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Datasheet

The Perspective of the World is an international periodical sponsored by Ipea (Institute of Applied Economic Research), a body belonging to the Presidency of the Federative Republic of Brazil, and was designed to promote contemporary debates, emphasizing the theme of development from a South – South perspective. The goal is to formulate proposals for the development of public policies and to encourage international comparisons, focusing on the scope of political economy.
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EDITORIAL

The Perspective of the World Review is an international periodical sponsored by Ipea (Institute of Applied Economic Research), a body belonging to the Presidency of the Federative Republic of Brazil through the Secretariat for Strategic Affairs (SAE).

The journal will feature versions in Portuguese and English and was designed to present and promote contemporary debates, emphasizing the theme of development from a South – South perspective. Its field of knowledge is that of political economy, with plural approaches on the essential dimensions of development such as economic, social and sustainability-related issues.

The goal is to enhance the debate in order to formulate proposals for the development of public policies and, accordingly, to encourage international comparisons and interdisciplinarity – always highlighting the role of planning. *The Perspective of the World Review* takes the ambition to formulate questions faced by contemporary civilization, which wants to enjoy comfortable living standards and dignified living conditions, but must simultaneously respect the limits of what the planet can support in terms of environmental exploitation.

It is important to point out the tribute given to Fernand Braudel through the enhancement of his formulation on the *the perspective of the world*, which, together with the *structures of everyday life* and the *wheels of commerce*, shapes his originality. Braudel always sought to address issues involving the dimensions of development in a historical and long-term perspective. He emphasized that a world dominated by a mode of production based on the accumulation of capital had always had to balance society, market and state. As the master taught us, in places where the task was most successful, there was prosperity, and where difficulties were persistent, results were controversial.

This initiative is not new in Brazil – its great precursor was Celso Furtado, in *The Economic Growth of Brazil*. This seminal work was welcomed by Braudel as innovative under a methodological perspective. It is based on this inspiration that *The Perspective of the World Review* begins its journey.

Editorial Board

SUMMARY

GLOBALIZATION: "GETTING THE PROCESS RIGHT" FOR CONVERGENCE AND RISING WORLD INCOME

Heiner Flassbeck
Massimiliano La Marca

The increasing global dimension of trade, financial flows and of knowledge diffusion involving both developing and advanced economies is the source of potential gains and challenges that differ according to the stage of development and the economy's idiosyncratic features. Can global integration be a win-win game for its participants? Is a benefit-maximizing and cost-minimizing "integration process" possible under a realistic assessment of its distributional and institutional effects? The paper reviews critically the orthodoxy of open markets and confronts them with the existing "consensus" empirical evidence in order to identify the emerging actual forces that shape the alternative patterns of integration, their costs and benefits.

GLOBALIZAÇÃO: "AJUSTANDO O PROCESSO" EM DIREÇÃO AO AUMENTO E À CONVERGÊNCIA DA RENDA MUNDIAL

A dimensão do aumento global do comércio, dos fluxos financeiros e de difusão de conhecimentos envolvendo as economias em desenvolvimento e avançadas é a fonte de ganhos potenciais e desafios que diferem, de acordo com o estágio de desenvolvimento, as características idiossincráticas da economia. A integração global pode ser um jogo de ganha-ganha para seus participantes? É um benefício de maximização e minimização de custos do "processo de integração", sob uma avaliação realista de seus efeitos distributivos e institucionais? O artigo analisa criticamente a ortodoxia de mercados abertos e os confrontam com o consenso "existente" de evidências empíricas, a fim de identificar as forças emergentes reais que moldam os padrões alternativos de integração, seus custos e seus benefícios.

1 INTRODUCTION: THE AGE OF DIVERGING INTEGRATION

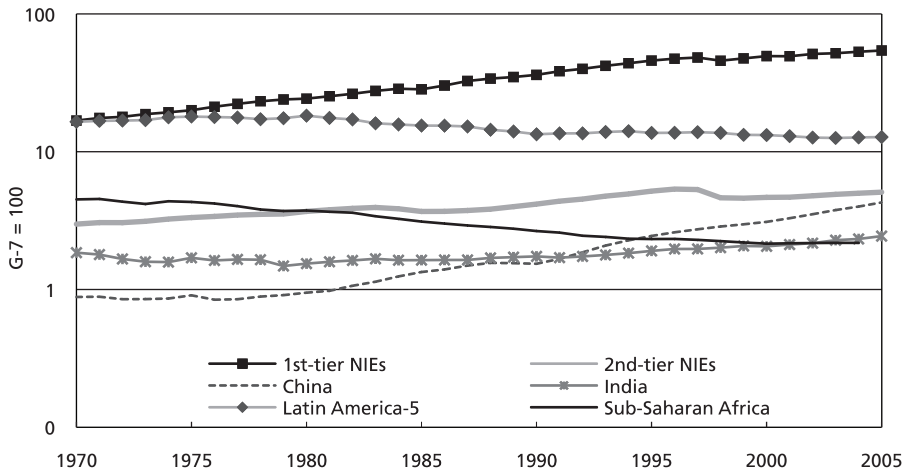
The process of economic integration in the last two decades and before the financial crisis gained a global dimension as well as unprecedented depth. It has involved a large number of diverse economies and a variety of newly-traded final and intermediate goods, services and financial instruments. Trade and financial integration is not a new process if we consider the large flows between European nations as well as, until the early 20th century, between those nations and their colonial extensions. However, it was the modern revolutions in transportation and communication systems, along with new possibilities for delocalizing productive processes arising from modern manufacture and service production, which enabled the change in the scale and scope of trade and financial exchange among sovereign nations.

Indeed, the most salient feature of modern globalization has been the combination of policy reforms, market deregulation and liberalization undertaken almost simultaneously by many developing countries and transitional economies during the last decades. Post-socialist economies and countries that once relied on heavy protective measures while pursuing an import-substitution industrialization strategy underwent a process of domestic and external liberalization. As part of a larger package of policy and institutional "market friendly" reforms, the process of external liberalization aimed at improving efficiency by redirecting resources from uncompetitive tradable and inefficient non-tradable production and government spending toward sectors of supposed comparative advantage. In addition, capital market openness was expected to provide finance for development and poverty reduction for poorer economies and more profitable investment opportunities for richer, aging countries.

Another striking feature of globalization in the last decades was the emerging radical divide between those economies that were narrowing their income and technology gap with the most industrialized ones as compared with those that were not. Indeed, the phenomenon of "falling behind" rather than catching up has been the most common experience of latecomers (UNCTAD/TDR, 2003; Pritchett, 1997). Even before the crisis we have been experiencing an age of "diverging integration", where alternative approaches to opening up to trade and financial flows, associated with more broadly-defined alternative development, seemed to explain the differences in countries' success in reaping potential gains from globalization.

Figure 1.1 shows the income dynamics of some single economies, groups of countries and regions, relative to the most industrialized countries. It provides some striking evidence with regard to the outcomes of alternative integration patterns. The impressive converging trend of the first-tier newly industrializing (mostly South-East Asian) economies (NIEs) and the diverging pattern of Latin American economies, both sharing the same relative starting income in 1970, are accompanied by lower volatility of the former group compared to the latter, with the exception of the large swings of the late 1990s Asian financial crisis. The second-tier NIEs and China have improved their relative position, although starting at a much lower income level. Where traditional policy reforms were instituted the most, notably in Latin America and in some sub-Saharan countries, relative income worsened.

FIGURE 1.1
GDP per capita (log scale) in selected developing countries and regions compared to the G-7, 1970 – 2005



Source: UNCTAD and United Nations with the exception of sub-Saharan Africa whose source is World Development Indicators 2006, World Bank. Calculations are based on constant GDP (1995 US$).
Note: Latin America-5 comprises Argentina, Brazil, Chile, Colombia and Mexico; the first-tier NIEs comprise Hong Kong (China), the Republic of Korea, Singapore and Taiwan Province of China; the second-tier NIEs comprise Indonesia, Malaysia, the Philippines and Thailand. South Africa is not included in sub-Saharan Africa.

Therefore, there is a need for defining an alternative model for integrating a country into the world economy that does not rely on indiscriminate liberalization of the current and capital accounts. It has been shown widely that today's most developed economies achieved industrialization by relying on heavily protectionist measures and other kinds of unorthodox policies (e.g. Chang, 2002). In the same way it has been shown how the first-tier NIEs pursued outer-oriented strategic trade and industrial policies that selectively oriented resources toward dynamic industries with a mix of incentives and discipline, rendering them more competitive internationally (Amsden, 1989 and 2001; UNCTAD/TDR 1996 and 2003). First-tier and second-tier NIE economies and China appear to have found sustainable ways of narrowing the income gap with developed economies; Latin America and sub-Saharan Africa have not.

Though historical experience cannot be emulated tout court due to constantly changing world political and technological conditions, historical evidence should help us shape our common wisdom on viable development and integration processes.

In order to identify and explain the reasons for the failure of internal and external liberalization in realizing sustainable integration into the world economy, we have to reconsider our traditional economic wisdom and take a critical perspective. Some logical structures, deeply rooted in orthodox economic knowledge, appear to be ill-suited to help us understand the complex dynamics of prices and quantities in an integrated world economy, raising more "puzzles" than explanations.

Section B of this chapter provides a critical review of conventional wisdom and suggests different ways to interpret the complex dynamics affecting the outcome of economic integration. In section C the traditional case for free trade and financial liberalization is given a reality check by looking at some broadly-shared empirical evidence. Section D underlines the complex dynamic interaction between institutional change, policy determination and economic performance, relating the sources of development with the issues of integration and local determination of institutional forms. Section E sheds some light on how macroeconomic determinants can lead to lasting developmental effects. Section F draws some conclusions regarding the design of a new multilateral system.

2 THE INTEGRATION PROCESS IN THE TRADITIONAL VIEW

In its most popular and quoted definition, the core of economic activity in market economies would consist of actions that "rationally" lead to "efficient allocation of scarce resources under alternative uses." This simple view, which appears quite intuitive in modern economics, captures the essence of received standard theory built during centuries of overlapping contributions and systematic reinterpretations. Obviously, to a large extent it shapes the methodology underlying the way one sees the world from an economic perspective.

2.1 The resource allocation mechanism

Traditional trade theory, for instance, explains the patterns of free international trade, along with associated gains derived from international production specialization and labour division, by assuming that the existing methods of production, consumption and input supply preferences are given at any point in time, along with the "relative scarcity" of given resources (typically unskilled and skilled labour or capital). This leaves economic actors the scope to determine, by action based on individual preferences within existing market structures, the composition of goods produced and exchanged as well as their relative prices. Growth theory in this context explains per capita income differences and changes by focusing mainly on changes in the "relative scarcity" of production factors and resulting productivity dynamics. Open economy macroeconomics explains trade in goods, services and financial assets as the outcome of resource allocation driven by the relative real returns of the production of tradable or non-tradable goods and services, along with consumption, and saving as well as portfolio and real investment.

The efficiency and optimality results characterizing the working of market economies emerging from such a theoretical setting basically rely on arbitrage arguments in their broadest connotation: the natural economic activity of an "atomistic rational utility-maximizing" agent, ultimately concerned with his/her consumption possibilities, is to reallocate real and financial resources from lower to higher-return employments up to the point where rates are equalized. The equalization of returns across productive sectors and across space (regionally or internationally) and time (with the decision to allocate resources from present consumption to future consumption through saving) indicates that there are no opportunities for welfare improvement left to be exploited, which represents the perfect coordination of self-interested market participants towards consistent and Pareto optimal plans.

The arbitrage logic not only unifies the various branches of economics having differing objects and scopes of investigation, but it also provides an immediate rationale for the main theoretical prediction regarding global economic integration through external liberalization, i.e., that economic openness fundamentally broadens the possibility of efficient resource allocation and therefore the scope for arbitrage gains that can be readily captured by market participants. The "integrated economy" is the locus where market forces can replicate the efficient outcome of a domestic liberalized economy on a global scale. As repeatedly pointed out by prominent academics and policy makers: "… fundamentally, the case for free trade is the case for the market system. The benefits come in the form of greater realization of the efficiencies available from specialization, from more rapid technology transfer and more productive allocation of resources, from comparative advantage and from the spur of competition. They show up in higher rates of economic growth, leading to higher wages and higher returns to capital, leading to higher standards of living" (Summers, 1999: 7).

The conditions for market efficiency, and lack thereof, have been widely addressed by the theory of market failure as well as by welfare and second-best economics. Although preserving the general equilibrium framework, they emphasize how an insufficient degree of information and rationality, the presence of increasing returns to scale, lack of prefect competition and the role of institutions can affect the outcome of market forces and lead to suboptimal outcomes. Market failures and the role of aggregate demand, for example, are at the core of the traditional argument for industrial policy as expressed in the classical works of Young, Rosenstein-Rodan, Hirschman, Myrdal, Kaldor and, more recently, in the empirical studies of late industrialization (e.g. Amsden, 1989 and 2001; UNCTAD/TDR 1996 and 2003). As emphasized in UNCTAD/TDR (2006), a proactive industrial policy designed to support productive dynamism and technological upgrading becomes necessary when (i) there are significant dynamic economies of scale and learning that give rise to increasing returns at the firm level; (ii) complementarities in investment, production and consumption can result in market failure; (iii) information externalities associated with investment in goods or modes of production exist that are new for the respective economy.

A more radical reconsideration of conventional economic wisdom is required if we acknowledge that short-term outcomes, shocks and monetary conditions have permanent or long-run effects. While neoclassical theory is fundamentally "a-temporal" and relies on a comparison of "static" production and trade configurations, completed by the stable operation of market forces through the "arbitrage" mechanism, the alternative view insists that "path dependence" and "hysteresis" effects are ubiquitous in real economies.

As pointed out in Flassbeck (1988) and Palley (2003), any comparative advantage configuration needs to be supported by a well-behaved nominal adjustment process able to equilibrate the absolute competitive advantages among economies. In a high-productivity country for instance, that would otherwise enjoy absolute competitive advantages in all sectors, nominal wages and prices need to rise to the point where the country will find it convenient to import the goods in which it has a comparative disadvantage and vice versa. Prices and/or exchange rates need to be consistent with the relative price configuration of the trade equilibrium. However, if price and wage changes are not consistent with economic activity in this way, and if exchange rate volatility can lead to persistent misalignment, then the necessary nominal adjustment failure can have permanent real consequences. Flassbeck (1988) points to the inherent flaws of the information-generating process of capital markets to explain these phenomena and Palley (2003) presents a number of other possible sources of hysteresis such as (i) habit-based consumption; (ii) fleet investment principle; (iii) lock-out through increasing returns; and (iv) destruction of organizational capital. All of these factors can favour the persistence of contingent outcomes due to short-term and/or monetary conditions. In other words, if some productive activities face temporary competition, then these activities and the associated know-how can get lost forever regardless of their original availability in technology and factor endowment, even if the unsustainable competition - based on the Walrasian arbitrage logic – is temporary in nature.

If valid, price and real return equalization as the equilibrium outcome of arbitrage forces should form the basis for the empirical manifestation of the efficiency of the market allocation hypothesis. Hence, the law of one price (LOP) and purchasing power parity (PPP) are the single most important rules that have to hold if the neo-classical theory can justifiably claim to hold the key to our understanding of globalization and international integration. The former states that for any single commodity, prices are equalized across borders. If the LOP holds for a sufficient number of goods, nominal exchange rates are tied to PPP, an equilibrium condition that, in its strongest version, requires cross-country equalization of traded goods price index levels expressed in the same currency and, in its relative version, simply requires that price inflation differentials across countries be offset by nominal exchange rate change. While the LOP rules out price competition by assuming that price differentials in similar goods are readily arbitraged away, PPP represents the simplest real equilibrium, money-neutral condition in the trade literature and a building block of most monetarist macro models. A failure of the former can be interpreted as the manifestation of a constant tendency of trade in single goods to be affected by exchange volatility and monetary shocks. In this case, production and trade strategies have lost the almost natural setting of comparative advantage equilibrium. In the same way, a failure of the latter implies the relevance of nominal exchange rate fluctuation and overall monetary conditions on the relative aggregate price of goods and therefore the relevance of terms of trade shocks and consumption switching effects.

According to Froot and Rogoff (1995), Rogoff (1996), and Sarno and Taylor (2002), the "consensus" empirical evidence is that the real exchange rate tends to PPP only in the very long run, while single-traded goods analyses show very high volatility and persistent deviations from LOP parity; in both cases large and volatile deviations are of the same order of magnitude as those of the nominal exchange rate. Thus the persistence of the deviations cannot be explained by the temporary effects of price stickiness and, even more importantly, the short-term volatility of real exchange rates cannot be ascribed to real shocks.

Therefore, while PPP and LOP can preserve a central role in explaining arbitrage-based models, the puzzling evidence for both may form the surface of a more complex explanation of real economic dynamics, where production structure and trade are constantly changing due to contingent economic conditions.

Under this perspective, it is clear why unregulated market forces often appear unable to coordinate arbitrage-seeking actors and do not automatically lead to the optimal configuration of production on a global scale. However, if capital flows have adverse effects on exchange rates or influence monetary policies in a way that permanently affects production and trade patterns – regardless of the existing potential for specialization and world welfare improvement – globalization is not such a smooth exercise as envisaged by the traditional mainstream approach.

3 INTEGRATION THROUGH LIBERALIZATION OF THE CAPITAL ACCOUNT?

The traditional case for financial integration is based on the benefits of pooling and allocating savings toward the most productive uses across countries. The principle of comparative advantage and mutual gains from free trade in goods is extended to the trade in financial assets along three main dimensions. Countries can benefit from financial integration if: (i) they have different capital endowments and different risk-free returns to capital and benefits (neoclassical convergence argument); and/or (ii) have desired consumption and savings time patterns not "in line" with their available income (inter-temporal trade argument); and (iii) face different potential fluctuations of production that affects their consumption possibilities (risk-sharing argument).

3.1 Capital integration in theory

The standard open economy neoclassical-Solow-Swan model has provided the first and the most resilient argument for capital account liberalization and financial integration (Summers, 2000, being an example of its lasting influence). If technical knowledge is diffused across countries and if technology displays its traditional decreasing returns to capital, then risk-adjusted return on investment is a decreasing function of capital endowment. Under financial openness, the real interest rate differential between capital-abundant developed countries and capital-scarce developing economies would ignite spontaneous arbitrage forces and generate a flow of funds that would provide developing countries with the additional foreign savings required for new investment and growth. The convergence in the asset returns, capital intensity, technology and per capita incomes would be assured through temporary current account deficits or net capital inflows.

Standard neoclassical theory, therefore, implies a strong correlation between capital inflows, new productive capacity and convergence. Given the absence of any form of relevant uncertainty concerning the profitability of capital, savings generate their own investment by direct "transmutation," as in the open economy-Solow model. Similarly, foreign savings inflows are supposed to reduce the risk-free rate and the equity premium through better risk diversification. Lower cost of equity capital would in turn stimulate investment. In both cases, financial openness would directly induce capacity building and growth through capital accumulation (Fischer, 1998; Henry, 2003).

A second argument for financial liberalization rests on the mentioned inter-temporal approach to the current account, where free trade in commodities and in financial assets are the most efficient ways of "buffering" expected and unexpected income variations and of "smoothing" consumption through net lending and borrowing between countries. Free capital flows in this framework not only permit better productive allocation of financial wealth but also a reduction of the effect of real shocks on consumption and therefore improve overall aggregate welfare. In the inter-temporal approach of the current account, popularized by

Obstfeld and Rogoff (1995 and 1996) for instance, current and capital account imbalances are the intentional means of transferring income over time. Countries would arbitrage away the "returns" of having "consumption today instead of tomorrow" by allowing "desired misalignments" between income and spending. In this world, the pattern of trade is passively determined by capital flows.

Global financial integration would also allow countries to share the production risk associated with exogenous idiosyncratic shocks. The "risk sharing" argument in international finance is basically a global scale extension of the well-known portfolio allocation theory: national productive capital is conceived of as a risky asset, whose return depends on volatile production, which can be sold abroad in the form of shares of domestic firms. Countries with different production structures, which are therefore subject to uncorrelated shocks in production, can improve their national welfare by trading assets, reducing the asset return volatility and consequently reducing the volatility of their consumption levels. If risk is perfectly shared among economies, any country's gross national product (GNP) is uncorrelated with its gross domestic product (GDP) and depends only on global production. Consumption growth rates are correlated across countries and less volatile than domestic output. If output volatility becomes irrelevant for welfare, national production can even become more specialized and benefit from scale economies and comparative advantages. From this perspective, developing countries could be advised to reduce further their production diversification in order to increase and stabilize their consumption levels!

Beyond these main arbitrage arguments there are less direct channels by which trade and financial integration through liberalization is supposed to stimulate growth and convergence: (i) technological spillovers generated by foreign direct investments (FDIs) that are undertaken after a more informed evaluation of their intrinsic profitability and are more stable than bank lending and portfolio flows; (ii) the positive influence of openness in the development of domestic financial markets through competition, enhanced liquidity and introduction of new forms of financial intermediation; and (iii) the discipline (a "tie-your-hands" policy) that markets would impose on a lax public sector by restraining monetary arbitrariness and stimulating investment-friendly tax reforms. The last two arguments share the same logic, e.g., that external competitive pressures can discipline and improve the efficiency of institutions and policies and that efficiency gains will largely offset any eventual adjustment costs (Gourinchas and Jeanne, 2003).

3.2 Some empirical evidence

However, the supposed outcomes of financial liberalization do not find much support even in the "consensus" empirical evidence. Prasad, Rogoff, Wei and Kose (2003) sum up the existing literature and assess that "…an objective reading of the result of the vast research effort undertaken to date suggests that there is no strong, robust, and uniform support for the theoretical argument that financial globalization per se delivers a higher rate of economic growth…[and] the volatility of consumption growth has, on average, increased for emerging market economies in the 1990's" (Prasad et al., 2003: 3) so that "… while there is no proof in the data that financial globalization has benefited growth, there is some evidence that some countries may have experienced greater consumption volatility as a result" (ibid.: 1).

A weak association of better growth performance with financial openness between groups of countries (industrialized compared to developing and more financially-open developing countries compared to less-open countries) does not provide any causal relation between integration and growth, nor does the former seem to be a sufficient condition (as in the cases of Venezuela, South Africa, Jordan and Peru) or even a necessary condition for the latter (as in the cases of China and India). Financial openness could be an advantage for mature or already sound and stable economies. Prasad et al. show that even correcting for initial income, schooling, average investment-to-GDP ratio, policy instability and regional location, there is basically no association between capital account openness and growth rates.

According to Mody and Murshid (2002), "... the weakening, over time, of the relationship between aggregate capital flows and investment is consistent with an increase in the share of portfolio flows in long-term capital … [and] 'merger and acquisitions' – as distinct from the traditional 'Greenfield' foreign investments – have become more prominent, implying that more of the foreign capital is being used to purchase assets rather than finance new investments." (Mody and Murshid 2002: 5). However, a positive association of FDI and growth cannot be taken for granted: it has been pointed out that FDI can be associated with crowding out "domestic" private investment, while human capital and knowledge accumulation through FDI spillovers can be of a second order magnitude. Indirect negative effects on investment can also be generated by the current account difficulties a country may incur by the repatriation of profits and intermediate input imports associated with the FDI (UNCTAD/TDR 2003).

4 THE ROLE OF POLICIES AND INSTITUTIONS IN THE DEVELOPMENT AND INTEGRATION PROCESS

The dismal evidence relating financial integration, growth and income volatility and the overall disappointing economic performances of many reforming countries have induced a radical rethinking of the relevance and effectiveness of standard policy reforms. Macroeconomic stability, privatization and both domestic and external liberalization were regarded for a couple of decades as the key reforms able to realign actual economic performance with the undistorted incentive structure of an ideal self-regulated "market economy".

It has been claimed recently that the Washington consensus reform policies did not work because of poor regulatory and supervisory institutions, inflexible labour markets, ineffective judiciaries and poor governance in the reforming countries. It is claimed that reform policies did not find the proper institutional environment to deliver the expected results. The “institutional prerequisites” that make external trade and financial liberalization work would come about with a broader agenda of “second generation” reforms including major changes in economic, political, and judicial institutions.

Policies and institutions are indeed the fundamental determinants of economic change and their mutual interaction is a fundamental analytical key for explaining alternative experiences in the development process.

For instance, it is quite uncontroversial to say that capital inflows are sterile or can even increase macroeconomic volatility if not coupled with national institutions and policies that are able to channel them into investment or technological improvement. Questions arise as to what kind of financial institutions should be developed in order to gain from financial openness and whether financial openness should follow, or is instead a precondition for, implementing sound macroeconomic and financial institutions.

A standard argument is that the domestic financial market should be developed to allow a more effective channelling of portfolio flows and bank lending into productive investment. The institutional set up should therefore allow for more “absorptive capacity” and induce a more favourable selection of financial flows capable of producing technological spillovers, reducing volatility and increasing growth.

Moreover, financial liberalization would represent a catalytic factor able to induce institutional reforms and policy discipline (Kose et al. 2006). External liberalization would provide “potential collateral benefits” that would outweigh the traditional positive effects of capital mobility by forcing a proper policy and institutional environment. The latter argument reflects traditional economic categories such as creative power arbitrage in the allocation of resources to competing ends. Institutions and well-behaved policies would act as pre-existing articles to be picked up from existing menus under the pressure of international competition in the same way that pre-existing technologies are chosen through market signals and driven to efficiency through competition.

Unfortunately, the evidence that economies with sound financial institutions enjoy benefits from openness does not provide any causal direction between outcomes and preconditions. Institutional analysis has shown the impossibility of clearly detecting either a one-to-one correspondence between desired economic outcomes and institutional setup or a set of institutional “blue prints” generally applicable to developing countries (UNCTAD/TDR, 2006). Institutional soundness, economic performance and effective integration appear to be linked in a virtuous circle, with strong evidence that industrialized economies benefited more from financial integration, while even the most integrated and more industrialized developing economies suffered from increased volatility.

Thus, financial openness is not a precondition for setting off a catching-up process. This is due not only to highly systemic global financial instability but also to the fact that capital accumulation, product differentiation and technological upgrading are induced by forces other than simple arbitrage.

The endogeneity and the dynamic role of policies and institutions in determining short-run outcomes with long-run consequences are analysed next.

4.1 Functional relations between determinants of growth and structural change

A detailed account of the possible interaction between institutions and other direct and indirect factors affecting one country's economic performance and structural change cannot neglect the cultural and historical specificity and complexity of each single economy. However, a general diagrammatic representation of the main causal linkages between the main determinants of institutional change and economic performance may highlight some common salient features of institutional functions along with internal and external constraints to economic change, providing a guideline for the following analysis (figure 1.2).

FIGURE 1.2
Number of countries with current account deficit

Source: UNCTAD secretariat calculations, based on WEO April 2006 database.

As emphasized in various issues of the Trade and Development Report, long-run economic growth and the associated sustained catching-up of developing economies are characterized by a rise in labour productivity and productive dynamism achieved through technological change and innovation embodied in new investment in physical and human capital (channel F, figure 1.2). Technological upgrading, productive dynamism and restructuring allowed by new investments are the main direct sources of economic performance, providing the source of productivity gains and income growth (channel G). Factor employment, accumulation and the process of technological change, under the influence of overall macroeconomic conditions – the original central focus of growth and development analysis – are however proximate causes or even manifestations of growth itself. In fact, as described more extensively in the following section, investment and technological progress are not passively generated by macroeconomic stability and exogenously-given saving behaviour but are mostly affected by the perception of the opportunities induced by the incentive structure that institutions and policy jointly provide (channels A , B and C).

For instance, industrial policies favouring productive dynamisms, technological upgrading and the system of institutions consistent with them may jointly allow for overcoming information and coordination externalities and other barriers due to dynamic scale economies (UNCTAD/TDR 2006, chapter VI) both directly and indirectly favouring macro and market conditions. The appropriate system of institutions includes the functions of property definition, market access regulation and price stability, The role of macroeconomic factors and their employment patterns (D) on the combined process of resource accumulation, along with the more direct role of macroeconomic variables in fostering investment (E), have been the object of a number of policy controversies during recent decades and will be dealt with in the following section.

The quantitative influence of geographical factors, directly on performances (L) and indirectly through institutions (M), have also been extensively explored and appear to depend strongly on country-specific natural and historical conditions. Conceptions of the nature and role of institutions merge with those concerning societal evolution in the understanding of the process of institutional change (K) as well as understanding how policies can affect institutions and the role of the latter in determining the effectiveness of the former (H).

Global interdependence is represented by the interaction of the external environment/rest of the world and the domestic economy both through the effect of competition affecting directly economic performance (I) and possible external shocks (exchange rate, diverse capital flows and FDIs) affecting the macro environment, investment, innovations and structural change conditions (J).

International institutions can provide global public goods such as international economic and financial stability, reducing the effects of financial crisis, preventing contagion and limiting negative international spillovers, beggar-thy-neighbour and any other self-interested policies undertaken by large, relatively influential economies. Moreover, international institutions can influence the effectiveness of domestic policies, both by influencing economic performance and by constraining domestic policies directly at the source.

Competing models of development entail alternative ways of defining the relevant functions that institutions perform, their relation to policies and how they drive the incentives leading to accumulation, productivity increase and economic restructuring.

Evans (1998) has grouped the main competing ways of characterizing economic policies into (i) the "market-friendly model", (ii) the "industrial policy model", and (iii) the "profit-investment nexus". The first approach would characterize the previously-mentioned process of "development by means of external liberalization" (World Bank, 1993) as an application of the rule of "getting the fundamentals right". This is achieved through institutions and policies able to preserve macroeconomic stability, predictability, the transparency of market dynamics and the rule of law, while avoiding market-distorting subsidies and preventing rent seeking activities.

The second model would interpret the successful industrialization experiences of East Asian countries as the outcome of a performance-based control system of regulation and price distortions, along with the existence of organizational entities capable of providing industry-specific incentives for shifting resources to sectors of higher return and higher growth potential (Amsden, 1989). The third model focuses more on increasing the overall level of investment by fostering institutions and implementing policies for raising profitability through temporary and selective protection against international competition and by diverting profit from consumption and speculation (UNCTAD/TDR 1996, chapter II; 2003, chapter IV; and 2005, chapter I).

These partly competing, partly overlapping models can be analysed in terms of the functions performed by policies and instructions, their mutual relationship (channel H, figure 1.2) and their joint contribution to technological change and productive restructuring (channel A, B and C). This analysis of institutions and policies as means for shaping the incentives of actors, as well as shaping their constraints and their objectives, is the object of the following sections, along with the existing scope and degree of freedom for formulating policies and reshaping institutions consistently with the external dynamic environment.

5 GETTING THE "MACRO PRICES" RIGHT: SHORT-RUN CONDITIONS FOR LONG-RUN DEVELOPMENT

To grasp the complexity of economic systems under Keynesian "objective uncertainty" we have to drop the assumption of the representative agent's maximizing behaviour and Walrasian adjustment. "Expenditure changes" and "expenditure switching" due to price shocks in traded goods and internal relative prices, wage determination and overall profitability are instead critical factors for one country's competitiveness and the incentive for investment and for building capacity. There has been an increasing awareness of the need of including into the theoretical framework the complex interactions of economic groups such as workers, firms and shareholders in a world of uncertainty that is permanently bombarded by unforeseen shocks.

For instance, in the saving-determined-growth and current-account-balance theory, if saving falls short of desired investment, "... foreigners must take up the balance, acquiring, as a result, claims on domestic income or output." (Obstfeld and Rogoff, 1995: 1734). Thus in this world, an increase in the saving rate of private households and a corresponding drop in consumption demand do not lead to an immediate fall of companies' profits and accumulation. However, real world experience is that firms do not invest more if they have already piled up unsold stock as involuntary inventories (and therefore incurred in larger costs) and/or capacity utilization is lower than before as an immediate outcome of falling consumption demand. In a world of money and uncertainty, the decision to save more and consume less can have grave repercussions on the goods market before it impacts on the capital market.

The decision, as Keynes has put it, "not to have dinner today" depresses the business of preparing dinner today without immediately stimulating any other business. If the saving rate of private or public households suddenly rises, companies, faced with falling demand and falling profits, will react with falling investment if they do not possess more systemic information than just the information about the drop in demand. That is why the secular decline in the saving rate of private households in the industrialized world that started at the beginning of the 1990s – the savings rate of the G-7 countries almost halved, falling from around 9 per cent in 1992 to 4.5 per cent in 2005 – is mirrored in the secular rise of the savings of corporations from 8.5 per cent to 11.5 per cent. Hence thrift of private households is not a virtue per se but has to be analysed in the context of all the other forms of saving by other agents, including the saving of companies.

The failure of market participants to coordinate and clear markets in a Walrasian fashion brings to the fore the role of the independence of savings and investment decisions and the role of profits as the savings of companies. It also highlights the importance of the exchange rate on the one hand, and of labour market conditions and labour productivity changes on the other. For example, in a world of differing productivity performances of companies and the rule of LOP on the labour market, prices are sticky but profit rates vary with the level of economic activity. Moreover, the relocation of production to low-wage countries in most cases takes place by moving the existing capital-intensive technology of the high-wage country to a low-wage location. Thus it is not the smaller quantity of capital and the reduction in overall capital costs that determine the relocation but rather the chance to realize a temporary monopoly rent, which is higher when the capital importing country's wage levels are lower and when its overall productivity and growth rates are smaller.

In this world, a current account deficit or a growing "inflow of foreign saving" can emerge in the wake of negative shocks on the goods market, for example due to falling terms of trade or a lasting real appreciation. A real appreciation directly diminishes the revenue of companies if market shares are protected by a pricing-to-market strategy. If companies try to defend their profit margins, a fall in market shares and a swing in the current account towards deficit is unavoidable as a rule. Higher net inflows of foreign savings that correspond to an increase in net-imports do not automatically lead to higher investment, which is instead negatively affected by falling real income and profits. In that case, net capital flows would be the symptom of a negative shock. On the contrary, if current account surpluses are the result of growing exports and rising market shares, with profits fuelled in the export sector, there can be second-round positive effects in the domestic sector's output and investment. Crucial, therefore, are the effects of the emergence of a current account surplus (induced by rising exports, import substitution or an improvement in the terms of trade) on profits and jobs for the creditor country, and vice-versa.

The nature of short term capital flows and the role of interest rates and exchange rates (nominal and then real) as the main transmission channels is the most important source of consumption and output volatility. There is no monetary autonomy in an open economy. The traditional "impossible trinity" (fixed exchange rates, open capital accounts and monetary autonomy) has to be replaced by an "impossible duality" (Flassbeck, 2001). Reserves and liquidity increase under a pegged exchange rate or under a managed float when, facing a flush of capital flows in the domestic financial system, monetary authorities intervene to prevent excessive appreciation. Obviously, no intervention means leaving the capital inflows "excessive", and that implies unwanted appreciation of the domestic currency, with all its effects on growth and income generation. Appreciation means to stimulate the consumption of non-tradable goods and imports. The competitiveness of production and the current account is weakened; capital formation is penalized by falling profitability and the borrowing risks increase until a "sudden stop" of flows and devaluation become inevitable again.

If interest rates are fully used to respond to external shocks, they cannot perform their adjusting role between saving and investment and guarantee full employment. Additionally, the industrialized world has seen other cases of external shocks. During the oil-price shocks, interest rates did not fall despite falling capacity utilization as monetary policy was fighting higher inflation induced by the ensuing negative supply shock. Interest rates may even go up in a cyclical downturn if financial markets dictate higher interest rates to a developing country due to increasing risks of a default. The negative effects of falling private demand on profits may be aggravated by pro-cyclical fiscal policy in developing countries if "the markets" expect a quick reduction of public budget deficits.

