his or her peers and signaled the importance of cooperative behavior. When workers feel that their interests coincide with those of owners, they are not likely to resist long-term productivity innovations that raise profits or even those that involve labor-saving techniques.

The fact that banks were allowed to own shares of industries encouraged their involvement in the affairs of these firms when they faced trouble. This reduced the risks inherent in credit financing and created a coincidence of interest between lenders and borrowers.

### **3.3. Managing Competition**

The encouragement of cooperation runs the risk of creating collusion to raise prices and restricting output and entry. There is always the risk of rent seeking behavior and corruption when discretionary powers by government are exercised. Fostering competition increased efficiency and reduced the possibility of abuse of discretionary powers. The East Asians looked at competition in terms of its effectiveness and not in terms of the number of firms, more in terms of outcome than of process. The state sponsored contests within the firm and between firms. Those who succeeded were rewarded (firms that achieved higher exports relative to others received more credit at lower real rates of interest and higher tariff and tax exemptions). The criteria for success were made clear and the rules of the contest were well specified including who will evaluate performance. The system reduced the scope for abuse and corruption.

### **3.4. Equitable Growth**

Industrial policy in East Asia followed a determined effort to redistribute wealth. Most of the countries in the region introduced land reforms and balanced the relationships governing urban/rural affairs and capital/labor relationships. This balancing of opportunities and capacities paid well. Raising income and education in the rural areas, gave them purchasing power to buy domestically produced goods and the ability to save more and invest in the domestic economy. Higher education meant a steady supply of competent workers and bureaucrats to man the growing needs of industry and

government. Equitable distribution of income, wealth and opportunities sustained the political stability of the countries. In contrast, Latin American countries embarked on import substitution policies within the existing income and wealth disparities. Those who commanded the purchasing power had low marginal propensities to buy domestic goods and when they saved they allocated their saving to unproductive investment (real estate speculation) at home or luxury goods from abroad. The massive inequities were perpetuated and resulted in the destabilization of most of the polities in the region. The Latin American import substitution policies failed while those in East Asia prepared the grounds for the massive transformation of their economies.

Targeting equitable distribution of income resulted in higher wages but did not reduce the high rates of savings. Higher wages (efficiency wages) were matched by increasing productivity and the high rates of bonuses in workers incomes engendered the high savings rates despite the more equitable distribution of resources. Discouraging investment in real estate prevented housing prices from rising as well as raising investment in productive assets.

The early pursuit of universal literacy formed a corner stone of the distribution policies of the state. These policies promoted greater equality and the emphasis on female literacy reduced fertility, population pressures and increased the supply of educated labor. Affirmative action in Indonesia and Thailand protected the indigenous population and thwarted any imbalances that could have arisen from asymmetric abilities and opportunities.

The East Asian experience torpedoed the presumed conflict between growth and equity. High rates of growth generated the resources to use to promote equity, just as the more equitable distribution of resources and opportunities sustained the high growth rates.<sup>xxii</sup>

### **3.5. Export-Lead Growth**

Early on East Asians were worried that profit signals in the presence of market failure may not be the appropriate signals for allocating resources and investment. They found quickly that exports provide a better measuring rod. Domestic sales performance is not a good measure of efficiency because it could result from the monopoly position of the firm in the domestic market. For the same reason, profits may be the result of similar forces and represent a transfer from consumers and as such they can not be used as measures of social gain. Those who succeed in foreign competition must be more efficient. But banks typically prefer to finance domestic operations because these are often less risky. The governments in East Asia focused on promoting exports by way of correcting the market failures inherent in bank finance, tariffs and other restrictions on imports. The government instituted performance-based subsidies and erected a host of export promotion activities. This they did through the provision of infrastructure, differential access to credit and foreign exchange, licenses and other regulatory procedures designed to enhance the reputation of the country's exports and the development of export markets. They did not help by increasing the profitability of

exporting relative to domestic sales as some suggest, they seem to have taken some direct initiatives to open markets and increase the reputation value of exports.

The success of the East Asian countries in 1960s until 1996 and the failure of some states in the region in managing and thwarting the financial crisis in late 1990s have called into question the standard decentralized markets paradigm. Advances in economic theory further challenged the simplistic interpretation and policy prescriptions of neoclassical economics. In the next section, I will focus on how the Asian financial crisis has contributed to the debate about the appropriate role of the state in economic development. It seems that the state again when strong and when weak it can make a substantial difference to the health of the economy and society. It is ironic that those who have championed weak roles for the state in developing countries have pursued unquestionably strong state action themselves.

#### **IV. The Role of the State and The Asian Financial Crisis:**

Why has East Asia become embroiled in financial turmoil and why has it turned savage? Just when there seemed to be a growing acknowledgement across the economic and political disciplines that state involvement was vital to the rapid growth of the Southeast Asian economies, along came the financial hurricane and with it a reconsideration of the consensus.

Though commentators disagree about the fundamental causes of the crisis, two different views emerged. One focuses on internal variables within the nation-state, giving primacy to domestic vulnerabilities (i.e., flawed policies and institutions). The second directs the focus outward to international financial markets (i.e., speculators and investor panic).<sup>xxiii</sup>

