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Incensed about Inequality

Martin Wolf

Economic Growth and Globalization

In the mid-1970s I was the World Bank's senior divisional economist on India during the country's worst post-independence decade. After a spurt of growth in the early phase of its inward-looking development, growth in incomes per head had ground virtually to a halt. Hundreds of millions of people seemed, as a result, to be mired in hopeless and unending poverty. In a book published in 1968, a well-know environmentalist doomsayer, Paul Ehrlich, had written the country off altogether. For a young man from the UK, work in India as an economist was both fascinating and appalling: so much poverty; so much frustration; so much complacency. Yet I was convinced then, as I am now, that, with perfectly feasible policy changes, this vast country could generate rapid rates of economic growth and reductions in poverty. No iron law imposed levels of real output (and so real incomes) per head at only 10 per cent of those in high-income countries.

Since those unhappy days, India has enjoyed the fruit of two revolutions: the green revolution, which transformed agricultural productivity; and a liberalizing revolution, which began, haltingly, under Rajiv Gandhi's leadership, in the 1980s and then took a 'great leap forward' in 1991, in response to a severe foreign exchange crisis, under the direction of one of the country's most remarkable public servants, Manmohan Singh, the then finance minister. Slowly, India abandoned the absurdities of its pseudo-Stalinist 'control raj' in favour of individual enterprise and the market. As a result, between 1980 and 2000, India's real GDP per head more than doubled. Stagnation has become a thing of the past.

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India was not alone. On the contrary, it was far behind a still more dynamic and even bigger liberalizing country – China, which achieved a rise in real incomes per head of well over 400 per cent between 1980 and 2000. China and India, it should be remembered, contain almost two-fifths of the world's population. China alone contains more people than Latin America and sub-Saharan Africa together. Many other countries in east and south Asia have also experienced rapid growth. According to the 2003 ***Human Development Report*** from the United Nations Development Programme, between 1975 and 2001, GDP per head rose at 5.9 per cent a year in east Asian developing countries (with 31 per cent of the world's population in 2000). The corresponding figure for growth of GDP per head for south Asia (with another 22 per cent of the world's population) was 2.4 per cent a year. Between 1990 and 2001, GDP per head rose at 5.5 per cent a year in east Asia, while growth rose to 3.2 per cent a year in south Asia.

Never before have so many people – or so large a proportion of the world's population – enjoyed such large rises in their standards of living. Meanwhile, GDP per head in high-income countries (with 15 per cent of the world's population) rose by 2.1 per cent a year between 1975 and 2001 and by only 1.7 per cent a year between 1990 and 2001. This, then, was a period of partial convergence: the incomes of poor developing countries, with more than half the world's population, grew substantially faster than those of the world's richest countries.

This, in a nutshell, is why [labor leader Jay] Mazur and the many people who think like him are wrong. Globalization has not increased inequality. It has reduced it, just as it has reduced the incidence of poverty. How can this be, critics will demand? Are absolute and proportional gaps in living standards between the world's richest and poorest countries not rising all the time? Yes is the answer. And is inequality not rising in most of the world's big countries? Yes, is again the answer. So how can global inequality be falling? To adapt Bill Clinton's campaign slogan, it is the growth, stupid. Rapid economic growth in poor countries with half the world's population has powerful effects on the only sort of inequality which matters, that among individuals. It has similarly dramatic effects on world poverty. The rise of Asia is transforming the world, very much for the better. It is the 'Asian drama' of our times, to plagiarize the title of a celebrated work by a Nobel-laureate economist, the late Gunnar Myrdal.

What, the reader may ask, has this progress to do with international economic integration? In its analysis of globalization, published in 2002, the World Bank divided seventy-three developing countries, with aggregate population, in 1997, of 4 billion (80 per cent of all people in developing countries), into two groups: the third that had increased ratios of trade to GDP, since 1980, by the largest amount and the rest. The former group, with an aggregate population of 2.9 billion, managed a remarkable combined increase of 104 per cent in the ratio of trade to GDP. Over the same period, the increase in the trade ratio of the high-income countries was 71 per cent, while the 'less globalized' two-thirds of countries in the sample of developing countries experienced a decline in their trade ratios.

The average incomes per head of these twenty-four globalizing countries rose by 67 per cent (a compound rate of 3.1 per cent a year) between 1980 and 1997. In contrast, the other forty-nine countries managed a rise of only 10 per cent (a compound rate of 0.5 per cent a year) in incomes per head over this period. These more globalized countries did not have particularly high levels of education in 1980. At that time, they were also a little poorer, as a group, than the rest. Subsequently, the new globalizers, as the World Bank calls them, cut their import tariffs by 34 percentage points, in average, against 11 percentage points for the other group. They also achieved a better reading on the rule of law than the others. The World Bank's conclusion is that, 'as they reformed and integrated with the world market, the "more globalized" developing countries started to grow rapidly, accelerating steadily from 2.9 per cent in the 1970s to 5 per cent in the 1990s'.

While what the Bank says is both true and important, it should be observed that its notion of a group of twenty-four countries is something of a fiction. China and India contain, between them, 75 per cent of the group's combined population. With Brazil, Bangladesh, Mexico, the Philippines and Thailand, one has 92 per cent of the group's population. Moreover, Asian countries dominate: they make up 85 per cent of the population of this group of globalizing countries.

What, then, do we learn from the success of the countries picked out as globalizers by the World Bank? We can say, with confidence, that the notion that international economic integration necessarily makes the rich richer and the poor poorer is nonsense. Here is a wide range of countries that increased their integration with the world economy and prospered, in some cases dramatically so. A subtler question is precisely what policies relatively successful developing countries have followed. Critics are right to argue that success has not required adoption of the full range of so-called 'neo-liberal' policies – privatization, free trade and capital-account liberalization. But, in insisting upon this point, critics are wilfully mistaking individual policy trees for the market-oriented forest. What the successful counties all share is a move towards the market economy, one in which private property rights, free enterprise and competition increasingly took the place of state ownership, planning and protection. They chose, however haltingly, the path of economic liberalization and international integration. This is the heart of the matter. All else is commentary. [...]

Growth and Inequality

Thirty years ago, China and India were among the world's poorest countries. Today, the poorest seems to be Sierra Leone, a country with a population of only 5 million. China's average real income per head is now some ten times higher than Sierra Leone's. The largest very poor country today is Nigeria, with a population of 127 million in 2000 and a real income, at PPP, just a fortieth of that of the US (and a fifth of China's). Again, this means that rising ratios between the average incomes of the world's richest and poorest countries are consistent with declining inequality among countries, weighted by their populations. Moreover, it is also perfectly possible for inequality to have risen in every single country in the world (as Mazur alleges, wrongly) while global inequality has fallen. Unless the increase in inequality among individuals within countries offsets the reduction in population-weighted inequality among countries, not only inequality among (population-weighted) countries, but also inequality among individuals will have declined.

Andrea Boltho of Oxford University and Gianni Toniolo of Rome University have computed population-weighted inequality among forty-nine countries that contain

80 per cent of the world's population, back to 1900. To compute their measure of inequality, the gini coefficient, the authors weight the average income, at purchasing power parity (in order to compare standards of living), of each country by its population. They conclude that inequality among countries, weighted in this way, reached its maximum in 1980, at a value of 0.54, but has fallen by 9 per cent since then, to 0.50, a level not seen since some six decades ago. This decline in inequality among countries, weighted by their population size, is exactly what one would expect.

The reason for weighting distribution among countries by population is that it is people who matter, not countries. Then the right thing to do must be to take account of changes in distribution of income within countries as well. A paper by François Bourguignon and Christian Morrison, for the World Bank, has attempted this heroic task for 1820 to 1992. [...] The most important conclusion is that, since the beginning of the nineteenth century, changes in inequality among the world's individuals have been driven by changes in the relative wealth of nations. In particular, the steeply rising inequality among the people of the world in the nineteenth and first half of the twentieth century was driven by the divergent performance of Europe and the British offshoots, on the one hand, and Asia, on the other. What matters then is relative rates of economic growth over extended periods. Consequently, Asia's improved growth performance, and especially that of the Asian giants, has started to reverse this picture of rising inequality over the past two decades.