Income growth can therefore be achieved only by constantly managing the dynamics of open economies to achieve investment plans exceeding saving plans ex-ante. In such a world, even with the private incentive to "thrift" left unchanged, the economy as a whole may expand vigorously. The "savings" corresponding to increased investment are generated through investment and the original investment may be "financed" through liquidity created by bank credit based on expansionary central bank policy. Increased investment stimulates higher profits, as temporary monopoly rents of the company sector rise. These profits provide for the macroeconomic savings required from an ex post point of view to "finance" the additional investment (or repay the bank credit).

Some of these lessons have been learned by developing countries the hard way. Figure 1.3 shows the change in the number of economies, grouped by region, that are running a current account deficit. In 1996, before the financial crises in Asia and Latin America, South Asian and South-East Asian economies were experiencing large net capital inflows and 17 out of the 22 countries of the region had a current account deficit, while in 1998 all 19 Latin American countries had an external deficit. After the 1997 and 1998 crises that respectively affected the two regions, the number of deficit countries has sharply declined and each region is running a current account surplus as a group. This can be interpreted as a fundamental change in the perception of globalization and of development strategy regarding these two crisis-stricken regions. From a strong reliance on foreign capital inflows, they moved towards a policy of preserving favourable monetary conditions such as slightly undervalued exchange rates and low interest rates, thereby favouring growth by stimulating export demand, competitiveness and productive investment.

This solution has to be seen as a self-defence mechanism against the most important threat of the globalized economy: the systemic financial instability arising from short term volatility of capital. The accumulation of reserve in surplus countries, from a very narrow perspective, may be suboptimal but it is the necessary outcome of the lack of a global financial system that could complement and make more effective the global trading system (UNCTAD/TDR, 2006). A reasonable global financial architecture that would set rules for the management of capital flows and exchange rates would not only allow for larger international financial stability but also for smaller global imbalances, which means smaller current account surpluses in emerging market economies and a smaller deficit in the United States.

6 CONCLUSIONS

With the unfolding of the financial crisis world economic integration has shown its positive and its negative side. Although the crisis originated in the developed world it quickly spread to developing countries and countries in transition. In the past globalization has been more of a success story in some parts of the world. Its results have been positive for some but disenchanting for others. Not only the crisis has dealt a major blow to an overly simple view of the world, the pure market approach. Those countries that have undertaken an indiscriminate lowering of barriers for trade and financial flows and have abstained from any proactive policy of industrialization and integration strategy have fared the least well. Conventional wisdom provides us with predictions about the nature and gains from free capital and trade flows based on well-established and self-consistent basic principles of arbitrage and flexibility of prices. However, the power of these principles to explain real world markets is clearly limited. Indeed uncertainty, the general scarcity of knowledge and information, as well as the influence of contingent conditions, institutions and history seems to nullify the role of reallocating resources as compared with the adoption of new technologies and new investment in permanently changing structures of production.

Moreover, the lack of instantaneous and well-behaved nominal adjustment renders any underlying real equilibrium configuration irrelevant because comparative advantages are not realized, real investment returns are not equalized and prices do not settle to their parity level before new shocks set in. On the contrary, temporary nominal and real outcomes of monetary policies, exchange rate misalignment and external shocks permanently affect the direction and quantity of economic change. Hysteresis and path-dependent features of real market economies, together with the existence of market failures, call for a role of proactive policies in industrial, trade and macroeconomic management at both the domestic and global levels. Competitiveness of countries is extremely relevant in such disequilibrium dynamics, but it has to submit to international scrutiny to avoid “races to the bottom” and international trade wars.

The “right process” of integration is one of effective outer-oriented development in combination with a growth strategy. It requires a clear understanding of the limits and potentialities of market forces, the effectiveness of national macroeconomic and industrial policies and the right balance between discipline and flexibility in multilateral global governance.

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ECONOMIC PARTNERSHIP AGREEMENTS BETWEEN THE EU AND THE AFRICAN, CARIBBEAN AND PACIFIC GROUP OF COUNTRIES: NEW GOVERNANCE OR NEW DEPENDENCY?

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For a long time, the cooperation between the European Union (EU) and the African, Caribbean and Pacific Countries (ACP) has been considered a "progressive" model of partnership. However, the Cotonou Agreement (2000) marked a deep change in the relationship between them, since it imposed the implementation of a free-trade-based commercial framework, requiring relationships to be based on a new form of governance. Many ACP countries dispute the use of the concept of governance by the EU, considering it an instrument of power aiming to establish a new center (EU) – periphery (ACP) dependence in the context of globalization. To analyze this process, this paper reviews the stakes involved in negotiations, the action of legitimizing the EU (the new governance), the building of critical discourse (the new dependence) and the effects of this confrontation on the implementation of agreements.

OS ACORDOS DE PARCERIA ECONÔMICA ENTRE A UNIÃO EUROPEIA E O GRUPO DE PAÍSES DA ÁFRICA – CARIBE – PACÍFICO: NOVA GOVERNANÇA OU NOVA DEPENDÊNCIA?

Durante muito tempo, a cooperação entre a União Europeia (UE) e os países da África – Caribe – Pacífico (ACP) foi considerada um modelo "progressivo" de parceria. No entanto, o Acordo de Cotonou (2000) marcou uma profunda mudança na relação entre estes parceiros, dado que impunha a implementação de um quadro com base no livre comércio e exigia que as relações entre as partes tivessem como base uma nova forma de governança. Muitos países da ACP questionam o uso do conceito de governança pela UE, considerando-o um instrumento de poder com o objetivo de estabelecer uma nova dependência centro (UE) – periferia (ACP) no contexto da globalização. Para examinar tal processo, o presente artigo analisa os interesses envolvidos nas negociações, a ação de legitimação da UE (a nova governança), a construção do discurso crítico (a nova dependência) e os efeitos deste confronto sobre a aplicação dos acordos.

1 INTRODUCTION

Major economic partner and primary donor of development aid, the EU has always had a particular position vis-à-vis ACP countries.

For a long time, the cooperation between the European Community and African, Caribbean and Pacific Countries (ACP group[1]) has been considered a "progressive" model of partnership between North and South, through a permanent and paritarian institutional framework, as well as specific exchange mechanisms.

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1. ACP: African, Caribbean and Pacific Group. In 1975, only 46 ACP countries participated in the Convention. The number of participating countries went up to 57 in 1979, then 66 in 1984, and finally 70 in 1990. Many ACP countries are micro-states.

As of the Lomé agreements (1975, 1979, 1984, 1989), relationships between the EEC[2] and ACP countries received even greater focus. The Cotonou (Benin) Agreement, signed in 2000 between the EU and 77 ACP countries, marked a profound change in the relationship between partners.

The change in philosophy was radical. Cotonou imposed the gradual implementation of a free-trade-based commercial framework, requiring relationships to be based on a new form of governance that also affected aid modalities. In this new philosophy, governance is central. The EU defends the establishment of a new governance in the EU / ACP[3] relationship, no longer characterized by the relationship between former colonial peoples / colonized peoples, or donor / beneficiaries, State to State, but by equality among parties, common interests, and integration of civil society and private sector in trade[4]. The EU intends to establish this new governance of international economic relations by means of Economic Partnership Agreements. In other words, it intends to focus on the logic of "Arguing" rather than in the logic of "Bargaining"[5] (Risse, 2000). In addition, the EU calls upon ACP countries to adopt good governance (democratic governance) and create governance indicators according to which ACP countries will be judged.

However, many ACP countries dispute the use of the concept of governance by the EU, considering it pure rhetoric and an instrument of power and influence aiming to establish a new center(EU)-periphery(ACP) dependence in the new context of globalization.

The controversy came to light during the negotiations of Economic Partnership Agreements (EPAs), which started in 2002 and were supposed to end by December 2007, but actually continued in 2008 and 2009.

From the onset of negotiations, the European Commission affirms its commitment with the search for the truth, the common good, and consensus, but was unable to convince ACP countries, which benefited from the support of

2. European Economic Community.

3. According to Héritier, governance refers exclusively to 'types of political steering in which non-hierarchical modes of guidance, such as persuasion and negotiation, are employed, and / or public and private actors are engaged in policy formulation' (Héritier 2002: 185) .

4. "European and African Commissions shall take on their responsibilities, but they are not omnipotent and have no centralizing role in partnership building. Member States and sub-regional organizations also have their part to play. But we also heavily rely on parliaments, civil society and the private sector to actively take part with us in this implementation process. The central place taken on by democratic players and African and European civil societies, i.e., in the heart of the strategic partnership and its implementation, constitutes an innovation, which I hope will enable the emergence of a genuine "people-centered partnership". Louis Michel, Europe-Afrique: l'indispensable alliance, Conference of European and Pan-African parliaments, Lisbon, 7th December, 2007.

5. In the logic of "Arguing," actors do not seek to impose their interests. They first seek to understand and reach a consensus on the definition of the situation in order to collectively consider how best to cope with problems and challenges, "relationships of power, force and coercion are assumed absent when argumentative consensus is sought" (Risse, 2000, 11).

cause coalitions. In trying to effect the signing of agreements, it ends up by tapping on insistently in the practice of pressure. The more the European Commission engages in "bargaining", the more it undermines the exercise of "consensus building", delegitimizing its speech and leading to accusations of practicing the balance of power rather than the new governance it alleges to promote. Finally, the agreements were only partially adopted, given the mistrust between partners and the absence of common stock.

To analyze this process, this paper concentrates on four stages: a review of the stakes involved in negotiations, the action of legitimizing the EC (the new governance), the building of critical discourse (the new dependence), and the effects of this confrontation on the implementation of agreements.

2 BACKGROUND

2.1 From Lomé (Togo) to Cotonou, a paradigm shift

2.1.1 Lomé: a model of north-south economic relationship?

From 1975 to 2000, relations between the European Economic Community and ACP countries were governed by the Lomé agreements, which combine selective support to the development of former 'European' colonies and the promotion of a new concept of international relations. Lomé's international regime is based on some fundamental principles of affirmative action policies and preferential access to European market by means of the implementation of non reciprocal trade agreements. In the area of trade, Lomé takes on three instruments: a non-reciprocal preference system, a process of stabilization of export revenues, and the protocols produced. ACP[6] countries can export their products to the EU at protective tariffs that are lower than those practiced by other non-ACP countries, while not being obliged to open their borders to imports from Europe. In addition, a system is established to stabilize export earnings in the segments of agricultural products (STABEX) and mineral products (SYSMIN). Finally, protocols are created concerning competing products of European production such as beef, sugar, banana and rum, guaranteeing importation quotas to Europe at European domestic prices[6]. At the political sphere, the Lomé agreements proclaim partners equality, respect for national sovereignty, search for mutual interests, interdependence, and the right of each State to adopt its own strategies. They establish joint management of the relationship between EU and ACP countries by creating joint institutions: ACP-EU Joint Assembly (composed of legislators from both parties), Council of Ministers, Committee of Ambassadors.

6. That is to say, prices higher than world prices because of EU subsidies.

Many believe that, by incorporating several southern ideas on the "new international economic order", Lomé represents "a possible framework for the North to support the countries from the South" (Bitsch, Bossuat, 2005, 342).

2.1.2 The collapse of the protection model

The 90's marked a profound change in paradigm within the EC in the understanding of North South relationships. The belief in the need to provide countries with protection against the destabilizing effects of markets gave place to the belief in the virtues of trade liberalization. The issues of human rights and good governance, as well as questions about the effectiveness of aid take a new place in discussions.

In mid 1990's[7], the Lomé agreements were considered a failure by Europe, now deeply rooted in the paradigm of free trade. In the trade area, ACP countries have not benefited from trade preferences offered to them, while the protections locked them in a vicious cycle of uncompetitive economies[8]. The prevailing view is that ACP countries lack the capacity for economic diversification and poor governance undermines economic and social development. These findings are contained in the conclusions of the Green Paper of the Commission (1997).

2.1.3 Cotonou: liberalization and new governance

At the expiration of the Lomé agreements, the EC proposed a new form of agreement on trade and development intended to reflect the "new European consensus on development". The Cotonou Agreement[9] (2000) radically broke away from Lomé. It affirms the priority of political issues relating to "good governance"[10] and the need to establish an ongoing dialogue about these issues among partners. The "fight against poverty" became the central objective of development policies rather than the sectors of cooperation and development referred to in the Lomé agreements. Finally, the Cotonou Agreement provides for the establishment, after a preparatory phase of a few years, of free trade agreements (EPAs) between the EC and ACP countries.

As of 2000, trade issues have spiraled out of DG Development's (DG DEV) control whose field of intervention became limited.

The transition to the Cotonou Agreement means the official end of automatic preferential benefits, but also the introduction of conditionalities.

7. Let us recall the overall context of these ideas: the fall of the Berlin Wall in 1989, creation of the single market in 1992, establishment of the World Trade Organization in 1995, implementation of the HIPC process in 1997...

8. European Commission Green Paper on relations between the European Union and ACP countries on the eve of the 21st Century, Challenges and options for a new partnership, Brussels, 1997.

9. The agreement was signed in June 2000 between 15 European countries and 77 ACP countries for a period of 20 years.

10. Indeed, the term appears only later to refer to abovementioned ideas.

In the political sphere, "good governance" became the cornerstone of development and cooperation policies. Articles 96 and 97 of the Cotonou Agreement allow for cooperation to be suspended in cases of corruption or serious human rights violations. Moreover, as of 2006[11], the EC has been developing an ambitious strategy. With the "Governance Profiles" and the system of "Incentive Tranch", the institution seeks to earmark a share of the tenth of the European Development Fund (EDF) to the results of reforms undertaken by ACP countries.

The EU adds to the traditional criteria of democratic governance (human rights, democratic principles of the rule of law, public efficiency) issues of market economy, migration, international security, the fight against terrorism, management of natural resources... Despite EC protests, the considerable extension of the governance concept can pose a Damocles sword on ACP countries[12].

In terms of economic relations, we pass "from a logic of development cooperation, sheltered from the turbulence of global competition, to a logic of ACP exposure to international competition" (Petiteville, 2001, 435). On trade, relying on the jurisprudence of the World Trade Organization on trade in bananas, the EC supports the need to do away with the privileged trade regime and to sign economic partnership agreements (EPAs) compatible with international trade rules.

However, Cotonou merely defines an agenda and negotiating objectives. The aim is to put in place before 2008 (deadline obtained from the WTO) Economic Partnership Agreements (EPAs) based on reciprocity between the EU and ACP regions. In addition, requirements will differ depending on whether or not countries belong to the group of Least Developed Countries (LDCs). In the first case, they may choose to sign these agreements – which is the option encouraged by the EU - or choose the privileged option, which is offered by the initiative "Everything but Arms"[13]. Non-LDC countries should choose between the EPA and a less advantageous regime of Generalized System of Preferences (GSP) which makes them lose their commercial advantage.

For the EC, the negotiation of trade agreements is included in the new governance of international relations based on the search for collective interest and not on the patronage of the North. However, very quickly, ACP countries consider to be put under pressure to sign agreements whose consequences can be disastrous for them.

11. COM (2006) 421 Final, Brussels.

12. This design has led to vigorous questioning of European Commissioner Louis Michel by the socialist group in the European Parliament: "What topics or criteria - such as "market-friendly policies" ("property regime", "labor regulations" ..), "fight against terrorism", against "the proliferation of mass destruction weapons", or certain points on migration ("satisfactory cooperation on the implementation of the readmission obligation") contained in Sections 5 ("Economic Governance"), 6 ("Internal and external security) and 8 (" International and regional context ") of the "governance profile" - participate in the evaluation of "good governance" of a State? "(Letter of Glenys Kinnock and Marie-Arlette Carlotti to Commissioner Louis Michel, Brussels, 15th December 2006).

13. WTO-approved, they offer free access to EU markets. But the ranking of countries in both categories is based on WTO categorization and presented serious classification problems when compared to the UNDP's Human Development criteria.

3 THE NEGOTIATIONS ON EPA: A REVELATION

3.1 The content of agreements

EPAs aim to implement an asymmetric free-trade area (full opening on EU's side and a little less on PCA's sides) between EU and ACP common markets. They include three components: regional integration of ACP, EU / ACP free trade area, and development aid. To strengthen regional integration, the six groups of ACP countries should establish sub-regional free trade areas or customs associations: Southern Africa (SADC), East Africa (ESA / COMESA), West Africa (ECOWAS), Central Africa (CEMAC and part of the ECCAS), the Caribbean (CARIFORUM) and the Pacific.

Negotiations started in 2002, but progress was very slow despite the deadline of 31st December 2007 for signing the agreements. The EC fails to overcome the reluctance of ACP countries.

In the area of trade, controversies arise mainly on the interpretation of Articles 37.5, 37.6 and 37.7 of the Cotonou Agreement (Alavi, Gibbon, Mortensen, 2007). *These sections provide that "negotiations of economic partnership agreements will be undertaken with ACP countries that consider themselves ready to do so, at the level they deem appropriate, and in accordance with procedures agreed by the ACP Group, taking into account the process of regional integration between ACP States (Article 5). The EU "shall examine the situation of non-LDC countries that, after consultation with the Community, decide they are not able to negotiate economic partnership agreements and will study all possible alternatives to provide these countries with a new trade framework equivalent to their existing situation and in compliance with WTO rules (Article 6). Furthermore, the EU shall take into account the "level of development, socio-economic impact of trade measures, and their ability to adapt and adjust their economies to the liberalization process. Therefore, negotiations will be as flexible as possible with regard to the establishment of a transition period of sufficient duration, the final product coverage, taking into account sensitive sectors, and the degree of asymmetry in terms of timetable for tariff dismantling, while remaining compliant with WTO rules in force on that date" (art. 7)*[14].

In interpreting and applying these two objectives in the EPA negotiations, the positions of the EC and ACP countries differ substantially, especially as regards sensitive terms of the Cotonou Agreement "appropriate level", "taking into account the regional integration process," "equivalent to the existing situation", "flexible" ...

The EC defends the benefits of signing a trade-liberalization agreement the fastest and widest possible ("New Trade Strategy"[15]), both in terms of sectors

14. Our underlining (FXM).

15. The essential elements of the new strategy elaborated in 2006 is to go "beyond what can be achieved at the global level by seeking deeper reductions in tariffs; by tackling non-tariff barriers to trade, and by covering issues which are not yet ready for multilateral discussion, such as rules on competition and investment», Speaking Points by Commissioner Peter Mandelson, 4th October 2006.

(goods, services, measures to facilitate trade development) and percentage of goods involved. The European Union promotes the rapid adoption of agreements covering competition policies, protection of property rights, standardization and certification, sanitary and phytosanitary measures, respect to the environment, standards in the fields of labor, foreign investment, opening of public markets, data protection. ACP countries defend longer deadlines and important exceptions. The EU says it is ready to accept the flexibility and relatively long implementation deadlines[16], but under exceptional circumstances and provided agreements are signed. ACP countries respond that the EU is going beyond the agreements celebrated at WTO and want to exclude services from free trade agreements. They want to link their agreement to support by the EU to the follow-up measures required to enable their economies to endure competition, and first want to strengthen their regional unions before opening their borders.

With Cotonou and the wish to conclude the free trade agreements, the EC is faced with a major challenge.

As part of EPA negotiations, the continuation of two largely conflicting objectives, the signing of free trade agreements and the maintenance for non-LDC countries of "*a new trade framework equivalent to their existing situation and compliant with WTO rules* (Article 36.6), make persuasion particularly important as well as the ability to form a cognitive framework common to the EU and the two groups of ACP countries.

In the field of EPA negotiations, the EC has faced a broad coalition of NGOs from the North (Oxfam, Christian Aid), the South, northern parliamentarians, organizations of southern states[17]. They stress the ethical issue and criticize EC's forceful approach, the strategies to pressure adhesion of ACP countries, the lack of consideration to the interests of ACP countries, and highlight the disastrous effects of agreements for countries and their populations.

4 EPAS: NEW GOVERNANCE OR NEW DEPENDENCY?

4.1 The EC: building the legitimacy of agreements

Any change to an important policy, especially if it intends to avoid lasting antagonism, can not rely solely on the exercise of force. It necessarily requires an exercise of legitimation, especially if the change is not desired by the partners who will bear its primary effects and will question prior arrangements, national values and preferences traditionally expressed.

16. Between 10 and 12 years at the onset of negotiations, deadlines will be progressively extended under pressure from ACP countries.
17. Among which, South Africa /RSA has played a key role.

The exercise of legitimation requires a discourse capable of projecting a coherent vision of the future, of clearly demonstrating benefits for partners, and redefining core values in a manner favorable to the policies proposed (Merrien, 1993, 1998; Schmidt, 2000). The essential purpose of EC's discourse on EPAs is to perform a radical change in the beliefs and identities of ACP actors, going from a cognitive framework centered on unequal exchange (in other words, still within a structuralist view of development) to a free trade perspective focused on the opportunities offered by global trade[18]; and from an identity based on requested economic assistance to an identity of strategist economic actors able to take advantage of the opportunities available to them.

In its desire to impose its options, the EC tries to establish its legitimacy on three priority areas identified by Scharpf (1996): Legitimacy by "inputs", "outputs", and fairness in procedures (procedural fairness). It seeks to integrate problems and solutions within a framework that delegitimizes certain ideas and policies, and restricts the adoption of particular policies. However, it is primarily in the area of legitimacy by outputs that it attempts to reach consensus.

4.1.1 The benefits of Economic Partnership Agreements

In this perspective, EC's reports define "scenarios no so much about what should happen as about what will happen, according to their tellers, if the events or positions are carried out as described (Roe, 1991, 288). It develops, in the way of dramatization, what will happen in a positive way if the actions are carried out correctly and the serious consequences that will arise from non-compliant actions. EC's tale [19] is based on a series of key elements, repeated indefinitely[20]:

- the inability of previous solutions to boost development: despite 30 years of non-reciprocal trade benefits with the EU, the level of ACP exports to the EU declined to represent a negligible level of trade. The old policies have not led to competitiveness of ACP countries, or to economic growth, or to trade diversification. ACP countries remain exporters of primary commodities.
- the functional character of the solutions that respond to the context of globalization: the agreements will put a halt to the process of economic marginalization of ACP countries, and will contribute to growth, poverty reduction and regional integration.

18. "The Economic Partnership Agreements are a road out of dependency - out of a contracting share of export trade. They are designed to help build regional markets, build up productive capacity and diversify ACP economies. And ultimately they are designed to develop trade between the EU and the ACP regions - not because we want to force open ACP markets to our imports, but because a market that is open to imports is a healthy market. It means lower cost goods, downward pressure on inflation and a platform for a country's exports, Peter Mandelson, Address to the European Socialist Party Conference, Brussels, 19th October 2006.

19. We based our analysis primarily on the documents published by the EC, the speeches by Peter Mandelson, Louis Michel and José Barroso (see Official Records in Bibliography).

20. And a high number of copy/paste and cut/copy of entire paragraphs, making the speeches interchangeable.

- The benefits of trade liberalization: liberalization will improve the lives of consumers, increase the quantity and quality of products and services, and helps make the region more competitive globally.
- Liberalization must include an ambitious agenda (WTO +): competition policy, intellectual property protection, environmental and labor standards, and public procurement are part of the agenda.
- The proposals are credible: Asian countries have built their economic growth this way, and those that have chosen economic protectionism and national planning have failed[21].
- The EU defines reasonable deadlines for the implementation of agreements.
- It is quite possible to reduce the negative consequences in terms of tax revenues by changing the tax base.
- The EU will provide assistance to help countries cope with adjustment costs and to integrate into the global economy.
- There is no choice: WTO rules and the deadline should be complied with.
- There are no other credible alternatives: "There is no plan B".

As regards the opponents, the EU classically sought to discredit their arguments both as regards "outcomes" and the process. However, in the interplay between science and policy forums (Jobert, 1994), the EC initially sought legitimation through the rhetoric about the benefits of trade and the legality and "fairness" of procedures, and finally, only in a final stage, by science (the predictable economic effects).

Paradoxically, the scientific struggle became instrumental for communities of cause (Advocacy Coalitions[22]) associated to ACP countries more reluctant to turn against the EU, while its toughness in negotiations strengthened the cause of EPA opponents. The counter discourse attempted to demonstrate - successfully - that far from symbolizing a new form of north-south governance, EPAs would build a new dependence of ACP countries vis-à-vis Europe.

4.2 EPA: a new dependence?

From the very beginning, EC proposals on EPAs were object of debate. Evaluations of the legitimacy involved several networks defending their position through often specific key channels (magazines, clubs, networks), and competing

21. See, Mandelson, speech at LSE, 4th February 2005.
22. Sabatier, 1992.

to win the public opinion. The debate encompassed several fields: the field of science, the political field and the field of public opinion[23].

In the debate on EPA, opponents challenged the legitimacy of inputs, outputs, and finally the legitimacy of procedures. The anti-EPA community defended its points based on analyses by neoclassical experts, as well as on other conventional and "unorthodox" economic analyses. It highlights the asymmetries of power favoring the EC in the negotiations.

4.2.1 The weak legitimacy through the "outputs": the results of economic modeling

When negotiations begin, serious studies on the effects of economic agreements were surprisingly few[24]. In the early 2000s, the EC seemed convinced that the benefits of the agreements it wishes to sign would be recognized by all. Thus, the rhetoric work of persuasion was prioritized.

However, since the establishment of the WTO, increasing attention has been paid to the development of quantitative models[25] to measure the effects of trade liberalization on a country or group of countries. Economic analysis has become a preferred means of legitimation.

The rulers of the South, initially reluctant of these analyses or lacking the required human capacity to accomplish them, became increasingly aware of the results provided by the models[26]. The WTO, UNCTAD, and other southern organizations, such as the South Center, worked towards developing their negotiators' capacity, resulting in considerable improvements of negotiators in developing countries concerning trade negotiations (Page, 2003).

However, the models were far from conclusively confirming EC's optimistic discourse. In terms of results, their conclusions only partially legitimize the positive aspects of the agreements (ODI, 2006). Most studies point out that EPAs have overall positive effects only under very restrictive assumptions: if one takes into account strictly the perspective of trade effects, if one admits behavior assumptions whose realism is questionable, and if the costs of the indispensable adjustments are not included in the calculations. Even under these

23. In the sense provided by Pierre Bourdieu's work, that is to say, space for relationships organized according to a logic determined by specific interests and opportunities. This definition is similar to that of the concept of Forum used by Bruno Jobert (1994).

24. « So far, there are very few studies available that try to quantify the impact of EPAs on ACP countries. Most studies focus on policy options for ACP countries and/or discuss EPAs from a more general development perspective » (Bormann et alii, 2007, 2007, p 235).

25. GTAP, Mirage, Linkage, Michigan, G.Cubed…

26. « Before the 1999 WTO Ministerial conference in Seattle, African countries were passive participants; since then, they have played a more proactive role in the negotiations. This has led to an increase in the demand for technical tools to help them define their positions and also assess the impact of the different reform proposals put forward by other WTO members on Africa », Hammouda, Osakwe, 2008, p 152.

circumstances, EPA effects are negative for many countries. CEPII's MIRAGE model[27] shows the disastrous effects of the model advocated by the EU (Bouet et al, 2007): the implementation of EPAs would generate a strong growth of EU's exports, but would have very limited impact on the exports of ACP countries. In addition, all studies underline the methodological difficulties inherent to the exercise and the virtuous assumptions maintained. This last point is important. Indeed, "all models assume that tariffs cuts will automatically translate into a proportionate reduction of prices, while it is likely that some of the cuts will be appropriated by producers and / or importers.[28] This assumption, combined with the results obtained by the models, creates doubts about the good will and selflessness proclaimed by the EU. [29]

In terms of regional integration, the implications are quite negative. EPAs format leads to a risk of increasing tariff dispersion among partners and among products (Stevens, 2006). Moreover, even if these agreements may result in positive effects for consumers, they result in some considerable loss of government revenues. This drop could reach 20% of public revenue for the group of West African countries, less than that for East African countries in general, but up 24.5% for Comoros (Bormann, 2007; ECDPM, 2007), i.e., more than the average spending of these countries in basic primary sectors. Indeed, most ACP countries derive their income from trade taxes. In Benin, Comoros, Ivory Coast, Gambia, Guinea, Madagascar, Mali, and Swaziland taxes on international trade represent between 35% and 50% of state revenues[30].

This decrease in revenue would seriously hamper States' ability to provide basic services, (ODI, 2006; Bormann, 2007[31]; Milner, 2005; Karingi, 2005).

For ACP countries, the loss of public revenues, the main tools of political legitimacy, has far greater importance than the gains from trade. We now understand their resistance. Ultimately, the options facing ACP countries are equally risky:

- To conduct a thorough tax reform and a significant increase in VAT[32]. However, as shown by the reforms attempted in West Africa for over 25 years, this type of reform has proved a task, if not impos-

27. Centre d'études prospectives et d'informations internationales de Paris.

28. ODI, The potential effects of EPAs : What quantitative models say , Briefing paper, June 2006, p 6.

29. The World Bank itself, suspects that the EU seeks to imprison African countries in agreements with them rather than promote radical liberalization measures needed by Africa (Brenton et al, 2007, 7).

30. Source : IMF, Government finance statistics Yearbook, 2004.

31. « We cannot reach any final conclusions about the welfare impact of the EPAs from the relative magnitude of trade effects alone. Even in a partial equilibrium framework, the negative impact from subsequent terms-of-trade effects or losses in tariff revenue from trade liberalisation might outweight the increase in consumer surplus » (Bormann and alii, 2007, 247)

32. This solution has been advocated for over twenty years by IFIs and an epistemic community (Haas, 1990, 1992) of experts in finance and international financial organizations, see, Odd-Helge Fjeldstadt, (2007), Taxation and state building : poor countries in a globalized world, ABCDE Conference, May.

sible, at least extremely difficult in ACP countries (Danielson, 2003; Bormann et al, 2007).[33]

- To further reduce State's spending. Although it is possible to improve the efficiency of ACP States, this option is not risk-free if it leads to reduced provision of basic services or slows the creation of infrastructure. It is in clear contradiction with the Millennium Goals and PRSPs[34]. Overall, it can cause serious internal conflicts[35] and increase the immigration flows the EU seeks to limit;
- To expect a considerable increase in international aid, which is subject to political risks[36], or rely on the capacity-building program, which is an essential component of EPA assistance. But this option is equivalent to linking a binding signature to a promise.

Finally, contrary to expectations, econometric models do not legitimize EU's proposals, much to the opposite, such models actually weaken them. The EC was obliged to shift the economic debate from quantitative models to the new trade theory so as to highlight the considerable effects that trade liberalization could have over productivity and growth. However, as pointed out by ODI, "the literature is not, however, clear cut on this" (2006, 3). With the end of the Washington Consensus (Gore, 2000; Maxwell, 2005), belief in the beneficial cascade effects of trade on growth and poverty has been questioned (Rodrick, 1998, 2001, Winters, McCulloch and McKay, 2004; UNCTAD, 2004, Cling, 2007).

The weak results of economic analysis opened space to external criticism, and limited the ability to forge the coalition hoped by the EU with some large regions or ACP countries.

4.2.2 NGOs and the initiatives of legitimization of EC's positions

In the discussion on EPA, critics deconstruct EC's discourse to highlight the balance of power that lies beneath the apparent procedural democracy. Legitimacy through the inputs was low because, despite the formal joint decision-making on a common path, the guidelines were formulated by the EU and ACP countries were not able to challenge the new guidelines. In the area of outputs, since the EC constantly legitimizes its guidelines by means of the outputs expected, it is logical that the

33. Bormann et al said that it is theoretically « straightforward to replace import tariffs with domestic taxes…Most ESA countries already started in the 1990's implementing tax reforms, including the introduction of value added tax system. However experience has shown that they often encounter severe difficulties in replacing import tariffs with other taxes or in collecting taxes domestically » (2007, 248). Also, Omran and Stiglitz (2005) make very strong reservations about the actual efficiency of a tax reform with emphasis on VAT.

34. Poverty reduction appears as the priority objective of the Cotonou Agreement (art. 1).

35. «The occurrence of civil conflict in Africa is intimately related to the failure of governments to deliver the type of public expenditure that the people want, i.e, with a strong redistributive component such as in health and education »… « a high wage policy is fairly effective for buying civil peace » (Azam, 2000, 42).

36. Let us bear in mind that since the Millennium Declaration and the commitments made on that occasion, international aid has declined globally, and significantly.

questioning of potential adverse effects undermines its foundation. Transparency and fairness in the negotiation process were finally challenged globally.

Regressive economic effects

In the economy, the cause coalitions gathering NGOs of different origin, denounced EPAs as a policy of drastic opening of ACP countries to EU's exports of goods and services[37] that will not pay off EU's financial promises. They lead to a series of dramatic effects:

- a dramatic drop in State revenues,
- privatization of public services at the expense of the poor
- deindustrialization of a large part of Africa,
- blocking of the value added process of ACP products
- reduction of benefits of the process of regional economic integration
- the economic re-colonization of Africa
- limitation of economic policy instruments available to governments of ACP countries[38].

A power strategy

In the political sphere, Europe is accused of trying to impose its economic interests. Critical communities stress the ethical issue and criticize EC's forceful methods, the strategies employed to force ACP countries to join, the indifference to the interests of ACP countries:

- Waiting for the implementation of its own reform of the common agricultural policy before opening to liberalization;
- Offering an extremely short deadline for acp countries to program the essential adjustments,
- Creating new forms of subsidies for european farmers that distort prices in detriment of acp producers;
- Seeking to impose a liberalization agenda that goes far beyond the concessions negotiated in the wto (doha round)
- Being in a position to establish new standards to counteract the effects of lower tariffs (phytosanitary standards, standards on product origin ...)

37. The EU proposes to increase substantially its development aid, to create a compensation fund for tax losses, to support ACP countries to develop their economies, in particular through specific aid for trade (Aid for Trade) added to a tenth of DEF.
38. See especially Goodison, 2005, 2007.

- Imposing a liberalization that covers a very large percentage of trade and have limited exceptions,
- Imposing too short a deadline for implementation,
- Giving priority to trade liberalization rather than to regional strengthening
- Waiting for agreements to be signed before engaging in aid to support the adjustment costs.

Unfair procedures

Europe is accused of using unfair procedures:

- Making believe that there is no option other than that of greater bilateral liberalization
- Imposing too short a deadline for signing,
- Making pressure on individual countries and groups of countries to sign the agreements,
- Refusing to link trade reform and public support of the eu, but using the latter as a pressure tool.

The issue of instrumentalization of governance is also raised.

These criticisms were found in many NGOs[39] publications (eg. Christian Aid, Oxfam, ENDA Tiers Monde ...). They were listed by the press of countries of the South (and often of the North[40]), European parliamentarians[41], African Heads of State[42], and are supported by artists[43] and prestigious universities[44]. European States were obliged to take their distance rather than being in an uncomfortable position[45].

39. «Unequal partners : how EU-ACP Economic Partnership Agreements (EPAs) could harm the development of many parts of the world's poorest countries », (Oxfam international, 2006); « Poor countries threatened by EU push to sign free trade deals », (Oxfam international, 2006); « Accord de partenariat ou de paupérisation économique ? » (Coordination-sud,, 2006) ; « La coalition des ONG exige une autre coopération EU/ACP » (Enda, Dakar, 2007), etc.