The crisis had two faces-- a normal face and an abnormal face. Linda Weiss (1999) argues that this schematic approach is more fruitful than the internal/external dichotomy. Financial crises have always been a normal pattern of capitalist development.<sup>xxiv</sup> Whether one's perspective is 15 or 150 years, it appears that the history of capitalism is strewn with financial crises of one form or another. The implication that no country is immune does not mean that all countries are equally susceptible to financial crises. In the world of volatile capital flows, some countries have become more vulnerable than others. These are countries that have domestic weaknesses, which before the crisis were thought to be benign.<sup>xxv</sup> But the Southeast Asian countries were model economies with striking prospects for continued growth. Most of them enjoyed high savings, balanced budgets, disciplined and highly educated labour force, strong private sector investment, low inflation, a relatively egalitarian income distribution and a long and unbroken record of strong exports. Vulnerability should be put in perspective: it seems to be a condition not a cause of the crisis.<sup>xxvi</sup> The crucial issue is why has a problem that should have been transient and quite quickly rectified, like so many others before, turn into a full-blown disaster?<sup>xxvii</sup> Domestic factors can explain a country's vulnerability but cannot explain why has the crisis turned lethal. They cannot explain why the bursting of the property bubble in Thailand, for example, turned into a full-blown capital flight. The real answer

should be seen by examining why some East Asian countries were more vulnerable than others to the financial meltdown. In other words why has the crisis been so uneven in its occurrence (Why Korea was more vulnerable than Taiwan) and why was it so severe in the East Asian setting relative to economic fundamentals and to earlier crises in Mexico and elsewhere?

The main arguments here is that while global financial markets obviously and directly produced the Asian crisis (by way of speculative runs and sudden withdrawal of funds—the so called investor panic or herding), they were not the primary determining factor. For the financial markets to precipitate the crisis in the first place, two less obvious variables had to be present. The first has to do with domestic vulnerability in the real economy. Here it is the weak and decomposing institutional capacities, particularly those of the state. This in turn exacerbated real economy vulnerabilities such as falling exports, rising current account deficits and surplus capacity. There is also a necessary second factor. This is the externally induced vulnerability. The common denominator of the second vulnerability is the strong external power of the United States pursuing its own national economic agenda (with strong input from its domestic financial interests), partly on its own and partly in concert with the IMF.<sup>xxviii</sup> Both arguments implicate state power. The basic thesis here is that the relative weakness of State Capacity (in Southeast Asia) and its marked if not complete decomposition in Korea made these economies prone to speculative investment (in Korea's case over-investment in excess capacity sectors), asset bubbles, current account deficits, and consequently to unabated financial crisis. The flip side of this argument is the reason that explains why Taiwan, Singapore and China were able to avoid the crisis.

In the Korean case, it was not institutionalized weakness per se but the gradual decomposition of core capacities of the state that paved the way for high-risk and short term borrowing as well as over-investment by Chaebol, which in turn exposed Korea to sudden downturns and capital flight. Ironically, the weakening of domestic state power to deal with the crisis was accentuated by the relative strength of US international state power.

In what way, then, is state power at issue in the crisis? When analysts invoke the state's role to explain the crisis, they typically draw on one of two quite different interpretations. By far the most common is “excessive state interventionism” or “too much state power” thesis.<sup>xxix</sup> According to this view the Asian crisis as a demonstration of the folly of state intervention in the economy. The excessive intervention and too much state power have brought the crisis down by distorting the market. For if the state was not so interventionist in their economies in the first place, there would be fewer distortions (corruption, cronyism, and rent seeking) blocking efficient market allocation. The crisis was an inevitable consequence of state-led-capitalism (the Japanese model) that has recently proved its failure.<sup>xxx</sup> For all its crude overtones that replay the fruitless “state-versus-market” dichotomy, this is probably the most popular version of what has gone wrong in Asia. It is favored by the IMF, top officials of US Treasury and the Federal Reserve, and by liberal economists generally.

Alternatively there are those who contend that the crisis was an inevitable consequence of the absence or the weakened regulatory regimes and little state control. As Joseph Stiglitz, Nobel laureate and ex-chief economist and vice president of the World Bank put it, “The Crisis was caused in part by too little government regulation (or perverse or ineffective government regulation).”<sup>xxxix</sup> The too little control thesis is chiefly concerned with the laxity of regulatory control over capital inflows that came in the wake of financial liberalization (hence over exposed to unhedged short term debt). After all the opening of the capital account is central to the whole story of what has gone wrong in Asia. The crux of the matter is too much short term capital (denominated in foreign currency) coming to service long-term investments (at pegged exchange rates). The moral is clear. If the state were a stronger regulator—preventing dangerous inflows—there would be no crisis. It seems very plausible but there are more at issue than the regulatory capacity. The real issue is why capital has flowed in such massive amounts in the first place. In other words, what were the capital being used for and how did that use reflect underlying institutional weaknesses and exacerbate economic vulnerability? Why has capital flown out in a seemingly unstoppable hemorrhage—to the point that Indonesia, as the worst case, would become totally disconnected from the international banking system?

Identifying weaknesses in the real economy is not a difficult task in the Southeast Asian experience. These include—falling export growth, which caused the ballooning current account deficits in the two years prior to the crisis, slowness to upgrade skills, products and technology, and an over-reliance on price-sensitive goods that are being produced more competitively by new producers down-market (Thailand). The real question here is why have these countries been unable to stop over investment, and speed the process of upgrading skills, products and technology? In all of these cases (Thailand, Indonesia, and South Korea) the reason is squarely weakened institutional discipline and the decomposition in the power of the state to co-ordinate investment and to guide the transformation of the economy. While these factors were crucial weaknesses, a hostile external environment that exacerbated the crisis complemented them.

In Thailand and Indonesia the state failed to co-ordinate investment into productive sectors of the economy and to hasten upgrading of skills and technology. This failure paved the way for high levels of speculative investment, particularly in real estate, falling export growth, and rising current account deficits. In Southeast Asia, the flip side of this institutional failing manifested itself in increased foreign indebtedness by private corporations and financial institutions, massive investment in non-tradable products, and ultimately property bubbles which burst, triggering the first phase of the crisis. In Korea, state capacities had been gradually decomposing and the government stood helpless as private companies and banks borrowed excessively in foreign short term markets and companies over invested in leading export sectors (steel, petrochemicals, semiconductors and cars). The over supply resulted in falling exports, massive interest payments, a spate of corporate collapses and finally a full-blown financial crisis.