This World Bank study suffers from two defects: to take the analysis so far back, it had to rely on highly limited, indeed sketchy, data; and it ended in 1992, at the beginning of yet another decade of rapid growth in Asia, not least in China. More recent studies, on similar lines, remedy these defects. These are by another group of three authors at the World Bank, by Surjit Bhalla, formerly a World Bank economist, and by Xavier Sala-I-Martin of Columbia University. All three reach a very similar conclusion: global inequality among households, or individuals, peaked in the 1970s, whereupon it started to fall. This decline happened not because of greater equality within countries, but because of greater population-weighted equality among them. [...]

The bottom line is that it is plausible that inequality among individuals across the world has been falling over the past two decades, because of the relatively rapid growth of the Asian giants. This is consistent with rising inequality within many countries, rising relative gaps between the average incomes of the richest and very poorest countries, and increasing absolute gaps between the average incomes in the high-income countries, on the one hand, and virtually all developing countries, on the other. But the latter simply shows the tyranny of history. By 1980, inequality among countries was so large that it was impossible for absolute gaps to close, until there was much greater convergence of relative incomes.

Yet this ignores the fact that a great many countries have not enjoyed rapid growth, most notably in Africa, but also, to a lesser extent, in Latin America, the Middle East and, in the 1990s, the countries in transition from communism, especially the former Soviet Union. In the 1990s, for example, according to the Human Development Report, fifty-four countries, with 12 per cent of the world's population, had negative growth rates in real incomes per head, while another seventy-one countries, with 26 per cent of the world's population, had growth of between zero and 3 per cent a year in real incomes per head. Similarly, in the World Bank's study of globalization, countries containing 1.1 billion people had virtually stagnant real incomes between

1980 and 1997. While the poor performance of so many countries may not have prevented global income distribution from improving (though it will tend to do so once China's average incomes rise above the world average), it has certainly had a significant impact on the scale and regional distribution of world poverty. [...]

Growth and Poverty

From being universal, extreme poverty has become, if not rare, the affliction of less than a quarter of a vastly increased human population. But, again, it is necessary to look more closely at what has happened in the supposed period of globalization, the years since 1980. Here, the authoritative voice is that of the World Bank, the institution whose 'dream is a world without poverty'. The numbers come from two recent World Bank publications. They reach the following conclusions.

First, the number of people in extreme poverty fell from 1.18 billion in 1987 to 1.17 billion in 1999, but not before jumping upwards to 1.29 billion in 1990.

Second, enormous declines in the number of people in extreme poverty have occurred in dynamic east Asia, from 486 million in 1990 to 279 million in 1999, including China, and from 114 million to 57 million, excluding China. In China itself, the decline, between 1990 and 1999, was from 376 million to 222 million. Rapid growth reduces poverty dramatically. This remains today, as it has been for two centuries, an abiding truth.

Third, the number of people in extreme poverty fell very modestly in south Asia between 1990 and 1999, while it rose sharply in eastern Europe and central Asia (the former Soviet empire) and, above all, sub-Saharan Africa, from 217 million in 1987 to 241 million in 1990, and then 315 million in 1999.

Fourth, the regional incidence of poverty fell dramatically in east Asia, from 30.5 per cent of the population in 1990 to just 15.6 per cent in 1999. Excluding China, it fell from 24.2 to 10.6 per cent. In China, it fell from 33 per cent of the population to just under 18 per cent over nine years. This was, without doubt, the most rapid reduction in the incidence of extreme poverty anywhere, ever.

Fifth, the incidence of poverty also fell sharply in south Asia (dominated by India) in the 1990s, from 45.0 per cent of the population in 1990 to 36.6 per cent in 1999. But it rose sharply in eastern Europe and central Asia and also increased in sub-Saharan Africa, from 47.4 per cent of the population to 49.0 per cent. [...]

Poverty and Human Welfare

In the developing world as a whole, life expectancy rose by four months each year after 1970, from fifty-five years in 1970 to sixty-four years in 2000. It rose from forty-nine in 1970 to sixty-two in south Asia and from fifty-nine to sixty-nine in east Asia. Tragically, life expectancy fell in thirty-two countries in the 1990s, mostly because of the AIDS epidemic, or the gross incompetence (or worse) of governments, as in North Korea and Zimbabwe. It also fell because of western hysteria about DDT, which removed the only effective way of controlling that dreadful curse, malaria. Improvements in life expectancy have meant a decline in global inequality as well. In 1950, average life expectancy in developing countries was two-thirds of the levels in high-income countries (forty-four and sixty-six years of age, respectively). By 2000, it was 82 per cent (sixty-four and seventy-eight).

Meanwhile, in the developing world as a whole, infant mortality rates have fallen from 107 per thousand in 1970 to eighty-seven in 1980 and fifty-eight in 2000. In east Asia, the region with the fastest-growing economy, they have fallen from fifty-six in 1980 to thirty-five in 2000. In south Asia, infant mortality fell from 119 in 1980 to seventy-three in 2000. In sub-Saharan Africa progress was, once again, slower. But infant mortality fell even there, from 116 in 1980 to ninety-one in 2000.

Losing a child must inflict the sharpest grief human beings can suffer. The decline in infant mortality is thus a tremendous blessing in itself. So, too, is the rise in life expectancy. But these improvements also mean that it makes sense to invest in education. The world increasingly produces smaller families with much better-educated children. On average, adult literacy in developing countries rose from 53 per cent in 1970 to 74 per cent in 1998. By 2000, adult male illiteracy was down to 8 per cent in east Asia, though it was still 30 per cent in sub-Saharan Africa and (a real scandal this) 34 per cent in south Asia. Adult female illiteracy was more widespread than that for men, but was also improving. Between 1990 and 2000, female illiteracy fell from 29 per cent to 21 per cent in east Asia. In south Asia, it fell from 66 per cent to 57 per cent (an even worse scandal than the low rate for men), while in sub-Saharan Africa it fell from 60 to 47 per cent. Illiteracy is much lower among the young. This guarantees that rates will continue to fall, as time passes.

The reduction in fertility rates has also been remarkable. In the developing world as a whole, births per woman (the fertility rate) have fallen from 4.1 in 1980 to 2.8 in 2000. In east Asia, the fertility rate, down from 3.0 to 2.1, is already at close to the replacement rate. In Latin America, the fertility rate has fallen from 4.1 to 2.6. Even in south Asia it has fallen from 5.3 in 1980 to 3.3 in 2000. Again, progress has been slowest in sub-Saharan Africa, where the birth rate has only fallen from 6.6 in 1980 to 5.2 in 2000. But, in all, these reductions tell us of improved control by women of their fertility, of fewer children with more parental investment in each and of far stronger confidence that children will survive to maturity. The demographic transition that is now under way in the developing world is immensely encouraging. It is also an indication – as well as a source – of rising welfare.

Now, let us look at hunger. Growth in food production has substantially outpaced that of population. Between 1961 and 1999, the average daily food supply per person increased 24 per cent globally. In developing countries, it rose by 39 per cent, to 2,684 calories. By 1999, China's average daily food supply had gone up 82 per cent, to 3,044 calories, from a barely subsistence level of 1,636 in 1961. India's went up by 48 per cent to 2,417 calories, from 1,635 calories in 1950–1. According to estimates by the United Nations Food and Agricultural Organization, the average active adult needs between 2,000 and 2,310 calories per person. Thus the developing-country food supply has gone, on average, from inadequate to adequate. Hunger persists. But the FAO estimates that the number of people suffering from chronic undernourishment fell from 920 million in 1969–71 to 790 million in 1997–9, or from 35 to 17 per cent of the population of developing countries. Trends in sub-Saharan Africa, the continent that did not grow, were far worse. Between 1979–81 and 1997–9, the share of the population that was undernourished declined from 38 to 34 per cent, but absolute numbers, in a rapidly growing population, rose from 168 million to 194 million.