40. L'intelligent, 11th November 2007, « African employers say no to Brussels » ; Le Monde, 11th December 2007, « In Lisbon, the offensive of African countries against EU »; Le Figaro, 07/12/2007, « EU seeks new relationship with Africa» ; La Tribune 23/01/2008, « EU to review ACP agreements» ; L'Intelligent, 22/10/2007, « EPA negotiations come to a halt », etc.

41. Jean-Claude Lefort, Report on the negotiation of Economic Partnership Agreements with African, Caribbean and Pacific Countries, Information documents of the National Assembly, N. 3251, European Union Delegation, National Assembly, 2006.

42. Especially Abdoulaye Wade, President of Senegal.

43. Le Monde, 17th January 2008, " African rappers against free trade"

44. «In its economic partnership agreement (EPA) negotiations with the ACP, the European Union seems to have forgotten the development dimension and pursues an agenda that reflects primarily the interest of the EU alone ». Letter of prominent scholars in the Financial Times, 7th August 2007.

45. DFID's 2005 report was unanimously regarded as a move away from the EC, forcing DFID to defend EPAs a few years later (2007) in "Ten myths about Economic Partnership Agreements (EPAs)".

The EC complains that the campaign of criticisms "made the job of ACP negotiators harder, undermining them domestically and pushing some into a position of negotiating in private while criticizing the agreements in public."[46] It pushed the EC into a major campaign in defense of its arguments and strategy. But from a strategic perspective, the EC no longer has the initiative, which weakens their position quite considerably.

4.2.3 The consequences of controversy on the agreements

Paradoxically, without having succeeded in creating a global consensus and unable to change negative perceptions of its ACP partners, the EU finds itself in the position of having to increase the pressure, alternating threats and promises to pressure countries into signing up, further intensifying criticism by opponents. However, since countries classified as LDCs (which represent a majority of ACP countries) chose the favorable trade regime "Everything but Arms", trade was a threat somewhat fragile.

At the end of 2007, presented as the deadline, only nine countries out of forty-one in the LDC category had chosen the option proposed by the EC. As for non-LDC ACPs, they were torn between the risk of losing trade benefits with the EU if they do not sign and the fear of restructuring, adjustment costs and social costs entailed by their signature.

Most ACP countries are now seeking an alternative: an extension of Cotonou, EPAs+, GSP+[47], ect.

Although tirelessly stated since the beginning of negotiations that "there was no plan B", the Commission was obliged to accept a two-step approach in order to achieve "interim agreement" related exclusively to trade in goods. Agreements on services and investment rules are referred for further discussion. Negotiations with individual countries continue, while the EC has opted for separate discussions with various regional groupings, leading to variable agreements[48]. In the field of agreements, the EC accepted a relatively large list of sensitive products for which tariff protection is maintained, and allowed longer implementation periods. By mid-2009, EPAs were implemented only in a very limited and incomplete fashion.

The inability to produce a global consensus with ACP countries and civil society had the effect of breaking European consensus itself.

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46. CE, DG Trade, Note on the state of play in the EPAs negotiations, Brussels, 20th December 2007.
47. See Bouet, 2007 ; Messerlin, 2007, Bilal et alii, 2007.
48. Europa, Update : EPAs, 11th January 2008, memo/08/15.

5 CONCLUSION

As we have seen, EC's discourse has constantly evoked the model of new governance of North-South relations. Europe made use of all available forums to remind about the profoundly altruistic nature of its action. The European Commission explained that it did not seek to uphold its own interests, but rather the best interests of its partners, and that it is ready to discuss the validity of its assumptions, but under reasonable timeframe, given the constraints of the WTO.

However, negotiations have revealed a gap between rhetoric and practice. On the one hand, the EC called for dialogue and seemed willing to seek for the common good. It developed arguments that make sense. On the other hand, it was inflexible towards the roadmap, the framing, the contents and timing of agreements. It used persuasion as well as power (threats, promises, risk of isolation[49]).

The gap between the rhetoric of truth and the practice of "bargaining" reinforced the doubts about EU's real intentions. The intransigent position of European negotiators[50] reinforced the view that the EC has embarked on a strategy to preserve its own interests, particularly in the context of economic competition with China.

Thus, throughout the years of negotiations, the EC was constantly defensive, unable to build a global consensus around its positions. In contrast, external criticism grew steadily and was able to mobilize significant discursive resources.

Somehow, the EU was in a situation similar to the one named by Christopher Hill (1993, 2004) and Toje (2008) as the "capability-expectations gap". Even though, in recent years, the cooperation between the two directions (DG DEV and DG TRADE) and the two commissioners has been particularly close. However, one can assume that the EC has been the victim of poor assessment on the part of resistances in ACP countries. Convinced of the strength of the free trade premise, it did not quite take into account the "political" fears of rulers of the South. It did not assess the strength of social networks correctly.

In terms of the conquest of ideas, it has not proved capable of effectively mobilizing scientific networks[51], nor networks that may be won over by its message.

In the practice of "bargaining", it has underestimated ACP actors and the support they could receive from experts and NGOs involved. Its all or nothing strategy, which presupposed the ability to implement the threat of rupture, was

49. José M Barroso wrote to the Presidents of Cameroon and Gabon, Paul Biya and Omar Bongo, to alert them to the urgency of signing the EPAs, L'intelligent, 9th December 2007.

50. On several occasions ACP representatives highlighted this point, complaining about the gap between the open discourse of Peter Mandelson and the closed positions of EC negotiators.

51. One hypothesis is that the EC, unlike the World Bank or IMF, has no sufficient human resources to fight properly in the field of ideas.

completely unrealistic. ACP countries are aware that the EU needs them in many arenas. This strategy proved a failure.

The EC was unable to make indispensable concessions in a timely manner. It concentrated on preparing speeches about misunderstandings, missed opportunities, scapegoats and conventional policies of threats, rewards, power relations and unstable commitments. This result has had medium- and long-term consequences over the social capital shared by the partners involved.

Ultimately, even if the EC manages to convince ACP countries to review their positions, the consequences of this scenario are very negative. By not taking a realistic view of trade and by being too closed to the concessions requested, the EC has wasted considerable common social capital and raised new resentments.

The destruction of strong social capital may therefore have strong effects on Europe's ability to build an alliance with ACP countries (especially Africa) in other areas, especially that of international trade negotiations, of collective security, not to mention the benefits accruing to commercial and political opponents, such as China and the USA.

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FINANCIAL GLOBALIZATION AND POST-CRISIS PERSPECTIVES

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It has become obvious at least since September 2008 that we are going through a severe downturn. What we have instead is a *systemic crisis*, a much more severe disruption which puts the functioning of our entire capitalist system in question. These kinds of crises occur when structural changes in the modus operandi of our capitalist system have engendered underlying imbalances, which, in the absence of self-correction, explode into the open with paralyzing force. The objective of this paper is to analyze the past three major crises (1873-79, 1929-39, and 1979-82) identifying behavioral patterns about things they share in common, which may help us figure out what is happening today.

GLOBALIZAÇÃO FINANCEIRA E PERSPECTIVAS PÓS-CRISE

Tornou-se evidente, pelo menos desde setembro de 2008, que estamos atravessando uma grave crise. Hoje, vivenciamos uma crise sistêmica, um distúrbio muito mais grave que coloca em cheque o funcionamento do sistema capitalista. Este tipo de crise ocorre quando alterações estruturais no *modus operandi* deste sistema geram desequilíbrios, que, na ausência de autocorreção, explodem com força paralisante. Este artigo tem por objetivo analisar as três grandes crises passadas (1873-1879, 1929-1939 e 1979-1982), identificando padrões de comportamento, sobre o que têm em comum, que podem nos ajudar a descobrir o que está acontecendo hoje.

1 LESSONS FROM PAST CRISES

It has become obvious, at least since September 2008, that we are going through a severe downturn. The intensity of the retrenchment, whether looked at from the point of view of employment, production, trade, asset values or aggregate spending levels, confirms that this is not a normal recession of the kind we go through recurrently every four to seven years. Those kinds of adjustments tend to be shorter and less pronounced than the kind of crisis we are facing today. What we have instead is a *systemic crisis*, a much more severe disruption that challenges the functioning of our entire capitalist system. These kinds of crises occur when structural changes in the modus operandi of our capitalist system generate underlying imbalances, which, in the absence of self-correction, break out with paralyzing force. We had such instances of structural crises in 1873-79, 1929-39, and 1979-82.

While each of these past structural crises had its own unique context, there are nonetheless certain historic lessons to be drawn from them, things they share in common, which may help us figure out what is happening today. Specifically, we can draw three important conclusions from the behavioral patterns of those past three major crises:

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1.1 The intensity of financial instability

They all started with a period of heightened financial instability – the legendary "Panic of '73," the unprecedented stock market crash of October 1929, and the (in)famous monetary policy switch by the Fed in October 1979 in the wake of a major dollar crisis. One can make the argument, based on empirical data on each of these crises, that there is a generally positive correlation between the severity and length of the credit crunch at the onset of the crisis and the subsequent disruption of economic activity as the crisis plays out. This was especially evident in the wake of the Great Depression following the dual collapse of the international gold standard (September 1931) and the US banking system (1931-33). But in the other two crises, the credit system breakdown shaped the recessionary adjustments that followed.

In light of this connection, the current crisis shows all the signs of being a serious one. The amount of damage done to the global financial system in the wake of last year's near-collapse of a vast shadow banking system built around securitization and credit derivatives threatens the solvency of leading banks and operational capacity of key markets - conditions which are difficult to overcome. In the meantime, desperate attempts by excessively leveraged borrowers across the entire spectrum of our debt-dependent economy to avoid default by selling off their assets in steadily declining markets puts the entire economy through what Irving Fisher (1933) has so aptly called a *debt-deflation spiral* (and what today we refer to much more prosaically as "deleveraging"). Such conditions run the risk of depression-like conditions unless reversed as soon as possible.

1.2 The global dimension

Each of these four structural crises started in the United States, but ultimately engulfed the world economy. Reaching beyond its country of origin, the crisis deepened as it widened. In other words, global contagion by the crisis served as a negative multiplier, making the downturn worse. There is, one may even argue, a correlation between its geographic spread and its depth. That connection was most brutally observed during the 1930s Great Depression, when America's 40% across-the-board tariff under the 1930 Smoot-Hawley Act, the subsequent German debt moratorium, and Britain's suspension of the gold standard in September 1931 took down the entire world economy. This experience makes it that much more important to avoid protectionist responses today, lest we want to repeat that horrible experience of turning a local downturn into a worldwide depression.

Today's crisis is already remarkable in how much it has eroded all the drivers of globalization, triggering sharp declines in trade, portfolio investments, direct investments and lending not seen since the 1930s. That too bodes ill for what we are facing, since the speed and degree of declines in these cross-border activities today is worse than in the 1870s or the 1980s.

1.3 Ending systemic crises

A third lesson to draw from past systemic crises is that they do not end on their own. Unlike self-correcting recessions, normal downturns in the course of the economy's cyclical fluctuations which the economy gets out of by cutting excess supplies below demand, the more severe systemic crises do not have an inherent way out. There are two reasons for this structural inability. One is the damage typically done to the banking system during such crises (which is why they are systemic in the first place), requiring long-term fixes to resuscitate. The other is the force of individually rational responses to the crisis, which make matters worse when taken together and projected onto the macroeconomic level. Spending cutbacks, spikes in household saving, business lay-offs, and other micro-rational responses all serve to reinforce the negative multiplier effects that pull the economy down. Hence, it is safe to conclude that systemic crises can only be overcome by strong policy responses and structural reforms.

If we apply these lessons to our situation today, we must conclude that the crisis we are facing today is a major one likely to last for several years, cause massive losses in income and employment and engulf the entire planet. Both the degree of the financial instability preceding it and the global contagion witnessed since it broke out indicate that this particular crisis is among the great ones in the annals of industrial capitalism. We have a severely damaged banking system and dysfunctional financial markets that have triggered a debt-deflation spiral likely to sharply limit trade and foreign investment flows. So it all depends on the policy response to get us out of this mess, since the crisis is not likely to subside on its own.

2 A UNIFIED POLICY RESPONSE

When looking at how governments have reacted in the face of a rapidly deteriorating economic scenario following the deflationary shock of Lehman's collapse on 15 September, 2008, we cannot but be impressed with the speed of their response. Even the lame-duck Bush Administration felt compelled to initiate a $700 billion bank bailout, the now-infamous Troubled Assets Relief Program (TARP), after having earlier given every American household a tax-credit check to stimulate aggregate demand (in Spring 2008). Here again it seems obvious that lessons from the past have been well learned, especially with regard to the long period of inaction by the Hoover Administration following the stock market crash of October 1929 and its devastatingly misplaced policies once it decided to act (e.g. spending cuts, protectionism, and refusal to let the Federal Reserve act as lender of last resort in proportion to the extent of the banking crisis). No, governments were not going to repeat the same mistakes again this time. They reacted swiftly instead. Perhaps even more interesting is the fact that governments have reacted so similarly, so much in unison. Even though differing in degree, their responses have centered around the same three focal points of crisis management:

2.1 Monetary policy

Central banks across the world, led by the Fed, have rapidly and significantly lowered interest rates since the onset of the crisis in August 2007 (and even more so since the crisis entered its brutal debt-deflation phase in September 2008). Even the notoriously tough-minded European Central Bank has taken significant steps in that direction. The reason for this unified monetary policy stance is quite obvious, namely the need to bring the de-leveraging process under control before it allows deflation to take hold in the output and labor markets as well as in the minds of a majority of actors.

Once started, deflation is hard to get rid of and is arguably a more painful problem than inflation. For one, with buyers expecting prices to come down even more, they are inclined to wait for this to happen. This wait-and-see attitude, no doubt a self-fulfilling prophecy that justifies the same caution going forward, encourages systemically depressed levels of economic activity. Moreover, deflation forces debtors to repay with higher-valued money and thus makes existing debt levels much more burdensome. This is dangerous, especially in light of historically high levels of indebtedness among many consumers and financial institutions today. Thus, for both these reasons, it is imperative to prevent the asset-deflation process associated with de-leveraging from permanently spilling over into product and labor markets. We are obviously getting closer to this critical threshold every day, as evidenced by the sharply decelerating inflation rates having already moved into negative territory when measured as producer price index and/or more generally on a quarterly (rather than annual) basis. Luckily, we started this deceleration process from a relatively high level of inflation across the globe due to the bubble in commodities immediately preceding the 2007 subprime crisis.

The only way for central banks to do their fair share in the fight against the debt-deflation spiral is to push down nominal interest rates under their control hard and fast. What we need are <u>negative</u> "real" (i.e. inflation-adjusted) interest rates to lessen overall debt burdens, flood the stressed credit system with liquidity, and allow hard-pressed banks some breathing space from steeper yield curves, giving them a more profitable spread between the interest they pay on their (short-term) liabilities and the interest they earn on their (longer-term) assets. Ben Bernanke, the chairman of the Fed and an economist renowned for his academic work on deflation (see, for instance, Bernanke, 2002; 2005), understood this right away. He has thus tried to lower the two interest rates under the Fed's control at least as rapidly as the deceleration of inflationary pressures, if not faster, to provide the U.S. economy with the needed boost from a sustained period of negative "real" interest rates in the hope of thereby avoiding the settling in of widespread deflationary pressures and expectations. When Henrique Meirelles, the president of Brazil's central bank, boasts that Brazil's real interest rates are now the lowest they have been for quite some time, as he did yesterday in this forum, he does not acknowledge sufficiently that this is indeed happening amidst a remarkably violent downturn and that, in light of the deflationary pressures at work across the globe, Brazil's "real" interest rates better be that low or even lower. Henrique Meirelles falls more into the camp of Jean-Claude Trichet, the head of the European Central Bank, and Mark Carney, the head of the Canadian central bank, who worry too much about inflation, yesterday's problem, and are therefore too cautious in fighting this crisis. There is room for the SELIC to drop more swiftly.

As inflation falls to zero and threatens to turn into widespread deflation, central banks will bring their target interest rates to zero as well, as has already been done by the Fed, the Bank of England, and the Bank of Japan. There will be a convergence in that direction as the depth and length of the global crisis become clearer (especially after the current optimistic expectations of an imminent turnaround in late 2009 or early 2010 have proven false). At that point, traditional monetary policy ceases to function normally, since central banks will by then have been deprived of their major policy tool. New, more unorthodox monetary policy measures should be adopted at that point. We have already seen how the Bank of Japan fought a decade of deflation during the 1990s with so-called "quantitative easing" that boosted bank reserves through purchases of government securities and other assets. And, even more tellingly, Bernanke's Fed has over the last year and a half launched nearly twenty new liquidity injection programs involving asset swaps aimed at easing credit conditions and unclogging blocked financial markets (if not replacing them altogether). We shall see a lot more experimentation in that direction by many, if not all, of the G-20 central banks.

2.2 Bank bailouts

As a complement to zero interest and credit-easing monetary policy, central banks have also tried to deal with a severely damaged banking system no longer strong enough to supply the wider economy with sufficient amounts of credit. In retrospect, it was actually quite remarkable how rapidly governments reacted to the cascade of bank failures in the United States and the European Union during September 2008, pushing beyond their traditional lender-of-last-resort interventions aimed at individual bank rescues designed to deal with isolated failures. Realizing right away the scope of the shock triggered by the collapse of Lehman, the U.S. and the EU governments scrambled for about a week for an adequate system-wide response before Gordon Brown provided the answer with an ingenious combination of bank liability guarantees, loss insurance for impaired asset values and injections of public funds to recapitalize more or less insolvent banks. Since then, most governments in the OECD club of rich nations (e.g. EU members, US, Japan, Australia) have introduced similar bank rescue packages which they have already had to adjust and extend in many instances.

2.3 Fiscal stimulation

As Keynes (1936) understood so clearly, monetary policy loses much of its effectiveness during major systemic crises, when everybody wants to cut back spending and nobody wants to borrow. At that point, the banks may well end up hoarding much of the liquidity injected by the central bank, a situation he characterized as a *liquidity trap* and one which we surely face once again today. In such a situation, it becomes imperative for governments to step in as source of additional demand. With the private sector cutting back in a series of negative feedback loops, only government has the means to boost aggregate spending levels in counter-cyclical fashion. Depending on prevailing multiplier effects (which differ greatly from country to country in terms of effectiveness of automatic fiscal stabilizers as well as in terms of different types of fiscal stimulation), governments need to boost budget deficits in proportion to the overall decline of economic activity they are facing in their domestic economies. This calculation explains Obama's $787 billion stimulus package of February 2009. Of course, other leaders (especially those in the €-zone of the EU) have acted much less ambitiously, worried about the longer-term implications of taking on so much new public debt.

Looking at the various stimulus packages passed by the G-20 countries, including China's ambitiously large package or Brazil's growth acceleration program (PAC), we see that they have tended to combine some tax relief, measures to shore up income maintenance and other social insurance programs, revenue-sharing help for lower levels of government in the provinces and municipalities, as well as infrastructure projects in the areas of transportation and construction, et cetera. In this regard, we have even seen welcome moves to invest in a broader and more modern range of infrastructure projects to boost energy efficiency, alternative energy sources, environmental improvements, education, health care, and affordable housing. The latter trend, even though in most instances just a fairly modest beginning, promises to yield important long-term benefits for the national economies concerned.

These policy responses, albeit steps in the right direction, were too weak and too late to prevent a remarkably sharp decline in production, trade, and employment in the last quarter of 2008 and first quarter of 2009. In these six months of economic free fall, the world economy has lost 20 million jobs, three million in the United States alone. While we must acknowledge that such policy measures suffer a certain time lag and hence cannot have their effectiveness assessed until later, they may not have yet sufficed to turn the world economy around toward recovery. We shall see only later, say at the end of 2009 and in early 2010, whether or not this is indeed the case. The danger of continuous decline, however, is very deep, once we have started such a rapid downward spiral of de-leveraging, asset deflation, spending cutbacks, and job losses. These forces of retrenchment feed each other, and are further reinforced by the mass psychological damage to confidence and risk taking. Keynes' prescient concepts of liquidity trap (i.e. hoarding of cash reserves by frightened and damaged banks) and paradox of thrift (i.e. increase in saving by fearful households that further cut already depressed consumer spending) are once again in full swing. And, as we saw during the Great Depression of the 1930s, whenever those precaution reactions are unleashed, they are very difficult to stop and turn around. This is especially so once deflationary expectations have taken root among the wider public. Then spending threatens to shrink further, as people decide to delay purchases and so take advantage of future price declines. If indeed the downturn continues unabated, we shall undoubtedly see further policy efforts.

3 THE CHALLENGE OF INTERNATIONAL POLICY COORDINATION

Apart from having reasons to worry whether the policy responses among the various countries have been sufficiently large and timely, we also have to understand that these strictly national initiatives do not really address the specifically internationalized nature of the crisis. With globally interconnected financial markets having frozen across borders, we have a synchronized global downturn. It has already become dramatically clear during the course of the past year that one country's or region's decline reinforces the downturn in other places, and vice versa. Just as global channels of cross-border economic activities had a positive multiplier effect boosting growth, so has their simultaneous decline – crystallized around a stunning shrinkage of global trade, massive repatriation of foreign investments, and capital flight pushing up risk premiums on any less-than-stellar securities – exacerbated the collapse of domestic economic activity in so many parts of the world.

So we have had a negative global economy multiplier reinforcing domestic downward spirals, a kind of de-globalization that is undoing and reversing much of the global growth stimulus of recent years. This has already meant a dangerous squeeze for emerging market economies dependent on exports and capital imports, and it is not clear that even Brazil will be able to escape the negative consequences of shrinking trade, reversal of capital flows, and lack of reliable trade finance. Export-dependent economies are therefore especially vulnerable to the negative de-globalization multiplier.

The global dimension of this crisis requires a good deal of international cooperation and policy coordination. For instance, it is clear that we need a substantial boost in the lending capacity of multilateral lenders (e.g. International Monetary Fund, World Bank, regional development banks) to help emerging market and developing economies compensate the reversal of private capital flows, secure more trade finance, and get help for domestic stabilization programs. We will also have to coordinate bank bailout schemes as well as unconventional monetary policy efforts across borders to make sure that the emerging new financial system, which these efforts are contributing to create, will have a minimum of cross-border harmonization so as to secure a global level playing field for an inherently transnational financial system. If not, we run the risk of financial protectionism, which will exclude many countries from adequate access to international capital supplies. Thirdly, there may well be a need for a globally coordinated fiscal stimulus program to counteract the shrinkage of trade-based demand, and such spending may usefully be directed towards a whole host of supra-national public goods and infrastructure issues – climate change, food production, alternative energy, public transport, community health care, education – which arguably could (and should) serve as the new global growth pillars of our post-crisis economy. Finally, we may in that context also wish to address the prevailing global imbalances centered around unsustainably large current account imbalances by having the surplus countries, like Germany, Japan, or China, undertake disproportionately larger stimulus packages that boost (hitherto inadequate) domestic spending. This would make it much easier for the deficit countries, especially the United States, to go through their adjustments without triggering dangerous debt-deflation spirals that threaten to push the entire world economy into depression.

Unfortunately, such needed increase in international policy coordination runs afoul of existing institutions at the center of world economy management. Those institutions, such as IMF, World Bank, World Trade Organization, Bank for International Settlements, G7, etc. were shaped decades ago, have never been adjusted to changing realities, and are therefore utterly outdated, even anachronistic, when it comes to their functions, their governance structure, their policy tools. They are not capable of dealing with the challenges of today's global economy. So in the face of this globally synchronized downturn, the worst crisis in seven decades, we run the risk of compounding inadequate domestic policy responses with an institutional inability on an international scale to save the world economy from disintegrating.

Luckily, there are two signs of hope amidst this otherwise dismal situation which allow us a glimmer of optimism. One is the arrival of Obama in the White House, giving us a charismatic and popular new US president who takes an activist approach to this crisis and has moved with lightning speed to address some of the key crisis management challenges dealing with this crisis in the first 100 days of his presidency – large fiscal stimulus, financial institutions repair, foreclosure modification program to deal with the housing crisis and emphasis on global coordination – while also stressing the need to lay the foundations for renewing America's long-term growth capacity by promoting investments in infrastructure, education, health care (including stress on cost containment) and alternative energy. The other is the formation of a new global governance institution in the form of the G-20 and its commitment to convene regularly in order to launch coordinated policy responses. While the first two summits (in New York on 15 November 2008 and London on 2 April 2009) have already proven how difficult it is to have twenty governments agree on anything substantial and then translate their general announcements into concrete reality, they have at the same time shown a remarkable degree of willingness for collective action. I am thinking here in particular of the G-20's agreement to revamp and boost the resources of multilateral organizations responsible for global crisis management (especially the International Monetary Fund and the Financial Stability Forum), to define the principles of regulatory reform pertaining to financial institutions and markets, and to forsake the temptations of protectionism. So the G-20 mechanism, while fraught with all the shortcomings of global governance in an era still dominated by national interests, is an important first step in the direction of global crisis management on a level that befits the level of globalization already achieved.

4 THREE TIME DIMENSIONS OF REFORM

As befits a structural crisis of the kind we are currently confronting, we need to contemplate major policy reforms to get us onto a path of sustainable recovery. What often gets ignored in mainstream discussions of such reform is that there are different types of reform depending on their respective time dimensions, and they have to be properly integrated. In other words, we must distinguish between necessary short-term measures, medium-term initiatives, and long-term transformations. And then, in addition, we need to make sure that these three time-differentiated paths of structural change are coordinated in such a fashion that one leads to the other and they all support each other. This is the only way that we can affect major structural change in our system and make sure it works effectively towards greater stability.

4.1 Short-term reforms

While we have put into place stimulative fiscal and monetary policies to counter the dramatic global reduction of aggregate demand, and have also managed to halt the disintegration of the banking sector, any chance for recovery depends on bringing the severely damaged banking sector back to a modicum of health and strength. That system is the heart of our economy, and one cannot expect a body to move swiftly as long as it has a weak heart. Some countries are better off in this regard than others. Take, for instance, China, Canada, or even Brazil. More traditional bank structures and tougher regulatory constraints (see e.g. Brazil's insistence on large reserve requirements for banks) in each of these countries have ironically left the major banks there much less exposed to the speculative excess that has felled their American or European counterparts. In the United States or Europe, however, we have unfortunately ended up with severely damaged banking systems that will limit the ability of these regions to recover. Massive rescue operations by the Fed, the Bank of England, the European Central Bank, the Swiss National Bank, or the Russian central bank have prevented the collapse of too-big-to-fail banks, especially after the Lehman bankruptcy taught everybody about the risks of letting a systematically important financial institution fail. But in each of these areas we have yet to figure out how to turn these saved zombie banks back into full-bodied and strong lenders. Of course, we know that those banks will need to have substantially larger capital cushions in the future, and such recapitalization initiatives may come about with funding support from the stock market, other financial institutions (e.g. private equity funds), or the government. The Obama Administration's idea of stress tests for nineteen systemically important US financial institutions to determine their future capital needs is an important first step in that direction. Equally urgent is dealing with all the toxic assets still on the books of the world's leading banks that are weighing them down by causing additional losses, eating up already scarce capital, and undermining public confidence. The US Treasury, first under Paulson in 2008 and then Geithner in 2009, has tried to figure out without success how to set up a new infrastructure of publicly funded buyers who would purchase toxic assets of US banks at a discount. Other countries, notably Britain and Germany, have started down a similar path, aiming to split their most vulnerable and loss-ridden banking institutions into "good" and "bad" banks and then liquidate the latter gradually. We know from the experience of Sweden and Japan in the 1990s that systemic banking crises can only be resolved if and when banks have a way to get rid of their impaired assets without suffering exceedingly large write-down losses in the process. We should not waste too much time before effectively tackling the issue of toxic assets on the books of banks, because the depth of the ongoing global downturn threatens to leave already weakened banks with more and more impaired assets.

As we try to nurse sick banks back to good health, we also need to recognize that the current crisis was primarily the result of regulatory failure and therefore can only be resolved with a proper effort at re-regulation. While there are discussions and preparatory efforts in that direction under way in all the major developed economies, we need a globally coordinated approach to the issue, since banks are today truly transnational in nature and as such operate beyond national boundaries. It is thus imperative to come up with a consensus as to what is needed for an effective global regulatory regime, an effort perhaps best carried out in the scope of the G-20, the Financial Stability Forum, and/or the Bank for International Settlements. Over the last six months, we have begun to identify areas of agreement as to necessary steps – larger and more resilient capitalization levels for banks that are applied countercyclically (e.g. see Spain's system of "dynamic provisioning"); tighter supervision of systemically important financial institutions with stronger coordination among national supervisors; tougher disclosure-of-information rules; caps on executive compensation and better incentive systems for banking executives; and more stable structures for financial markets. These areas of agreement are all highlighted in three crucial reports published this month (March 2009) on the banking crisis and on what should be done about it in terms of regulatory and supervisory initiatives – the De Larosière Report for the European Commission, the Turner Report furnished by the head of Britain's Financial Services Authority, and the Geithner Report from the US Treasury. All of these are available on the internet, and worth reading.

Finally, both the Obama Administration and European leaders have committed to a new level of regulatory intervention, that of macro-prudential supervision. This involves setting up a systemic risk regulator that tries to identify the emergence of unsustainable bubbles, excessive leverage, and/or any other development in the credit system with a large potential for eventual disruption. This plan raises several important questions. The first is who should be responsible for systemic risk regulation, and here the Americans believe firmly that it should be the job of central banks like the Federal Reserve. Furthermore, what should the powers of such a macro-prudential regulators be to stop any identified excess from exploding the whole system? Such tools, such as leverage ratios, asset-based reserve requirements and mandatory equity stakes in high-risk funding schemes, may be useful here. There is, thirdly, the key question as to whether the monetary authorities will be capable of identifying systemic risk in the making. This requires observers who have a different mindset than the one presented by the mainstream vision of automatically self-balancing markets and rational investors. Instead, systemic risk regulators will need to be well versed in theories of financial crisis dynamic, notably Hyman Minsky (1964, 1982, 1986) on financial instability.

4.2 Medium-term reforms

The dual task of repairing and re-regulating the financial services sector will be undertaken over the next year or two in most of the world's major economies. As these reforms are being implemented, attention will shift to the second dimension of the current crisis – global imbalances and the prevailing international monetary system that produced them. The long boom preceding this crisis had been driven by the ability of the United States to run up large and continuously growing trade deficits that were financed automatically by surplus countries keeping their reserves denominated in US dollars. In that sense, the United States served a useful "locomotive" function in the world economy, enabling many other countries – industrial nations (Europe, Japan), emerging market economies (China, Brasil, etc), and commodity producers (e.g. OPEC, Russia) – to push export-led growth. This interdependence between the United States as the "buyer of last resort" for the rest of the world and export-driven surplus countries became especially pronounced after 2003 when a US housing bubble gave American families owning a home (and that includes nearly 70% of all households) the means to borrow growing sums against the rising values of their homes. At its peak in 2006, US consumer debt and the costs of servicing that debt reached record levels (of 137% of GDP and 18% of disposable income respectively), while the US collectively spent 107 dollars for every 100 dollars it produced. These are unsustainable magnitudes, and the current crisis is not least the result of a breakdown of this growth configuration.

As the crisis unfolds, we will come to realize that we will not be able to return to the status quo ante. In other words, the US consumer will no longer be able to buy up the surplus goods of export-dependent producers across the globe. What we have today is a major financial crisis that turned into a global overproduction crisis. This change in the nature of the crisis will not only manifest as major bankruptcies of industrial firms (e.g. American car manufacturers, such as General Motors and Chrysler) and retailers (Circuit City in the US). No, the overproduction crisis will also express itself in terms of added financial instability. For one, the pain of "bad debt" spreading on the balance sheets of banks all over the world will make them even weaker than they are already. Perhaps even more dramatic, however, will be a crisis brewing over government debt. This may hit a number of countries which have seen dramatic increases in budget deficits and lack the means to bring them under control in the time required for such adjustments, as for instance Britain or the Eastern European countries (from Hungary to Latvia). The most important target of a crisis of confidence in government debt may, however, be the United States whose budget deficit has risen from about 3% of GDP before the crisis to 12% per annum over the next few years. Obama understands the dangers of having such huge deficits for too long, but the members of the US Congress, and the political climate of the country at large, do not want to take spending-restraint and/or revenue-raising measures to decrease those deficits over time.

The key here is to understand that, once investors start worrying about US budget deficits, they will trigger a crisis of confidence in the US dollar and its world money status, thus starting to question the current international monetary system that has given the US dollar a dominant role it no longer can or must play. That chapter of the crisis dynamic may not be too far off, and it is in that significant context that there is a growing chorus among Chinese policy makers expressing worries about China's excessive accumulation of dollar-denominated reserves. Even though the dollar has strengthened over the last year as panicky investors looked at the world's vehicle currency as a safe haven, this strength is only temporary. We may soon have a reversal towards a much weaker dollar and rising interest rates on US Treasuries, endangering any recovery and setting the stage for a deeper crisis of the international monetary system.

We may then move from the asymmetry between America's external deficits and the rest of the world's surpluses to a more complicated system of three self-contained currency blocs, with free trade and capital flows within each but protectionist, adversarial relations between them. One such bloc is led by the United States and based on the continued dominance of the dollar as reserve and transaction unit of account among bloc members. It is not clear how many or which countries such a bloc will comprise in the end. A second bloc will emerge around the euro and comprise non-EU Europe as well as the non-European part of the Mediterranean and some of Europe's former colonies. Finally, China will take increasingly aggressive steps to deregulate the yuan and so make it circulate internationally, if for no other reason than to escape its current predicament of a dollar trap. Thus a Chinese zone of influence will emerge, not just in Eastern Asia, but also in some areas of Africa and Latin America where China has made large resource and cooperation commitments in recent years.

This triadic configuration of the world economy will be difficult to manage as the three currency blocs compete for influence and markets. Commodity producers (OPEC) and large emerging market economies (Brazil, India, etc.) will try to diversify their reserves among all three key currencies and so come to hold the key to the stability potential of such a fragmented system. Still, the inherent contradiction between monetary fragmentation and financial concentration (with the crisis having left global finance controlled by even fewer gigantic transnational banks) will require careful management and the introduction of new policy mechanisms for that purpose. We are in this context bound to return to the idea of John Williamson (1983) for a system of target zones among the world's leading key currencies to keep the world economy from excessively large currency price shocks triggered by the tensions of choice among three nearly equal rivals. Such exchange rate stabilization, first tried in the failed experiment among the G-7 countries in the Louvre Agreement of 1987, requires a strong measure of international policy coordination, in particular the ability of the leading powers at the center of each key currency bloc (US, Germany, China) to contain any balance-of-payments disequilibria among them and counterbalance through policy cooperation any developing asymmetries that threaten to be disruptive if left unchecked.

4.3 Long-term reforms

At the same time there is the distinct possibility that we will over the medium term take important steps towards an entirely different international monetary system, one no longer based on national currencies as international exchange medium . It is time to return to an idea developed by John Maynard Keynes near the end of his life in preparation for the Bretton Woods Conference, that of a new economic world order rooted in a new supra-national form of world money (which he termed "Bancor") issued and managed by an international clearing union (see Keynes, 1941; also Guttmann, 1994 for an updated version). We already have an embryonic form of such supra-national money, namely the Special Drawing Rights (SDRs) issued by the International Monetary Fund. As it stands, the SDR is a basket of four key currencies with a dominant share for the dollar, followed by the euro, and small shares for the pound and yen. At some point soon the SDRs will come to include the yuan, and Chinese officials have in recent weeks already begun to discuss proposing such an adjustment.