What is clear from the financial crisis in all the Asian countries that experienced it, is the transmission of the real economic difficulties into the financial economy and back into

the real economy. In Thailand, the fall in exports resulted in current account deficits and the latter required borrowing. The borrowed funds were invested in non-tradable sectors (real estate). When repayment difficulties were experienced, interest rate hikes were used to attract more foreign capital to finance the deficits. These triggered a massive decline in real estate prices that burst the bubble economy. Invited speculative attacks against the currency, massive capital flight and ended up triggering massive unemployment and output losses. Had the economy moved to higher level exports, as did Taiwan and Korea (in the past) by way of a selective industrial policy, which linked credit allocation and tax incentives to investment in high productivity sectors, the cycle of difficulties above may not have been encountered. The end result for Thailand was the massive capital inflows whose composition and destination the state has appeared neither able nor willing to shape.

The decline in the transformative capacities of the state in Asia had another consequence.<sup>xxxii</sup> These weaknesses have tended to underpin weak regulatory control in the financial sector. Conversely, where the transformative powers remained robust as in Japan, Singapore and Taiwan—the approach to financial liberalization has tended to **re-affirm rather than remove state control over capital flows**. Korea and Taiwan affirm this proposition by the way each went about liberalizing the corporate bond market. In 1993, the Koreans folded the Economic Planning Board. When they approached the liberalization of the capital account in the early 1990s, they did so with a view to preparing the ground for further dismantling state control over the economy—not to maintaining it. Rising wages and declining exports in the 1990s made Korea less attractive to foreign lenders, thus placing a premium on long-term interest rates. Long term loans became more expensive, harder to obtain, and recorded a net outflow. It was against this background that the Ministry of Finance took the decision to relax Chaebol greater access to short term portfolio investment. The result was a surge of foreign capital inflow in excess of \$27 billion between 1991-94. The contrast with Taiwan's deregulation of the corporate bond market in 1993 is instructive. The Central Bank allowed for the first time corporations to remit proceeds of overseas bonds for domestic use. However, this was accompanied by new rules that such foreign currency remittances must be invested in plant expansion, and the total national aggregate of these inflows must **not exceed \$3 billion**. Moreover, the Central Bank backs up the regulations with close monitoring, intervening under its emergency powers when it suspects foreign inflows are not being used for the designated purposes. In the early 1990s, the Central Bank **closed the Taiwan Stock Market for a year** when it suspected that capital inflows were not invested but used to speculate against its currency.

To the extent that the Korea-Taiwan differences suggest different routes to liberalization, Korea appears to have moved towards state role minimization, market-enhancing direction, While Taiwan, like Japan, has chosen a more state-enhancing path via regulation. Korea succumbed to financial difficulties that Taiwan avoided without much difficulty.

There remains the issue of external pressure and the strong state intervention by the US, the IMF and other western powers to prevent first the Koreans and then the Japanese

from dealing with the financial crisis before it burst. The first such manifestation of the foreign pressures came when Korea was preparing to enter the OECD. It is then that the US made Korea's membership in the OECD conditional upon greater opening of the capital market.<sup>xxxiii</sup> It may be misleading to leave the impression that external pressures were the main push factor for nodding Korea into a more liberalizing stance. The drive to liberalization has been underway throughout the 1980s. It manifested itself in many forms and small decisions that coalesced into a major liberalization program. External pressure simply made the transition easier and more certain.

The Korean financial crisis, which began in January 1997 with the collapse of the Hanbo group, has a lot to do with private sector excesses: uncoordinated over investment exacerbated by state retreat, that is, massive private borrowing for investments in sectors not only already well-supplied by other Chaebol (steel, petrochemicals, and semiconductors) but also price sensitive and subject to downturn. It certainly had nothing to do with weak-state cronyism (crony capitalism) or even of a strong state overriding efficient market logic.<sup>xxxiv</sup>

The domestic vulnerabilities, by themselves, do not produce financial crisis of the magnitude experienced in Asia. Moreover, the kind of vulnerabilities identified above are not lethal. Many suggest that it was investor panic, self-fulfilling expectations and sheer herd behavior where everyone withdraws from the market simply because that is what everyone else is doing. But what sustained and nurtured the panic in the first place? To invoke panic is to provide not so much an explanation as a restatement of the problem. Why has capital flight been so massive, so relentless and so damaging? There is no escape but to look outside the nation state for answers.<sup>xxxv</sup>

Of the three international power actors involved in deepening the crisis, it has been the US Treasury-finance nexus that has been least visible yet the most damaging. While the IMF is also implicated in the unfolding drama, its role has differed on two counts: its interventions have neither enjoyed the level of autonomy disposed by other actors nor deployed their more calculated self-interest. The key proposition is the US administration has not merely used the crisis as a leveraging opportunity to prise open markets once closed to foreign financial institutions, it has played a critical role in deepening the crisis.

First, the US did not act with due speed to contain the panic, indeed appeared also to prevent containment by Japan or the IMF, intervening only after the situation had deteriorated to an alarming degree. The US and the IMF could have easily persuaded the lenders to roll over their loans without IMF guarantees and by calming the foreign exchange markets by ensuring that lenders understood that Korea's problem of inadequate reserves was a temporary problem of liquidity, not insolvency. This is precisely what the US and the IMF did during the 1996 Mexican currency crisis. Their timely intervention worked perfectly. It was not until Korea's foreign exchange reserves were depleted and after the major damage had already been done that the US Federal Reserve-in January 1998- took the steps that would have earlier averted the crisis: bringing together the major players to co-ordinate a program of debt restructuring and short term debt rollovers.