Now, turn to what has become one of the most controversial indicators: child labour. One would expect that more prosperous parents, with fewer children, who are also expected to live longer, would wish to see their children being educated rather than at work. So, happily, it has proved. The proportion of children aged ten to fourteen in the labour force has, according to the World Bank, fallen from 23 per cent in all developing countries in 1980 to 12 per cent in 2000. The fall in east Asia has, once again, been astonishing, from 26 to 8 per cent. In south Asia, it has fallen from 23 to 15 per cent. In sub-Saharan Africa, the decline has been less impressive, from 35 to 29 per cent. China's transformation has been breathtaking, with a fall from 30 per cent in 1980 to just 8 per cent in 2000. In lagging India, the fall was from 21 to 12 per cent. Thus, just as one would expect, countries whose economies have done well in the era of globalization have been ones in which parents have chosen to withdraw their children from the labour force. Parents have never put their children to work out of indifference or malevolence, but only out of necessity. [...]

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Is Globalization Reducing Poverty and Inequality?

Robert Hunter Wade

The neoliberal argument says that the distribution of income between all the world's people has become more equal over the past two decades and the number of people living in extreme poverty has fallen, for the first time in more than a century and a half. It says that these progressive trends are due in large part to the rising density of economic integration between countries, which has made for rising efficiency of resource use worldwide as countries and regions specialize in line with their comparative advantage. Hence the combination of the "dollar-Wall Street" economic regime in place since the breakdown of the Bretton Woods regime in the early 1970s, and the globalizing direction of change in the world economy since then, serves the great majority of the world's people well. The core solution for lagging regions, Africa above all, is freer domestic and international trade and more open financial markets, leading to deeper integration into the world economy.

Evidence from the current long wave of globalization thus confirms neoliberal economic theory – more open economies are more prosperous, economies that liberalize more experience a faster rate of progress, and people who resist further economic liberalization must be acting out of vested or "rent-seeking" interests. The world economy is an open system in the sense that country mobility up the income/wealth hierarchy is unconstrained by the structure. The hierarchy is in the process of being flattened, the North–South, core–periphery, rich country–poor country divide is being eroded away as globalization proceeds. The same evidence also validates the rationale of the World Trade Organization (WTO), the World Bank, the International Monetary Fund (IMF) and other multilateral economic organizations as agents for creating a global "level playing" field undistorted by state-imposed restrictions on markets. This line of argument is championed by the more powerful of the centers of "thinking for the world" that influence international policy making, including the intergovernmental

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organizations such as the World Bank, the IMF and the WTO, also the US and UK Treasuries, and opinion-shaping media such as *The Financial Times* and *The Economist*.

The standard Left assumption, in contrast, is that the rich and powerful countries and classes have little interest in greater equity. Consistent with this view, the "antiglobalization" (more accurately, "anti-neoliberal") argument asserts that world poverty and inequality have been rising, not falling, due to forces unleashed by the same globalization. The line of solution is some degree of tightening of public policy limits on the operation of market forces; though the "anti-neoliberal" camp embraces a much wider range of solutions than the liberal camp.

The debate tends to be conducted by each side as if its case was overwhelming, and only an intellectually deficient or dishonest person could see merit in the other's case. For example, Martin Wolf of *The Financial Times* claims that the "anti-globalization" argument is "the big lie." If translated into public policy it would cause more poverty and inequality while pretending to do the opposite. [...]

The Regional Collage

The growth rate of world GDP, measured in US dollars and at current exchange rates, fell sharply from around 5.5% in 1970–80 to 2.3% in 1980–90 to 1.1% in 1990–2000. This is bad news, environmental considerations aside. But it still grew a little faster than world population over the past two decades; and the (population-weighted) GDP of developing countries as a group grew a little faster than that of the high-income countries. On the other hand, regional variation within the global South is large. [...] During 1960–90 the per capita incomes of sub-Saharan Africa, Latin America, and West Asia and North Africa fell as a fraction of the core's; South Asia's remained more or less constant; East Asia's (minus China) rose sharply; China's also rose sharply but from a very low base. The most striking feature is not the trends but the size of the gaps, testimony to the failure of "catch-up." Even success-story East Asia has an average income only about 13% of the core's. It is a safe bet that most development experts in 1960 would have predicted much higher percentages by 2000. [...]

How does the collage – positive world per capita growth and wide divergence of economic performance between developing regions – net out in terms of global trends in poverty and inequality?

Poverty

The standard poverty numbers – the ones normally used in discussions about the state of the world – come from the World Bank's data set. This is the source of the claims that, in the words of President James Wolfensohn, "Over the past 20 years the number of people living on less than $1 a day has fallen by 200 million, after rising steadily for 200 years" and "the proportion of people worldwide living in absolute poverty has dropped steadily in recent decades, from 29% in 1990 to a record low of 23% in 1998." The opening sentence of the Bank's *World Development Indicators 2001* says, "Of the world's 6 billion people 1.2 billion live on less than $1 a day," the same number in 1987 and 1998.

No ifs or buts. I now show that the Bank's figures contain a large margin of error, and the errors ***probably*** flatter the result in one direction. [...]

There are several reasons to expect a large margin of error, regardless of direction. First, the poverty headcount is very sensitive to the precise level of the international poverty lines. This is because the shape of income distribution near the poverty line is such that, in most developing countries, a given percentage change in the line brings a similar or larger percentage change in the number of people below it. Recent research on China suggests that a 10% increase in the line brings a roughly 20% increase in the poverty headcount.

Second, the poverty headcount is very sensitive to the reliability of household surveys of income and expenditure. The available surveys are of widely varying quality, and many do not follow a standard template. Some sources of error are well known, such as the exclusion of most of the benefits that people receive from publicly provided goods and services. [...]

Third, China and India, the two most important countries for the overall trend, have PPP-adjusted income figures that contain an even bigger component of guess work than for most other significant countries. The main sources of PPP income figures (the Penn World Tables and the International Comparison Project) are based on two large-scale international price benchmarking exercises for calculating purchasing power parity exchange rates, one in 1985 in 60 countries, the other in 1993 in 110 countries. The government of China declined to participate in both. The purchasing power parity exchange rate for China is based on guestimates from small, ***ad hoc*** price surveys in a few cities, adjusted by rules of thumb to take account of the huge price differences between urban and rural areas and between eastern and western regions. The government of India declined to participate in the 1993 exercise. The price comparisons for India are extrapolations from 1985 qualified by later ***ad hoc*** price surveys. The lack of reliable price comparisons for China and India – hence the lack of reliable evidence on the purchasing power of incomes across their distributions – compromises any statement about levels and trends in world poverty.

Fourth, the often-cited comparison between 1980 and 1998 – 1.4 billion in extreme poverty in 1980, 1.2 billion in 1998 – is not valid. The Bank introduced a new methodology in the late 1990s which makes the figures noncomparable. The Bank has recalculated the poverty numbers with the new method only back to 1987. [...]

We can be fairly sure that the Bank's poverty headcount has a large margin of error in ***all*** years, in the sense that it may be significantly different from the headcount that would result from the use of PPP conversion factors based more closely on the real costs of living of the poor (defined in terms of income needed to buy enough calories, micronutrients and other necessities in order not to be poor). By the same token we should question the Bank's confidence that the trend is downward.

We do not know for sure how the late 1990s revision of the method and the PPP numbers alters the poverty headcount in any one year and the trend. But it is likely that the Bank's numbers substantially underestimate the true numbers of the world's population living in extreme poverty, and make the trend look brighter.