But there are bigger changes under way with regard to the SDRs, notably a new large issue that would boost the crisis-fighting resources of the IMF at a time when a growing number of its members will need assistance to survive the global downturn intact. This, it seems, is going to be on the agenda of the next G-20 meeting in London. There has not been a new issue of SDRs for decades, as the United States have consistently vetoed such a step which could undermine the special world money status of the US dollar. So a new issue of SDRs, especially in the $250bn range as is being discussed in the run-up to the London Summit of the G-20 leaders, would be a very significant step. Still, even such an agreement may be difficult to carry out in practice since any new issue depends on parliamentary approval of the countries whose currencies comprise the SDR basket. In other words, US Congress would have to approve a large budget allocation of US dollars to the IMF for any such new issue of SDRs. There is likely to be a lot of political opposition among both right-wing and left-leaning members of Congress, as worries about US spending combine with resistance to bail out bankers and help foreigners. It is precisely at that point that we might see a new discussion, namely how to depoliticize the issue of SDRs and give a beefed-up IMF more control in the process. For the SDRs to become a useful counterpart to the dollar and other key currencies, and eventually the new centerpiece of a broader institutional reform, it will have to be issued more easily and freely. The IMF, for instance, could issue bonds in the world's capital markets that would be used to back SDRs and may eventually even be denominated in SDRs. We may then also see rapidly growing use and circulation of SDRs among private parties so that this new form of world money can grow to take over the international monetary system. At that point the IMF, in cooperation with the national central banks, could set up Substitution Accounts to absorb excess dollars, euros, and yuan sold by anyone willing to hold SDRs instead.

We can therefore envisage a long transition period where the SDRs may compete with the key currencies. If that is the case, it may behoove us to find a mechanism for electronically earmarking SDRs within an officially controlled payment system. In this way we could get newly issued SDRs directed to finance socially useful and growth-promoting activities. It would then be conceivable to set up a key part of the world economy in an entirely different way than we are used to today. Using specifically earmarked SDRs, we could fund provision of global public goods affordably, from alternative energy sources, environmental preservation, organic food production and distribution, education, research, community health care, to economic and political security, as the new growth pillars of the world economy (especially if and when the currently organized world economy cannot replace the US consumer as the center of its growth dynamic). Perhaps even more interesting would be the idea of using earmarked SDRs to build an alternative <u>progressive</u> financial system which would integrate mutual savings banks, funding cooperatives, micro-finance schemes, partnership-based investment banks, non-profit credit unions, and socially responsible mutual or pension funds into the SDR-based payments system. Such a system would naturally be inclined to fund public good growth pillars. We could reinforce such a reconstituted socially oriented set of institutions with new global taxes in support of our public good objectives, such as the Tobin Tax on financial crossborder transactions or a carbon tax to move away from fossil fuels. Be that as it may, the idea would be to have this new progressive, SDR-based system compete side by side with the post-crisis system of profit-seeking financial institutions and their use of key currencies in international transactions. If, as I suspect, the SDR system manages to outperform the narrow profit-seeking system and attract ever-larger resource allocation through a system of substitution accounts, then we will have used this crisis to put in place a gradual and logically compelling transition towards a much better and more humane socioeconomic system that befits the challenges we face together as a planet in the 21st century.

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BRAZIL 2022: A LAND OF GOOD HOPE?

Ignacy Sachs

"Brazil is well placed to become a paragon of the Lands of Good Hope", a perspective of positive participation and leadership in a moment when the world experiences a deep crisis. Whether a statement or a question, this strong idea will be tested in the next decade. Ignacy Sachs analyzes the ecological, structural and institutional conditions that are necessary to enable the country to play a leading role in fostering South-South cooperation while enhancing biocapacity, the latter a central concept to the author. Today, we are in presence of four inter-related crises. The complexity and the opportunities of our times are analyzed within an ecosocial development framework.

BRASIL 2022: TERRA DA BOA ESPERANÇA?

"O Brasil está bem posicionado para se tornar um modelo de Terra da Boa Esperança," uma perspectiva de participação positiva e de liderança em um momento em que o mundo experimenta uma profunda crise. Se isto corresponde a uma afirmação ou a uma questão, esta ideia, bastante forte, será testada na próxima década. Ignacy Sachs analisa as condições ecológicas, estruturais e institucionais necessárias para permitir ao país desempenhar um papel de liderança na cooperação Sul – Sul, ao mesmo tempo ampliando a biocapacidade, esta, um conceito central para o autor. Estamos, hoje, na presença de quatro crises inter-relacionadas. A complexidade e as oportunidades de nossos tempos são analisadas em uma visão ecodesenvolvimentista.

1 INTRODUCTION

Markets are short-sighted and lack social and environmental sensibility. The last thirty years of neoliberal counter-reform, based on the myth of self-regulating markets, have severely undermined, if not destroyed, the nations' ability to undertake long-term planning and thinking about what in Brazil is subsumed in the term "national project".[1] The present crisis is an opportunity to reverse this trend and bring forward the concept of socially inclusionary and environmentally sustainable development and its core engine: employment-led economic growth, promoted by a developmental State.

In his pioneering writings on the methodology of long-term planning, Michal Kalecki chose a fifteen-year time span as a suitable horizon.[2] He would often joke with us that everything going beyond fifteen years rather belonged to the realm of astrology.

To set a debate on the long-term prospect for the Brazilian economy, society and politics, we might choose 2022 as the end year. This is a highly symbolic choice, as Brazil will then celebrate the bicentennial of its independence. Moreover, 2022

1. This term has been frequently employed among others by Celso Furtado.

2. See the section on long-term planning in *Collected Works of Michal Kalecki*, volume III, pp.181-254, edited by Jerzy Osiatynski, (Oxford: Clarendon Press, 1992).

will mark the fiftieth anniversary of the UN Conference on Human Environment, held in Stockholm, which was instrumental in bringing to the fore the concept of ecodevelopment, afterwards renamed sustainable development.

Development goals ought to be socially oriented and predicated on the double ethical principle of synchronic solidarity with the present generation and diachronic solidarity with the future generations. To achieve these goals, it is necessary to engage in a sustained economic growth process, at least so long as the basic needs of those living at the bottom of the social pyramid are not adequately fulfilled. The right to decent work for all is its cornerstone, side by side with a social safety net for those who live below the poverty line, the disabled and the elderly. At the same time, the growing pressure of the human population on the biosphere imposes a code of responsible conduct towards nature.

A key question to answer in this context is **which State for which development?** As a matter of fact, we are compelled to answer the same question for the third time in eighty years, the first two rounds having been the aftermath of the 1929 crisis and that of the Second World War.

The 1929 crisis led to a competition between three major institutional responses: Nazism, real Socialism and Roosevelt's New Deal. In the short run, Nazism proved quite efficient at putting Germans back to work by resorting to a Keynesian policy *avant la lettre*: an armament race, which unfolded into the Second World War and its tragic consequences.[3]

The same question – which State for which development? – became central to post war politics. The thirty years that followed the end of the war were marked by a fair measure of consensus about three ideas:

- in order to exorcise the memory of the great crisis and mass unemployment, it was necessary to put at the centre of economic thinking a proactive State capable of providing full employment at the centre of economic thinking;
- economic State interventionism was to be supplemented by social policies aimed at establishing a Welfare State;
- finally, planning was necessary to avoid the waste of resources. When Von Hayek published in 1944 in London his libel against planning[4], he was the dissident. Everybody around him was planning.

3. This is not to say that the armament race is the only possible Keynesian policy. In the late forties of the past century, a controversy opposed partisans of a left wing Keynesianism advocating public investment in socially oriented projects, such as housing, to a right wing, favourable to an armament race as part of the competition between the two rival political systems.
4. F. Von Hayek, *The road to serfdom*, (London: Routledge, 1944).

These three *idées-force* were shared on both sides of what became known as the iron curtain. However, the two competing systems – reforming capitalism and real socialism – differed sharply in the ways to implement them. On several occasions (the Berlin blockade, the Cuban crisis), the world came to the brink of a third world conflict. Stimulated by the competition with the Socialist bloc, Western capitalism went through three decades of a golden age[5], which coincided, however, with the Chinese revolution, the decolonisation process and the emergence of the Third World.

As for the Socialist bloc, its rising power was soon jeopardized by the Soviet-Chinese rift and the 1968 entry of Soviet tanks in Prague to repress the local brand of "socialism with a human face". In spite of Gorbatchev's later efforts, the countries of the Soviet bloc failed in their attempt to democratise and the Soviet Union imploded in 1991, as a consequence of the fall of the Berlin Wall in 1989.

These events paved the way for a thirty-year span of neoliberal counter-reforms, associated with the names of Margaret Thatcher in the UK and Ronald Reagan in the US. It is to be hoped that the present crisis will put an end point to this period of retrocession in terms of the pursuit of inclusionary and sustainable development, even though the neoliberals have not disarmed as yet.

At first sight, everybody has become Keynesian at this juncture, recognising that the State has a major role to play in anti-crisis policies. Yet, behind this apparent unanimity, one finds diametrically opposed stances between those who would like to seize the crisis as an opportunity to steer a new course (among which I include myself), and those who would be happy with the socialisation of the losses suffered by private banks and enterprises, so as to enable them to return as soon as possible to business as usual.

2 ONE CRISIS OR FOUR?

In reality, we are in the presence of four inter-related crises.

The financial crisis started in Wall Street by fair people with blue eyes, as pointed out by President Lula, and unfolded into a major socio-economic crisis of worldwide proportions. The parallel with the 1929 crisis is often made; however, there are at least two differences. On one hand, the globalisation processes are far more advanced today. This explains the intensity of the crisis. Not only do wages in developed countries lag behind the increases in productivity, but American and European workers are also replaced by Chinese and Vietnamese low-paid ones.[6] On the other hand, one may expect policy

5. This expression was coined by Steve Marglin, from Harvard University. The well-known French economist Jean Fourastié used the term: *les trente glorieuses*.

6. See on this point A. Lipietz, *Face à la crise, l'urgence écologiste*, (Paris: Les Éditions Textuel, 2009), p.19.

makers to have learnt some lessons from studying the past. In a sense, history never repeats itself. The response hitherto has been much stronger than in 1929, which is not to say that the end of the crisis is within rapid reach.[7]

A corollary to the socio-economic crisis is the impending need to reassess and reorganise the present pattern of highly asymmetric globalisation; the awkward relationship between the United States and China (a future G2?) looms high in it, the UN system is loosing its power in comparison with the G20 and the WTO, and developing countries are at pains to find a framework for an expanded South-South cooperation.

The third crisis is of an entirely different nature and must be analysed in a different time perspective. The threat of highly detrimental and partly irreversible climate change brings us back to the very long time span of the coexistence between our species and the biosphere, our habitat. We are at the beginning of the third great transition.[8]

The first started twelve thousand years ago, with the domestication of plant and animal species, the sedentarisation of human populations, paving the way to urbanisation, writing and the emergence of the State. This was indeed a major mutation in which humankind began to artificialise its environment.

The second can be dated back to the end of the seventeenth century. It consisted in the ever expanding use of fossil fuels – first coal, then oil and gas – and led to the successive technical and industrial revolutions, an unprecedented growth of human population – we shall be nine billion in 2050 –, the rise and fall of colonial empires and two terrible world wars.

We are now on the threshold of the third great transition: a gradual exit from the oil age and, if we are smart enough, from the fossil energy altogether. This transition will certainly take decades but once it is off, future historians will see the fossil fuel age as a brief, yet eventful, interlude in the long history of our co-evolution with the biosphere.

The fourth crisis is of an intellectual nature and relates to development thinking.

We are sitting on several failed paradigms: real socialism, the neoliberal model, based on the myth of self-regulating markets and even the social democracy

7. See i.a. Martin Wolf, "Crise de 1929, le retour ?", *Le Monde*, 23rd June 2009.

8. For the description of the first two transitions, see Clive Ponting, *A Green History of the World* (London: Penguin Books, 1993) and also Jean Guilaine, *Les racines de la Méditerranée et de l'Europe*, (Paris: Collège de France – Fayard, 2008). The eminent French historian who authored the second book drew the following rather pessimistic conclusion in his last lecture before retiring: *'Only ten thousand years after this extraordinary adventure, the inventory is not impressive as a great portion of our contemporaries do not have enough to eat. The hope raised by the Neolithic Age has partly turned into a nightmare. Who is the culprit? Certainly man himself, who became possessive and destructive, putting all his energy in imposing his domination on his peers and evermore deteriorating his environment. Man tirelessly denatures himself. It looks more like the path to alienation rather than to freedom.'*, p.89-90

in so far as, under the assault of the neoliberal counter-reform, it retreated behind the oxymoron 'yes to market economy, no to market society'.

We must also discard two fallacies.

Compulsive urbanisation is not the only path leading to development; the slum planet is probably the worst of all possible worlds.[9] Contrary to an entrenched prejudice, we cannot afford, in this beginning of the twenty-first century, to avoid a difficult debate about a new cycle of rural development. Peasant farmers still account for almost half of the human population. Among them, only a small minority benefited from the green revolution. The productivity gap between farmers in developed countries and the pre-green revolution farmers in the South was, according to Samir Amin[10], of ten to one before 1940, but nowadays it reaches hundred to one.

What is at stake is the fate of three billion people, among them a fair proportion of the poorest among the poor. Samir Amin is right to say that, within the next half century, even the most rapid industrial development will not be able to absorb even a third of that manpower reserve. *"It is necessary to accept the permanence of a peasant agriculture throughout the visible future of the twenty-first century. Not on account of a romantic nostalgia of the past, but quite simply because the solution of this problem calls for the overcoming of the capitalist logic, inscribed in the long secular transition to world socialism. One must therefore figure out policies regulating the relationship between the 'market' and peasant agriculture"*[11], respectful of the food sovereignty of nations.

The more so that, in employment terms, we are going through a period of 'deindustrialisation'.[12] The industrial output advances mainly through increases in labour productivity, bringing about a jobless growth. That is why it is necessary to identify and make the best possible use of all the opportunities for employment-led growth.[13]

On the other hand, experience shows that disembodied technical progress is not the only engine of growth. Natural resources still matter mostly when coupled

9. Mike Davis's book on this subject *Planet of Slums* (2004), was translated in French as *Le Pire des mondes possibles : de l'explosion urbaine au bidonville global*, (La Découverte, Paris 2006).

10. Samir Amin, *Sur la crise – sortir de la crise du capitalisme ou sortir du capitalisme en crise*, (Pantin: Le Temps des cerises 2009), pp.139-140. See also his earlier book, *Pour un monde multipolaire*, (Paris: Syllepse, 2005).

11. *Op cit.*, p.142.

12. Gabriel Palma, *Four sources of 'de-industrialisation' and a new concept of the 'Dutch Disease'*, (University of Cambridge, November, 2004).

13. See on this point, Ignacy Sachs, "L'Economie politique du développement des économies mixtes selon Kalecki: croissance tirée par l'emploi", in *Mondes en Développement*, Paris, vol. 27, n°106, 1999, p. 23-34 (in portuguese: "A economia do desenvolvimento segundo Kalecki: crescimento puxado pelo emprego", in I. Sachs *Rumo à ecossocioeconomia – Teoria e pràtica do desenvolvimento*, Paulo Freire Vieira, (org.), São Paulo: Cortez Editora, 2007; pp. 357-377); and also *Desenvolvimento includente, sustentável, sustentado*, prefácio de Celso Furtado, (Rio de Janeiro: Garamond, 2004).

with research aimed at increasing their productivity, widening the spectrum of derived products and improving the social organisation of production and distribution processes.

3 RESHAPING THE DEVELOPMENTAL STATE

This brings us to the roles of a proactive developmental State acting in a public – private **mixed economy**, a concept central to Kalecki's and Tsuru's thinking about developing countries[14] and predicated on the search for a socially inclusionary and environmentally sustainable economic growth path. The social and environmental challenges ought to be tackled simultaneously, so as to create a fair measure of opportunities of decent work[15] while mitigating climate change by reducing the emission of greenhouse gases.

It is up to the State to organise the planning process, which may be described by the following adjectives: strategic, flexible, continuous and negotiated with all the actors of the developmental process – the State, entrepreneurs, workers and the third sector (organised civil society).

Public banks are an important lever in the hands of the State, not only as a source of financial resources, but also as an actor capable of imposing substantive conditionalities to borrowers. So are public enterprises acting in strategic sectors of the economy.

In order to bring into the plan the myriad of small scale farmers and producers, their organisation in cooperatives and other forms of collective entrepreneurship ought to be encouraged. In parallel, steps must be taken to create synergies between large enterprises and the universe of small producers. In Albert Hirschman's terms, we must carefully explore to this effect the backward and forward linkages of large enterprises.[16]

Furthermore, the developmental State cannot omit itself, as already said, from developing a social safety net for the disabled, the elderly and all those living below the poverty line, completing the ongoing processes of land reforms, introducing changes in the fiscal system in order to make it more equitable and expanding research in the public sector, so as to be sure that long-term priorities of national development are properly addressed. Private research has a propensity to 'short-termism' and seeks profitability at the expense of a long term vision of social interest.

14. See M. Kalecki, *Collected Works of Michal Kalecki*, volume V, edited by Jerzy Osiatynski, (Oxford: Clarendon Press, 1993). See in particular "Problems of financing economic development in a mixed economy", pp.45-60. See also S. Tsuru, *Towards a New Political Economy, Collected Works of Shigeto Tsuru*, volume 13, Kodansha, Ltd., Tokyo, 1976, "Merits and Demerits of the Mixed Economy in Economic Development: Lessons from India's Experiences", pp.17-34.

15. At first sight, the concept of decent work, put forward by the ILO, may seem fuzzy. It has however the merit of insisting on three simultaneous criteria: fair pay (taking into consideration the level of economic development of each country), fair work conditions and social relations.

16. See A. Hirschman, S*trategies of Economic Development*, (New Haven: Yale University Press, 1958).

While discussing the functions of the developmental States, one may recall the premises on which the 1975 Dag Hammarskjöld Report *What Now* was predicated[17]: *'Development is a whole. Its ecological, cultural, social, economic, institutional and political dimensions can only be understood in their systematic interrelationships, and action in its service must be integrated.'* (p.28).

Development must be geared to the satisfaction of needs and seek the eradication of poverty as its paramount goal. How to reconcile the need-oriented approach with the logic of the market is a major concern, partly overcome by expanding the universal network of social services – social safety nets, education, health, sanitation, maybe housing – provided by the State outside the market. An intriguing mix of the two approaches was suggested by the Indian expert in water management, Shekhar Singh: the water required to satisfy the consumption needs of riparian populations of the Ganga River and for the maintenance of the river's ecosystem should be kept outside the market. Water for irrigation should be allocated through the market.

Another consideration in this respect is the scope to be given to the production outside the market of goods for self-consumption, a common feature in peasant communities and pre-capitalist societies. Will it expand in post-capitalist economies in which the length of heteronomous work will be gradually reduced, leaving more time for leisure and autonomous work?[18] *What Now* put at the centre of the debate the concept of endogenous and self-reliant as opposed to mimetic development, while stating explicitly that it should not be confused with autarchic development. It also insisted on defining development strategies in harmony with the environment. This may look like a tall order, yet the present configuration compels us more than ever to abide by it.

Brazil urgently needs to regain its capacity for long term planning, severely undermined as the result of the neoliberal counter-reform. However, compared to other countries, it can rely on a strong public financing system, led by the BNDES, Caixa Econômica Federal, Banco do Nordeste and Banco do Brasil. The State oil monopoly – Petrobras – is another strong asset.

So are the pro-poor social policies, which consist of cash transfer payments to some fifteen million families living below the poverty line, conditioned by

17. This report was prepared on the occasion of the seventh special session of the UN General Assembly, convened to discuss the New International Economic Order, a subject that should be put again on the agenda of the international community. *What Now*, (Uppsala, 1975).

18. On the discussion of this subject, the reader may be referred to the works of Ivan Illich (*Œuvres complètes*, volumes 1 and 2, Paris: Fayard, 2004 & 2005), and André Gorz, *Métamorphoses du travail* (Paris: Galilée, 1988 and Folio Essais, 2004). See also Ignacy Sachs, *Espaços, tempos e estratégias do desenvolvimento*, trad. de L.L. de Vasconcelos e E. Araujo. (São Paulo: Vertice, 1986). On the analysis of the social models of time use, see Ignacy Sachs, "Developing in harmony with nature: consumption patterns, time and space uses, resources profiles and technological choices", in *Canadian Journal of Development Studies*, Ottawa, vol. 1, n°1, 1980.

regular attendance to school and vaccination of their offsprings (Bolsa Família).[19] These are now supplemented by the Territórios da Cidadania programme, aimed at providing opportunities for social inclusion through decent work and thus emancipating the beneficiaries of the Bolsa Família from their excessive dependence on cash transfer payments by the State.[20]

Recent years have also seen some progress with respect to the improvement of backward and forward linkages between large enterprises, which recognise their social responsibility, and small producers. However, a fair measure of synergy between these two groups of development actors is yet to be achieved.

Among the policy instruments that require streamlining and more systematic use, are the economic-ecological zoning and the certification schemes, which are at present voluntary but could become compulsory.

On the negative side, one should mention a fiscal system, whose regressiveness has recently been pointed out by a report commissioned by the Council for Economic and Social Development (CDES).[21] A badly missing tribute is a carbon tax which could be offset by a simultaneous reduction of employers' social security contributions, so as to discourage fossil energy consumption while stimulating employment.[22] The proceeds of the carbon tax together with royalties from the exploitation of oil could feed sovereign funds, such as the recently established Amazon Fund, aimed at financing the transition to a low carbon economy.

Another missing attribute is a highly progressive land tax, penalising large unproductive estates and instrumental in fostering the unfinished agenda of land reforms, which looms high among the urgent tasks to be completed.[23] Family agriculture is at a disadvantage, compared with large scale agribusiness, still quite influential in the Brazilian Congress. The agriculture plan for 2010 foresees 92.5 billion reais for the large scale

19. Bolsa Família may be considered as a variant on the theme of citizen basic income tirelessly advocated in Brazil by Eduardo Matarazzo Suplicy. (See his book *Renda Básica de cidadania: a resposta dada pelo vento*, Porto Alegre: LPM Pocket, 2006). As a matter of fact, it consolidated several social programmes into one, including the Bolsa Escola, a fellowship programme for children attending primary schools, pioneered by the former governor of Brasília, Cristovam Buarque.

20. A parallel can be drawn between this programme and the Indian Employment Guarantee Scheme.

21. See CDES, *Indicadores de equidade do sistema tributário nacional - Relatório de observação n°1*, Brasília, June 2009.

22. The carbon tax was successfully introduced by Scandinavian countries and is to be preferred to the trade of carbon credits. About the latter, George Monbiot (*Heat - How to Stop the Planet Burning*, London: Penguin Books, 2007) has this to say*: "Just as in the fifteenth and sixteenth centuries, you could sleep with your sister, kill and lie without fear of eternal damnation, today you can leave your windows open while the heating is on, drive and fly without endangering the climate, as long as you give your ducats to one of the companies selling indulgences."*, (p. 210).

23. An effective enforcement of such a land tax, with imposition rates increasing with the size of the estate and progressing in time would put the land owners before the following alternative: either to invest in making their land highly productive (and thus create employment) or sell it to a public bank that will redistribute it through the land reform process.

agriculture and only 15 billion reais for family agriculture; however, the latter figure represents an increase of 525% as compared with the funds allocated to family farmers in 2002/2003.

Finally, to complete this brief review of the present setup, the situation in the field of public research shows many positive aspects but a lot of progress still to be made.

4 WHERE DO WE MOVE TO?

As already said, the crisis should be used as a turning point to move towards structural reforms.

Immediate transition to socialism – the revolutionary path – is not on the agenda. We may recall that the Eastern European countries defined themselves as people's democracies, thereby implying that the transition between capitalism and socialism needed some time. Anyhow, the memory of the implosion of the Soviet Union is still too fresh, which is not to say that the demise of real socialism should be read as an unconditional approval of capitalism, the end of history as proclaimed by Fukuyama,[24] who has since retracted himself from this extreme view. According to Joseph Stiglitz, the present crisis unleashed in developing countries a wave of disillusion with respect to the American brand of capitalism.[25]

Are we therefore speaking of reforms within capitalism? Of post-capitalism? Of green republicanism, which *"not only offers a critique of excessive wealth creation and its misdistribution, but equally importantly sets its face against 'green consumerism' as a solution or viable path of transition from unsustainability."*[26]? How should one classify in this context the 'third way' proposed by Nehru in India under the name of *'socialistic pattern of society'* (as distinct from the socialist one), in which the public sector was supposed to grow at a quicker rate than the private one?

Let us not trap ourselves in the semantic discussion, which has kept many generations of Talmudists busy looking for an answer to the tantalising question: at what point does a black cow with white spots become a white cow with black spots? In compensation, we need to add an 's' to capitalism and socialism and engage in comparative studies of different actual brands of

24. Francis Fukuyama, The End of History and the Last Man. (*Glencoe, Ill.: Free Press 1992*).

25. Joseph Stiglitz, Los mensajes tóxicos de Wall Street', Other News Info, http://other-news.info, 24th June 09. The author, who believes in the Western type of democracy and in the working of regulated markets, fears that this disillusion will prevent the developing countries from learning the correct lesson from the crisis, namely that the way out of it calls for a regime in which the roles of the market and of the State are balanced and the State is strong enough to manage the regulation effectively.

26. See John Barry, "Towards a Green Republicanism: Constitutionalism, Political Economy, and the Green State", *The Good Society*, volume 17, no.2, 2008, p.7. (University of Maryland).

capitalism and socialism[27], not in order to find readymade blueprints to be replicated, but to stimulate social imagination. History remains open and it is up to coming generations to innovate. In view of the demise of real socialism and of the neoliberal counter-reform, I would be inclined to think that they are more than ever condemned to invent and experiment new solutions.

At least three lines of action seem open to Brazil in its endeavour to transform the present crisis in an opportunity to enter the path of structural changes:

- expanding the universal network of social services, which do not require the mediation of the market as part of a new cycle of territorial development;
- enlarging the perimeter of the social economy[28] within the market economy, and
- engaging into a green socioeconomic agenda, which is not tantamount to giving priority to environmental concerns at the expenses of the social ones. Both ought to be tackled simultaneously, and I agree with Tom Zeller Jr. when he writes that *"the idea is a sort of kill-two-birds-with-one-stone approach to global warming and global poverty"*[29], but I do not necessarily share the qualification which follows in brackets: *"while making money at the same time"*.

They will be briefly discussed below.

5 BRIDGING THE CIVILISATIONAL GAP BETWEEN CITIES AND THE COUNTRYSIDE

Arthur Lewis's seminal article on *Economic Development with Unlimited Supplies of Labour*[30], published in 1954, argued that developing countries have a dual economy: a traditional (rural) sector with low productivity surplus labour and a modern capitalist (urban) sector. Development will consist of gradual emptying of the traditional sector by providing to the rural migrants more productive and better paid urban jobs. His Nobel Prize notwithstanding, history took a less optimistic course. We have already seen that outright urbanisation and

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27. As far as capitalisms are concerned, see the pioneering study of *Michel Albert Capitalisme contre capitalisme, (Paris: Éditions du Seuil, 1991), the body of literature produced by the so-called French School of regulation, (in particular,* Robert Boyer, *La théorie de la régulation. Les fondamentaux*, (Paris: La Découverte, Coll. Repères, 2004) and, as an attempt to understand the Chinese puzzle, Yashong Huang *Capitalism with Chinese Characteristics – Entrepreneurship and the State* (Cambridge: Cambridge University Press, 2008). According to this author, *"capitalism with Chinese characteristics is a function of political balance between two Chinas – the entrepreneurial, market-driven rural China, vis-à-vis the state-led, urban China […] When and ever rural China has the upper hand, Chinese capitalism is entrepreneurial, politically independent, and vibrantly competitive in its conduct and virtuous in its effects. When and where urban China has the upper hand, Chinese capitalism tends toward political dependency on the state, and is corrupt."* (p.xvi - xvii). The comparative study and post mortem *sine ira et studio* of the different brands of real socialisms is still to be produced.

28. The term social economy used by European scholars corresponds to the concept of 'economia solidária', as used by their Brazilian counterparts.

29. T. Zeller Jr. "Developing a greener Third World", *International Herald Tribune*, June, 8th 2009.

30. *Economic Development with Unlimited Supplies of Labour*, Manchester School of Economic and Social Studies, vol. 22, *1954*.

full employment pushed by industrial expansion are not likely to happen on a worldwide scale in this century.

Instead of stimulating rural – urban migrations, we should therefore emphasise programmes aimed at bridging the civilisational gap between large cities and the countryside by extending to the rural people some of the amenities and opportunities of urban life, while exploring the scope for decentralised industrialisation, enabled by modern communication and production techniques.[31] Deconcentration of industries is welcome, insofar as it helps to offset the counter-productivity phenomena associated with excessive growth of metropolitan cities and creates jobs in the secondary and tertiary sectors in the rural areas.

Hence the importance of extending, throughout the national territory, the networks of social services provided by the State outside the market economy, in fulfilment of citizen rights. Let it be said that development can be seen as the effective universalisation of the three generations of human rights: political, civil and civic; economic social and cultural, starting with the right to decent work; finally collective rights such as childhood rights, environment and city rights.[32]

Two observations are in order here. If properly designed, social services are fairly labour intensive, which is welcome, the more so that they generate a demand for qualified labour, contributing in this way to diversify the social fabric of local communities.

On the other hand, the cost of extending the social services networks to rural areas is inferior to that of providing adequate infrastructure and housing to rural migrants accruing to cities; likewise, the outlays required to fund new jobs are lower in the rural setting as compared to the urban one.

Social services provided by the State act outside the market economy. So long as their expansion occurs at a rate higher than the growth rate of the market economy, the proportions between the market and the non-market in the global economy will change in favour of the latter.

6 EXPANDING THE SOCIAL ECONOMY

Let us turn now to a different kind of structural change, this time inside the market economy. The aim is to enlarge the scope of *'social economy'* in European terms[33] – cooperatives, mutualities, non-profit associations and all other forms of

31. See on this point the pioneering book by Michael Piore and Charles Sabel, *The Second Industrial Divide: Possibilities for Prosperity*, (New York: Basic Books, 1986) and the large body of literature on the example of decentralised industrialisation in North Eastern Italy, the Terza Italia in Arnaldo Bagnasco's terms.

32. See on this point, Sachs, Ignacy, "O desenvolvimento enquanto apropriação dos direitos humanos", *Revista Estudos Avançados* (USP São Paulo) August 1998, vol.12, no.33.

33. As already mentioned, the Brazilian term is 'economia solidária'.

collective entrepreneurship that do not follow the rule of private appropriation of the profits. They compete with private and public enterprises, but manage themselves, at least in theory, on the principle of one person, one vote, and, as a rule, decide collectively about the destination to be given to profits, if any, with strong preference for their reinvestment, so as to consolidate and expand their activity. The major hurdle to be avoided when these organisations grow in strength is to prevent them from adopting the behaviour of large capitalist enterprises, their competitors on the market.

In the Brazilian economy, there is still a large scope for promoting all kinds of cooperatives, mutual companies, producers' associations and other forms of organised civil society geared to the non-profit principle. Once more, if their overall rate of growth exceeds that of the global economy, a structural change will occur. Some might be tempted to speak of the subversion of the capitalist system. Why not, after all?

7 ROAD BLOCKS FOR A SOCIALLY RESPONSIBLE GREEN NEW DEAL

The Green New Deal is at the top of the political agenda all over the world and ought to be considered as a priority by Brazilian planners. For reasons that have already been explained, we should resist giving priority to environmental concerns at the expense of the social ones. Let us state once more, that what is needed is a socially responsible green agenda, which addresses simultaneously the two major challenges of climate change and social inequalities.

This said, Brazil should be enthused by this prospect on the account of its enormous potential to produce all sorts of biomass within a development strategy respectful of the principles of social inclusiveness and environmental sustainability. Brazil is endowed with favourable climates, abundant water resources (with the exception of the North East *polígono das secas*), the largest tropical forest in the world still 80% intact (which is not tantamount to condoning the ongoing deforestation), and world class biology and agronomy research. It is therefore favourably placed to explore the trinomial **biodiversity – biomass – biotechnologies**, the latter applied at the two ends of production, so as to increase biomass productivity and widen up the spectrum of biomass derived products. Insofar as biomass is food, feed, fuel, fibres, plastics, building materials, bioproducts turned out by biorefineries, pharmaceuticals and cosmetics, we may speak of a **biocivilisation** in the making.[34]

A properly designed green agenda could contribute to the mitigation of climate change, while shaping a new rural development pattern, predicated on an 'evergreen revolution'[35] and geared to the consolidation and expansion of family agriculture.

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34. See Ignacy Sachs, "Da civilização do petróleo a uma nova civilização verde", *Estudos Avançados*, (Universidade de São Paulo) 19 (55), 2005.

35. The term 'evergreen revolution' was coined by M.S. Swaminathan in *Sustainable agriculture: towards an evergreen revolution* (Delhi: Konark Publishers, 1996). French scholars use the term 'doubly green revolution'. Its two pillars are agroecology and the pre-eminence given to family and peasant farming.

The latter aspect, namely the social organisation of biomass production, is the one that causes at present the greatest concern. While recognising the weight of modern agribusiness in the Brazilian economy, we cannot afford to loose this extraordinary opportunity to consolidate family agriculture, favouring instead large scale highly mechanised and, therefore, jobless agriculture at the top of jobless development of industries. Social sustainability is as important as environmental sustainability.

Realistically speaking, the dual structure of the biomass-based Brazilian economic complex will not disappear in the fifteen-year time span discussed in this paper. Once more, the question is: what will be the relative growth rates of the two subsystems and what should be the policies leading to a shift in relative GNP shares favouring family agriculture.

In the following sections, I discuss selected key issues that the socially responsible green agenda will have to consider.

8 ECOLOGICAL FOOTPRINT AND BIOCAPACITY

These concepts offer a suitable methodological starting point. Biocapacity is defined as the total regenerative capacity of the biosphere available to meet human needs, while the ecological footprint evaluates the amount of biocapacity actually mobilised by human economy throughout the year. The evaluation is made in global hectares per capita (gha) corresponding to the average world productivity.[36]

The footprint of each crew member of spaceship Earth is at present 2.7 global hectares, while the biocapacity at each person's disposal is of only 2.1 global hectares. These world averages are misleading insofar as they mask the fundamental opposition between deficit countries that tend to colonise the biocapacity of others and surplus countries, whose biocapacity is still underused. Should we call the latter Lands of Good Hope, like Pierre Gourou?[37]

The latest data for Brazil, a leading Land of Good Hope, are the following: total ecological footprint: 2.4 gha per capita, total biocapacity: 7.3 gha, ecological reserve: 4.9 gha.[38]

The construction of the green agenda should include on the one hand, attempts at reducing the ecological footprint (and, most of all, the carbon footprint) and on the other hand, steps aimed at making good use of biocapacity as well as at increasing it.

36. See Wackernagel M. & Rees W., *Notre empreinte écologique*, (Montréal: Ecosociété, 1999); Wackernagel et al., *National Footprint and Biocapacity Accounts: the Underlying Calculation Method*. Updated data on footprint and biocapacity are available on *www.footprintnetwork.org*. For a good overview of the subject, see A. Boutaud & N. Gondran, *L'empreinte écologique*, (Paris : La Découverte, 2009).