By not intervening the US was merely bringing policy into alignment with the new geopolitical reality in the aftermath of the dismantling of the Soviet Union. In the post-cold war environment, there was no longer a significant national “security” interest in protecting Asia that in the past would so often override the economic interest of opening Korean markets to US goods and finance. Deputy Treasury Secretary (now Secretary) Lawrence Summers proclaimed in February 1998 that “The IMF has done more to promote America’s trade and investment agenda in Korea than 30 years of bilateral trade talks.”<sup>xxxvi</sup>

While global and national are commonly portrayed as antithetical, mutually exclusive principles of organization and interaction, the Asian Crisis has shown that they are in fact interdependent and mutually reinforcing. The extent and sustainability of financial liberalization will continue to depend on the solidity of domestic structures. Where these structures are weak, global networks merely end up undermining their conditions of existence. Indonesia’s case is a good example of domestic collapse that had gone hand in hand with the country’s involuntary detachment from the global financial system. At the other extreme lies the Malaysian response of voluntary semi-detachment from global finance, ostensibly in an effort to build and strengthen its institutional capacities. Somewhere between these two extremes, others like Hong Kong, Taiwan, and Singapore are drawing lessons from the crisis by tightening and improving capital controls. Above all the lesson from the Asian Crisis is that of the implausibility of a world economy sustained by unlimited global flows, and draws attention instead to the underlying institutional limits to liberalization.

## **V. The Role of the State in the Current Crisis:**

Financial crises are endemic to the capitalist system. Booms and busts characterize the history of capitalism. The historical record of financial slumps in the west in the past three decades is rich and continuous. The 1980s witnessed a number of financial crises starting with the Savings & Loans crisis, then the bankruptcy of a major bank (Continental Illinois) and then black Monday on October 19, 1987 when stock prices on the New York Exchange lost over 20% of their value in one day. The 1990s were no different with financial crises in Britain in 1992 (the Sterling Crisis), then Mexico in 1994 and 1996 and then the financial crisis of Southeast Asia in 1997 and the crisis in Argentina in the late 1990s and the early 2000, then the dot.com disaster in 2001, the collapse of Enron on December 2, 2002 and now the sub-prime debacle.

It may be convenient to dismiss the new crisis as another blip in the financial markets. The seriousness and uniqueness of the current crisis, however, suggest that this may not be the case. There are a few distinguishing features that make this crisis different from preceding difficulties and suggest that its impacts are going to be more profound and that its consequences may last a longer time than any of the previous crises. There are early indications that suggest that this crisis, unlike many others before it, is finally beginning to shake the present economic orthodoxy and is calling into question some of the

fundamental tenets of neo-liberal economics about the respective roles of the state and markets in the economy.

What started as a real estate collapse with housing prices falling over 30% in less than a year (the early estimates put the losses so far at \$2 trillion in the US alone), the subprime lending led to widespread foreclosures as high risk lending to groups without sufficient resources to support their mortgage payments dragged few banks into insolvency and sank giant mortgage guarantors such as Freddie Mack and Fannie May when mortgagees abandoned their homes whose prices fell below the mortgaged value. This real estate crisis could have been restricted to the balance sheets of mortgage lenders and guarantors but banks and investment banks bundled their risky (toxic) mortgages with other good assets trying to hide the true risk content of these mortgages. Other financial institutions such as insurance agencies, investment banks, hedge funds and other financial institutions fell too into bankruptcies. Corporations with assets in the trillion dollar range saw their assets evaporate in days if not hours. The liquidation of assets flooded the stock exchanges precipitating continuous large daily double-digit declines in share prices. Ripples and hiccups in the financial sector turned into tidal waves prompting Alan Greenspan (The Ex-Chairman of the Federal Reserve Board) to call it a Credit Tsunami. But why has this vicious cycle started in the first place, could be stopped and when will it stop?

The roots of the problem are serious and run deep into the fabric of the capitalist system, its mechanisms and values. **First**, banks throughout the 1990s and beyond were beaming with liquidity. This excess liquidity had two origins. First, the Bush administration recognizing the unpopularity of the Iraqi war pumped money in the economy to insulate Americans from any negative economic consequences the war could produce, much of it was borrowed money from surplus countries in Asia, Europe and the Arabian Gulf. Easy credit and low interest rates were observed throughout the last decade and more. **Second**, the rise in the price of oil in the past few years transferred money from China, Europe and Japan into Arab Gulf States that “invested” these surpluses primarily in US financial markets supporting and expanding this excess liquidity phenomenon. Banks with excess liquidity extended their loan portfolios this time to the Third World within. Similar conditions prevailed in 1970s during the Vietnam War and the first oil shock that created the Third World Debt Crisis. The cheap credit financed a real estate boom, the magnitudes of which were never experienced before in the US. People borrowed money and bid housing prices up and with the rise in housing prices they re-mortgaged their properties and used the new money to finance large consumption purchases or new speculative purchases of real estate. When the real estate bubble finally burst, prices of properties collapsed and with “no recourse” borrowing (lenders can only repossess the assets that they lent money for their acquisition but cannot claim other assets to cover their losses) banks were left with many homes abandoned by their owners with negative equity. Had banks managed their risks the way they usually did and are expected to do as a conservative institution, the crisis perhaps could have been limited. Unfortunately the banks did not match their risky liabilities with secure assets or adequate capital. Their assets were risky too, made primarily of bundled assets with dubious value and their capital was woefully inadequate.

**Third**, it is fair to ask here why is it that the richest country in the world would have a large segment of its working population without sufficient incomes to pay the mortgages' interest and other payments? Surely the notorious income distribution issues in the US have had a major influence on the initiation and propagation of the crisis. Some of the difficult statistics on the polarized income and wealth distribution in the US are listed below:

- The top fifth of Americans in 2004 were earning 43 percent more than in 1977. The bottom fifth was earning nine percent less. The richest one percent of workers was earning 115 percent more.
- Because of inflation, workers earning minimum wage have 20 percent less buying power they had 20 years ago.
- If average worker pay had risen at the same rate as CEO pay in the last ten years, worker pay would be \$110,399. Instead, it is only \$29,267.
- The average executive in 2000 made 419 times more than the average blue-collar worker. In 1970 this multiple was only 15.