On the other hand, it is quite plausible that the ***proportion*** of the world's population living in extreme poverty has fallen over the past 20 years or so. For all the problems with Chinese and Indian income figures we know enough about trends in other variables – including life expectancy, heights, and other nonincome measures – to be confident that their poverty headcounts have indeed dropped dramatically over the past 20 years. If it is the case (as some experts claim) that household surveys are more likely to miss the rich than the poor, their results may *overstate* the proportion of the population in poverty. The magnitude of world population increase over the past 20 years is so large that the Bank's poverty numbers would have to be *huge* underestimates for the world poverty rate not to have fallen. Any more precise statement about the absolute number of the world's people living in extreme poverty and the change over time currently rests on quicksand.

Inequality

The world poverty headcount could move in one direction while world inequality moved in the other. The neoliberal argument says that they have both dropped. But in the past several years world income distribution has become a hot topic of debate in international economics and in sociology (much hotter than trends in world poverty). Disagreements about the overall inequality trend should not be surprising given the variation in regional economic performance – different ways of measuring emphasize different parts of the collage.

The only valid short answer to the question, "What is the trend of world income distribution?" is, "It depends on which combination out of many plausible combinations of measures and countries we choose." [...]

Proposition 1. ***World income distribution has become rapidly more unequal, when incomes are measured at market exchange rates and expressed in US dollars.***

No one disputes this. The dispute is about what the figures mean. Most economists say that exchange-rate-based income measures are irrelevant. GDP incomes should always be adjusted by PPP exchange rates to take account of differences in purchasing power, they say. This makes a big difference to the size of the gap between rich and poor. As noted, the PPP adjustment is made by computing the relative prices for an average bundle of goods and services in different countries. The PPP adjustment substantially raises the relative income of poor countries. India's PPP GDP, for example, is about four times its market exchange rate GDP. The PPP adjustment thus makes world income distribution look much more equal than the distribution of market-exchange-rate incomes. [...]

Proposition 2. ***World PPP-income polarization has increased, with polarization measured as richest to poorest decile.***

The broad result is hardly surprising: the top 10% comprises almost entirely people living in the core countries of North America, western Europe, and Japan, where incomes have grown over the past 20–30 years, while a large chunk of the bottom 10% is comprised of African countries where incomes have stagnated or fallen. According to one study, the trend of richest to poorest decile goes like this: 1970–92, 1980–109, 1990–104, 1999–104. Another study finds a jump in the ratio of 25% over 1988–93. The change is made up of the top decile pulling sharply up from the median and the bottom decile falling away from the median. The polarizing trend would be much sharper with the top 1% rather than the top decile.

Proposition 3. ***Between-country world PPP-income inequality has increased since at least 1980, using per capita GDPs, equal country weights (China = Uganda), and a coefficient like the Gini for the whole distribution.***

Of course, we would not weight countries equally if we were interested simply in relative well-being. But we would weight them equally – treat each country as a unit of observation, analogous to a laboratory test observation – if we were interested in growth theory and the growth impacts of public policies, resource endowments, and the like. We might, for example, arrange (unweighted) countries by the openness of their trade regime and see whether more open countries have better economic performance. [...]

Proposition 4. ***Between-country world PPP-income inequality has been constant or falling since around 1980, with countries weighted by population.***

This is the result that the neoliberal argument celebrates. There are just two problems. First, exclude China and even this measure shows a widening since 1980; also exclude India and the widening is pronounced. Therefore, ***falling income inequality is not a general feature of the world economy, even using the most favorable combination of measures.*** [...]

With 38% of the world's population, China and India shape world trends in poverty and inequality. They have grown very fast over the past decade (India) or two (China), if the figures are taken at face value. China's average purchasing power parity income rose from 0.3 of the world average in 1990 to 0.45 in 1998, or 15 percentage points in only eight years.

We can be sure that world poverty and inequality are less than they would be had China and India grown more slowly. About any stronger conclusion we have to be cautious. First, recall that China's and India's purchasing power parity numbers are even more questionable than those for the average developing country, because of their nonparticipation in the international price comparisons on which the PPP calculations rest. Second, China's growth in the 1990s is probably overstated. Many analysts have recently been revising China's growth statistics downward. Whereas government figures show annual real GDP growth of 7–8% in 1998 and 1999 one authority on Chinese statistics estimates that the economy may not have grown at all. [...]

Over the 1990s China's annual growth rate is more likely to have been around 6–8% than the 8–10% of the official statistics. This one change lowers the probability that world interpersonal distribution has become more equal.

We have to be cautious about going from China's fast growth to falls in world income inequality not only because China's growth rates and income level may be overstated but also because the rise in inequality within both China and India partly offsets the reduction in world income inequality that comes from their relatively fast growth of average income – though careful calculations of the relative strength of the two contrary effects have yet to be made. China's surging inequality is now greater than before the Communists won the civil war in 1949, and inequality between regions is probably higher than in any other sizable country. The ratio of the average income of the richest to poorest province (Guangdong to Guizhou) rose from around 3.2 in 1991 (current yuan) to 4.8 in 1993, and remained at 4.8 in 1998–2001. The corresponding figure for India in the late 1990s was 4.2, the United States, 1.9. [...]

The evidence does support the liberal argument when inequality is measured with population-weighted countries' per capita PPP-adjusted incomes, plus a measure of average inequality, taking China's income statistics at face value. On the other hand, polarization has clearly increased. Moreover, several studies that measure inequality over the whole distribution and use either cross-sectional household survey data or measures of combined inequality between countries and within countries show widening inequality since around 1980. The conclusion is that world inequality measured in plausible ways is probably rising, despite China's and India's fast growth. The conclusion is reinforced by evidence of a quite different kind. Dispersion in pay rates within manufacturing has become steadily wider since the early 1980s, having remained roughly constant from 1960 to the early 1980s. Meanwhile, absolute income gaps are widening fast.

Globalization

I have raised doubts about the liberal argument's claim that (a) the number of people living in extreme poverty worldwide is currently about 1.2 billion, (b) it has fallen substantially since 1980, by about 200 million, and (c) that world income inequality has fallen over the same period, having risen for many decades before then. Let us consider the other end of the argument – that the allegedly positive trends in poverty and inequality have been driven by rising integration of poorer countries into the world economy, as seen in rising trade/GDP, foreign direct investment/GDP, and the like.

Clearly the proposition is not well supported at the world level if we agree that globalization has been rising while poverty and income inequality have not been falling. Indeed, it is striking that the pronounced convergence of economic policy toward "openness" worldwide over the past 20 years has gone with divergence of economic performance. But it might still be possible to argue that globalization explains differences between countries: that more open economies or ones that open faster have a better record than less open ones or ones than open more slowly.

This is what World Bank studies claim. The best known, ***Globalization, Growth and Poverty***, distinguishes "newly globalizing" countries, also called "more globalized" countries, from "nonglobalizing" countries or "less globalized" countries. It measures globalizing by *changes* in the ratio of trade to GDP over 1977–97. Ranking developing countries by the amount of change, it calls the top third the more globalized countries, the bottom two-thirds, the less globalized countries. It finds that the former have had faster economic growth, no increase in equality, and faster reduction of poverty than the latter. "Thus globalization clearly can be a force for poverty reduction," it concludes.

The conclusion does not follow. First, using "change in the trade/GDP ratio" as the measure of globalization skews the results. The globalizers then include China and India, as well as countries such as Nepal, Côte d'Ivoire, Rwanda, Haiti, and Argentina. It is quite possible that "more globalized" countries are *less* open than many "less globalized" countries, both in terms of trade/GDP and in terms of the magnitude of tariffs and nontariff barriers. A country with high trade/GDP and very free trade policy would still be categorized as "less globalized" if its *increase* in trade/GDP over 1977–97 put it in the bottom two-thirds of the sample. Many of the globalizing countries initially had very *low* trade/GDP in 1977 and still had relatively low trade/GDP at the ***end*** of the period in 1997 (reflecting more than just the fact that larger economies tend to have lower ratios of trade/GDP). To call relatively closed economies "more globalized" or "globalizers" and to call countries with much higher ratios of trade/GDP and much freer trade regimes "less globalized" or even "nonglobalizers" is an audacious use of language.