37. P. Gourou, *Terres de bonne espérance. Le monde tropical*, (Paris: Plon, 1982).

38. Global footprint Network 2008, Ecological Footprint and Biocapacity 2005, data updated on October, 26th, 2008. *Op. cit.* One should observe however that the figure for the carbon footprint, 0.04 gha, seems underestimated.

9 CHANGING THE ENERGY PARADIGM

Central to the reduction of the carbon footprint is the change of the energy paradigm by acting along three lines: seeking greater energy sobriety, improving the energy efficiency and replacing fossil fuels with all available renewable energies – solar, wind, hydro, geothermal, tidal and, last but not least, biofuels.

Of course, in the long run, the most effective will be reduction of the demand profile for the energy, obtained by changes in consumption and lifestyle patterns, models of spatial organisation of national and world economy (greater density of local economies, less mobility) and in the transportation systems (greater reliance on rail and water transport, lesser room for motorcars). But these variables are difficult to play with, important as they may be.

As to substitution fossil fuels by renewable energies, the following observations are in order here.

The mere substitution of oil-based fuels by biomass based ones will not be sufficient in the absence of policies aimed at greater energy sobriety and efficiency in final use. But, at the same time, the competition between fuel and food for scarce land and water resources need not lead to a social catastrophe caused by the crowding out of food production necessary to feed the hungry billion by biofuels for rich people's cars.[39] And this for a variety of reasons:

First of all, the hungry do not go hungry because of lack of food production, but on account of their inability to purchase it, as shown by Amartya K. Sen and more recently by Sylvie Brunel[40]. The latter author writes: *"it is wrong to indict agrofuels and non-food crops as producers of hunger. It would be true if food were in short supply on the Earth, which is not the case. Agrofuels can on the contrary offer to peasants the prospect for lucrative markets, increasing their living standards and allowing them to remain on their land."* (p. 272).

The prospect of feeding the growing world population, which will exceed nine billion by the middle of the century, is not too worrisome. According to Ghislain de Marsily, agricultural production has reached 20% of its theoretical potential. 40% are lost because of diseases, 20% because of climatic accidents and 20% in post harvest losses. Furthermore, one must bear in mind that, in developed countries 30% of food purchases are wasted if we include in this the

39. For a review of this subject, see my contribution to R. Abramovay (ed.), *A energia da controvérsia*, (São Paulo: Editora Senac, 2009). The latest to join the group of outright critics of biofuel production in Brazil is the leader of MST Pedro Stedile, who, in a recent article, denounced the *'diabolic alliance between oil and motorcars enterprises and the transnationals of agribusiness to act in the South hemisphere countries with abundant land, sun and water to propose the production of agrofuels.'* (J. P. Stedile, "MST: 25 anos de teimosia," *Democracia viva*, n°42, May 2009, p.10).

40. A. K. Sen, *Poverty and Famines: An Essay on Entitlements and Deprivation*, (Oxford: Clarendon Press, 1982); S. Brunel, *Nourrir le monde, vaincre la faim*, (Paris: Larousse, 2009).

fresh products thrown out by the distribution circuits after their end-by date.[41] In addition, in many regions of Africa and Latin America, productivity per hectare is still very low, which allows them to achieve significant and rapid progress in agricultural production by incorporating well-known techniques.

These are not reasons to indulge in excessive self-confidence, but neo-malthusian pessimism is to be equally discarded. Bruno Parmentier is right to point out the need for a major research effort, based on agroecology and on an alliance between agronomists, social scientists and economists, aimed at producing more with less resources by inventing not one, but tens of thousands of local agricultures, well adapted to micro-conditions.[42]

Secondly, the competition between food and biofuel production can be greatly decreased by resorting to integrated food-energy production schemes adapted to different biomes instead of insisting on juxtaposing monoproduction chains and by resorting to dedicated crops for fuel production instead of using food crops, so as to avoid the contamination of food prices by the price hike of fuels.

In particular, there is room for better integration of cattle breeding with oil seed production using oil cakes as feed, while increasing the number of heads per hectare of pasture and in this way free some of the pasture land for food production.

Furthermore, the potential competition between food and fuel turns into complementarity in the second generation of biofuels consisting of cellulosic ethanol extracted from all sorts of agricultural and forest waste; this second generation is around the corner.

Finally, in the longer run, the third generation of biofuels will use algae as feedstock, thus shifting production from agricultural land to water ecosystems.

This evolution will have to go hand in hand with the elimination of predatory forms of bioenergy use, consisting of charcoal production based on massive deforestation. To this effect, we ought to resort to the production of green charcoal based on an efficient carbonisation of agricultural and forest waste, grasses and planted trees.[43]

At the same time, we ought to have in mind that direct substitution of fossil fuels by renewable ones can be complemented by their indirect substitution, arising from a wider use of biomass based products, which

41. G. de Marsily, *L'eau, un trésor en partage,* (Paris: Dunod, 2009), p.123.

42. Bruno Parmentier, "Comment nourrir neuf milliards d'habitants ?", in M. Wieviorka (ed.) *Se nourrir, l'alimentation en question, les entretiens d'Auxerre*, (Paris: Édition Sciences Humaines, May 2009). See also by the same author, *Nourrir l'humanité*, (Paris: La Découverte, 2007).

43. Pro-natura International, an NGO also working in Brazil, won an international prize from the ALTRAN Foundation for developing such a process.

require less fossil energy than their equivalents of mineral origin. This leads us to the exploration of the whole biomass-based economic complex consisting, as already said, of food, feed, green fertilisers, bioenergies, building materials, fibres, plastics, the product mix turned out by biorefineries, pharmaceuticals and cosmetics.

10 ENHANCING BIOCAPACITY

The second leg of the green agenda should be geared to learning how to make good use of the existing biocapacity[44] and how to enhance it by increasing the productivity of biomass production in different land, forest and water ecosystems. Three important subjects are to be mentioned in this connection.

Prospective studies show that Brazil has an enormous potential for aquiculture along the 8.5 thousand kilometres of its Atlantic coast, 4 million square kilometres of its Exclusive Economic Zone, in the Amazon and Pantanal regions, as well as in manmade lakes, which total 10 million hectares[45], not only to produce food but also to grow algae likely to become a major feedstock for the third generation of biofuels.

Likewise, Brazil can count on a significant expansion of tree plantations for different purposes: pulp and paper, wood industry, edible and fuel oils, cellulosic ethanol, fruit and other non wood products, etc. In the longer run, it should be possible not only to work with a zero deforestation rate, but to significantly increase land tree cover. At present, the so-called 'planted forests' (in ecological terms, a misnomer for tree plantations) cover 5.5 million hectares. Probably, a zero could be added to this total.

Another opportunity may arise with assisted photosynthesis, recycling carbonic gas in greenhouse production of different kinds of biomass.

11 WHITHER THE AMAZON REGION

The Amazon region and its forest, perhaps the single most important laboratory of modern biocivilisation in the world, represent a great responsibility and an extraordinary opportunity for Brazil.

Deforestation must stop as soon as possible and a major effort in this direction should be co-financed by the international community. The recently created Amazon Fund should be expanded and put to this use.

At the same time, we should discard the transformation of the Amazon pristine forest into a mega natural reserve. The region is today home to twenty-five million

44. See Catherine & Raphäel Larrère, *Du bon usage de la nature – pour une philosophie de l'environnement*, (Paris: Aubier, 1997).

45. Secretaria Especial de Aqüicultura e Pesca, *Mais Pesca e aqüicultura – Plano de desenvolvimento sustentável*, Brasília. See also A. Ostrensky, J. R. Borghetti & D. Soto, *Aqüicultura no Brasil – O desafio é crescer*, (Brasília: SEAP/FAO, 2008).

people – many of them the most endangered species of the region, in the words of the local poet Thiago de Melo. How many more will join them in the next decades? All the efforts should go to evolve an inclusionary and sustainable strategy for the already deforested areas, transformed into 'development reserves', so as to reduce the pressure on the standing forests. The latter should be carefully managed, with the possibility of increasing their yield by densifying the forest with useful species. As already said, the Amazon region is also endowed with an extraordinary potential for aquiculture.

A difficult problem to solve is the transformation of the Manaus industrial centre. It was set as an entry point in Brazil for electro-domestic appliances and other industrial goods assembled from imported parts. However, in the long run, it should be able to process local raw materials and generate a flow of industrial exports.

12 INTEGRATING THE STRUCTURAL CHANGES

The structural changes outlined above do not represent as yet a full fledged plan, a task which goes far beyond the scope of this paper. Let me just mention that, in order to monitor and assess these changes, planners will have to use new performance indicators, such as:

- evolution of ecological footprint and of biocapacity;
- relative growth rates of market and non-market activities related to cultural models of time-use by different social groups (with special reference to women);
- growth rate of social economy as compared with that of global economy;
- growth rate of the biomass-based complex compared with the overall growth rate of the economy;
- relative shares of family agriculture and large scale agribusiness.

13 BRAZIL, A PARAGON OF THE LANDS OF GOOD HOPE

As a country with surplus biocapacity, Brazil is well placed to become a paragon of the Lands of Good Hope, playing a leading role in fostering South-South cooperation (with special reference to exchanges with African countries) and in defending in the international forums the need to define different, yet complementary, strategies for countries with biocapacity surplus and for countries with biocapacity deficit, the burden of the adjustment falling on the latter.

These are complex issues, likely to generate conflicts of interest and difficult negotiations among the two groups of countries. That is why Brazil would be well advised to take the initiative of convening an annual international forum to debate these matters.

A final comment. *I owe to the readers of this paper an explanation as to why, after much hesitation, I decided to put a question mark in its title. Objective conditions are met in Brazil to enter on the path of socially inclusive and environmentally sustainable development, as well as to play a leading political role among the Lands of Good Hope. However, it is the political process that will decide whether Brazil will seize this opportunity and I have no ways of prejudging its outcome. Three general elections will take place in 2010, 2014 and 2018 before we reach the symbolic year 2022, which will be again an electoral year.*

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CRISIS OR OPPORTUNITIES: CHINA'S RESPONSE TO THE GLOBAL FINANCIAL CRISIS

Cai Fang
Du Yang
Wang Meiyan

With the international financial crisis, many issues draw attention about China, such as the impacts of the crisis in the country and the crisis-tackling policies adopted by the government. There is also the question if China will continue its economic miracle in the post-crisis period and from what sources will China depend on to sustain its economic growth. In order to answer these questions, the authors firstly explain the growth patterns in the country since the 1960s and its specificities. Then they show the sources of economic slowdown during the present crisis. Thirdly, the economic recovery policies are presented. The authors also explain the opportunities open by the crisis to improve the social protection network in the country. They conclude showing the persisting challenges.

CRISE OU OPORTUNIDADE: RESPOSTA DA CHINA À CRISE FINANCEIRA GLOBAL

Com a crise financeira internacional, surgem diversas questões sobre a China, tais como os impactos da crise no país e as medidas planejadas e adotadas pelo governo para combater seus efeitos. Questiona-se também se a China continuará seu milagre econômico no período pós-crise e de quais fontes dependerá para manter seu crescimento econômico. Para responder a tais questionamentos, os autores explicam inicialmente o padrão de crescimento do país a partir da década de 1960, apresentando as particularidades deste. Em seguida, mostram as fontes de desaceleração da economia durante a crise. Depois, abordam as medidas adotadas de combate à crise. Os autores também explicam as possibilidades abertas pela crise de melhoria da rede de proteção social e concluem apresentando os desafios que ainda persistem.

1 INSTITUTE OF POPULATION AND LABOR ECONOMICS, CHINESE ACADEMY OF SOCIAL SCIENCES

During the course of the global financial crisis, a few issues concerning China have drawn attention of both Chinese and outsiders. Firstly, how the Chinese economy was hit by the current crisis – namely, to what extent have the economic slowdown and social shock been caused by direct impact of the crisis. Secondly, how can China adequately cope with the crisis and ultimately survive disaster and how has its crisis-tackling policy worked so far. Thirdly, will China maintain its economic miracle in the post-crisis period and, if the answer is yes, what sources will China depend on to sustain its economic growth. This essay tries to answer those major concerns by providing narrative and statistical explanations.

2 THE GROWTH PATTERN IN CHINA

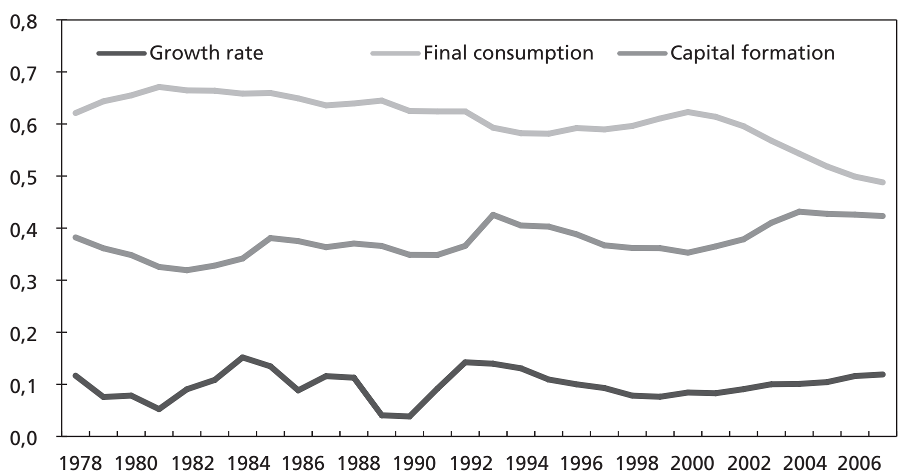
After the East Asian Miracle in the 1960s and its world-wide recognition in the 1990s, economic growth in China is generally accepted as another miracle of economic development. Although the miracle is far from the end, it has impressed the whole world. It is well known that China has experienced remarkable economic growth during the past three decades. In spite of the economic fluctuation that took place in the late 1990s due to the impacts of the Asian financial crisis and economic restructuring of State Owned Enterprises, and despite the recent shock from the global financial crisis, China has been achieving leading economic growth rates. Since 1978, when China began to implement its economic opening and reform policy, the annual growth rate of real GDP in the three decades has been around 11 percent, and the annual growth rate of real GDP per capita has remained at 10.8 percent. In the new century, China has managed to maintain its striking economic performance even after the high growth rates of the last quarter century.

While fast economic growth has provided successful experiences and lessons, the economic growth pattern of China is characterized by the following weaknesses that are believed to be internal, giving rise to its vulnerability in face of the external crisis. First of all, over-reliance on accumulation of economic growth factors has led China to economic growth driven by heavy investment. Secondly, development in export-oriented sectors is labor-intensive and of low value added. Given the weaknesses in the Chinese labor market, which is characterized by mass employment of migrant workers moving between inland and coastal provinces, shocks to employment are much larger than GDP loss when a crisis occurs. Understanding the characteristics of China's growth pattern is helpful in evaluating the impacts of and the responses to the global financial crisis.

The Chinese economy has been driven by investment rather than consumption. After a slight rise in total factor productivity (TFP) and in its contribution to growth in the early stage of reform, China's TFP performance has been weak since the 1990s (for example Zheng et al., 2004; Kuiijs and Wang, 2005). Thanks to the completion of the demographic transition, the entire period of reform and opening in China has been characterized by an adequate supply of labor force and a high savings rate. This demographic dividend resulted from the fact that the productive population structure emerged through a marketized resource allocation mechanism and participation in the global economy. The favorable population factor has provided a window of opportunities for China's economic growth and thus, the phenomenon of diminishing return to capital has been deterred (Fang and Wang, 2005). In the meantime, the economic growth in transition China has heavily replied on inputs of production factors rather than on productivity improvement.

It is worth examining the relative contributions of investment and final consumption to economic growth. Picture 1 shows the economic growth rate, savings rate, and share of GDP by final expenditure. The ratio of capital formation to GDP reflects the dependence of growth on investment and the ratio of final consumption mirrors the relative importance of consumption in the economy. The curves reveal the following trend. The investment and economic growth fluctuations match each other, while the relation between final consumption and economic growth is insignificant. The pattern implies that investment has been the most important driving force. In particular, since 2001, a period with fast economic growth, the ratio of final consumption to GDP has been decreasing steadily.

PICTURE 1
Economic growth rate and share of GDP by final expenditure



Source: National Bureau of Statistics (2008), *China Statistical Yearbook in 2008*, China Statistical Press.

The relationships may be furthered investigated through a simple regression (Table 1). Using GDP by expenditure data from 1978 to 2007, we regress the growth rate on capital formation ratio and final consumption ratio. The regression outcomes indicate that an additional percentage point increase of capital formation drives the economy to grow 0.64 percentage point, while the impact of the final consumption ratio is statistically insignificant.

TABLE 1
The impact of investment and consumption on economic growth: 1978-2007

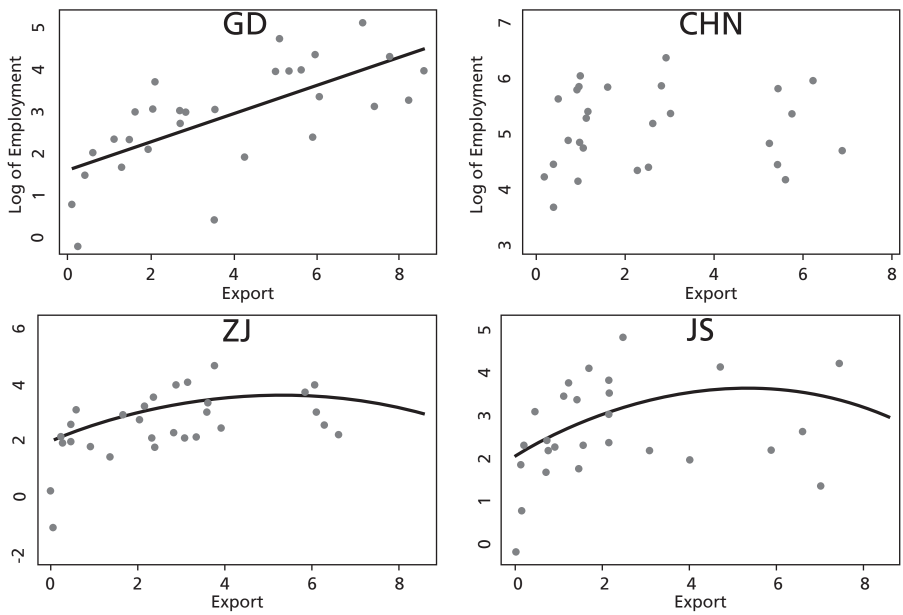
	Coefficient	t	significance
ratio of final consumption to GDP	0.227	1.23	Insignificant
ratio of capital formation to GDP	0.639	2.27	Significant at 5%
R^2 (Adj - R^2)		0.20 (0.14)	
Number of Observations		30	

As a developing country, it is necessary for China to drive economic growth through intensified investment. However, sustained high investment rates may crowd out the final consumption, and a growth pattern heavily reliant on investment increases economic fluctuation.

The other concern regarding the economic growth pattern is that China also needs to mobilize domestic demand. After the outbreak of the economic crisis, there has been wide discussion on a shift from external demand to domestic demand, which is considered one of the key components of economic restructuring. With globalization, the export-oriented sectors in China have been developing well, and have become a major component of the Chinese labor market. However, the unique institutional setting of household registration, known as the *hukou* system, which prevents migrants from permanently settling down in destination cities where they have found employment, causes mass inflows of labor when the economy booms and mass returns of labor during economic recession.

While migrant workers generally concentrate in coastal areas where the most export-oriented and labor-intensive industries are located, the recent financial crisis may further slow down the migration trend in the near future. In the areas where employment is most concentrated – the Pearl River Delta and the Yangtze River Delta – there is a tendency towards employment increases and export increases (see Picture 2). With the direct shock to the export-oriented sector, the crisis is likely to have serious negative impacts on employment. In addition, most low skilled rural migrant workers work in labor-intensive firms, so the financial tsunami brings with it more shocks to migrant workers. Our conjecture is supported by the widely reported phenomenon of large numbers of migrant workers returning to their hometowns (Sheng, 2009).

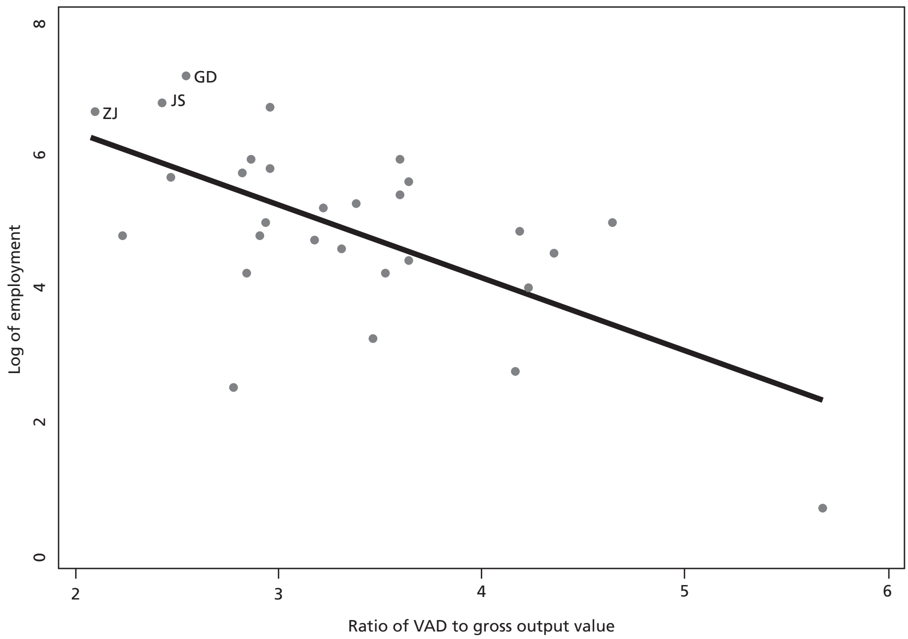
PICTURE 2
Exports and employment in manufacturing



Source: National Bureau of Statistics (NBS) (2007), *Data on Economic Census*, China Statistics Press.
Note: The horizontal axis is the ratio of exported value to total sale value in sub-sectors of manufacturing, and the vertical axis is employment in the sub-sectors. GD, CHN, ZJ, and JS refer to Guangdong, China, Zhejiang, and Jiangsu respectively. Each dot on the scatter plot represents a sub-sector in manufacturing. The picture indicates that in Guangdong, Zhejiang, and Jiangsu, the more export-oriented the sub-sector, the greater the employment concentration.

Given the economic structure of the regions where employment is concentrated, the recent financial crisis could cause bigger losses for employment than for GDP. The fast growing regions, such as Pearl River Delta and Yangtze River Delta, concentrate the most employment in China. These two regions are the first choice of industries that were transferred out of newly industrialized economies. For this historical reason, both the economic and the employment structures are more labor intensive and export-oriented in those areas. Picture 3 shows the relationships between employment intensity and economic intensity by province in 2007. Each dot on the scatter plot represents a province in China. The horizontal axis is the ratio of value added to gross output value in manufacturing, while the vertical axis is the log employment in manufacturing.

PICTURE 3
The relationship between employment and tatio of VAD to GOV



Source: National Bureau of Statistics, *China Statistical Yearbook* (2008), China Statistics Press.
Note: GD, ZJ, and JS refer to Guangdong, Zhejiang, and Jiangsu respectively.

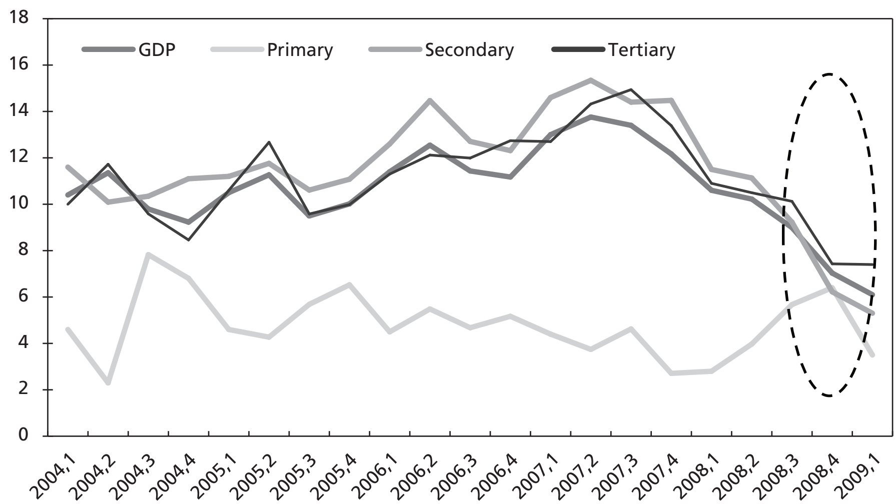
It is evident that provinces with a high VAD to GOV ratio tend to employ fewer workers because we see a clear negative relationship between employment and VAD to GOV ratio. Naturally, when facing the same shock, the economies on the right of the picture may lose more GDP, while those on the left may lose more employment. As marked in the picture, the Pearl River Delta (Guangdong) and Yangtze River Delta (Zhejiang and Jiangsu) are at the very left of the picture, which implies that the employment shock from the crisis will be substantial. According to a survey on migrant workers, the unemployment rate among this group was about 7 percent at the end of 2008 (Sheng, 2009). It goes without saying that coping with the labor market shock, rather than simply stimulating economic growth, should be prioritized.

3 THE SOURCES OF ECONOMIC SLOWDOWN: DOMESTIC OR EXTERNAL?

One question we want to answer here is to what extent Chinese economic growth is driven by external demand. To provide the answer, first we should clarify the share of external demand in GDP.

The world economy is plunging in 2009. However, the impact of the financial crisis on the Chinese economy occurs mainly through the second order transmission channel. The slowdown of economic growth in the main economies led to declining external demand for Chinese products, which in turn contributes to the Chinese economic slowdown. Picture 4 shows the quarterly GDP growth rate of the overall economy and by sector. The curves indicate that the Chinese economy maintained a fast growth rate before the fourth quarter of 2008, and the quarterly growth rates, compared to the same period of the previous year, were all above 9 percent. The economy grew 7 percent in the fourth quarter of 2008, then dropped to 6.1 percent in the first quarter of 2009.

PICTURE 4
Quarterly growth rates by sector



Source: Website of National Bureau of Statistics, www.stats.gov.cn.

The curves also show that the secondary industry is the most affected of the three sectors. The slowdown of growth in manufacturing reflects the impact of the crisis on the real economy. Considering that the secondary industry has been the most import pillar of economic growth in China, its contribution to the significant slowdown of GDP growth is understandable. In the fourth quarter of 2008, the growth rate for the secondary sector was 6.2 percent, and 5.3 percent in the first quarter of 2009. It is rare for the secondary sector to grow more slowly than the overall economy in two quarters in a row.

The dramatic slowdown of economic growth has drawn the attention of policy makers, who changed the direction of macro policies from containing inflation to maintaining economic growth at 8 percent. In the next section of this paper, we are going to discuss the policy instruments used to reach the economic growth target, and their implementation.

In addition to maintaining the economic growth rate above 8 percent, the outbreak of the financial crisis further revealed the structural problem of the Chinese economy. Given the imbalance of the macro economy, policy makers need to examine the following issues. First, as the driving force to economic growth, the desired policy should encourage final consumption, which plays a more active role in long-term economic growth. Second, the recovery policy needs to boost domestic demand and reduce dependence on external demand.

The ratio of total value of import and export is often used to reflect the openness of the economy, and the ratio in China was 0.59 in 2008. At first glance, it is quite a high ratio. However, it indirectly reflects the relationship between international trade and economic growth, and does not measure the proportion of value added of exported goods in GDP. In order to reflect the share of external demand in GDP, the value added of exported goods to GDP needs to be determined.

Unfortunately, the current statistical system in China does not provide the value added of exported goods directly. Based on information about items and value of exported goods by sub-sector and the ratio of value added to gross output by sub-sector, we can estimate the value added of exports in each sub-sector by multiplying value of exports in each sub-sector by ratio of value added to gross output, as shown in Table 1. According to our estimation, the total value added of exported goods accounted for 10.1 percent of GDP in 2007.

TABLE 1
Value added of exported goods by sub-sector in 2007

	Total value of exports (billion yuan)	Ratio of value added to gross output (%)	Value added (billion yuan)
Food Processing from Agricultural Products	145.73	26.53	38.66
Food Manufacturing	107.47	30.66	32.95
Beverage Manufacturing	6.36	37.06	2.36
Waste Recycling and Disposal	7.7	23.81	1.83
Tobacco Manufacturing	4.9	77.29	3.79
Mining and Processing of Non-Ferrous Metal Ores	181.02	37.88	68.57
Raw Chemical Materials and Chemical Product Manufacturing	392.04	27.39	107.38
Chemical Fiber Manufacturing	202.58	26.32	53.32
Rubber Manufacturing	77.63	27.7	21.5
Manufacture of Leather, Fur, Feather and Related Products	125.58	28.73	36.08

Processing of Timber, Manufacture of Wood, Bamboo, Rattan, Palm and Straw Products,	87.41	29.27	25.59
Manufacture of Paper and Paper Products	70.55	27.56	19.44
Textiles Manufacturing	1272.4	26.23	333.75
Manufacture of Textile Wearing Apparel, Footwear and Caps	234.67	29.8	69.93
Manufacture of Non-metallic Mineral Products	202.74	31.17	63.19
Manufacture of Metal Products	886.61	26.3	233.18
Manufacture of General Purpose Machinery	1754	27.73	486.37
Manufacture of Electrical Machinery and Equipment	2304.3	25.2	580.68
Manufacture of Transport Equipment	421.91	25.69	108.39
Manufacture of Measuring Instruments and Machinery for Cultural Activity and Office Work	312.56	27	84.39
Manufacture of Artwork and Other Manufacturing	529.69	27.09	143.62
Total	9328.3	-	2515.1

Source: National Bureau of Statistics, *China Statistical Yearbook* (2008), China Statistics Press.

Based on a similar calculation and data sources, we can estimate the value added in 2006, and share of economic growth in external demand and domestic demand in 2007. The 2008 data have not been released yet, so the estimate for 2008 is based on more assumptions. Table 2 presents the output. In 2007, the contribution of external demand to economic growth was 12.4 percent (1.51 percentage points), and 10.1 percent in 2008 (0.91 percentage point). It is thus clear that exports only contribute to a very limited extent to economic growth. If the parameter maintains the 2008 level, we may deduce the impacts of declining exports over economic growth in 2009. As noted earlier, exports declined 24.7 percent in the first five months compared to the same period of the previous year, causing a 0.2 to 0.4 percentage point drop of economic growth. Given that a substantial decline of exports has already taken place, the possibility of further decline is lower (as shown in the picture, exports stop declining in the chain index). Therefore, declining exports will not be a major barrier to achieving the goal of 8 percent growth.

TABLE 2
The contribution of domestic and external demand to economic growth

	2006	2007	2008
GDP (current price)	211923.5	249529.9	300670
Economic growth rate (%)	11.8	12.2	9.0
GDP deflator (%)	-	4.94	10.5

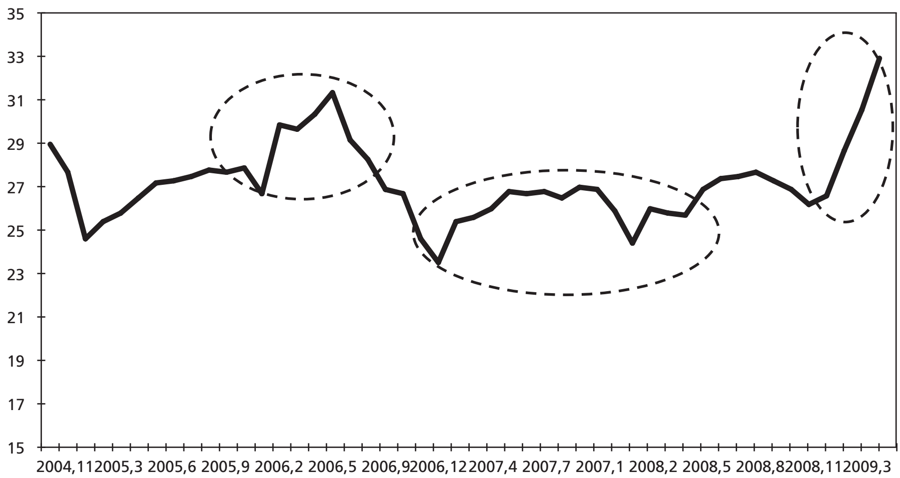
Value added of exports (billion yuan, current price)	2076.1	2515.1	3030.6*
Value added of exports/GDP (%)	0.098	10.08	-
Value added of domestic demand (billion yuan, current price)	19116.25	22437.89	27036.44
Value added of exports (billion yuan, previous year = 100)	-	2396.65	2741.46
Value added of domestic demand (billion yuan, previous year = 100)	-	213811.7	244573.0
Real growth of external demand (%)	-	15.44	9.00
Real growth of domestic demand (%)	-	11.85	9.00
Contribution of External Demand to Economic Growth (percentage point)	**-**	**1.51**	**0.91**
Contribution to Economic Growth from domestic Demand (percentage point)	-	10.69	8.09
Contribution to Economic Growth from domestic Demand (%)	-	87.6	89.9
Contribution to Economic Growth from External Demand (%)	**-**	**12.4**	**10.1**

Source: Author's calculation from National Bureau of Statistics, *China Statistical Yearbook* (2008), China Statistics Press.
* The exported value by item and ratio of value added to gross output in 2008 have not been released yet, so the value added of exports in 2008 is based on Value added of exports /GDP in 2007 multiplied by GDP of 2008.

So how can we explain the slowdown of economic growth since the financial crisis broke out? As noted earlier, investment has been the main driving force for economic growth. It is the slowing down of investment, which is to a large extent a result of tight macroeconomic policies right before the financial crisis hit the real economy, that slowed down economic growth. After the crisis, the monetary policy emphasized loans to private sectors. For instance, in the first half in 2009, loans to households increased steadily and loans to non-financial companies grew rapidly. By the end of June 2009, household loans had increased 23.8 percent over the same period of the previous year. Loans to non-financial companies increased 37 percent, 24.4 percentage points higher than the same period of the previous year.

Picture 5 shows the monthly changes of fixed asset investments since 2004. Before the period of inflation started in early 2007, investment remained at a high level. Since then, tight macro policies implemented to contain price levels have had effects on investment. As shown in Picture 5, the level of fixed asset investment was relatively low. Considering that economic growth usually follows investment, it is reasonable to deduce that the contraction of investment in 2007 led to the economic slowdown, while the outbreak of the financial crisis simply strengthened prudent investment expectations, translating into low economic growth in 2009.

PICTURE 5
Fixed asset investment in China: 2004-2009



Source: Website of China Economic Information Center, www.cei.gov.cn.

It seems appropriate to believe that the stimulus plan that will eventually bring about expansion of investment will help China achieve the target of 8 percent economic growth in 2009. When the stimulus funds reach their destination, the size of fixed asset investment will expand. Monthly growth rates in April and May have already exceeded 30 percent (Picture 5). Since rebound investment is encouraged by the central government, which is quite rare in China, it is expected that the economy will soon peak its investment and recover from the depression.

In addition to economic growth, the follow-up policy needs to address additional issues. First of all, the social impacts of the financial crisis deserve more attention. Although the affected sectors, characterized by labor intensive technology, provide a limited contribution to economic growth, they have a significant impact on employment, in particular migrant workers' employment. The next section describes this impact in detail. Secondly, the follow-up recovery plan should focus more on the structural adjustment of economic growth, fostering the growth of consumption and correcting the imbalanced macro economic structure.