Working households in the middle of the economic scale have lost 11 percent of their net worth since 1983. In the same period, lower-middle-class and poor families -- the 40 percent at the bottom of the economic scale -- lost 80 percent of their net worth. The top one percent increased their net worth by 17 percent.

What is causing the wealth and wage gaps to grow so sharply? What is it about the new economy that favors the rich so dramatically over the poor?

The sensationalized bull run on the stock market is one significant factor. Since 1983, the value of the stock market has increased 13-fold, so that \$100 invested in 1983 would be worth \$1300 in 2000. Unfortunately, less than half of the population owns any form of stocks, and the vast majority of those who do -- three quarters of stockholders -- have less than \$5,000 invested in the market. The richest 10 percent of Americans, who own 88 percent of stocks and 90 percent of bonds, are the ones that significantly benefited from the bull market.

The loss of well-paid manufacturing jobs has also greatly contributed to the wealth gap. Here, too, Wall Street is responsible, along with the United State's increasingly liberal international trade laws. As corporations search for ways to report higher and higher profits -- the most dependable way to raise their stock price -- they often cut costs by shipping manufacturing jobs overseas, where labor costs are minimal. Not only does this practice create exploitative sweatshop labor in Third World nations, it also puts millions of Americans out of well-paid, middle-class jobs. Between March 1998 and end of 2000, 491,000 American manufacturing jobs had been lost to overseas factories because of cost-cutting measures.

In addition to losing jobs, middle class workers are rapidly losing health care and other benefits. Because of benefit cutbacks, 40 percent of middle class workers are not insured by their employers in 2000. That is up from 33 percent a decade ago, a change that indicates a significant plunge in many Americans' quality of life. This also contributes to the growing wealth gap, as more middle- and lower-income people are forced to pay medical bills out of pocket.

Coinciding with and likely contributing to the loss of middle-class benefits, wages and jobs are the declining power and membership of unions. Only 13.9 percent of the workforce belongs to a union, a sharp decrease from 35 percent in the mid-1950s. As workers lose collective bargaining power, they have few avenues to challenge those who set their wages.

The irony about declining and stagnant wages is that workers today are far more productive than ever before. The average worker in 2000 produced 12 percent more per hour than he or she did in 1989, helping to more than double corporate profits in the past decade. When one looks at where those corporate profits go -- instead of rewarding workers with higher wages, the money finds itself squarely in CEOs' pockets. Average CEO pay jumped by 481 percent in the 1990s.

An increasing wealth gap has numerous negative ramifications. Acute concentration of wealth gives rich individuals and institutions disproportionate power over markets and industries, creating the unstable economy of today. By pumping billions into a hyper-inflated stock market, investors have precipitated a significant stock market recession. For the poor, lower wages and assets have forced a record number of personal bankruptcy filings and debt foreclosures, placing a heavy tax burden on the rest of society.

In the meantime, globalization and the new economy made millionaires out of a lucky few, while passing by the majority of Americans. John F. Kennedy quipped many years ago: "A rising tide lifts all boats." But Kennedy had a different kind of economy in mind, one based on secure manufacturing and agricultural jobs. In today's globalized new economy, the rising tide theory doesn't hold water. Today's rising tide may lift the big, shiny boats with stock-reinforced platinum hulls, but it leaves everyone else swimming for their lives or sinking.

It is not difficult to argue that this skewed wealth and incomer distribution phenomenon is the natural outcome of market forces that were allowed to unfold without the corrective intervention of the state. Markets reward the successful and in the new economy winners take all. In the absence of social forces for moderating and correcting this market failure unequal distribution becomes endemic and inequality grows. Globalization that drove outsourcing and the pursuit of cost cutting opportunities, left working Americans with lower incomes and dwindling opportunities. It is small wonder that Robert Freedman has dubbed this phenomenon as... "Are our wages are made in Beijing."<sup>xxxvii</sup>

**Fourth**, it is telling that the several bankruptcies, difficulties and crises in a number of financial institutions did not alert the public to the over exposed nature of financial markets, the risky behavior of several participants and lack of institutional checks and balances. The lack of oversight, the excessive and mindless deregulation and an intellectual infrastructure that justified and rationalized the mindless pursuit of greed came to a crashing end in August 2008. But why did it last so long? Why nothing was done to deal with these overt manifestations of impending doom and the vulnerability of the system?

**Fifth**, the dismantling in 1997 (under President Clinton) of the regulatory regime defined by Glass-Steagall law under which banks and other financial institutions operated from the Great Depression onwards, gave license to these institution to engage in risky behavior and to indulge in highly speculative ventures. Under the pretext of financial innovation, derivatives, junk bonds, credit default instruments were traded by banks and other financial institutions. These speculative instruments had high financial rewards but were highly risky. Billions can be gained or lost in hours. The fact that investment banks, hedge funds, insurance companies and even commercial banks were able to trade in these markets created a casino-like system that distorted and polluted the investment practice and corrupted capital markets with toxic assets that compromised the very foundation of these markets and their orderly and balanced performance.