Excluding countries with high but not rising levels of trade to GDP from the category of more globalized eliminates many poor countries dependent on a few natural resource commodity exports, which have had poor economic performance. The structure of their economy and the low skill endowment of the population make them dependent on trade. If they were included as globalized their poor economic performance would question the proposition that the more globalized countries do better. On the other hand, including China and India as globalizers – despite relatively low trade/GDP and relatively protective trade regimes – guarantees that the globalizers, weighted by population, show better performance than the nonglobalizers. [...]

Conclusion

It is plausible, and important, that the proportion of the world's population living in extreme poverty has probably fallen over the past two decades or so, having been rising for decades before then. Beyond this we cannot be confident, because the World Bank's poverty numbers are subject to a large margin of error, are probably biased downward, and probably make the trend look rosier than it really is. On income distribution, several studies suggest that world income inequality has been rising during the past two to three decades, and a study of manufacturing pay dispersions buttresses the same conclusion from another angle. The trend is sharpest when incomes are measured at market-exchange-rate incomes. This is less relevant to relative well-being than PPP-adjusted incomes, in principle; but it is highly relevant to state capacity, interstate power, and the dynamics of capitalism. One combination of inequality measures does yield the conclusion that income inequality has been falling – PPP-income per capita weighted by population, measured by an averaging coefficient such as the Gini. But take out China and even this measure shows widening inequality. Falling inequality is thus not a ***generalized*** feature of the world economy even by the most favorable measure. Finally, whatever we conclude about income inequality, absolute income gaps are widening and will continue to do so for decades.

25

Grounded

Income Inequality and Speculative Investment Led to the Financial Meltdown

Branko Milanovic

The current financial crisis is generally blamed on feckless bankers, financial deregulation, crony capitalism and the like. While all of these elements may be true, this purely financial explanation of the crisis overlooks its fundamental reasons. They lie in the real sector, and more exactly in the distribution of income across individuals and social classes. Deregulation, by helping irresponsible behavior, just exacerbated the crisis; it did not create it.

To go to the origins of the crisis, one needs to go to rising income inequality within practically all countries in the world, and the United States in particular, over the last thirty years. In the United States, the top 1 percent of the population doubled its share in national income from around 8 percent in the mid-1970s to almost 16 percent in the early 2000s. That eerily replicated the situation that existed just prior to the crash of 1929, when the top 1 percent share reached its previous high watermark. American income inequality over the last hundred years thus basically charted a gigantic U, going down from its 1929 peak all the way to the late 1970s, and then rising again for thirty years.

What did the increase mean? Such enormous wealth could not be used for consumption only. There is a limit to the number of Dom Pérignons and Armani suits one can drink or wear. And, of course, it was not reasonable either to "invest" solely in conspicuous consumption when wealth could be further increased by judicious investment. So, a huge pool of available financial capital – the product of increased income inequality – went in search of profitable opportunities into which to invest.

But the richest people, and the hundreds of thousands somewhat less rich, could not invest the money themselves. They needed intermediaries, the financial sector. Overwhelmed with such an amount of funds, and short of good opportunities to

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invest the capital as well as enticed by large fees attending each transaction, the financial sector became more and more reckless, basically throwing money at anyone who would take it. While one cannot prove that investible resources eventually exceeded the number of safe and profitable investment opportunities (since nobody knows a priori how many and where there are good investment opportunities), this is strongly suggested by the increasing riskiness of investments that the financiers had to undertake.

But this is only one part of the equation: how and why large amounts of investable money went in a search of a return on that money. The second part of the equation explains who borrowed that money. There again we go back to the rising inequality. The increased wealth at the top was combined with an absence of real economic growth in the middle. Real median wage in the United States has been stagnant for twenty-five years, despite an almost doubling of GDP per capita. About one-half of all real income gains between 1976 and 2006 accrued to the richest 5 percent of households. The new "gilded age" was understandably not very popular among the middle classes that saw their purchasing power not budge for years. Middle-class income stagnation became a recurrent theme in the American political life, and an insoluble political problem for both Democrats and Republicans. Politicians obviously had an interest to make their constituents happy for otherwise they may not vote for them. Yet they could not just raise their wages. A way to make it seem that the middle class was earning more than it did was to increase its purchasing power through broader and more accessible credit. People began to live by accumulating ever rising debts on their credit cards, taking on more car debts or higher mortgages. President George W. Bush famously promised that every American family, implicitly regardless of its income, will be able to own a home. Thus was born the great American consumption binge which saw the household debt increase from 48 percent of GDP in the early 1980s to 100 percent of GDP before the crisis.

The interests of several large groups of people became closely aligned. High net-worth individuals and the financial sector were, as we have seen, keen to find new lending opportunities. Politicians were eager to "solve" the irritable problem of middle-class income stagnation. The middle class and those poorer than them were happy to see their tight budget constraint removed as if by magic wand, consume all the fine things purchased by the rich, and partake in the longest US post World War II economic expansion. Suddenly, the middle class too felt like the winners.

This is what more than two centuries ago, the great French philosopher Montesquieu mocked when he described the mechanism used by the creators of paper money in France (an experiment that eventually crumbled with a thud): "People of Baetica", wrote Montesquieu, "do you want to be rich? Imagine that I am very much so, and that you are very rich also; every morning tell yourself that your fortune has doubled during the night; and if you have creditors, go pay them with what you have imagined, and tell them to imagine it in their turn."

The credit-fueled system was further helped by the ability of the US to run large current account deficits; that is, to have several percentage points of its consumption financed by foreigners. The consumption binge also took the edge off class conflict and maintained the American dream of a rising tide that lifts all the boats. But it was not sustainable. Once the middle class began defaulting on its debts, it collapsed.

We should not focus on the superficial aspects of the crisis, on the arcane of how "derivatives" work. If "derivatives" they were, they were the "derivatives" of the model of growth pursued over the last quarter century. The root cause of the crisis is not to be found in hedge funds and bankers who simply behaved with the greed to which they are accustomed (and for which economists used to praise them). The real cause of the crisis lies in huge inequalities in income distribution which generated much larger investable funds than could be profitably employed. The political problem of insufficient economic growth of the middle class was then "solved" by opening the floodgates of the cheap credit. And the opening of the credit floodgates, to placate the middle class, was needed because in a democratic system, an excessively unequal model of development cannot coexist with political stability.

Could it have worked out differently? Yes, without thirty years of rising inequality, and with the same overall national income, income of the middle class would have been greater. People with middling incomes have many more priority needs to satisfy before they become preoccupied with the best investment opportunities for their excess money. Thus, the structure of consumption would have been different: probably more money would have been spent on home-cooked meals than on restaurants, on near-home vacations than on exotic destinations, on kids' clothes than on designer apparel. More equitable development would have removed the need for the politicians to look around in order to find palliatives with which to assuage the anger of the middle-class constituents. In other words, there would have been more equitable and stable development which would have spared the United States, and increasingly the world, an unnecessary crisis.

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The Twin Excesses – Financialization and Globalization – Caused the Crash

Ashok Bardhan

In their effort to explain the global crisis analysts have identified lax regulation and other attributes of the financial system as the principal culprits. To grasp fully the reason it also needs to be recognized that this is the first crisis of the modern era of globalization. If the proximate cause is the "laissez faire" to "laissez financer" progression in free-market idolatry, leading to bubbles in asset prices and the subsequent crash, then the facilitating condition was yet another quasi-bubble – a bubble in globalization. It may be easier to appreciate the virulence and speed with which the crisis has spread if we recognize that in addition to over-financialization domestically, there was perhaps over-globalization internationally.