4 ECONOMIC RECOVERY POLICIES

The Chinese government has accumulated experience coping with the outside shock from the Asian Financial Crisis. Since then, policy makers have realized that, in order to reduce the negative impacts of the shock, a timely policy response is crucial in tackling major financial crises. Policy makers have also learned that, in order to effectively reduce the impact of a crisis, in addition to economic policy, social policy plays a key role.

In terms of its scope and magnitude, this financial crisis is much bigger than the Asian Financial Crisis that took place a decade ago. Compared to the situation at that time, the Chinese economy is more integrated with the global economy, which makes the outside shock more significant. Meanwhile, with the rapid economic development of the past decade, Chinese economy is much stronger and the financial system is healthier. Therefore, the Chinese government is capable of responding to the crisis by implementing new economic and social policies.

4.1 Timely adjustment of macro policies

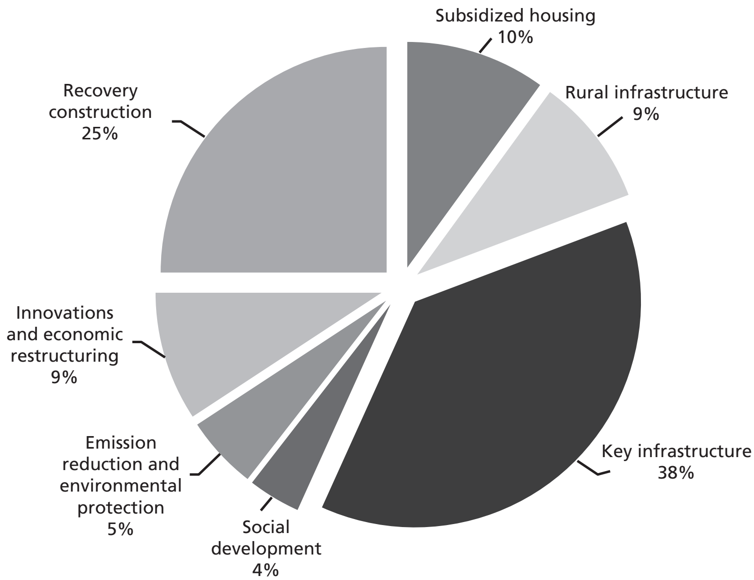
Prior to the global financial crisis, the main aim of the Chinese macroeconomic policy was to contain inflation. Since the fourth quarter of 2006, driven by soaring food prices, China's CPI experienced rapid growth. In the context of the changes in the inflation scenario, the Central Economic Work Conference, which convened at the end of 2007, clearly pointed out that the first priority of macroeconomic management was to "prevent the rapid economic growth from turning into overheating, and to prevent the structural price rise from evolving into full-blown inflation". The direct reflection is the monetary policy. At the end of 2007, in its *China Monetary Policy Report: Fourth Quarter in 2007,* the People's Bank of China clearly proposed to implement a tight monetary policy and restrain the rapid growth of currency and credit in 2008.

The macro policy underwent a sudden turn with the outbreak of the global financial crisis. The goal of macroeconomic management shifted from containing inflation to maintaining economic growth. In *The Chinese Government Work Report of 2009*, the target of maintaining 8 percent economic growth rate was clearly proposed. The main goal of the active fiscal policy and moderately flexible monetary policy is to prevent the economy from slowing down too much. The report discusses the main economic and social policy response provided by the Chinese government after the crisis.

4.2 Fiscal policy: a massive stimulus plan

The central government announced a 4-trillion-yuan plan to bolster the slowing economy through construction of key infrastructure (38 percent), recovery of earthquake-impacted areas (25 percent), subsidized housing (10 percent), and rural infrastructure (9 percent), investments in innovation and economic restructuring (9 percent), emission reduction and environmental protection (5 percent) and social development (4 percent) (Picture 6). It is apparent that the composition principle of the stimulus package is to combine long-standing bottleneck areas of the economy with priority areas that are intended to stimulate economic growth.

PICTURE 6
The composition of the stimulus plan



Source: Website of the National Development and Reform Commission (2009), www.ndrc.gov.cn.

In conclusion, with more employment-friendly investment – namely, allocating investment according to labor-absorbing ability of sectors, scenario 3 can create 74.6 percent more jobs than scenario 1 and 53.1 percent more than scenario 2. It is obvious that investment composition should take into consideration several factors, and any quantitative analysis can only roughly reflect reality. Our simulations, however, intend to show that with or without consideration of job creation, investment decision making can generate a substantial difference in employment absorption. The policy implication is that the central government should use key policy tools to guide the stimulus package to invest in more employment-friendly sectors, regardless of whether the investment is made by central government itself, local governments, or private investors.

4.3 A moderately flexible monetary policy

As the financial crisis spread and deepened, the People's Bank of China (PBC) eased the monetary policy and explicitly proposed to carry out a moderately flexible monetary policy. The PBC adjusted the orientation, priority, and intensity of the monetary policy in a timely manner in accordance with the macro economic goal, maintaining stable and relatively rapid economic growth by employing several instruments, including money supply, loans, and interest rates.

The moderately flexible monetary policy evolved from a tight monetary policy that was implemented in the first half of 2008. At that time, in order to prevent rapid economic growth from becoming overheated, and to prevent the structural price rise from turning into entrenched inflation, the PBC adopted a tight monetary policy. After raising the benchmark deposit and lending interest rates on six occasions in 2007, the PBC kept the interest rate policy unchanged in the first half of the year. After the financial crisis, the PBC has been working to ease its monetary policy. This dramatic change demonstrates that the Chinese government attaches great importance to its policy response to the crisis.

The first priority of the moderately flexible monetary policy is to ensure sufficient liquidity within the banking system. In order to achieve this goal, the PBC reduced the intensity of open market operations and raised the level of new loans. According to the *China Monetary Policy Report: First Quarter in 2009* released by the PBC in May, by the end of March 2009, the outstanding broad money M2 posted 53.1 trillion yuan, representing a year-on-year increase of 25.5 percent and an acceleration of 9.3 percentage points in relation to the previous year. The RMB loans increased too, Outstanding RMB loans recorded 35 trillion yuan, up 29.8 percent year on year. In the first quarter of 2009, the new RMB loans increased 4.6 trillion yuan, 3.2 trillion yuan more than the same period of previous year. It is clear that increasing the liquidity of the banking system has been the main policy tool for the Chinese government to cope with the crisis.

The PBC also uses interest rate as leverage to support economic growth. In 2008, RMB lending rates rose before declining. In the first 8 months of 2008, the interest rates of RMB loans increased steadily. In August, the weighted average interest rate of RMB loans issued by financial institutions stood at 8.19 percent, 0.3 percentage point higher than the beginning of the year. Since September 2009, the PBC has lowered the benchmark interest rate five times, which keeps the weighted average interest rate of RMB loans at a low level. In December 2008, the weighted average interest rate of RMB loans issued by financial institutions stood at 6.23 percent, a decline of 1.96 percentage points from the peak in August and 1.66 percentage points lower than in the beginning of the year.

In addition to interest rates, the PBC adjusted the required reserve ratios frequently, according to the macro economic situations. In 2007, the PBC raised required reserve ratios on 6 occasions. In the first half of 2008, three more raises were needed to reduce money supply. After the crisis, the PBC lowered the required reserve ratios on three occasions in the second half of 2008.

4.4 Active labor market polices

The financial crisis has had significant negative impacts on China's labor market. In order to reduce employment losses, the Chinese government has adopted active labor market policies. Firstly, as we know, medium-sized and small-sized enterprises create mass employment opportunities; however, the ability of these enterprises to resist risks is lower. With the outbreak of the financial crisis, these enterprises have reduced the number of jobs. The governments have taken measures such as reducing taxes and economic burdens to help medium-sized and small-sized enterprises to save employment opportunities and reduce employment losses. Secondly, the Chinese government has also taken many measures, such as providing training to help migrants whose jobs have been seriously affected by the financial crisis and college graduates who find it difficult to get a job.

In 2008, central finance earmarked 3.51 billion yuan to support the development of medium-sized and small-sized enterprises. In September 2008, the Ministry of Human Resources and Social Security and other ministries put forward some measures to support medium-sized and small-sized enterprises, such as more flexible market access conditions, improved administration, more policy support, diversifying financing channels and intensifying training. In November 2008, an executive meeting of the State Council put forward that medium-sized and small-sized enterprises should be given more credit support.

In December 2008, the Ministry of Human Resources and Social Security and other ministries adopted several measures simultaneously to lessen economic burdens and foster a more stable employment situation for enterprises. These measures include: (1) Enterprises with financial difficulties are allowed to delay payment of social security funds; (2) The insurance rates for medical, work injury, unemployment and maternity insurance are allowed temporary cut backs. However, the pension insurance rate cannot be lowered; (3) Unemployment insurance funds can be used to help enterprises with financial difficulties to maintain employment posts; (4) Enterprises with financial difficulties are encouraged to provide on-job training to their employees; (5) Economic compensation problems of enterprises with financial difficulties should be solved appropriately. It has been estimated that the implementation of the first three measures will reduce enterprises' economic burdens by more than 100 billion yuan and more than 10 million employment posts will be maintained.

Youth employment and employment of migrants have been seriously affected by the financial crisis. New labor market entrants, such as college graduates, also face difficulties getting jobs. The Chinese government has taken many measures to help these groups, which include employment service and training, etc.

The Ministry of Human Resources and Social Security and two other ministries jointly issued a Circular on Implementation of Special Vocational/ Skills Training Program on January 7, 2009. According to this circular, in 2009 and 2010, training programs will be offered to several groups of people that have been affected by the financial crisis to help them find jobs. These groups include employees of enterprises with financial difficulties, returned rural migrant workers without jobs, unemployed workers, including registered college graduates and unemployed rural migrant workers living in urban areas, and new labor market entrants. Employment services and assistance primarily target college graduates from poor families.

The Central Committee of the Communist Party (CCCP) issued the No.1 document of the year on February 1, 2009, which includes several measures to promote employment of migrants[1]. Enterprises are encouraged to keep migrant workers' jobs. Enterprises with financial difficulties can adopt flexible employment, elastic working time and on-the-job training to maintain employment posts. Favorable tax/fee/loan policies and other policies for business registration and information consultation target migrants who return home to start their own business. Relevant and practical skill trainings for migrant laborers have been implemented. Enterprises are also required to give migrant workers favorable employment treatment and pay migrants' waged fully and on time. Temporary income support or rural *dibao* are available to migrants who return home without jobs.

5 IMPROVING SOCIAL PROTECTION

The financial tsunami has started to affect the Chinese economy and employment. As the rest of the world, China's economic growth will plunge in 2009, although a severe recession is not expected. The export oriented sectors that are also labour intensive are suffering job losses. Unfortunately, China has no real time labour surveys and is unable to report monthly unemployment rates following international standards. Thus, it is hard to assess how severe the impact of the international crisis really is on the Chinese labour market.

But some official messages help to outline the labour market scenario. According to a survey conducted by the National Bureau of Statistics, 70 million migrants returned home before the 2008 Spring Festival. Among those returned migrants, only 12 million, accounting for17 percent of the total, returned because of factors related to the financial crisis, such as closing of enterprises, layoff, not being able to find jobs and

1. Each year's No.1 Document of the CCCP addresses major issues and work priorities. For many years, like this year, it has focused on rural development-related issues.

low income. Since the total number of migrants is about 140.4 million, the proportion of migrants who returned home due to factors related to the financial crisis exceeded 8 percent (Sheng, 2009). It goes without saying that coping with the labour market shock should be prioritized, rather than simply stimulating economic growth.

International experiences show that economic crises are usually an important occasion to expand social security coverage and improve social security levels. The economic crisis in the US from 1929 to 1933 induced the establishment of the social US security system. During the Asian financial crisis, China established its social security system in urban areas.

The financial tsunami has had impacts on employment in China, especially employment of migrant workers. However, the social protection system for migrant workers is still very limited. For migrants, expanding social security coverage, boosting urban and rural integration of the social security system and building portable social security between regions are very important strategies for coping with the tsunami. The social protection systems for urban residents and rural population also need improvement, not only with a view to providing better social security to the population, but also stimulating consumption indirectly.

On February 5, 2009, the Ministry of Human Resources and Social Security submitted draft *Regulations on Migrants' Basic Pension System* and *Regulations on the Transfer and Continuity of Basic Pension Relationship for Staff and Workers in Urban Enterprises* to public consultation. According to the *Regulations on Migrants' Basic Pension System*, migrants who have established a labor relationship with their employers in urban areas should participate in the migrants' basic pension system. The *Regulations on the Transfer and Continuity of Basic Pension System for Staff and Workers in Urban Enterprises* provides the basic principles to be followed by staff and workers in urban enterprises when changing their employment across provinces, fund transfers, coverage continuity, determination of retirement place and calculation of fund payment and wage index, etc.

In urban areas, the coverage of the basic medical insurance system for staff and workers of enterprises has been expanding gradually. The basic medical insurance system for urban residents was piloted in 2007 in 79 cities, with the participation of 42.91 million urban residents. In 2008, the number of cities increased to more than 300, and the number of urban residents who participate in this system has also increased significantly.

As regards unemployment insurance, from 1994 to 1998, the contributors remained almost at the same level. Since the issuing of the *Regulations of Unemployment Insurance* in 1999, the number of contributors started to increase rapidly. At the end of 2007, the number reached 116.45 million, including 11.5 million migrant workers. At the end of 2008, the number of unemployment insurance contributors reached 124 million, of which 15.49 million were migrant workers. While the total number of unemployment insurance contributors increased by 6.5 percent in 2008, the number of migrant worker contributors increased much more, reaching 34.7 percent.

Since early 1990s, the rural pension system has been piloted by various regions. However, unlike the urban pension system that has a mature and nationally universal plan, the rural pension system is at the experimental stage and has not made much progress. The central government has been actively promoting the establishment of a new rural pension program. On September 1, 2009, the State Council issued a document on piloting a new rural pension program, which indicated the formal startup of the system. According to this document, the new rural pension system will be piloted in 10 percent of the country's counties as of 2009. The basic idea is that the fund sources come from personal contributions, additional collective contributions, local and central government subsidies, and social donations, all going into individual accounts. The payment will be made in two parts: individual account accumulation and basic pension provided by government.

In rural areas, after losing the support of collective economy, it was difficult to maintain the original rural cooperative medical system. In October 2002, the Chinese government decided to set up a new rural cooperative medical system gradually all over the country. By the end of 2008, 2729 counties (districts, cities) had established this system, and 815 million rural inhabitants were covered by the system - a participation rate of 91.5 percent - reducing the economic burden of medical treatment for the rural population.

The Minimum Living Guarantee Program (*dibao* program) has become the basic social assistance system in China. Since the financial crisis, both urban and rural *dibao* programs have been developed steadily. By the end of 2008, there were 23.35 million urban *dibao* beneficiaries. The average urban *dibao* standard is 205.3 yuan, and the average monthly urban *dibao* benefit level is 143.7 yuan, increased by 12.6 percent and 39.9 percent respectively compared to 2007. The total expenditure on urban *dibao* was 38.52 billion yuan, a 40.2 percent increase compared to 2007.

At the same time, the rural *dibao* program has been established all over the country. By the end of 2008, there were 43.06 million rural *dibao* beneficiaries, a 20.7 percent increase compared to the previous year. The average rural *dibao* standard is 82.3 yuan, and the average monthly benefit level of rural *dibao* is 50.4

yuan, having increased by 17.6 percent and 29.9 percent respectively compared to the previous year. In 2008, the total expenditure on rural *dibao* was 22.23 billion yuan, a 113.5 percent increase compared to 2007.

The Ministry of Civil Affairs and the Ministry of Finance have jointly stipulated that, as of January 1, 2008, the monthly *dibao* benefit per person should increase by 15 yuan in urban areas and 10 yuan in rural areas. The central government provides some subsidy for urban and rural *dibao* beneficiaries. Local governments provide supplements according to their own financial situations. The non-*dibao* households with extreme financial difficulties can receive temporary assistance.

By January 8, 2009, the Ministry of Civil Affairs and the Ministry of Finance had distributed a one-time subsidy to the urban and rural poor, totaling 9.66 billion yuan and fully funded by the central government. 74 million poor people received the subsidy, including 62.8 million *dibao* beneficiaries, 5.3 million unemployed or *wubao* beneficiaries, and 6.4 million other vulnerable groups. Each urban *dibao* beneficiary received 150 yuan and each rural *dibao* and *wubao* beneficiary received 100 yuan.

Since the financial crisis, the Chinese government has also taken some measures related to compulsory education, which have attracted considerable attention. Since the fall term of 2008, students enrolled in compulsory education at state-run schools are exempted from payment of tuition and miscellaneous fees. Students from urban *dibao* households enrolled in compulsory education are provided with free textbooks. Accommodation and living expenditures of students from households with financial difficulties are subsidized. Migrants' children who meet the local admittance criteria are referred to the closest state-run school and are exempt from payment of tuition and miscellaneous fees.

6 CONCLUSIONS AND DISCUSSIONS

6.1 General statements on impacts of the crisis

The direct impacts of the financial crisis on China are limited. When the crisis broke out, only a few companies reported asset losses, since the openness of the financial sector has been limited. The actual impact of the crisis on China is mainly through the second order channel. Due to the shrinking of demand in developed countries, the export sector has been heavily affected. Export reduction has resulted in shutdown of firms in coastal areas, the most developed region in China. Considering that most firms are labor intensive, the impact has been greater on the labor market rather than on economic growth per se.

China slowed down the pace of economic growth that it had maintained for decades. In the first quarter of 2009, the quarterly economic growth rate was 6.1 percent, the lowest in the past ten years. Based on the analysis in this report, however, the domestic policy carried out in early 2008, rather than the outside shock, should be blamed for the economic slowdown. In this regard, it seems that the unprecedented economic stimulus plan currently underway will help the Chinese economy back to its normal path. In the first half of 2009, the economic growth rate was 7.1 percent, implying that the growth rate for the second quarter was around 8 percent, which is the target of the economic recovery plan.

The social impacts of the financial crisis deserve more attention. Although the affected sectors, characterized by labor intensive technology, provide a limited contribution to economic growth, they have a significant impact on employment, in particular migrant workers' employment. When the social protection system is imbalanced between urban residents and rural inhabitants, such effects can be even more severe.

6.2 Coexistence of challenges and opportunities

Although the economic slowdown is a challenge for macroeconomic policies in China, it opens a window of opportunity to improve the social protection system, if the social expenditure is appropriately included in the stimulus plan.

In fact, China has already benefited from such adjustment in social policies before. About a decade ago, the Asian Financial Crisis created labor market displacements in urban China. In addition to implementing an active labor market program, a series of social protection reforms was also implemented. Thus, China coped with the Asian financial crisis smoothly.

In the present crisis, the most affected are migrant workers. Unfortunately, migrants and rural inhabitants are not well protected by the current social protection system. In this regard, China can use the economic recovery opportunity to invest in social protection and improve the system for migrants and rural populations. The expansion of the social protection system will not only protect disadvantaged groups from a negative labor market shock, but will ensure their stability in the future. Once the low income population is well protected, their consumption is likely to increase, which is actually positive for the correction of China's imbalanced economic structure.

6.3 Issues that require caution

Some issues are of particular concern, even though the prospect of economic growth in the near future is optimistic. Among them, to correct the imbalanced economic structure is the most pressing.

Firstly, China should reduce its dependence on external demand for economic growth. China is one of the biggest countries in terms of the value of its exports, and external demand has contributed to its economic growth in the past decades and produced foreign exchange surplus. However, the huge foreign exchange surplus is a double-edged sword. On the one hand, it gives China room to deal with the financial crisis. On the other hand, it creates more connections between the Chinese economy and the rest of the world, which increases economic fluctuation factors.

Secondly, China should focus more on increasing final consumption. The analysis in this paper indicates that economic growth in China has been mostly driven by investments rather than final consumption. Policy makers are already aware of the trends and seek to change the pattern by addressing the importance of consumption to economic growth. However, in order to guarantee 8 percent of economic growth, the stimulus plan reinforces the role of investments. In this regard, the achievement of the economic growth target may lead to side effects in the future, making economic structure adjustment more difficult.

Finally, the process of economic recovery should also be a chance to balance the regional economy in China. There seems to be an indication that the flying geese model is going to emerge across provinces. For central and western China, the crisis opens a window of opportunity to catch up with their coastal counterparts. In fact, recently released statistics already showed that economic growth in inland China is becoming stronger. The continuation of labor-intensive industries by inland provinces, however, depends on how the development of those regions matches up to their comparative advantage, which we believe is still labor-intensive industries.

6.4 Prospects for the post-crisis era

The ongoing global financial crisis reveals the long-standing shortcomings of China's growth pattern. The tasks to change this pattern have been described by international scholars and leaders as rebalancing of economic growth, and by the Chinese government as transitions from export-oriented growth to domestic consumption-oriented growth, from input-driven growth to productivity-driven growth, and from secondary sector-dominated growth to more service-dominated growth. As a potential process of destructive creation - as coined by Schumpeter - this financial crisis can provide opportunities for China to accomplish those transitions.

The 30 years of economic reform and opening have just concluded half of China miracle's story – that is, the central and western provinces of China will continue to grow by catching up with their coastal counterparts. Before and at the time when the global financial crisis hit the real economy of China, there seems to have been a change in the regional growth pattern of industries – that is, industrial outputs in central and western regions have grown relatively faster than those in the eastern regions. At the same time, as a result of rising labor costs and a sharp drop in export orders, industries in coastal areas seem to lose their role as major drivers of Chinese economic growth.

However, the current changes in the regional pattern of industrial growth, or the industrial relocation trends, are mainly the result of central government's implementation of favorable policies and targeted investment. That created a comparative advantage that defies the industrial structure, which is dominated by heavy industries and inconsistent with the regions' resource endowments. Sustaining rapid economic growth in China requires building a domestic flying geese model so that the central and western regions can maintain the comparative advantage in labor-intensive industries. The urgent challenge for implementation of sound regional development strategies is to transform the government intervention and investment-oriented mode to a comparative advantage-following and market-oriented mode, in order to turn the industrial relocation of industries into an upgrading process of all regions, eastern, central and western, together.

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ADVENTURES OF THE DEVELOPMENT THEME IN MARXISM

Emir Sader

The defeat of the revolution in Germany and the tide of popular struggles in Western Europe caused Russia's isolation. This is likely to have defined Russia's destiny and that of 20th century socialism, conditioned as it was by economic backwardness, as a fundamental horizon limiting its development. Marx foretold that socialism would emerge in the center of capitalism, precisely due to the greater development of productive forces, with the corresponding greater development of social classes and the contradictions among them. The objective of this paper is to analyze how this imbalance between economy and politics did come about in the history of socialism in the 20th century and its consequences.

AVENTURAS DO TEMA DO DESENVOLVIMENTO NO MARXISMO

A derrota da revolução na Alemanha e o refluxo das lutas populares na Europa Ocidental provocaram o isolamento da Rússia. Foi assim que provavelmente se definiu o destino da Rússia e do socialismo no século XX, em que o atraso econômico constituiu-se como horizonte fundamental de limitação do desenvolvimento. Marx havia prognosticado que o socialismo surgiria no centro do capitalismo, justamente pelo maior desenvolvimento das forças produtivas e, paralelamente, das classes sociais e das contradições entre estas. O objetivo deste artigo é analisar como se deu esta defasagem entre economia e política na história do socialismo no século XX e suas consequências.

1 INTRODUCTION

What does Marxism have to say on development? Certainly, a lot. The Communist Manifesto already recognized, substantially, the extraordinary capacity of capitalism to expand productive forces – which repeatedly clashes with its incapacity to distribute income, generating the cyclical crises of overproduction or under-consumption.

One of the methodological pillar of Marxism is the contradiction between productive forces and production relations, whose dynamics reach a certain limit where production relations become a constraint to economic development. This is when a revolutionary period of transformation from one type of society, based on one means of production, into another.

These theoretical foundations made room for a great tradition of Marxist economists, from theoreticians and revolutionary leaders at the same time, such as Lenin and Rosa Luxemburg, to the great thinkers of Marxist economy and thinking in general, such as Maurice Dobb, Paul Baran, Paul Sweezy, Immanuel Wallerstein, Giovanni Arrighi, Samir Amin, Robert Brenner, among many others.

Alongside the theory, the concrete history of socialism brought many other economic challenges, some of which will be mentioned in this text. The USSR, China, Cuba, Vietnam, among other countries, had to face intense economic dilemmas that somehow, through the way they were addressed, also defined the future of these political processes.

As socialism emerged in the semi-periphery rather than in the center of the system, with all its economic development, and later expanded to the periphery, the economic problems required innovative approaches from Marxist theory and socialist political leaders. The economy became a privileged theme of Marxism, including the strong economicist biases in the models adopted by socialist governments.

Marx's analyzes were concentrated on England not with a view to focusing on the country, but to study the economy in which productive forces were most developed, and to capture, as best as possible, the laws of development of capital – the real subject of "The Capital". The contradictions between the productive forces and production relations became one of the interpretative pillars of Marxism. The other is the class struggle as an essential pillar of history.

In Germany, under the impact of its accelerated growth, what was to be known as the social-democratic interpretation of Marxism evolved, privileging the development of productive forces as a driver of the anti-capitalist struggle, vis-à-vis the struggles in the political sphere – in what was characterized as an economicist or structuralist view of Marxism.

The USSR, isolated as it was in the nineteen-twenties, produced another economicist stream of Marxism, centering its development in the expansion of productive forces. The issue of the relations between economy and politics resurfaced when the first historical expression of rupture of the imperialist chain took place in backward Russia and not in one of the countries at the center of capitalism. Gramsci characterized it as a "revolution against capital", in the sense that it did not follow Marx's prediction that it would take place in the more developed countries, due to the higher degree of expansion of the productive forces. Lenin interpreted this departure as a knot that had to be undone, when he claimed that it was easier to take over power in Russia – owing to the weakness of the political power of Czarism -, but that it was much more difficult to build socialism – not only due to economic backwardness, but also due to the qualification of the working class, both objectively and subjectively. Lenin – as well as Trotsky – intended the German revolution – in an economically developed country - to rescue the Russian revolution – in an economically backward country.

The defeat of the revolution in Germany and the tide of popular struggles in Western Europe caused Russia's isolation. This is likely to have defined Russia's destiny and that of 20th century socialism, conditioned as it was by economic backwardness, as a fundamental horizon limiting its development. Marx foretold that socialism would emerge in the center of capitalism, precisely due to the greater development of productive forces, with the corresponding greater development of social classes and the contradictions among them.

How did this imbalance between economy and politics come about, marking the history of socialism in the 20th century? What were its consequences?

2 THE MISADVENTURES OF CONCRETE HISTORY

Lenin's analysis is the one that best accounted for this unexpected and unprecedented phenomenon. First, by capitalism's shift to its imperialist phase, captured by several theoreticians at the end of the 19th century – Hilferding, Bukharin, among others. However, its historical and political dimensions were more clearly shown by Lenin.

The dynamics of the process of capitalist accumulation, analyzed by Marx, rests on a dynamics of continuous expansion that, nevertheless, clashes with the mechanisms of appropriation of surplus value, leading to what Marx characterized as a general trend towards a drop of the profit rate. Since accumulation is centered on surplus value, which in turn is centered on labor, the trend towards increased investments in constant capital – in particular technology – rather than variable capital – wages -, results in decreasing profit rates. This is recovered by the increase of profit mass, condemning capitalism to constant expansion of production.

Such expansion at company level was transferred to the national sphere, and as colonial powers were constituted, competition and dispute for new territories by the different powers was internationalized. The Berlin Conference itself, where the great colonial powers sliced up Africa with ruler and compass, expressed an extreme moment, identified by Lenin, when the great powers concluded the division of the world. As a consequence, since there was no limit to the process of accumulation, it would have to take place no longer as appropriation of new territories, but as expropriation of the spaces of other powers. In other words, the dynamics of capitalist accumulation pointed towards a new historical phase – the shift to the imperialist stage – and the historical period of inter-imperialist wars.

Lenin's prediction came true dramatically and severely throughout the first half of the 20th century, with the two world wars – in reality, a single war, divided into two parts -, that were actually inter-imperialist wars. After a relatively calm period under British colonial rule, World War I broke out, startling those who did not have Lenin's perception. After all, in the region of the world that considered itself the most civilized, the most savage conflict in the history of humanity erupted. A face-to-face war, fought with bayonets, that spread all around for four years and produced tens of millions of dead in the battlefields.

Lenin's Interpretation also explained why the imperialist chain would break at the edges rather than the center, as Marx had foreseen, making history take a detour before resuming its basic laws. The victory of the Russian revolution contradicted Marx's predictions, but did not abolish the central themes that socialism would have to inherit capitalism's economic development, in order to reshape it into a different, superior, socialist society.

For Lenin, capitalism's evolution to its higher imperialist phase was not only an economic phenomenon, but had several social and political consequences. By exploiting their colonies, imperialist powers shared the fruits of this exploitation with the other national classes, including the working class. Thus, a better remunerated working class would become a kind of labor aristocracy, aligned with colonial exploitation, disguised under the chauvinist ideology, instead of aligned with the people of the colonized countries.

Thus, while there was a reduction of contradictions in the center of capitalism, they became more severe in the periphery, in the colonized countries. The national issue became sharper, to the loss of the social contradictions in the center. This mechanism, typical of the imperialist phase, would contain the explanation why the system erupted in the periphery and not in the center, as Marx had originally predicted.

That was a moment of crisis of a basic rule of the modern age, which likened economic development to civilization. The most economically developed powers, which were therefore considered the most civilized, fought savagely. The same ones that had claimed to belong to the category of "civilization" and relegated others to the category of "barbarians". They fought over chauvinist ideologies of national superiority of one country over the other, covering up the inter-imperialist dispute to re-divide the world among the great imperialist powers.

Backstage, England's role as ruling power was also being questioned. The turn of the century had evidenced symptoms of exhaustion of the British empire as the world's dominant power, such as the war in South Africa, and China, that gave London a hard time. Two emerging powers fought to become the new ruler: Germany, after Bismarck's conservative modernization, and the United States, after the Monroe Doctrine and its agreements with England.

The break out of the war at first led the US to maintain its isolationist position, as if the war were a European issue and its interests were not at stake. When it realized that Germany was beginning to triumph and would emerge as the great successor of England, it quickly promoted the formation of an internal public opinion favorable to participation in the war – an indispensable condition to engage in such a bloody conflict. The year 1917 thus brought, on the one hand, the US's decisive entry in the war, tipping the scales to the western side. On the other, the Russian Revolution, which would lead the Soviet power to leave the war. Thus emerged the two superpowers that would play the major roles in the world's second post-war political scenario.

Postwar agreements, which punished Germany severely, especially in economic terms, confirmed the central goal of inter-imperialist dispute for the colonies and spaces within Europe itself. At the same time, for the first time economic development was used systematically and globally for military purposes by virtually all the major powers, redefining the role of development of the productive forces articulated with the anti-cyclical function of the war industry.

3 THE SCRIPT OF CONCRETE HISTORY

From the point of view of socialism and Marxism, the first war had a positive outcome: the Menshevik government's failure, an ally of the western powers and, thus, incapable of removing Russia from the war and addressing, through this route, the problem of the poverty of the masses. At the same time, it led to integration of peasants and workers in the war fronts, with weapons in hand. The accelerated growth of the Bolsheviks and, finally, their victory in October 1917, were directly related to World War I.

In Europe, Germany's defeat coincided with the country where socialism had developed most, due to the strength of the German Social Democratic Party, the fastest growing in the world, alongside the explosive German economic cycle of the last decades of the 19th century. Russia had become the weakest link in the imperialist chain, for condensing a set of contradictions, which allowed the Bolshevik revolution.

With its defeat, Germany took this place. Its economic development was blocked, its internal contradictions condensed. A true revolutionary situation was generated in the country, which foretold a radical solution to the crisis. The Nazi triumph soon after would confirm this diagnosis.

The Bolsheviks were confident of a revolutionary solution in Germany, which would rescue backward Russia. The defeat of the revolutionary projects of the Spartacus party, directed by Rosa Luxemburg and Karl Liebknecht, determined the isolation of the Bolshevik revolution. After that, Western Europe began to recover from the damages caused by the war, becoming economically and socially stable.

The global socialist movement split at the beginning of the war between social democrats (favorable to the participation of the social democrat parties sided with the bourgeoisie of each country in the war) and Communists, pacifists and internationalists. This division benefited the right wing even more, since the conflict between left wing parties weakened the left wing even more and facilitated the isolation of the USSR, severely criticized by social democracy as another version of totalitarianism.

The isolation of the Russian Revolution brought unexpected challenges for the Bolsheviks. What was only a momentary detour, according to Lenin, condemned the USSR to drawn out isolation. Internally, economic difficulties multiplied. In addition to the damage caused by the war, there was the 1917 revolution and the internal civil war – in which more than 10 foreign armies intervened in the country.

The Bolsheviks called on the peasants to take over their lands, while the workers socialized means of production in the cities. From this combination arose, in an unequal fashion, the worker-peasant alliance, which held strong contradictions. The peasants, with ownership of their lands, began to produce, encouraged by the leaders of the revolution. After an initial phase of socialization of the scarce existing resources, coined "war communism", Lenin began to implement a policy of economic opening, calling on small property owners – especially farmers – to multiply their production.

But the economic scarcity of the cities did not allow them to receive goods or remuneration in return. The peasants began to sell in the black market, as well as to the troops of the foreign armies. The Bolshevik government took this as an attempt to strangle the revolution by hunger.

These harsh material realities reflected the detour foreseen by Marx. Socialism had to face on its own what one of the Marxist theoreticians of the time – Preobajhensky – called "primitive socialist accumulation". If in its original formulation socialism was to be the denial and overcoming of capitalism, incorporating the level of development of the productive forces, in a radically different type of society, the break from capitalism in the periphery raised, among other problems, that of how to tackle the economic backwardness inherited from the defeated regime. This is what lay at the bottom of the debate between Stalin and Trotsky, after Lenin's death.

Trotsky intended to interpret directly Marx's theses on the need to develop the productive forces as a material base for the overthrowing of capitalism by socialism. He incorporated Lenin's interpretation, that backward Russia would be rescued by developed Europe. So Trotsky proposed to focus efforts on the internationalization of the revolution, to rescue the Russian revolution. He considered that closing at national level would be a death sentence for the revolution, surrounded by scarcity, by peasants, by military harassment and by external siege.

Stalin started from western stabilization, the disappearance of revolutionary alternatives in Europe and other places in the world. What was to become of Russia, what was to become of the Russian revolution? This is where the force of Stalin's argument resided. However, he turned necessity into virtue, by means of the theory of "socialism in one country".

Russia felt the problem intensely, when the retraction of the peasant economy caused hunger in the cities and the Soviet government responded with violent and massive expropriation of the peasants. This allowed the accumulation that led to accelerated industrialization, but until the very end the Soviet government was left with an unsettled agrarian issue and had to face the hostility of the peasantry, due to the violent way in which it attempted to address this issue.

The Soviet model privileged the development of the productive forces, the recovery of the economic delay in an imperative manner, sacrificing the alliance with the peasantry and even the internal democracy of the Party. Surrounded by imperialist powers outside and the agrarian economy inside, the Soviet power chose compulsory industrialization, as a fundamental strategic objective.

The industrial development of the 1930's allowed the USSR to resist the military onslaught of the biggest war power of the time – Nazi Germany –, years of the brutal siege of Stalingrado, and to advance on Berlin, becoming the decisive and final factor in the defeat of nazism. However, deep inequalities had been introduced into Soviet society and power.