A competitive deregulation dynamic was unleashed in the world in the late 1970s that put an end to the Bretton Woods Agreements in 1944. The latter were grounded in the aftermath of the Great Depression (Helleiner 1995) that saw the collapse of international finance.<sup>xxxviii</sup> Discredited by the financial crisis in the 1930s, the private and central bankers who had dominated financial politics before the 1930s were increasingly replaced at the levers of financial powers by a new class of professional economists and state managers whose social and ideological base was among labor and national industrial leaders. In place of the bankers' laissez faire ideology, the new social groups favored more interventionist policies that would make finance the "servant" instead of the "master" of economic life. Both John Maynard Keynes and Harry Dexter White belonged to this new class. Both saw the capricious short term capital movements to constitute a major source of damage to the international monetary system. Both argued that if stable exchange rates were to be maintained to anchor prices and trade, then short term capital movements must be restricted. Both also believed that the government must exercise full responsibility for maintaining full employment and a safety net for vulnerable social groups to insure their full participation in shoring up aggregate demand to the a level consistent with full employment. Short term financial movements to escape the burdens of social legislation had to be prevented from operating against what governments deemed to be the interests of the nation.

Many economists (Helleiner 1995) stress the role played by technological advances and market forces in the emergence of the new financial order that culminated in the new crisis in 2008. There is no question about the importance of the advances in telecommunication technologies and their price declines in supporting the integration of financial markets and in easing and speeding the transfer of money across national

borders. If prices of cars were to match the decline in CPU prices, a new car would cost \$5 dollars and would run thousands of miles per gallon of gas. Market forces embedded in the rise of the multinational corporation, the recycling problem of surplus OPEC funds, the restoration of confidence in the banking system throughout the 1950s are all considered crucial to the emergence of the new financial order. Those who favor the technological and market forces explanations of the re-emergence of the international financial order tend to underestimate the role of the state in the re-emergence of the new global international architecture. States contributed to this re-emergence in five distinct ways. First, they gave market actors much more freedom to operate than they would otherwise have had by simply liberalizing and removing barriers to international movement of capital. Second, by acting as the lender-of-last-resort states have and continue to play a crucial role in containing and preventing international financial crises, which otherwise might have brought down the entire global financial order. They did this over many crises although with varying degrees of speed and response. Third, states and their central banks have worked cooperatively to deal with crises and in providing a common front in the face of speculators and predatory financial behavior. These cooperative endeavors could have been cemented and institutionalized. They remained rather loose and expedient. Nonetheless, they proved to be formidable barriers in the face of speculators. Fourth, they tolerated and in some cases encouraged financial innovations in the belief that this may deepen financial intermediation and facilitate further globalization and freer trading regimes. They allowed financial operators more latitudes than ever before and opened the door to free capital allocations in the belief that this would lead to more efficient capital allocations and higher productivity of the global economy. Fifth, they dismantled many of the regulatory and supervisory roles they had practiced for decades in their domestic economies, opening the way for unfettered competition, mismanagement of risks and unprecedented number of failures and frauds.

The presence or absence of the state is of crucial importance to the understanding of the issues and challenges we are facing today as the global financial system teeters again on the brink of collapse.

It is quite telling that socialist President Francois Mitterrand in France 1981-83 and Labor Prime Minister James Callaghan in 1976 who fought initially to maintain fixed exchange rate regimes and tight capital controls to fight the stagflation (unemployment and inflation moving together) that ensued in the wake of higher oil prices and higher inflationary expectations have both reversed course and repudiated their earlier Keynesian inspired policies in favor of a more liberalized regimes (Helleiner 1995).

In Britain Chancellor Dennis Healey had given up too on Keynesian solutions in the face of stagflation in 1976. He pushed for austerity in the face of rising unemployment. The decision to accept the discipline of international financial markets was a major about face to a British labor government. Had the British government accepted the Labor Party Conference decision in September 1976 to espouse a comprehensive exchange control and the closing of London as an international financial centre, the embryonic global financial system that was emerging would have been dealt a fatal blow. In many respects Thatcherism was given a strong boost even before it succeeded the labor government.

The dramatic U-turn of the Mitterrand government was a turning point in the globalization process in several ways (Helleiner 1995). Within France, the embedded liberal bent that carried the Mitterrand government into office was rejected overnight in favor of a more neoliberal approach. Market liberalization, particularly in the financial sector, and monetary discipline became key policy goals. The French experience resonated beyond its borders. France soon became a staunch advocate of a neoliberal approach in the Pan European project under the leadership of Jacques Delors (Ex-Finance Minister in France) in his new capacity as the President of the European Commission. In many respects the French experience conveyed a troubling message that a left project is not sustainable within the new globalized financial system.

The “imperatives” of the new economy had subordinated earlier commitments of many western governments that fell quickly under the sway of neo-liberal policies of Milton Friedman and his cohorts at the Chicago School. But what specific ideas of the neo-liberal intellectual supra-structure that dominated the economic profession and the policy field were adopted and why did this intellectual system thwarted and derailed any attempt to re-institute supervision, oversight, regulatory regimes and shock absorbing constraints?

**Sixth**, the intellectual infrastructure condoning a free for all and Laissez Tout Faire was cemented by the Chicago School under the leadership of Milton Friedman who was rewarded with a Nobel Prize for Economics in 1976. The basic tenet of this school is the superiority of markets in allocating rationally and efficiently scarce resources. Nobody knows better than the individual involved about his or her preferences and if left alone will seek to maximize his/her welfare which is synonymous with social welfare as the society is nothing but the sum total of individual maximizers. No other reallocation can exceed this individually determined distribution. It is at once a general equilibrium from which nobody has any incentive to move and a Pareto optimal allocation as any other reallocation scheme would result in lower utility for some but no higher for any other member. In this framework, government intervention is welfare reducing and should be avoided. Thatcher’s government in Britain and Reagan’s government in the US accepted and promoted this philosophy. In fact the Bush Administration went even further espousing free markets and market driven policies as synonymous with American values.