While over-globalization was evident in ever-faster trade and capital flows and increasing off-shoring of production, over-financialization could be seen in the rise in the size of financial assets relative to the real economy as indicated by gross domestic product. Globally, the holdings of financial assets, comprising equities, government and private bonds and bank deposits, ballooned way out of proportion to global GDP, the primary underlying measure of real economic activity (see Figure 26.1). Similarly, the gross market value of outstanding derivative contracts more than doubled between mid-2006 and mid-2008. The share of financial services in GDP has increased dramatically in the US and UK in recent years; in the latter it has doubled in the last decade alone. In many countries, the financial sector grew to a size disproportionate to its primary raison d'être – to efficiently bring savers and borrowers together, allocate savings to viable investments, and manage diversification of risk.

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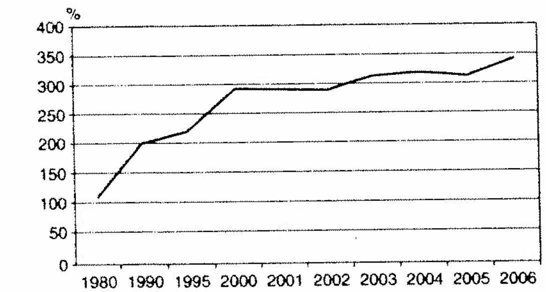

Figure 26.1 Global Financial Assets to Global GDP Ratio.
Source: McKinsey global institute.

Liquid and deep financial markets are necessary; indeed, they are the lifeblood of economic activity, but to extend the analogy, not if they cause high blood pressure to the economy!

Globalization too has played its role. A large part of the new trade volumes generated were a result of diversion from potential consumption by domestic consumers to consumption by consumers half-way across the world. There is an ongoing debate in China, for example, whether the economic wisdom of having nearly a 40 percent share of exports in GDP has served the developmental goals of the country well. At least some of the blame for income inequality, lopsided development and consumption stagnation in the country can be laid at the feet of the overgrown external sector.

Global imbalances, on which reams have been written, provided the financing for the insatiable appetite of US and other consumers, met by the unbounded capacity of China's manufacturing machine. Footloose capital ran hither and thither for better returns and ended up in high-risk investments. The US-China globalization axis may have been critical but by no means was it the only game in town. Reckless lending by western banks to East European clients drove much of the importing frenzy in those countries. It was finance that drove and propelled international trade, in addition to that generated by underlying patterns of global specialization and competitiveness.

Together with the financial sector, globalization, as we know it – global trade in goods and services, capital flows and off-shoring of production – seems destined to decline in the short term. The total market value of financial assets held worldwide has declined by about a third, or more than $50 trillion, in 2008 according to a report by the Asian Development Bank. Container traffic in the world's busiest ports is down by more than 20 percent. While trade volumes show greater volatility than GDP, the figures for the former show a near precipitous decline relative to the former. The IMF expects global GDP to decrease by 1.3 percent in 2009, while economists from the World Trade Organization forecast a 9 percent decline for global trade in the same year, both the largest drops on record since World War II. Export volumes are expected to decrease in every major region of the world. Indeed, double-digit declines in real national variables are so rare that declines in export volumes of over 30 percent, such as in the case of Japan, make one wonder about the "bubble-like" nature of the

underlying demand. On the other hand, while Euro area GDP and US GDP are both expected to contract in 2009, emerging economies are the one bright spot with a GDP growth forecast of 1.6 percent.

In addition to trade, global financial flows and cross-border investments are also expected to be adversely affected. The most dynamic economic region of the world, Emerging Asia, is expected to attract 40 percent less net private capital flows (which include portfolio and direct investments) in 2009. It is as if both ships and funds in search of a safe harbor are docked at home ports.

The prospect of offshoring, that recent offspring of globalization, presents a mixed picture. While any downturn can only serve to further intensify the ever-present cost-cutting impulse on the part of management, the fundamental nature of downsizing and restructuring underway in the US in key sectors, and the sharp cutbacks in many parent operations in the financial services sector, suggest that even the seemingly unstoppable phenomenon of offshoring may slow down. Already, there have been some cutbacks in the number of employees of offshore call centers.

Increasing interventions by national governments in the economic management of individual nation-states also tend to slow down the globalization process. National stimulus packages have a domestic stance and are inward-oriented, regardless of whether there is an explicit "buy domestic" provision, since greater reliance on government spending inevitably leads to less "leakage" internationally. The mounting job losses, complexity of the financial crisis, increasing range of conflicting interests, issues of inequality and fairness, and, last but not least, compulsions of electoral politics in an increasingly democratic world will all lead to greater state intervention, curbing the power of the market.

Far too rapid and distorted growth in global economic linkages and the financial services sector, as well as their mutual feeding off each other, have brought into sharper focus contradictions facing the future evolution of the global economy, the resolution of which is bound to affect globalization. While the future shape of regulatory reform is being vigorously debated, it is not clear how continued globalization will be affected in the medium term by the crisis.

All of this leads us to the following question: can we eat our cake, have it too, and trade it in on the global markets? Dani Rodrik has long pointed out the "inescapable trilemma of the world economy," that "democracy, national sovereignty and global economic integration are mutually incompatible." The present crisis shows that it is actually a quadrilemma. The international policy establishment must manage and reconcile simultaneously conflicting pulls and pushes. To begin with there are the universal free-market guiding principles. These operate in individual nation-states, which are the primary arena of economic policy. Economic policies, in turn, are largely shaped by a democratic polity that is apprehensive and insecure about increasing free trade and international economic integration. It is difficult to see how the tenuous co-habitation of these four – globalization, free-market principles, democracy, and national policy independence – can survive in the present circumstances. Something may have to give way, if just a little...

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Globalism's Discontents

Joseph E. Stiglitz

Few subjects have polarized people throughout the world as much as globalization. Some see it as the way of the future, bringing unprecedented prosperity to everyone, everywhere. Others, symbolized by the Seattle protestors of December 1999, fault globalization as the source of untold problems, from the destruction of native cultures to increasing poverty and immiseration. In this article, I want to sort out the different meanings of globalization. In many countries, globalization has brought huge benefits to a few with few benefits to the many. But in the case of a few countries, it has brought enormous benefit to the many. Why have there been these huge differences in experiences? The answer is that globalization has meant different things in different places.

The countries that have managed globalization on their own, such as those in East Asia, have, by and large, ensured that they reaped huge benefits and that those benefits were equitably shared; they were able substantially to control the terms on which they engaged with the global economy. By contrast, the countries that have, by and large, had globalization managed for them by the International Monetary Fund and other international economic institutions have not done so well. The problem is thus not with globalization but with how it has been managed.

The international financial institutions have pushed a particular ideology – market fundamentalism – that is both bad economics and bad politics; it is based on premises concerning how markets work that do not hold even for developed countries, much less for developing countries. The IMF has pushed these economics policies without a broader vision of society or the role of economics within society. And it has pushed these policies in ways that have undermined emerging democracies.

More generally, globalization itself has been governed in ways that are undemocratic and have been disadvantageous to developing countries, especially the poor within those countries. The Seattle protestors pointed to the absence of democracy and of

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transparency, the governance of the international economic institutions by and for special corporate and financial interests, and the absence of countervailing democratic checks to ensure that these informal and *public* institutions serve a general interest. In these complaints, there is more than a grain of truth.

Beneficial Globalization

Of the countries of the world, those in East Asia have grown the fastest and done most to reduce poverty. And they have done so, emphatically, via "globalization." Their growth has been based on exports – by taking advantage of the global market for exports and by closing the technology gap. It was not just gaps in capital and other resources that separated the developed from the less-developed countries, but differences in knowledge. East Asian countries took advantage of the "globalization of knowledge" to reduce these disparities. But while some of the countries in the region grew by opening themselves up to multinational companies, others, such as Korea and Taiwan, grew by creating their own enterprises. Here is the key distinction: Each of the most successful globalizing countries determined its own pace of change; each made sure as it grew that the benefits were shared equitably; each rejected the basic tenets of the "Washington Consensus," which argued for a minimalist role for government and rapid privatization and liberalization.