Inequalities between industrial economic development and agrarian development. Between the direct participation of generations of urban workers in the new State and the exclusion and repression suffered by the peasants. Between economic growth and social promotion of new generations of workers and internal repression to the Party. Between the generation of a military power and the poverty of the masses. Between nationalization of the means of production and the destruction of the *soviete* councils that were the basis of the workers' power.

Stalin's option structurally marked the Soviet model, which intended to move forward in the construction of socialism through the expansion of the productive forces. Until, in the 1960s, Khrushchev announced that the USSR would surpass US economically. It was the grander version of this vision. A backward European country, in five decades, in spite of the destruction caused by the civil war, the second world war, still managed – according to this version – to surpass the most developed capitalist power in the world.

This model was taken up by the international communist movement and by several other governments as a guide for the construction of socialism. Prioritizing economic development to the loss of political democratization. Defining socialism essentially as economic development.

4 PRIMITIVE SOCIALIST ACCUMULATION

As the revolution followed its heterodox path, not headed towards the countries of the developed center of capitalism, but moving increasingly to the periphery – China, Cuba, Vietnam -, the development issue became even more pressing. The world became increasingly polarized between the economic development of the central powers of capitalism and that of the peripheral countries on the three continents – Asia, Africa and Latin America.

The Soviet model was eagerly welcomed by the peripheral countries, which urgently needed models of accelerated economic development. It had a great influence on economies that had just emerged from colonialism, particularly in Africa and Asia.

The theoretical field of the bipolar world of the second postwar period was built around two opposing interpretations. For the socialist camp, the basic contradiction of the time was between capitalism and socialism, the Soviet model and the extension of the socialist camp represented the strength of this camp and its increasing expansion. For the capitalist camp, the contradiction was between democracy and totalitarianism. First, the nazi and fascist totalitarianism was defeated, later Soviet totalitarianism, and then Islamic totalitarianism was to be tackled.

During the period of existence of the socialist camp, it played a role of support to new countries that faced the issue of breaking away from capitalism. For Cuba, somehow, it worked this way, providing oil, weapons, preferential market. But Cuba wanted – and this was proposed expressly by Carlos Rafael Rodrigues, representative of Cuba in the CMEA – it to be a historical role expressly taken up by the socialist camp.

It was clear that Marx's claim that socialism should emerge in the center of capitalism was not only due to the more advanced constitution of the social classes and, presumably, due to class contradictions. It was also due to the essential material base for the construction of socialism. Not only to meet the basic needs of the population, but also to create the material conditions to overcome alienation: control over the work and production conditions by the producers themselves, through socialization of the means of production, but also sharp reductions of working shifts, allowing more free time for men to exercise their freedom.

When it appeared in the periphery, it was theorized – Trotsky did it most emphatically – that the constitution of an imperialist chain at world scale made the revolution mature in all of its links, even the most backward. This is what would have happened in Russia, which in order to address its pending national and agrarian issues had to break with capitalism and establish a workers' and peasants' State. The pending bourgeois issues would be settled under the rule of the proletariat – in the version of the concept of "skipping historical stages", which would explain the failure of the Mensheviks and their solution by the Bolsheviks, through the motto "Peace, bread and land", with which they took over power.

Conquering peace was only possible through a coalition of forces not committed with the division of the world between the great imperialist powers, and was a condition not only to prevent the suffering of the people in the battlefields, such as in the fratricidal war between workers of the two warring camps, but also, so that the resources spent in the war could be used to fight the hunger of the Russian people. The bread issue depended on the war issue. The conquest of the land by millions of peasants depended on an unrestricted coalition with the large property owners.

This is how the Bolsheviks put into practice the solution of the pending issues of the unconcluded democratic revolution, with the emerging socialist revolution. However, this did not solve the problem of the material development conditions of socialism, or the themes related to the economic development of the country. The agrarian structure remained backward, condemning the mass of peasants to extreme poverty. The urban structure lagged behind the urbanization and industrialization levels of the great western powers.

The theme of primitive socialist accumulation – already mentioned above – was raised for Marxist theory to address. Where to find the resources to take the material quality leap that would allow the construction of socialism in the periphery, in backward countries, where capitalism had been exhausted without having settled not even the agrarian issue? In the theory one can simply speak of "skipping stages", but the socialist stage had inherited backwardness – with all its connotations: ignorance, poverty, technological lagging, unskilled work force, etc.

In face of this quandary, as we said, characterizing the attitude of the peasants as sabotage and an attempt to siege and strangle proletarian power, Stalin began massive, hasty and violent expropriation of the peasants' lands. With this he accelerated tremendously the collectivization and nationalization of lands, at the same time placing in the hands of the Soviet State a large amount of resources to take a spectacular leap in the process of industrialization of the economy.

This measure marked the Soviet economic development deeply, both positively and negatively. Compulsory industrialization made the State's reasons – survival of the Soviet State in face of the threats of the imperialist siege, the harassment of the agricultural producers, the threats of continuity of the former through World War II – prevail over the capacity of social forces to undertake, in a conscious and organized manner, these basic tasks, that the survival of the Soviet State, isolated and antagonized by the western powers, depended on.

By prioritizing the development of the productive forces, the USSR achieved spectacular economic expansion for a decade – the 1930s -, recovering from the destructions of the previous decade. It later also managed to recover from the brutal destruction caused by the attacks of the German army during the second war and resume a cycle of expansion. The Soviet economy had already demonstrated, in the 1930s, while the capitalist economy suffered the harsh blows of the 1929 crisis, how its centralized planning left it immune to crises, retrocession and fluctuations, allowing it to grow at a reasonably uniform pace along time.

Since it started from a low level and had to face two major processes of reconstruction, the Soviet economy and the USSR as a country were able to present remarkable growth rates. It started from a backward level, similar to that of Turkey at the time of the Russian revolution, and in the second postwar period it had become a superpower, had divided up the world and was managing it together with the other superpower, the US.

The expansion of the productive forces was always its main flagship. It consolidated an economicist vision of Marxism. It intended for economic growth to turn socialism into the key element of superiority over capitalism. It believed that it was at the threshold of surpassing capitalism in the economic sphere and not in the quality and type of society.

The mechanism worked while the USSR developed a type of growth centered on reconstruction of infra structure, supply of basic goods, such as housing, clothing, furniture, shoes, etc. When this phase ended, demand began to focus on more technologically sophisticated products. When it had to depend on massive use of man power, on its it discipline, on centralized planning, the economy grew quickly.

As of the second half of the 1950s, demand became even more sophisticated, coinciding with Stalin's death and more flexible internal politics. Eric Hobsbawn has no doubt about it: the USSR lost the competition with the US along that decade. Not only because of the still elementary stages that Soviet industrialization was going through, but primarily because of the technological advances of the US economy, which took the lead in key high-tech sectors of the economy.

Even before it disappeared, the USSR had lost the technological battle with the US. The resumption of the cold war by Reagan forced the USSR to invest in military technology, for which it had no resources. Its economic structure became increasingly dual, with concentration of technological advances in the military sectors and huge lagging of other sectors of the economy. The world's bipolarity was guaranteed by the nuclear tie, without any comparison of GDP or per capita product or level of general technological development between the Soviet and US economies.

The aim of surpassing the US economically, making economic development capacity a factor of predominance, ended in failure. When the Internet was introduced, the game had already been decided, but if it hadn't, that would have been the definitive factor of technology defeat of the Soviet model.

Gorbachev's project was born frustrated, becoming the last chapter of the economicist interpretation of Marxism by the Soviet model. Social democracy had already abandoned its economicist interpretation of Marxism, when it abandoned Marxism definitively and took up projects to democratize capitalism.

Primitive socialist accumulation based on expropriation of the peasantry allowed an industrialization process, but was never able to rely on the agricultural economy, and always had to deal with the opposition of the peasants. It managed to drive the first stage of industrialization, but never to compete with the degree of economic development of countries at the center of capitalism. It became clear, in the end of the socialist camp, that the general demand was not the conquest of democracy, but access to the consumption of countries at the center of capitalism.

5 PRIMITIVE SOCIALIST ACCUMULATION IN THE AGE OF GLOBALIZATION

The end of the socialist camp is part of a set of regressive elements, marking the introduction of the contemporary historical period. Added to this is the shift from a bipolar world to a unipolar world under the rule of the United States, the shift from a long cycle of expansion of capitalism to long recessive cycle and the shift from a hegemonic regulatory model to a deregulating , neo-liberal model.

Its multiple consequences include the naturalization of the capitalist economy, as socialism was no longer a historical reality that it had been since the 1917 Bolshevik revolution. With the triumph of the western block in the cold war, its interpretation of the world won, raising the capitalist economy to the category of international economy, as if the possible historical horizon were limited to the market economy.

Among its effects, one of the most spectacular was China's choice for a market economy path – that they consider as market socialism. After a decade of the so-called "cultural revolution", which disorganized the whole of society, including the State, producing 200 million unemployed, in addition to very negative historical references – Albania and Cambodia, experiences of "equality in poverty" -, China faced the classic problem of primitive socialist accumulation. Deng Xiaoping – the great theoretician of the new phase of the Chinese process – claimed that socialism and poverty had nothing to do with each other. It was necessary to take a giant material leap.

The Chinese searched for capitals where they were to be found: in the market. Initially, in the capitals of the Chinese colony in other Asian countries, later directly in the economies of the center of capitalism. They drew lessons from the failed experience of Gorbachev in the USSR and, instead of trying to promote economic opening and political flexibility, on the contrary, they strengthened the role of the State to guarantee control over the economic opening.

Gradually the industrial sector was privatized, with the government keeping the area of infrastructure and services, but above all economic regulation, which allowed controlling the degree of economic opening. As the process of privatizations moved forward, the degree of state coverage in the social sphere decreased, especially in urban areas, where increasing shares of the population headed to, until almost half of the total population of China was living in cities.

The famous sentence "It doesn't matter whether the cat is black or white, as long as it catches mice", by Deng Xiaoping in 1978, at the time of launching of the program of reforms that changed, in a few decades, the face of China, reflected particularly the change of concepts of the country on the theme of development. The cultural revolution of the previous decade had developed the most radically opposing concept to this. Taking literally the Marxist interpretation that attributes to everything an inexorable stamp of class, the cultural revolution had made the most radical critique of the role of technique, division of labor, intellectuality, science, university, knowledge in general and culture.

The strongest criticism was against the division between material work and intellectual work, which allowed the latter to own knowledge, with the corresponding privileges. Seen as a product of the capitalist division of labor, the construction of large productive and economic structures in general, that would enable this division, were equally repudiated. The economic structure should rest on small units, controllable by the workers, at the same time that processes such as the cultural revolution should be undertaken, to purge Chinese society from the privileges of intellectuals and scientists, who tended to become autonomous and enjoy the privileges of knowledge and power. The cultural revolution virtually wiped out the university system of research, banishing millions of research studies that supposedly had been contaminated by the virus of capitalist forms of material and intellectual production. Even the Chinese State had many of its structures dismantled, as part of the anti-bureaucratic struggle.

This concept had triumphed in Albania and, more dramatically, in Cambodia. There, economic closing to the international market was combined with extolling of backwardness, covered up by equality and the claim that any form of modernization was "bourgeois and capitalist". Conservative tyrannies were established, both in relation to the essentially democratic forms of political life, and in relation to knowledge, research, culture, technological development, intellectuality and the scientific world. The urbanization processes were characterized as contaminated by the capitalist ideology, life in the field, in the small units of agricultural production was glorified. Millions of people were transferred forcibly to the rural areas, for processes of "political reeducation", based on the view that there they would experience "ideological purity", uncontaminated by capitalist influence.

The result was a brutal economic retrocession and a tyrannical regime. Scarcity is always a bad adviser, and tends to generate privileges, deeply stratified and rigid social structures, as well as repression and segregation. The defense of equality in poverty has nothing to do with socialism, it belongs to pre-capitalist times, it does not stimulate the increase of production and productivity, ultimately consolidating poverty in the name of equality and socialism. They could not survive for long, despite the closing and isolation, as well as the repression.

China, which had been a more prosperous and richer civilization than Europe, was submitted to something similar to the cultural revolution, but earlier it had tried the opposite path, with Mao's Great Leap Forward, in an attempt to overcome the Chinese material lag. China finally chose the path of accelerated economic development to overcome the lag, with market economy capitals and technologies, within a rationale submitted to the priorities defined by the Chinese State, above all lifting hundreds of millions of Chinese from poverty.

Within their long-term view of history, for the Chinese this is only a relatively short stage, in which the right to access basic goods and reinsertion in the international market are claimed, towards the construction of a relatively prosperous country. They consider this path as a type of solution, in the conditions of China, of the question of primitive socialist accumulation. However, they maintain their strategic objectives of construction of socialism and communism, of a society without classes and without State.

Cuba also has that to face similar issues. Cuban society had been diversifying when the USSR came to an end, and the country entered what was called a "special period", a situation reserved for some likelihood of war, but used in face of the huge emergencies that Cuba found itself submitted to.

The special period consisted of emergency measures to face the end of the collective planning system, which had allowed Cuba, when joining it almost two decades earlier, to have the cycle of greater economic development. First, through the long-term planning that the system allowed, leaving the country safe from the typical oscillations of capitalist economies, even more so in the case of a country that depended on exportation of surplus raw materials in the international market, as was the case of sugar.

Second, because it ensured a safe market for its exportations, with steady prices, just as it ensured the supply of oil and armaments. Thus, economic planning could be done in conditions of predictability and security provided by a collective framework that each country joined.

The abrupt end of the socialist camp left Cuba in the worst crisis of its history. It suffered a brutal drop of its gross domestic product, was left without oil, without a market for its export products, and only survived thanks to the legitimacy that the revolution had achieved in the mass of the population. There were power cuts for a few years, also in the tropical summers, when the lack of fans, refrigerators, television reduced the well-being of its population to an elementary level.

Five years after the start of the special period, Cuba adopted measures to increase flexibility, allowing people to open some businesses of their own, to work to cater for the demands of tourism, to receive remittances from abroad. The measures brought some relief of the most difficult situation experienced in Cuba, but other factors were crucial to overcome that situation, such as the important discovery of oil on the coast of the Island, agreements with Venezuela, China and Brazil.

However, this entailed recovery of a certain level of demand, without solving the structural problem of primitive socialist accumulation that had become more pressing since the end of the socialist camp. The change of government in the US might allow a negotiation that will minimally normalize economic relations between the two countries.

Cuba is preparing for two negotiations with the foreign capitals that it needs to take an economic leap in its internal situation, for which it does not have the advantages of China, such as a huge and rapidly expanding domestic market It has good quality work force, but nothing compared to the scale of the Chinese economy. But the question is open for Cuba.

6 DEVELOPMENT IN ANTI-NEO-LIBERALISM

In the shift from the long expansive cycle of capitalism at international scale to the current long recessive cycle, the theme of development was put off in the central agenda. The virtuous combination of growth in the center, the periphery and the socialist camp had achieved economic development, under different forms, in different places of the system. The agenda of the recessive cycle is under the command of monetary stability, fiscal adjustment, financial austerity. Development is now associated with inflation, state induction, income distribution – categories marginalized by the new triumphant consensus.

The Trilateral Commission highlighted one of the central themes of the new hegemonic agenda: the theme of ungovernability. In face of repressed demands not met by economies in recession, the concept of "restricted democracies", which would selectively meet demands, came under debate. It was clear that political democracies clashed with economies in recession. And that they would not be able to assimilate the existing demands and repressed demands. So they pointed to "restricted democracies", selective in meeting demands.

This position was adopted by neo-liberalism, which submitted all the demands to the filter of monetary stability. The result was a brutal recessive process. The anti-neo-liberal governments emerged attacking the two least resistant and weakest points of the governments that had implemented the model: social policies and regional integration. Other aspects, such as resumption of the State's functions as inducer of development and economic regulation, arose as a need of these two demands.

The policies of the new Latin American governments have not yet become an alternative development theme, since they only include a few, albeit essential, elements. Much less can one claim that they are on a clear path of overcoming of neo-liberalism or that they have anti-capitalist potential.

The essential objective of the neo-liberalism is to promote mercantilization – a historical objective. It consists of a historical reaction to the regulation process imposed by the Keynesian State. Overcoming neo-liberalism is to de-mercantilize. De-mercantilizing is to privilege the public sphere rather than the market, to promote universalization of rights in the place of mercantilization of social relations. The more de-mercantilization, the more the public sphere is strengthened, the more anti-capitalism is promoted – the essential objective of Marxism. It is an open process, the object of open ideological and political dispute, on whose outcome depends the future of neo-liberalism, of capitalism and, therefore, of socialism and Marxism.

WHAT ARE THE LESSONS FOR DEVELOPMENT SUCCESS FROM TRANSITION ECONOMIES: PUTTING THE SUCCESS STORIES IN THE POST-COMMUNIST WORLD INTO A BROADER PERSPECTIVE*

Vladimir Popov**

There are at least three reasons, why many transition economies succeeded by pursuing policies that are so different from radical economic liberalization (shock therapy) that is normally credited for the economic success of Central European countries.

First, optimal policies are context dependent, they are specific for each stage of development and what worked in Slovenia cannot be expected to work in Mongolia. Second, even for countries at the same level of development, reforms needed to stimulate growth are different; they depend on the previous history and on the path chosen. The reduction of government expenditure as a share of GDP did not undermine significantly the institutional capacity of the state in China, but in Russia and other CIS states it turned out to be ruinous. It is the growth diagnostics that should reveal the missing ingredient for economic growth. Introducing this "missing ingredient" should not result in the destruction of other pre-conditions for growth. The art of the policymaker is to create markets without causing the government failure, like it happened in many CIS countries. Finally, third, and most important, there are long term trajectories of development that are path dependent: once the country gets on a particular trajectory, it is sometimes better to stay on track because the costs of transition to a seemingly superior trajectory may be prohibitively high.

QUAIS SÃO AS LIÇÕES DAS ECONOMIAS EM TRANSIÇÃO PARA O SUCESSO DO DESENVOLVIMENTO: COLOCANDO OS CASOS DE SUCESSO NO MUNDO PÓS-COMUNISTA EM UMA PERSPECTIVA MAIS AMPLA

Há no mínimo três razões para o sucesso de muitas economias em transição na condução de políticas tão diferentes de liberalização econômica radical (terapia de choque), à qual normalmente se atribui o sucesso econômico dos países centro-europeus.

Em primeiro lugar, políticas ótimas dependem do contexto, são específicas para cada estágio de desenvolvimento, e não se pode esperar que o que funcionou na Eslovênia tenha igual efeito na Mongólia. Em segundo lugar, até mesmo para países em igual nível de desenvolvimento, as reformas necessárias para estimular o crescimento são diferentes: dependem da história anterior e do caminho escolhido. A redução da despesa governamental como proporção do produto interno bruto (PIB) não prejudicou significativamente a capacidade institucional do Estado na China, mas na Rússia e em outros estados da Comunidade dos Estados Independentes (CEI) foi um desastre. É o diagnóstico do crescimento que deve revelar o ingrediente que falta para o crescimento econômico. A introdução de tal "ingrediente que falta" não deve resultar na destruição de outras pré-condições para o crescimento. A arte do formulador de políticas é criar mercados sem causar o fracasso do governo, como aconteceu em muitos países da CEI. Finalmente, em terceiro lugar, e mais importante, existem trajetórias de desenvolvimento de longo prazo que dependem do caminho: uma vez que o país inicia uma determinada trajetória, às vezes é melhor permanecer neste caminho porque os custos da transição para uma trajetória aparentemente superior podem ser muito altos.

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* This article is partly based on Popov (2009a) and Popov (2009b).

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1 ABSTRACT

There are at least three reasons why many transition economies succeeded by pursuing policies that are so different from radical economic liberalization (shock therapy) that is normally credited for the economic success of Central European countries.

First, optimal policies are context dependent, they are specific for each stage of development, and what worked in Slovenia cannot be expected to work in Mongolia. Second, even for countries at the same level of development, reforms needed to stimulate growth are different; they depend on the previous history and on the path chosen. The reduction of government expenditure as a share of GDP did not undermine significantly the institutional capacity of the state in China, but in Russia and other CIS states it turned out to be ruinous. It is the growth diagnostics that should reveal the missing ingredient for economic growth. Introducing this "missing ingredient" should not result in the destruction of other pre-conditions for growth. The art of the policymaker is to create markets without causing government failure, as happened in many CIS countries. Finally, third, and most important, there are long term development trajectories that are path dependent: once the country gets on a particular trajectory, it is sometimes better to stay on track because the costs of transition to a seemingly superior trajectory may be prohibitively high.

2 STYLIZED FACTS

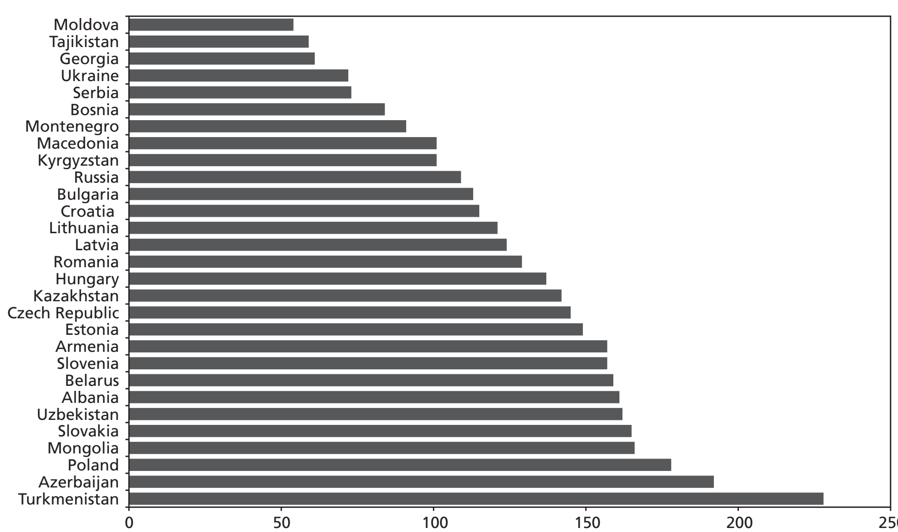
As Leo Tolstoy claimed in "Anna Karenina", "happy families are all alike; every unhappy family is unhappy in its own way". This wisdom, however, can hardly be applied to the development success of countries: it appears that success stories in the development and transition world are as different as they can be. It is not uncommon to come across contradictory statements about the reasons for economic success: economic liberalization and free trade are said to be the foundations of rapid growth in some countries, whereas successes of other countries are credited to industrial policy and protectionism; foreign direct investment, which is normally considered a growth-contributing factor, did not play any significant role in the developmental success of Japan, South Korea and pre-1990s China. Privatization of state enterprises, foreign aid, immigration, liberalization of the financial system, democratic political institutions – all these factors, just to name a few, are usually believed to be prerequisites of successful development, but it is easy to point out success stories that are not associated with these factors.

In the 1970s, the breathtaking economic success of Japan, which transformed itself into a developed country in just two postwar decades, was explained by the "Japan incorporated" structure of the economy – special relations between the government and companies (Miti), between banks and non-financial companies (bank-based financial system), between companies and workers (lifetime employment). After the stagnation of the 1990s, and especially after the 1997 Asian financial crisis that affected Japan as well, these same factors were largely labeled as clear manifestations of "crony capitalism" that should be held responsible for the stagnation.

Similar patters can be observed in transition countries – from Vietnam and China to former East Germany and Albania. Obviously, what worked in some countries did not work in others. Central European countries – Czech Republic, Hungary, Poland, Slovakia and Slovenia – and to a lesser extent other East European countries are claimed to be success stories of transition. The success is attributed to radical (shock therapy type) reforms – deregulation of prices and markets, macroeconomic stabilization, privatization, the elimination of soft budget constraints (subsidies to state and non-state enterprises), openness to trade and FDI, fast transition to consolidated democracy and membership in the EU.

But there are other examples of successes in the region as well. Suffice it to look at the charts below to realize that in the transition world, as elsewhere, "success" (at least as measured by the growth of GDP) is not always associated with economic liberalization and democracy. In 1989-2006 Turkmenistan was doing better than Poland; and Uzbekistan and Belarus – no worse than Hungary and Czech Republic (fig. 1). And whereas former Soviet Union states experienced on average a steeper and more lasting decline in output during the transformational recession of the 1990s (fig. 2), their speed of economic recovery was in many instances higher than that of Central European countries. In 2000-2007 average annual growth rates of GDP in Azerbaijan were 15%, in Armenia, Kazakhstan, and Turkmenistan – over 10% (fig.3).

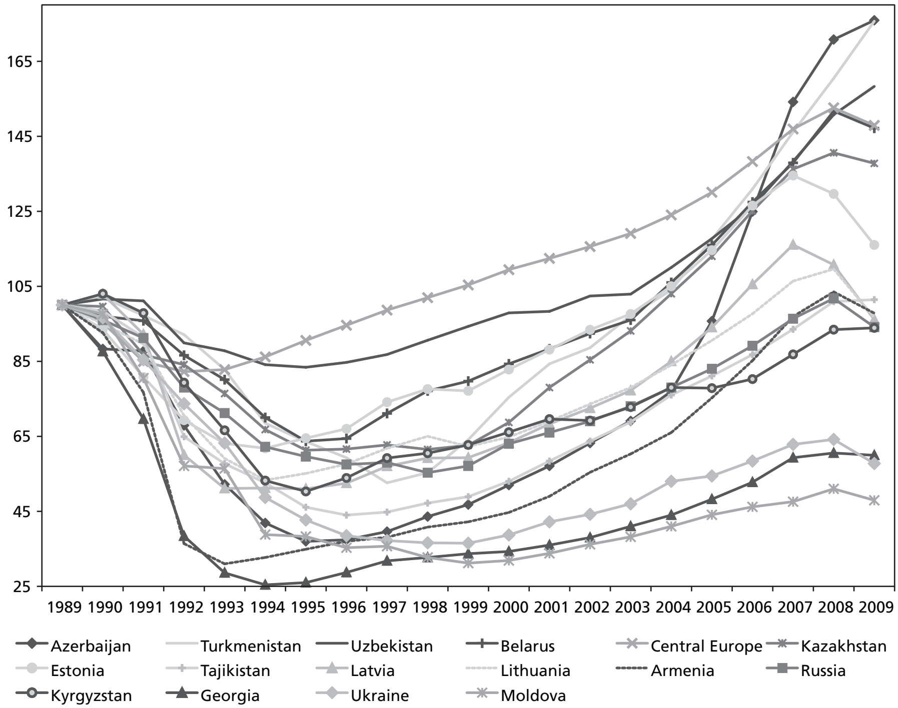
FIGURE 1
2008 GDP as a % of 1989 level



Source: Transition Report *for various years*, European Bank for Develpment and Reconstruction (EBDR).

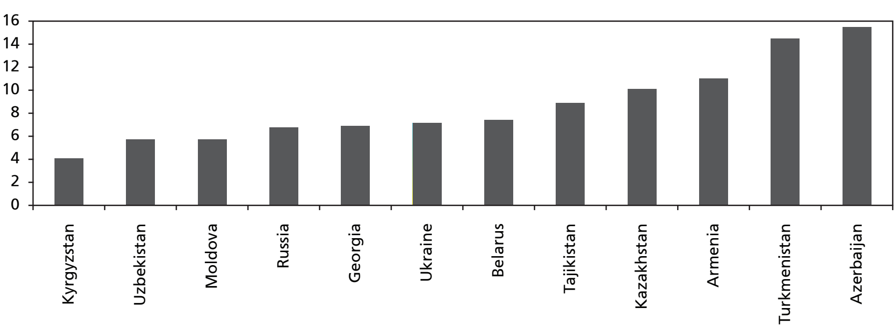
FIGURE 2

GDP change in FSU economies, 1989 = 100%



Source: Transition Report *for various years*, EBRD.

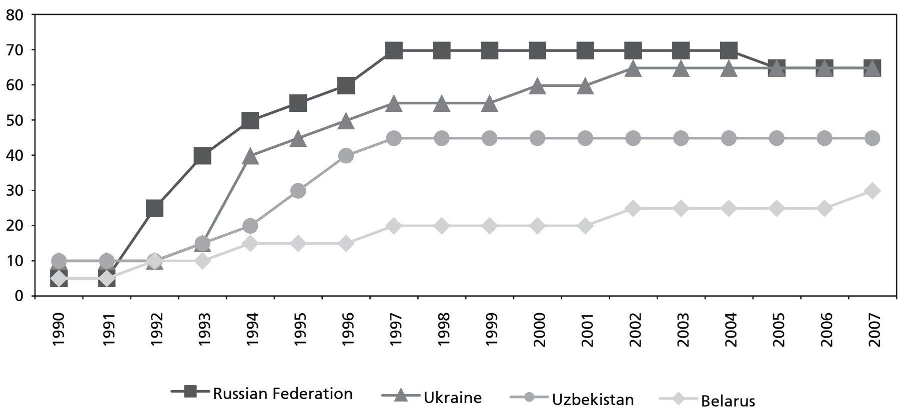
FIGURE 3



Source: Transition Report 2007, EBRD.

Among the "other", non-orthodox, success stories in the post-communist world are fuel rich Turkmenistan, Kazakhstan and Azerbaijan, fuel self-sufficient Uzbekistan and Vietnam, and fuel importers – Belarus and China. All these countries are non-democratic, but some are quite liberal economically (Kazakhstan), whereas others carry out heavy-handed industrial policy and even did not bother to privatize state enterprises in nearly two decades of economic reforms (the share of private sector in GDP in Uzbekistan – 45%, in Belarus – 25%, fig. 4).

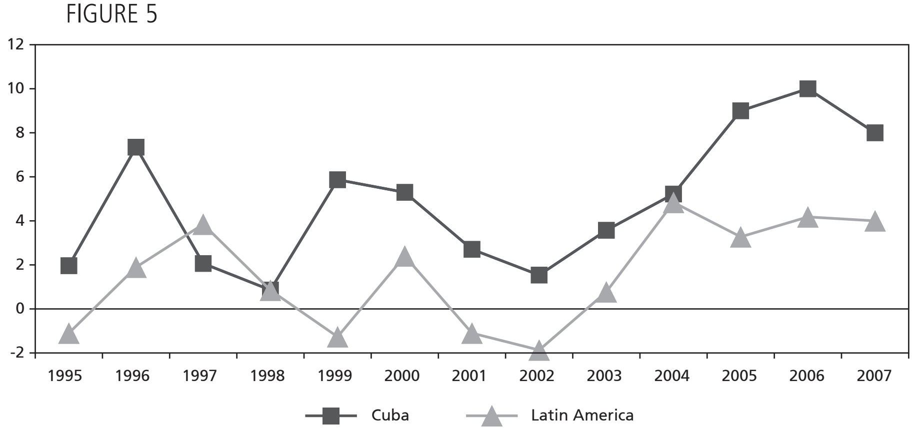
FIGURE 4
Private sector share in GDP, %



Source: Transition Report 2007, EBRD.

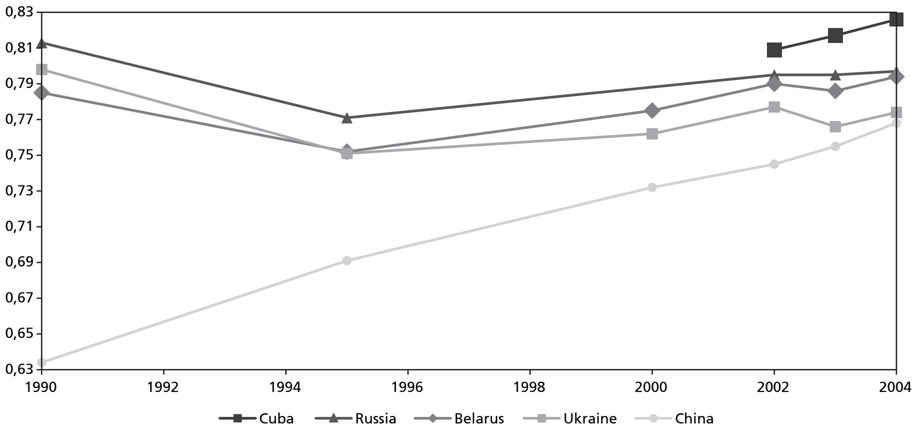
Not to mention the example of Cuba, which still has (despite all recent reforms) a centrally planned economy, but grows faster than Latin American countries on average (fig. 5). In addition, with the life expectancy of 77 years – one of the highest in Latin America (only Costa Rica has a similar indicator) and among communist and post-communist countries – Cuba has a very high Human Development Index, higher than most FSU republics and many EE countries (chart 6).

FIGURE 5



Source: World Development Indicators, 2007, World Bank.

FIGURE 6



Source: Human Development Report, 2007, UNDP.

3 STAGES OF DEVELOPMENT AND OPTIMAL POLICY

One explanation for the different foundations of success is that good policies are context dependent. There is a large body of literature that emerged in recent years and that questions the universality of recipes for reform. Simply put, this literature states that what may be good for a relatively developed country with reasonable institutions is not necessarily good for countries that are farther away from the technological frontier and where corruption flourishes. Even the simple enumeration of the areas where market-oriented reforms are found to be detrimental for less developed countries is quite impressive: free international trade and migration of skilled labor, elimination of subsidies to producers and promotion of competition, liberalization of capital flows and deregulation of domestic financial markets. The general conclusion of such studies is that developing countries should not embark blindly on market friendly policies/reforms, even if the latter proved to be beneficial in more advanced countries. On the contrary, in other areas, such as the protection of intellectual property rights or environmental standards, Western regulatory requirements are perceived to be too strict for poorer countries.

The argument in both cases is that most Western countries 100 years ago did not have either *laissez faire* markets, or today's strict standards of protection of environmental and human rights. Advocating the acceptance of these standards in less wealthy parts of the world, and even threatening developing countries with economic sanctions in case they refuse to accept such standards, the West, whatever the good intentions may be, *de facto* undermines the competitiveness of poorer countries and preserves their backwardness. There are even accusations of double standard (when the West was industrializing, it was not maintaining these standards) and "kicking away the ladder" (after the West got rich through exploitation of colonies and child labor, it does everything to slow down the growth of "the other world" – Chang, 2002).

Two recent papers by Acemoglu, Aghion, Zilibotti (2002a,b) offer a model to demonstrate to what extent economic policies depend on the distance to the technological frontier. These papers consider policies with respect to hiring managers (lifetime employment vs. temporary contracts) and vertical integration and size of firms[1], but the general principle can be extended to quite a number of areas, from trade liberalization to policies with respect to migration. Optimal policies do differ at various stages of development and the art of a policymaker is to shift gears at the appropriate time. For instance, even if private property is more efficient than state property in developed countries, government-controlled business entities can still be superior to privatized businesses in poor institutional environment, when contracts are poorly enforced, especially in areas where resource rent is generated (Chang, 2007).

It was also shown that policies in a variety of areas (trade protectionism, "exchange rate protectionism" – accumulation of foreign exchange reserves, technological imitation versus indigenous innovation, protection of IPR, industrial concentration versus development of small businesses, bank-based versus market-based financial system, liberalization of capital account, including FDI, migration of skilled/unskilled labor) do depend on the level of development (distance to technological frontier) and on the quality of institutions: cross-country regressions reveal the thresholds in per capita GDP and institutional indicators that separate positive and negative influence of various policies on growth (Polterovich, Popov, 2005, 2006)[2].

The same is true with regard to political regimes conducive to growth – democratization, unfortunately, leads to the weakening of institutional quality and lower growth, if carried out in countries with poor initial tradition of the rule of law and large resource wealth (Polterovich, Popov, 2007; Polterovich, Popov, Tonis, 2007; 2008).