Neoliberals were successful in convincing policy makers across the globe that controls and state intervention in capital and financial markets serve to defend outdated economic policies and interests. They convinced policy makers that liberalization and deregulation of financial markets are superior to alternative policies because they provide savers and investors to pursue more rational allocations of their resources that would lead to enhancing efficiency of the financial intermediation process both domestically and internationally. There is no debate about the fact that policy makers in the 1980s were disillusioned with the failure of Keynesian solutions to deal with the stagflation problem. Equally important and relevant is the fact that neoliberal arguments were supported by financial firms and multinationals in this period, both of whom saw capital controls as a cumbersome interference in their increasingly international oriented activities (Goodman and Pauly 1993).<sup>xxxix</sup> The alliance of neoliberal advocates with major corporate interests played a key role in promoting and cementing financial liberalization and competitive

deregulation in which western industrialized countries competed for financial flows and out did each other in seducing these flows their way by very generous and liberal dismantling of barriers and regulation.

**Seventh**, in no small way, globalization is at the heart of the current crisis and is responsible for far reaching and serious consequences. It is perhaps the second time in the recent times that the world economies are contracting in tandem. Globalization has tied the fortunes of the world together whether through the nexus of global financial markets or a common ideology of unbridled competition, free trade and deregulation. Today all economies of the world are on board the same sinking ship. This is the second time in 80 years that the world finds itself in one common situation. In the past when a crisis gripped Southeast Asia the rest of the world were able to avoid the Asian Contagion. In many respects its fallout did not affect in any substantial way other economies. Far from it, this time the entire world is tied together. By the time Asian financial markets close, European markets open and by the time the latter are about to close North American markets are open. Any minor setback in Asia is magnified throughout the global financial system and a vicious cycle is triggered that boomerangs throughout the world financial markets. The US dollar is traded daily to the tune of \$1.5 trillion; each week over \$50 trillion dollars cross international borders. In a world of instant capital mobility, there is little room to insulate domestic economies from global troubles.

Trade is growing at twice the rate of output increase and investment is growing at three times the rate of increase in output. Competitors are no longer thousands of miles away but a fraction of a millisecond. Trade surpluses in China and Saudi Arabia are mirror images of deficits in the US. It is ironic that China today is financing a major part of the deficits in the US. It has no option. It can stop doing so and the US dollar would sink like a lead balloon taking with it all the gains that China made by exporting more than it imports from the rest of the world. The US economy requires a daily injection of \$3 billion dollars from the rest of the world to keep its exchange value of the US dollar from falling. The US external debt is put at over \$13.7 trillion on September 30, 2008 (<http://www.ustreas.gov/tic/debta608.html>) and is growing each second. It is almost as high as US GDP (\$14.3 trillion estimated for 2008) for the same period. The lack of sustainability of the US economy and the huge internal and external debts, private and public have acted as an overhang on the international economy. The current financial crisis is in part a US crisis that migrated through to the rest of the world in much the same way the Great depression that started in the US in 1929 migrated to the rest of the world.

**Eighth**, there is little chance that the current crisis will stop at the financial and capital markets. It is already migrating to the real economy. Unemployment rates have soared in the US from a low of 4.5% last year to 6.7% and rising this November 2008. Jobless claims are at record highs and bankruptcies are rising by the week. The car manufacturing sector is in a state of de facto bankruptcy and waiting for an injection of immediate cash to last three months. It is estimated that for every job employed directly in the car manufacturing industry there are 7-9 jobs indirectly related to it. A collapse of car making in the US could translate quickly into a 2 million unemployed persons. It is in the nature of the modern economy that sectors are interrelated and highly interconnected.

In a way the economy is a set of gears, any problem in any segment could shut down the entire economic engine. If car making suffers so will the steel industry and the coal industry and the plastic industry and paint and varnish and so on down and up the value chains. Workers without employment incomes cannot afford to pay the mortgages (a second wave of defaults is now expected from those losing their jobs). They will not be able to buy clothes and beer and farmers everywhere will have hard time selling their barley and so on and so forth. Disequilibrium in the goods market (excess supply as demand falters) will result in excess supply in the labor markets triggering more unemployment. Disequilibria will multiply and expand. It is cumulative and works like a snow ball. Declines in wages cannot stem it, because lower cost of labor cannot make up for decreased and depressed demands.

In general any economy has four engines. Consumption, business investment, exports minus imports and government net expenditures. When unemployment rises and people are no longer sure about their jobs they will cut their expenditures. If they lose their wealth (housing prices have fallen and stock markets have lost a major chunk of their values) they will feel poorer and would again find it difficult to continue to spend and may instead favor saving any new income or new fortunes to bolster their lost wealth. In such a situation it is difficult to rely on consumers to play an active role in shoring up aggregate demand. It would be nice if one can get all the consumers together and explain to them that by spending more together they will save their jobs and the economy. Even if this was possible and consumers are persuaded of the reasonableness of the argument, free riding behavior would trump any concerted action.

If consumers are not likely to spend more and if anything they are more likely to spend less, it is reasonable to expect that businesses are not likely to invest. Why would they invest knowing that there are no consumers to buy the fruits of their investment? Surely lower cost of borrowing may be attractive but only if the expected future demand for their products is there. It is not likely that we can persuade business to assume its social or moral responsibilities to undertake risky investments. In some sense that animal spirit and mindless pursuit of greed is what got us in this mess in the first place.

World trade is also collapsing. The US economy is the largest market it buys more than 35% of all the Third World exports. More than 80% of Canada's exports and almost a similar share of Mexico's are destined to the US market. When the US GDP starts to decline so will its appetite for imports and this would soon translate in a major decline in world exports and incomes. A decline in exchange rates against the dollar in such circumstances amounts to no more than beggar my neighbor policies. Income declines will trump any advantage from lower export prices. Export oriented economies will feel the brunt of this situation and will have very limited options but to cut down their import demands. This will only serve to exacerbate the difficult situation and would result sooner or later with lower incomes for all. Targeting reduction of imports is not advisable because sooner or later this would come to haunt the initiators of such strategies as others follow suit.