In East Asia, government took an active role in managing the economy. The steel industry that the Korean government created was among the most efficient in the world – performing far better than its private-sector rivals in the United States (which, though private, are constantly turning to the government for protection and for subsidies). Financial markets were highly regulated. My research shows that those regulations promoted growth. It was only when these countries stripped away the regulations, under pressure from the U.S. Treasury and the IMF, that they encountered problems.

During the 1960s, 1970s, and 1980s, the East Asian economies not only grew rapidly but were remarkably stable. Two of the countries most touched by the 1997–1998 economic crisis had had in the preceding three decades not a single year of negative growth; two had only one year – a better performance than the United States or the other wealthy nations that make up the Organization for Economic Cooperation and Development (OECD). The single most important factor leading to the troubles that several of the East Asian countries encountered in the late 1990s – the East Asia crisis – was the rapid liberalization of financial and capital markets. In short, the countries of East Asia benefited from globalization because they made globalization work for them; it was when they succumbed to the pressures from the outside that they ran into problems that were beyond their own capacity to manage well.

Globalization can yield immense benefits. Elsewhere in the developing world, globalization of knowledge has brought improved health, with life spans increasing at a rapid pace. How can one put a price on these benefits of globalization? Globalization has brought still other benefits: Today there is the beginning of a globalized civil society that has begun to succeed with such reforms as the Mine Ban Treaty and debt forgiveness for the poorest highly indebted countries (the Jubilee movement). The globalization protest movement itself would not have been possible without globalization.

The Darker Side of Globalization

How then could a trend with the power to have so many benefits have produced such opposition? Simply because it has not only failed to live up to its potential but frequently has had very adverse effects. But this forces us to ask, why has it had such adverse effects? The answer can be seen by looking at each of the economic elements of globalization as pursued by the international financial institutions and especially by the IMF.

The most adverse effects have arisen from the liberalization of financial and capital markets – which has posed risks to developing countries without commensurate rewards. The liberalization has left them prey to hot money pouring into the country, an influx that has fueled speculative real-estate booms; just as suddenly, as investor sentiment changes, the money is pulled out, leaving in its wake economic devastation. Early on, the IMF said that these countries were being rightly punished for pursuing bad economic policies. But as the crisis spread from country to country, even those that the IMF had given high marks found themselves ravaged.

The IMF often speaks about the importance of the discipline provided by capital markets. In doing so, it exhibits a certain paternalism, a new form of the old colonial mentality: "We in the establishment, we in the North who run our capital markets, know best. Do what we tell you to do, and you will prosper." The arrogance is offensive, but the objection is more than just to style. The position is highly undemocratic: There is an implied assumption that democracy by itself does not provide sufficient discipline. But if one is to have an external disciplinarian, one should choose a good disciplinarian who knows what is good for growth, who shares one's values. One doesn't want an arbitrary and capricious taskmaster who one moment praises you for your virtues and the next screams at you for being rotten to the core. But capital markets are just such a fickle taskmaster; even ardent advocates talk about their bouts of irrational exuberance followed by equally irrational pessimism.

Lessons of Crisis

Nowhere was the fickleness more evident than in the last global financial crisis. Historically, most of the disturbances in capital flows into and out of a country are not the result of factors inside the country. Major disturbances arise, rather, from influences outside the country. When Argentina suddenly faced high interest rates in 1998, it wasn't because of what Argentina did but because of what happened in Russia. Argentina cannot be blamed for Russia's crisis.

Small developing countries find it virtually impossible to withstand this volatility. I have described capital-market liberalization with a simple metaphor: Small countries are like small boats. Liberalizing capital markets is like setting them loose on a rough sea. Even if the boats are well captained, even if the boats are sound, they are likely to be hit broadside by a big wave and capsize. But the IMF pushed for the boats to set forth into the roughest parts of the sea before they were seaworthy, with untrained captains and crews, and without life vests. No wonder matters turned out so badly!

To see why it is important to choose a disciplinarian who shares one's values, consider a world in which there were free mobility of skilled labor. Skilled labor would then provide discipline. Today, a country that does not treat capital well will find capital quickly withdrawing; in a world of free labor mobility, if a country did not treat skilled labor well, it too would withdraw. Workers would worry about the quality of their children's education and their family's health care, the quality of their environment and of their own wages and working conditions. They would say to the government: If you fail to provide these essentials, we will move elsewhere. That is a far cry from the kind of discipline that free-flowing capital provides.

The liberalization of capital markets has not brought growth: How can one build factories or create jobs with money that can come in and out of a country overnight? And it gets worse: Prudential behavior requires countries to set aside reserves equal to the amount of short-term lending; so if a firm in a poor country borrows $100 million at, say, 20 percent interest rates short-term from a bank in the United States, the government must set aside a corresponding amount. The reserves are typically held in U.S. Treasury bills – a safe, liquid asset. In effect, the country is borrowing $100 million from the United States and lending $100 million to the United States. But when it borrows, it pays a high interest rate, 20 percent; when it lends, it receives a low interest rate, around 4 percent. This may be great for the United States, but it can hardly help the growth of the poor country. There is also a high ***opportunity*** cost of the reserves; the money could have been much better spent on building rural roads or constructing schools or health clinics. But instead, the country is, in effect, forced to lend money to the United States. [...]

The Costs of Volatility

Capital-market liberalization is inevitably accompanied by huge volatility, and this volatility impedes growth and increases poverty. It increases the risks of investing in the country, and thus investors demand a risk premium in the form of higher-than-normal profits. Not only is growth not enhanced but poverty is increased through several channels. The high volatility increases the likelihood of recessions – and the poor always bear the brunt of such downturns. Even in developed countries, safety nets are weak or nonexistent among the self-employed and in the rural sector. But these are the dominant sectors in developing countries. Without adequate safety nets, the recessions that follow from capital-market liberalization lead to impoverishment. In the name of imposing budget discipline and reassuring investors, the IMF invariably demands expenditure reductions, which almost inevitably result in cuts in outlays for safety nets that are already threadbare.

But matters are even worse – for under the doctrines of the "discipline of the capital markets," if countries try to tax capital, capital flees. Thus, the IMF doctrines inevitably lead to an increase in tax burdens on the poor and the middle classes. Thus, while IMF bailouts enable the rich to take their money out of the country at more favorable terms (at the overvalued exchange rates), the burden of repaying the loans lies with the workers who remain behind.

The reason that I emphasize capital-market liberalization is that the case against it – and against the IMF's stance in pushing it – is so compelling. It illustrates what can go wrong with globalization. Even economists like Jagdish Bhagwati, strong advocates of free trade, see the folly in liberalizing capital markets. Belatedly, so too has the IMF at – least in its official rhetoric, though less so in its policy stances – but too late for all those countries that have suffered so much from following the IMF's prescriptions.

But while the case for trade liberalization – when properly done – is quite compelling, the way it has been pushed by the IMF has been far more problematic. The basic logic is simple: Trade liberalization is supposed to result in resources moving from inefficient protected sectors to more efficient export sectors. The problem is not only that job destruction comes before the job creation – so that unemployment and poverty result – but that the IMF's "structural adjustment programs" (designed in ways that allegedly would reassure global investors) make job creation almost impossible. For these programs are often accompanied by high interest rates that are often justified by a single-minded focus on inflation. Sometimes that concern is deserved; often, though, it is carried to an extreme. In the United States, we worry that small increases in the interest rate will discourage investment. The IMF has pushed for far higher interest rates in countries with a far less hospitable investment environment. The high interest rates mean that new jobs and enterprises are not created. What happens is that trade liberalization, rather than moving workers from low-productivity jobs to high-productivity ones, moves them from low-productivity jobs to unemployment. Rather than enhanced growth, the effect is increased poverty. To make matters even worse, the unfair trade-liberalization agenda forces poor countries to compete with highly subsidized American and European agriculture.

The Governance of Globalization

By contrast, [...] in the current process of globalization we have a system of what I call global governance without global government. International institutions like the World Trade Organization, the IMF, the World Bank, and others provide an ad hoc system of global governance, but it is a far cry from global government and lacks democratic accountability. Although it is perhaps better than not having any system of global governance, the system is structured not to serve general interests or assure equitable results. This not only raises issues of whether broader values are given short shrift; it does not even promote growth as much as an alternative might.

Governance through Ideology

Consider the contrast between how economic decisions are made inside the United States and how they are made in the international economic institutions. In this country, economic decisions within the administration are undertaken largely by the National Economic Council, which includes the secretary of labor, the secretary of commerce, the chairman of the Council of Economic Advisers, the treasury secretary, the assistant attorney general for antitrust, and the U.S. trade representative. The Treasury is only one vote and often gets voted down. All of these officials, of course, are part of an administration that must face Congress and the democratic electorate. But in the international arena, only the voices of the financial community are heard. The IMF reports to the ministers of finance and the governors of the central banks, and one of the important items on its agenda is to make these central banks more independent – and less democratically accountable. It might make little difference if the IMF dealt only with matters of concern to the financial community, such as the clearance of checks; but in fact, its policies affect every aspect of life. It forces countries to have tight monetary and fiscal policies: It evaluates the trade-off between inflation and unemployment, and in that trade-off it always puts far more weight on inflation than on jobs.

The problem with having the rules of the game dictated by the IMF – and thus by the financial community – is not just a question of values (though that is important) but also a question of ideology. The financial community's view of the world predominates – even when there is little evidence in its support. Indeed, beliefs on key issues are held so strongly that theoretical and empirical support of the positions is viewed as hardly necessary.

Recall again the IMF's position on liberalizing capital markets. As noted, the IMF pushed a set of policies that exposed countries to serious risk. One might have thought, given the evidence of the costs, that the IMF could offer plenty of evidence that the policies also did some good. In fact, there was no such evidence; the evidence that was available suggested that there was little if any positive effect on growth. Ideology enabled IMF officials not only to ignore the absence of benefits but also to overlook the evidence of the huge costs imposed on countries.

An Unfair Trade Agenda

The trade-liberalization agenda has been set by the North, or more accurately, by special interests in the North. Consequently, a disproportionate part of the gains has accrued to the advanced industrial countries, and in some cases the less-developed countries have actually been worse off. After the last round of trade negotiations, the Uruguay Round that ended in 1994, the World Bank calculated the gains and losses to each of the regions of the world. The United States and Europe gained enormously. But sub-Saharan Africa, the poorest region of the world, lost by about 2 percent because of terms-of-trade effects: The trade negotiations opened their markets to manufactured goods produced by the industrialized countries but did not open up the markets of Europe and the United States to the agricultural goods in which poor countries often have a comparative advantage. Nor did the trade agreements eliminate the subsidies to agriculture that make it so hard for the developing countries to compete.

The U.S. negotiations with China over its membership in the WTO displayed a double standard bordering on the surreal. The U.S. trade representative, the chief negotiator for the United States, began by insisting that China was a developed country. Under WTO rules, developing countries are allowed longer transition periods in which state subsidies and other departures from the WTO strictures are permitted. China certainly wishes it were a developed country, with Western-style per capita incomes. And since China has a lot of "capitas," it's possible to multiply a huge number of people by very small average incomes and conclude that the People's Republic is a big economy. But China is not only a developing economy; it is a low-income developing country. Yet the United States insisted that China be treated like a developed country! China went along with the fiction; the negotiations dragged on so long that China got some extra time to adjust. But the true hypocrisy was shown when U.S. negotiators asked, in effect, for developing-country status for the United States to get extra time to shelter the American textile industry.

Trade negotiations in the service industries also illustrate the unlevel nature of the playing field. Which service industries did the United States say were *very* important? Financial services – industries in which Wall Street has a comparative advantage. Construction industries and maritime services were not on the agenda, because the developing countries would have a comparative advantage in these sectors.

Consider also intellectual-property rights, which are important if innovators are to have incentives to innovate (though many of the corporate advocates of intellectual property exaggerate its importance and fail to note that much of the most important research, as in basic science and mathematics, is not patentable). Intellectual-property rights, such as patents and trademarks, need to balance the interests of producers with those of users – not only users in developing countries, but researchers in developed countries. If we underprice the profitability of innovation to the inventor, we deter invention. If we overprice its cost to the research community and the end user, we retard its diffusion and beneficial effects on living standards.

In the final stages of the Uruguay negotiations, both the White House Office of Science and Technology Policy and the Council of Economic Advisers worried that we had not got the balance right – that the agreement put producers' interests over users'. We worried that, with this imbalance, the rate of progress and innovation might actually be impeded. After all, knowledge is the most important input into research, and overly strong intellectual-property rights can, in effect, increase the price of this input. We were also concerned about the consequences of denying life-saving medicines to the poor. This issue subsequently gained international attention in the context of the provision of AIDS medicines in South Africa. The international outrage forced the drug companies to back down – and it appears that, going forward, the most adverse consequences will be circumscribed. But it is worth noting that initially, even the Democratic U.S. administration supported the pharmaceutical companies.

What we were not fully aware of was another danger – what has come to be called "biopiracy," which involves international drug companies patenting traditional medicines. Not only do they seek to make money from "resources" and knowledge that rightfully belong to the developing countries, but in doing so they squelch domestic firms who long provided these traditional medicines. While it is not clear whether these patents would hold up in court if they were effectively challenged, it is clear that the less-developed countries may not have the legal and financial resources required to mount such a challenge. The issue has become the source of enormous emotional, and potentially economic, concern throughout the developing world. This fall, while I was in Ecuador visiting a village in the high Andes, the Indian mayor railed against how globalization had led to biopiracy. [...]

Global Social Justice

Today, in much of the developing world, globalization is being questioned. For instance, in Latin America, after a short burst of growth in the early 1990s, stagnation and recession have set in. The growth was not sustained – some might say, was not sustainable. Indeed, at this juncture, the growth record of the so-called post-reform era looks no better, and in some countries much worse, than in the widely criticized import-substitution period of the 1950s and 1960s when Latin countries tried to industrialize by discouraging imports. Indeed, reform critics point out that the burst of growth in the early 1990s was little more than a "catch-up" that did not even make up for the lost decade of the 1980s.

Throughout the region, people are asking: "Has reform failed or has globalization failed?" The distinction is perhaps artificial, for globalization was at the center of the reforms. Even in those countries that have managed to grow, such as Mexico, the benefits have accrued largely to the upper 30 percent and have been even more concentrated in the top 10 percent. Those at the bottom have gained little; many are even worse off. The reforms have exposed countries to greater risk, and the risks have been borne disproportionately by those least able to cope with them. Just as in many countries where the pacing and sequencing of reforms has resulted in job destruction outmatching job creation, so too has the exposure to risk out-matched the ability to create institutions for coping with risk, including effective safety nets.

In this bleak landscape, there are some positive signs. Those in the North have become more aware of the inequities of the global economic architecture. The agreement at Doha to hold a new round of trade negotiations – the "Development Round" – promises to rectify some of the imbalances of the past. There has been a marked change in the rhetoric of the international economic institutions – at least they talk about poverty. At the World Bank, there have been some real reforms; there has been some progress in translating the rhetoric into reality – in ensuring that the voices of the poor are heard and the concerns of the developing countries are listened to. But elsewhere, there is often a gap between the rhetoric and the reality. Serious reforms in governance, in who makes decisions and how they are made, are not on the table. If one of the problems at the IMF has been that ideology, interests, and perspectives of the financial community in the advanced industrialized countries have been given disproportionate weight (in matters whose effects go well beyond finance), then the prospects for success in the current discussions of reform, in which the same parties continue to predominate, are bleak. They are more likely to result in slight changes in the shape of the table, not changes in who is *at* the table or what is on the agenda.

September 11 has resulted in a global alliance against terrorism. What we now need is not just an alliance ***against*** evil, but an alliance ***for*** something positive – a global alliance for reducing poverty and for creating a better environment, an alliance for creating a global society with more social justice.