There remains only one sector that can buck the trend and that is government. It alone is in a position to do so in these circumstances. A recessionary state in the economy means that government can increase its expenditures without crowding out exports or investment. It would work best if it is done quickly and massively. It is in the nature of fiscal policy (expenditure and tax policies) that it takes time to work. It is subject to parliamentary debates and three legendary lags that rob it of much of its vitality—a recognition lag, adoption lag and an implementation lag. This is in addition to the response lags in the economy as actors respond to the policy stimulus. It is also contingent on consumers not subverting the fiscal stimulus by continuing to retrench. Recessions provide a clear cut case for Keynesian solutions (provided that the income-consumption relationship is stable). The fact that actors trap their wealth in safe assets (money or near money) and that investors are not likely to invest even when interest rates and costs of loanable funds are low suggest that direct government expenditures (hopefully on socially necessary programs such as improving the infrastructure and cleaning and greening the economy) are the last resort to reverse the psychological and real damage that are associated with recessions. (Some have gone as far as saying that the current world economy is technically in recession but psychologically we are in a depression).

There is a corollary to all of this and that is that the economy that tolerates deficits in times of recessions should build surpluses in good economic times. Fiscal policy works best when balancing the economy over a cycle is seen to be superior to the narrow pursuit of balancing books. This corollary is quite meaningful because consumers are likely to recognize that current deficits would have to be paid for with higher taxes in the future (Ricardian equivalence). The state should make it absolutely clear that this balancing would only happen when the economy is healthy and vibrant. The superiority that some see in monetary policy over fiscal policy in being reversible will no longer hold as long as this reversibility in fiscal policy is transparent and clear. Monetary policy should accommodate fiscal policy for coherence but it is difficult to see that lower interest rates would spur much activity in a depressed economy. The interest rates in a recession are already too low or impotent in persuading actors to revise their economic calculations and behavior.

Furthermore, if fiscal stimulus is going to work it better starts with direct expenditures as these have typically higher multiplier effects than tax reductions. The latter can be used later on as the economy and psychology are changed favorably.

The moral of all this is about the pivotal role of the state in the economy which assumes critical magnitudes the closer an economy is to recession and the more depressed the private sector's psychology and expectations. But even in this clear cut case, the private sector can and may subvert any positive impulses from the government if it were to remain inert and unwilling to cooperate with government policies to kick-start the economy. Again and again the crux of the issue is the joint and cooperative nature of the relationship that should be seen in perspective and in context.

## **VI. Conclusions :**

Due to the increased importance of trade, the options available to national governments have narrowed appreciably over the past few decades. Governments scrambled to maintain international competitiveness. In the process they loosened their grip on their economies and retreated from their traditional role of providing social safety nets, moderating the negative distributional outcomes of the market and correcting market failures.

Ironically, a key component of the implicit social contract between labor and capitalists in the advanced economies throughout the 1950s and up to the late 1980s had been the provision by government of social insurance and social safety nets that included unemployment insurance, severance payments, universal medical insurance, etc. in exchange for the adoption of freer trade policies and stances.<sup>x1</sup> Globalization and freeing of trade had eroded these social contracts leaving labor and vulnerable groups helpless and defenseless in the face of massive restructuring of industry, biased and polarized income distribution regimes and massive employment losses. There are two seemingly contradictory trends in the post-war period in both developed and developing countries—the growth of trade and the growth of government. Before the Second World War, government expenditures averaged about 20% of GDP of the industrialized countries. By the mid 1990s this figure had more than doubled to 47%. These increases in the government role in the economy was more striking in advanced countries like the United States where it increased from 9 to 34 per cent, in Sweden where it increased from 10 to 69 percent or the Netherlands where it increased from 19 to 54 percent. It should not come as a surprise that the more open an economy is the more the government has to do to minimize the social impacts of openness to the international economy. It is clear that the social welfare state was the flip side of the open economy. It is here where Globalization has perhaps sewed the seeds of its demise. It is here where the Third World should have been more careful not to engage in opening their economies without first erecting the necessary institutions that can ameliorate and guide the opening process.

Openness and freer trade have eroded social programs and polarized labor markets and income and wealth distribution. Greater and more pronounced openness of the economy took place against a backdrop of government retreating from the provision of social programs and from playing the adjudicating force over negative market outcomes and continuing to lead and nurture development and growth. The real Arab challenge is for re-inventing a new role for government and not to retreat from the socioeconomic sphere, particularly at this crucial time.

A whole new nexus of institutions, values, techniques and management have combined to underpin the new economy. At the heart of all these changes is the ability of the new economy to develop, train and expand labor and organizational skills that can lead, manage, co-ordinate, plan and innovate success in this complex, rapidly changing and highly uncertain world. The change was not about adoption of techniques and the purchase of the appropriate technology. Rather, it was about building institutions, about restructuring activities, and about overhauling the entire old Fordist structures. These

changes are massive and drastic. They cannot happen piecemeal and they were not left totally to market forces and the private sector. Where the transition was successful, whether in developed or in developing countries, the transformative power of the state have guided and protected this transition. It was also done within a broader context than the small and fragmented nation states. Major trading blocs emerged, solidified and balanced the Globalization trends. The jump into the world arena, for many if not all the successful experiments, was cushioned and involved preparation through regional arrangements.

As long as developing countries have underdeveloped or missing markets, imperfect information, imperfect capital markets, small and disarticulated firms and as long as development requires acquiring new technology (new information), merit based bureaucracies, the provision of training, credit and subsidies, market mechanisms cannot be excluded nor could they be relied upon exclusively to gear or even spur economic development. A major role for the state is still necessary and the real issues are those associated with the nature, timing and character of its role and not with whether it is needed or not. More importantly the issue is about a balanced and proper relationship between the state and the private sector that is conceived within well developed institutions and transparent rules.

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