1. The authors assume that a change of a country's technological level is equal to the weighted sum of technological change due to imitations and innovations. The speed of imitation is fixed, whereas the speed of innovation is larger for more advanced economies. The experience of new managers is most important for imitations, whereas their talents are crucial for innovation. If the distance to the technological frontier is large, the economy would be better off giving managers long-term contracts that would lead to imitation and investment-based growth. But once the economy approaches the technological frontier and innovation yields greater returns than imitation, the lifetime employment system should be replaced by competitive selection.

2. Regression equations have the general form: **GROWTH** = **Control Variables** + **P**(a-b**X**), where **P** is the policy variable, for instance, degree of trade protection, and **X** is per capita GDP and/or institutional indicator, for instance, government effectiveness. There is a threshold level of per capita GDP and/or the quality of institutions: before this level is reached, the impact of particular policy on growth is positive, after it is exceeded, the impact turns negative.

In general, such a theory that prescribes a particular mix of policies to countries at different levels of development and with different institutional quality (different levels of human capital, different endowment with natural resources, etc.) seems to be the new emerging conventional wisdom that lays the new foundations of new development economics. In a sense, it is like filling the cells of the economic periodic table – once all initial conditions are factored in, a unique set of policies can be prescribed. The idea in its general form seems to be very intuitive and even trivial, especially to non-economists, but once it comes to particular policy prescriptions (for instance, trade protection can stimulate growth in countries with low level of development, but relatively good institutional capacity), the debates intensify.

Such an approach may explain why particular post-communist countries at a lower stage of development and with poor tradition of the rule of law (Azerbaijan, Belarus, China, Kazakhstan Turkmenistan, Uzbekistan, Vietnam) succeeded under authoritarian regimes and by pursuing economic policies that were often not at all liberal and differed a lot from shock therapy treatment that was used in Central Europe and is credited for its success. And it can also explain why their more democratic and more economically liberal counterparts with similar level of development and similar quality of institutions (Armenia, Georgia, Kyrgyzstan, Moldova, Mongolia, Russia, Tajikistan, Ukraine) did worse, sometimes much worse (fig. 1, 2).

4 GROWTH DIAGNOSTICS: MISSING INGREDIENTS

Still, this is a universal scheme – less straightforward than Washington consensus, but a universal one nonetheless. Another factor explaining successful performance of countries that pursued different policies is that there is more than one route to success. And the routes are path dependent. As Lenin wrote in 1916, "all nations will reach socialism, that is inevitable, but none in exactly the same way". It may well be that similar countries and even the very same country can achieve what is vaguely labeled "success" by taking different paths that lead to the same final destination and that are not very different in terms of costs and benefits along the way.

As a first step, it may be appropriate to distinguish between market-led and state-led economic systems. If for a given level of economic development there is one and only one optimal combination of state and markets, there should be countries on both sides of the optimal trajectory: leaning to the market, like SSA (Sub-Sahara Africa) and LA (Latin America, with the exception of Cuba, of course), South Asia (SA) and Commonwealth of Independent States (CIS) today, and leaning towards the state, like East Asia (EA) and communist countries before the 1990s. While the former had a lot of deregulation and markets, but not sufficient state capacity, the latter had a lot of state capacity, but heavily regulated and poorly liberalized markets or sometimes no markets at all. Whereas the major problem in the former was state failure, in the latter it was market failure.

A close analogy is that by Wassily Leontief (1974), who has written that an economy using the profit motive but without planning is like a ship with a sail but no rudder. It may move rapidly, but cannot be steered and might crash into the next rock. A purely planned economy that has eliminated the profit motive is like a ship with a rudder but no sail. It could be steered exactly where one wants it to go, if only it moved. To move forward while avoiding dangerous pitfalls, an economy needs both some reliance on the profit motive and some planning, a sail and a rudder.

Similarly, Steven Holmes (1997) claimed that the major lesson to be learned by Western democracies from recent Russian developments is exactly the one about the crucial importance of state institutions: whereas the Soviet Union has proven that a non-market economic system with a strong state cannot be efficient, Russia today is proving that the market without a strong state is as good as exchanging unaccountable power for untaxable wealth, leading to economic decline.

To put it differently, reforms that are needed to achieve success are different for countries with different backgrounds. Manufacturing growth is like cooking a good dish – all the necessary ingredients should be in the right proportion; if only one is under- or overrepresented, the "chemistry of growth" will not happen. Fast economic growth can materialize in practice only if several necessary conditions are met simultaneously, at the same time. Rapid growth is a complicated process that requires a number of crucial inputs – infrastructure, human capital, even land distribution in agrarian countries, strong state institutions, economic stimuli among other things. Once one of these crucial necessary ingredients is missing, growth just does not take off. Rodrik, Hausmann, Velasco (2005) talk about "binding constraints" that hold back economic growth; finding these constraints is the task of "growth diagnostics". In some cases, these constraints are associated with the lack of market liberalization, in others – with the lack of state capacity or human capital or infrastructure.

Why did economic liberalization work in Central Europe, but not in SSA and LA? The answer, according to the outlined approach, would be that in Central Europe the missing ingredient was economic liberalization, whereas in SSA and LA there was a lack of state capacity, not lack of market liberalization. Why did liberalization work in China and Central Europe and not in CIS? Because in CIS it was carried out in a way that undermined state capacity – the precious heritage of the socialist past, whereas in Central Europe, and even more so in China, state capacity did not decline substantially during transition.

Take a closer look at the Chinese case. It is important to realize that the rapid catch-up development of the post-reform period is due not only to and even not so much to economic liberalization and market-oriented reforms. The pre-conditions for the Chinese success in the past 30 years were created mostly in the preceding period of 1949-76. In fact, it would be no exaggeration at all to claim that without the achievements of Mao's regime the market-type reforms of 1979 and beyond would never produce the impressive results that they actually did. In this sense, economic liberalization in 1979 and beyond was only the last straw that broke the camel's back. The other, most important ingredients – strong institutions and human capital, had already been provided by the previous regime. Without these other ingredients, liberalization alone in different periods and different countries has never been successful and has sometimes been counterproductive, such as in Sub-Sahara Africa in the 1980s.

Market-type reforms in China in 1979 and beyond brought about the acceleration of economic growth because China already had an efficient government that was created by CPC after Liberation and that the country had not had in centuries[3] (Lu, 1999). Through the party cells in every village, the communist government in Beijing was able to enforce its rules and regulations all over the country more efficiently than Qing Shi Huangdi or any emperor since then, not to mention Guomindang's regime (1912-49). While in the late XIX century the central government had revenues equivalent to only 3% of GDP (against 12% in Japan right after the Meiji restoration) and under the Guomindang government they increased only to 5% of GDP, Mao's government left the state coffers to the Deng's reform team with revenues equivalent to 20% of GDP. Chinese crime rate in the 1970s was among the lowest in the world, Chinese shadow economy was virtually non-existent, corruption was estimated by Transparency International even in 1985 as the lowest in the developing world. In the same period, during "clearly the greatest experiment in mass education in the history of the world" (UNESCO-sponsored 1984 Report) literacy rates in China increased from 28% in 1949 to 65% by the end of the 1970s (41% in India).

To put it differently, by the end of the 1970s, China had virtually everything that was needed for growth except some liberalization of markets – a much easier ingredient to introduce than human capital or institutional capacity. But even this seemingly simple task – economic liberalization – required careful management.

3. To a lesser extent it is true about India: market-type reforms in the 1990s produced good results because they were based on previous achievements of the import substitution period (Nayyar, 2006).

The USSR was in a similar position in the late 1980s. True, the Soviet system lost its economic and social dynamism, the growth rates in the 1960s-80s were falling, life expectancy was not rising, and crime rates were slowly growing, but institutions were generally strong, human capital was large, which provided good starting conditions for reform. Nevertheless, economic liberalization in China (since 1979) and in the USSR and later – Russia (since 1989) produced markedly different outcomes (Popov, 2000, 2007a).

5 LIBERALIZATION WITHOUT DESTRUCTION OF STATE INSTITUTIONS

Searching for the reasons for China's successful performance, experts point to the household responsibility system and to township and village enterprises (TVEs), to SEZ (special economic zones) and to the one child policy, to FDI and to connections with *huaqiao* (overseas Chinese). But other countries tried more than once to replicate all these elements of Chinese policy – and generally failed. Not only because they did not have the preconditions in the form of physical infrastructure, human capital and working institutions (the USSR had all these), but because these preconditions for successful liberalization were often not preserved during the reforms. The trick of transition, as is evident *post factum*, was not to carry out economic liberalization, but to carry it out in such a way as not to throw away the baby with the bathwater, not to squander the precious achievements of the previous communist period in the form of strong institutions. China generally did not squander this heritage[4], even though government spending fell, income inequalities rose and crime rates increased, whereas Russia and most other CIS states did.

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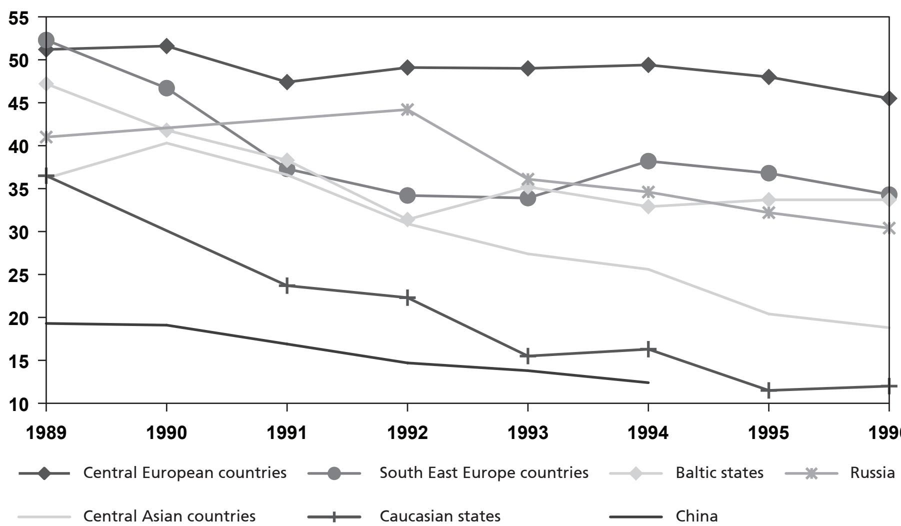
4. The post 1979 reform Chinese model of economic growth is based on principles that have nothing to do with the Washington or even post-Washington consensus. Responsible macroeconomic policies (no high inflation) is about the only principle of the Washington consensus that China has adhered to after 1979 (as well as before 1979), whereas with respect to other fundamental principles (fast deregulation and liberalization of prices and markets, downsizing of the government, privatization, opening up of the economy) Chinese policy was not only different from, but exactly the opposite of neoliberal prescriptions (Popov, 2007b). Since 1979, the Chinese economic model is based on:

- Gradual democratization and the preservation of the one-party rule in China helped prevent institutional collapse, whereas in Russia institutional capacity was adversely affected by the shock-type transition to democracy (Polterovich, Popov, 2007);
- Gradual market reforms – "dual track price system" (co-existence of the market economy and centrally planned economy for over a decade), "growing out of socialism" (no privatization until 1996, but creation of the private sector from scratch), non-conventional forms of ownership and control (TVEs);
- Industrial policy – strong import substitution policy in 1949-78 and strong export-oriented industrial policy afterwards with such tools as tariff protectionism (in the 1980s import tariffs were as high as 40% of the value of import) and export subsidies (Polterovich, Popov, 2005);
- Macroeconomic policy – not only in the traditional sense (fiscal and monetary policy), but also exchange rate policy: rapid accumulation of foreign exchange reserves in China (despite positive current and capital account) led to the undervaluation of yuan, whereas Russian ruble became overvalued in 1996-98 and more recently – in 2000-08. Undervaluation of the exchange rate via accumulation of reserves became in fact the major tool of export-oriented industrial policy (Polterovich, Popov, 2004).

Out of 30 transition economies, only a few did not experience sharp reduction of the share of government revenues/spending in GDP during transformation – Estonia, Vietnam and Central European countries (Czech Republic, Hungary, Poland, Slovak Republic, Slovenia); less dramatically than in other countries, government expenditure/GDP ratios fell in Uzbekistan and Belarus (fig. 7). It is easy to notice that these countries are precisely the ones that exhibited the most favorable GDP dynamics: in Central Europe the 2000 GDP surpassed the pre-recession level of 1989, whereas Uzbekistan, Belarus and Estonia (exactly in this order) came closer than other Soviet republics to restoring the pre-transition GDP level, and Vietnam did not experience any transformational recession at all.

FIGURE 7
Consolidated government revenues as a % of GDP

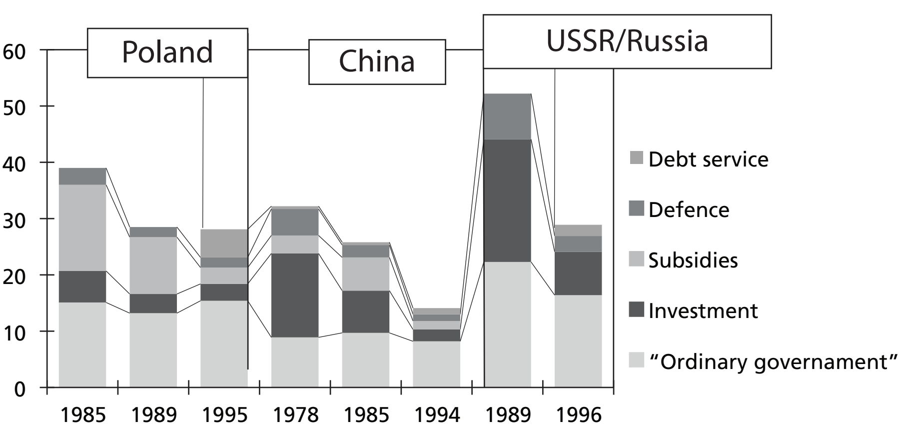


Source: Popov, 2000.

China seems to be an exception to this rule, since there was no transformational recession in China as well, but the share of government spending in GDP fell from 35% in 1978 to 13% in the mid 1990s. However, firstly, the major decrease occurred in the second half of the 1980s, whereas in the first stage of transition government spending grew pretty much in line with GDP. Secondly, the decrease in the share of state expenditure was a controlled process, i.e. it occurred due to the initiative of the government itself, not despite its efforts. And thirdly, the expenditure for the "ordinary government" (excluding subsidies, investment and defense spending) grew in line with GDP. Finally, since 1995 the share of state expenditure in GDP in China has been increasing (about 20% in 2007).

Three major patterns of change in the share of government expenditure in GDP generally coincide with the three major archetypes of institutional developments, and even broader - with three most typical distinct "models" of transition (fig. 8). Under **strong authoritarian regimes** (China), cuts in government expenditure occurred at the expense of defense, subsidies and budgetary financed investment, while expenditure for "ordinary government" as a percentage of GDP remained largely unchanged (Naughton, 1997); **under strong democratic regimes** (Poland), budgetary expenditure, including those for "ordinary government", declined only in the pre-transition period, but increased during transition itself; finally, **under weak democratic regimes** (Russia), the reduction of the general level of government expenditure led not only to the decline in the financing of defense, investment and subsidies, but to the downsizing of "ordinary government", which undermined and in many instances even led to the collapse of the state's institutional capacities.

FIGURE 8
Governement expenditure, % of GDP



Source: Popov, 2000.

While in China total budgetary expenditure and that for "ordinary government" were much lower than in Russia and Poland, they were sufficient to preserve the institutions running, since the financing of social security from the government budget was traditionally low. In Russia, however, although ordinary government expenditure seems to have been not that much lower than in Poland, the pace of its reduction during transition exceeded that of GDP: to put it differently, given the various patterns of GDP dynamics, while in Poland "ordinary government" financing grew by about one third in real terms in 1989-95/6 (and while in China it nearly doubled), in Russia it fell by about 2/3! The Russian pattern of institutional decay proved to be extremely detrimental for investment, and for general economic performance.

In most CIS states, reduction of government expenditure occurred in the worst possible way - it proceeded without any coherent plan and did not involve reassessment of government commitments. Instead of shutting down completely some government programs and concentrating limited resources on the others with a view to raising their efficiency, the government kept all programs half-alive, half-financed, and barely working. This led to the slow decay of public education, health care, infrastructure, law and order institutions, fundamental R&D, etc. Virtually all services provided by the government - from collecting custom duties to regulating street traffic - became symbols of notorious economic inefficiency.

Education and health care were free in the Soviet Union, but now these services are provided mostly for a fee and their quality is way below Soviet standards. Life expectancy declined from 70 years in 1987 to 65 years in 2006 (against 73 years in China). Criminalization of the country made a mockery out of the idea of the law and order: the murder rate surged from 10 in the late 1980s to about 30 per 100,000 of the population in the second half of the 1990s, as compared to 1–2 in Eastern and Western Europe, Japan and China, Israel and Mauritius. Only Columbia and South Africa had a higher murder rate than Russia, while Brazil and Mexico had a murder rate of about half Russia's level. Even the US rate, the highest among Western nations at 6–7 per 100,000 of the population, pales in comparison.

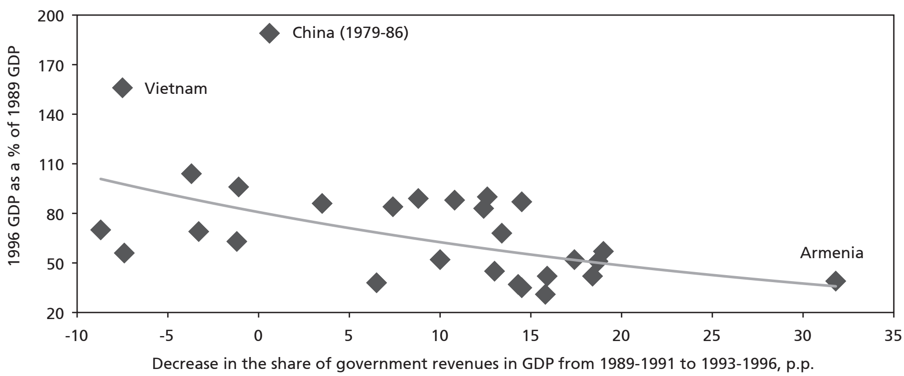
In 1980–85, the Soviet Union was placed in the middle of a list of 54 countries rated according to their level of corruption, with a bureaucracy cleaner than that of Italy, Greece, Portugal, South Korea and practically all the developing countries. In 1996, after the establishment of a market economy and the victory of democracy, according to Transparency International, Russia ranked 48th in the same 54-countries list, between India and Venezuela. In 2005 Russia fell below India. The shadow economy estimated at 10-15% of GDP in the late 1980s expanded to about 40% by the mid 1990s.

This argument is not about the optimal size of the state (a widely discussed issue in economics). It is about the unprecedented in economic history dismantling of the state that occurred in Russia and some other former Soviet republics in such a short period of time in the early 1990s. Simply put, if crime, income inequality, poverty and corruption are on the rise, the state needs more money, not less, to bring these unfavorable developments to a halt.

In Kolodko's words "there can be no doubt that *during the early transition there was a causal relationship between the rapid shrinkage in the size of government and the significant fall in output*" (Kolodko, 2000, p. 259).

If the indicator of change in the share of state expenditure in GDP is added into regressions explaining output change during transition, it remains statistically significant even after factoring in the conventional variables, such as initial conditions (per capita GDP before transition, distortions in the industrial structure and in trade patterns inherited from central planning), the impact of wars, macroeconomic stability (inflation rates) – see Popov, 2000, 2007a. But even in the chart it is apparent that the decline in the share of government revenues in GDP was correlated with the decline in output during the transformational recession (fig. 9).

FIGURE 9
Governement expenditure, % of GDP



Source: Popov, 2000.

Virtually everywhere in the transition world the reduction of government spending was accompanied by an increase in the share of shadow economy. Equally unpleasant was the accompanying increase in income inequalities. Only countries with the lowest decline of the share of state spending in GDP (Central Europe, Estonia, Uzbekistan, Belarus) managed to keep inequality increases within reasonable limits. In turn, the increase in income inequalities had a detrimental effect on economic growth because it contributed to social tensions and worsened the investment climate (Alesina, Perotti, 1996; Alesina, Rodrik, 1994) and because it created lobbies that opposed structural reforms and macro-stabilization (Fernandez, Rodrik, 1991; Persson, Tabellini, 1994). Besides, social inequalities created grounds for macroeconomic populism – redistribution of funds from winners to losers, from competitive to non-competitive sectors, from rich to poor (Kaufman, Stallings, 1991): the greater were income inequalities, the stronger was the lure to redistribute the economic pie instead of increasing it.

In general, from all points of view, the dynamics of government expenditure during transition seems to have been by far the more important factor of successful transformation than the speed of reforms. Keeping the government big does not guarantee favorable dynamics of output, since government spending has to be efficient as well. However, the sharp decline in government spending, especially for the "ordinary government", is a sure recipe to ensure the collapse of institutions and the fall in output accompanied by growing social inequalities and populist policies.

When real government expenditure falls by 50% and more - as happened in most CIS and South-East Europe states in a short period of time, in just a few years, there are practically no chances to compensate the decrease in the volume of financing by the increased efficiency of institutions. As a result, the ability of the state to enforce contracts and property rights, to fight criminalization and to ensure law and order in general falls dramatically.

Thus, the story of the successes and failures of transition is not really the story of consistent shock therapy and inconsistent gradualism. The major plot of the post-socialist transformation "novel" is the preservation of strong institutions in some countries (very different in other respects – from Central Europe and Estonia to China, Uzbekistan and Belarus [5]) and the collapse of these institutions in the other countries. At least 90% of this story is about government failure (strength of state institutions), not about market failure (liberalization).

6 LONG TERM PERSPECTIVE ON PATH DEPENDENCE: EXIT FROM THE MALTHUSIAN TRAP

Why did China manage to preserve relatively strong institutions during economic liberalization, whereas in Russia state institutions collapsed? Part of the answer is the impact of democratization on the quality of institutions: as argued in previous papers (Polterovich, Popov, 2007; Polterovich, Popov, Tonis, 2007, 2008), democratization carried out in a poor rule of law environment (weak state institutions) is associated with further weakening of institutions and with worsening of macroeconomic policy, which has a negative impact on growth and does not allow the creation of a stable democratic regime, especially in resource rich countries.

This is only part of the answer, however, because there are few examples of fast catch-up development under democratic regimes (Japan after the Second World

5. Countries like Belarus and Uzbekistan fall into the same group with Central European countries and Estonia - with small reduction of state expenditure as a % of GDP during transition, good quality of governance, little bribery, small shadow economy and low state capture index (Hellman, Jones, Kaufmann, 2000). In 2005, Belarus and Slovak Republic were the only two countries out of 25 surveyed in EE and FSU (BEEPS – Business Environment and Economic Performance Survey), where significant improvement was registered in 2002-05 in all 7 areas of economic governance (judiciary, fighting crime and corruption, customs and trade, business licensing and permits, labor regulations, tax administration) – EBRD, 2005.

War, Botswana and Mauritius after gaining independence in the 1960s). Besides, differences in the quality of state institutions among authoritarian regimes are huge – less than 1 murder per 100,000 inhabitants in pre-reform China and over 20 in SSA.

Another and more important explanation is probably the long-term development trajectory of institutions in China and Russia. The Chinese 1949 Liberation was similar to the Russian 1917 Revolution not only because communists came to power in both countries, but because traditional collectivist institutions, ruined by preceding Westernization, were re-established and strengthened. However, in Russia 1917-91 communist regime just interrupted the process of transplantation of Western institutions that was taking place since at least the 17th century, whereas in China the 1949 Liberation just returned the country to the long-term institutional trajectory that was briefly (and only partly) interrupted after the Opium Wars.

To put it differently, Russia had already been westernized before 1917, and collectivist institutions that were introduced in Russia by the 1917 Revolution were largely alien to the previous long-term institutional development. On the other hand, China aborted the unsuccessful attempt at westernization (1840s-1949) and returned to collectivist (Asian values) institutions. What was a passing episode and deviation from the trend in Russia was a return to mainstream development and a restoration of the long-term trend in China. Hence, economic liberalization from 1979 onwards in China, even though accompanied by growing income inequalities and crime and murder rates, did not result, at least not until today, in the institutional collapse.

A conventional interpretation of the role of institutions in the rise of the West is that the destruction of traditional structures since the 16th century unleashed entrepreneurial initiative. "The conventional wisdom, endorsed by many economic historians, most notably by Douglass North, points to a connected set of legal, economic, and social institutions that are thought to be necessary for or at least specially conducive to sustained economic growth. The most important are the rule of law itself, secure property rights, relatively untrammeled markets, and a degree of social mobility. They function by reducing the uncertainty surrounding saving, investment, and entrepreneurial activity, and by sharpening the incentives for able people to devote themselves to economic activity instead of violence and prayer. The Industrial Revolution happened when it did because these background conditions were met as they had not been met before; and England is where they were met soonest and most fully" (Solow, 2007).

New data that appeared in recent years, especially indices of the quality of institutions, triggered new debates not only among economic historians, but among general macro- and growth-economists. In an important paper (Acemoglu, Johnson and Robinson, 2001), entitled "Colonial Origins of Comparative Development", the authors used an astute indicator for instrumenting the institutions variable – mortality rate among settlers in the colonies of major European states in the 19th century. The argument was that, if these mortality rates were very high (Gambia, Mali, Nigeria had mortality rates hundreds of times higher than Australia, Bahamas, Canada, Hong Kong, New Zealand, US), the settlers did not bother to set good institutions in those countries.

The alternative interpretation of the role of institutions in the rise of the West and of the genesis of the institutions in colonized and non-colonized countries is the continuity perspective. All countries had traditional community structures in the past; everywhere before Reformation, under the Malthusian growth regime, the law of the land was what we now call "Asian values" – the superiority of the interests of the community over the interests of individuals. The Malthusian growth trap emerged due to the inability to mobilize savings from the low-income population. Lack of savings/investment did not allow an increase of the capital labor ratio ($K/L = k$) because population growth rates were relatively high and all investment went to create jobs for the new entrants into the labor force; nothing was left to increase k. Moreover, population growth rates depended on y, productivity (output per employee), so when y increased due to technical progress, A, population growth rates, n, grew as well, eating up all increases in y, achieved due to increases in A.

In the Solow growth model, labor productivity can increase due to technical progress A and due to the increase in capital/labor ratio, $k=K/L$:

$$y = A^*k^\alpha$$

The needed investment per employee (I_n) – to create jobs for the new entrants into the labor force and to replace retiring elements of capital stock (d – the share of the capital stock that retires annually) is equal to:

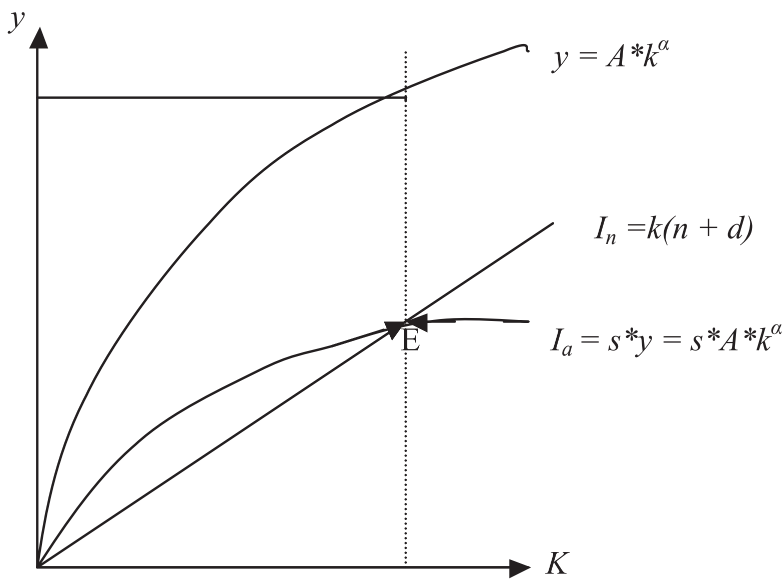
$$I_n = k(n + d)$$

The actual investment per employee, I_a, s equal to savings rate, s, multiplied, by output per employee, y:

$$I_a = s^*y = s^*A^*k^\alpha$$

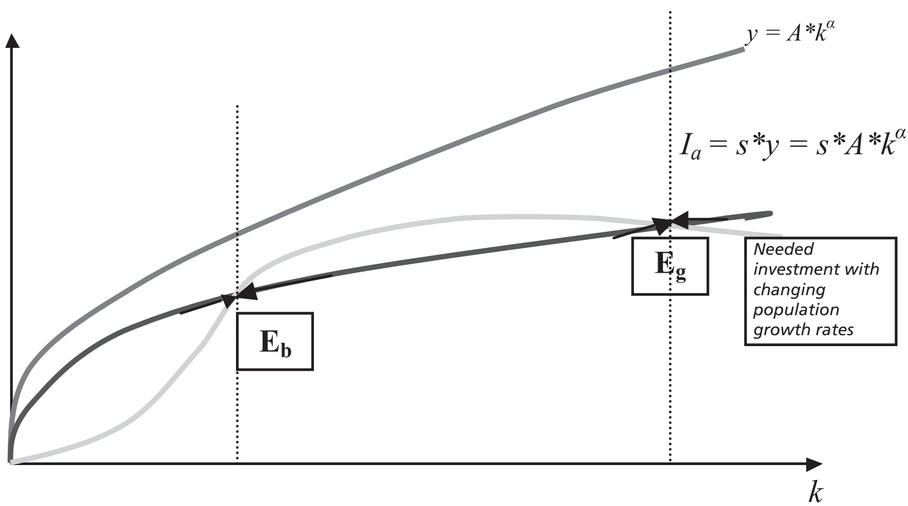
The equilibrium emerges at a point E, where needed investment, I_n, are equal to the actual investment, I_a, see scheme 1.

SCHEME 1
Equilibrium in the Solow model with fixed growth rates of the population



However if population growth rates are not constant, but change with the increase in productivity (and GDP per capita) – first rise with acceleration, then slow down, we get two stable equilibriums – one at a low level of income (bad equilibrium, E_b, growth trap) and another – at a high level of income (good equilibrium, E_g) – scheme 2.

SCHEME 2
Malthusian trap in the Solow model (with changing population growth rates)



In a Malthusian growth regime, before the transition to modern industrial growth, all countries were in bad equilibrium, $\mathbf{E_b}$, so that increases in productivity and per capita GDP, wherever they came from, were quickly absorbed by rising population growth rates, and per capita income declined. Countries had roughly the same productivity and competed on the basis of population: the might of the country was determined by the number of people within its borders and the number of soldiers that the country was able to mobilize in case of the war. Success in technical progress led to the growth in population (like in China before the Opium Wars), not to the growth of per capita income.

Attempts to break this vicious circle were probably taken more than once (Greece, Rome, Byzantine), but all ended up in loosing wars with foreign invaders. Countries that tried to eliminate collectivist institutions and to put the interests of the individual ahead of the interests of the community, experienced growth in income and wealth inequalities, which allowed increased savings and investment, but only at a cost of undermining their population growth that was crucial for maintaining the military might of the empires. When income levels were about $500 per capita (in 1995 dollars), increased income inequalities pushed too many people below the subsistence minimum and lead to increased mortality.

The West was the first to exit the Malthusian trap without being conquered by the neighboring countries with collectivist institutions. Making individual rights and freedoms sacred resulted in the growing income inequalities and increase in mortality, but allowed increased savings and investment and *K/L* ratio, overcoming the limits of the two-dimensional Malthusian world (more population => more GDP). The statistics available on Britain tell the story of huge costs of transition to modern industrial growth in the 16-19th century. The enclosure policy and the Industrial Revolution resulted in a dramatic increase of income inequalities, a rise in mortality and weakening of the institutions.

Despite the acceleration of productivity growth in 1500-1800 in the UK (to about 0.2% a year, so that GDP per capita in the UK more than doubled over three centuries[6]), the living standards of workers did not improve. "The single most important fact is that there is no evidence of any significant rise in material living standards for average workers in any societies before 1830" (Goldstone, 2007). This is consistent with the story of rising income inequalities, accumulation of wealth in the hands of a few, and increasing savings and investment rate (the latter increased during the Industrial Revolution from a mere 6% in 1760 to 12% in 1831 – Galor, 1998).

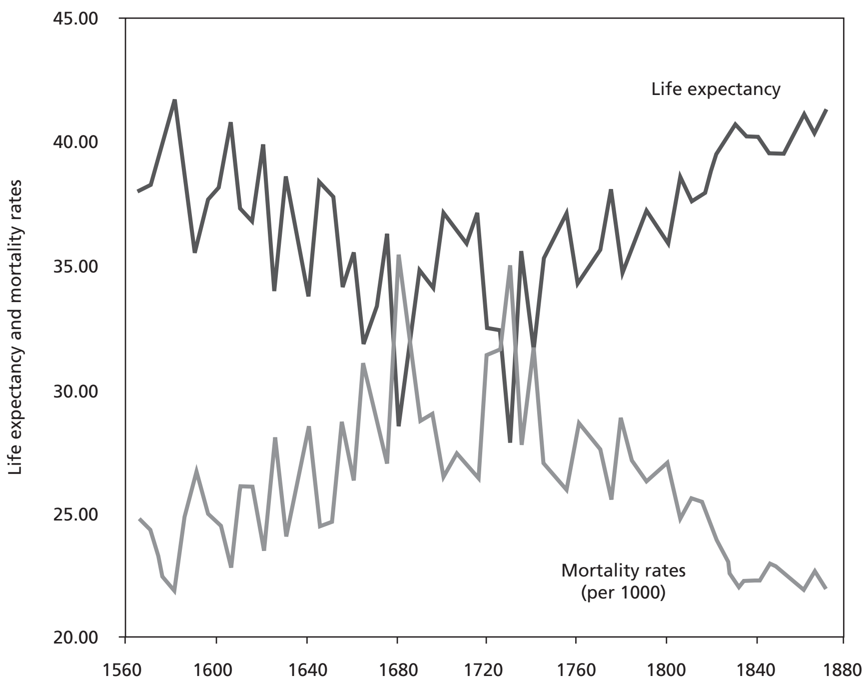
6. GDP per capita in the UK increased in constant 1990 international Geary-Khamis dollars from $714 in 1500 to $974 in 1600 to 1250 in 1700 to 1706 in 1820 (Maddison, 2008).

To put it differently, the escape from the Malthusian trap and the transition to the modern growth regime in Britain and later in other western countries became possible not so much due to the acceleration of technological progress and the increase in productivity growth rates. The necessary component of the transition was the elimination of collectivist institutions and the resulting increase in inequality that allowed increasing savings and investment to the point that the accumulation of physical capital started to exceed population growth and capital/labor ratio started to rise. The costs of this transition were extremely high – rising income inequalities and weakening of institutional capacity (high murder rate) leading, among other factors, to a decline in life expectancy from about 35-40 years to about 30-35 years in 1560-1730 (fig. 10).

The other regions of the world, including the most advanced regions, like China, stayed on a different trajectory of development – preservation of "Asian values" and slow, simultaneous growth of productivity and population. We can only speculate now what could have been the outcome of this other trajectory, where population size was the major determinant of competitiveness. The colonial expansion of the West interrupted the logical development along the second trajectory.

FIGURE 10

Mortality rates and life expectancy (at birth) in the course of early urbanization: England 1540-1870



Source: Galor and Moav, 2005, citing Wrigley and Schofield, 1981.

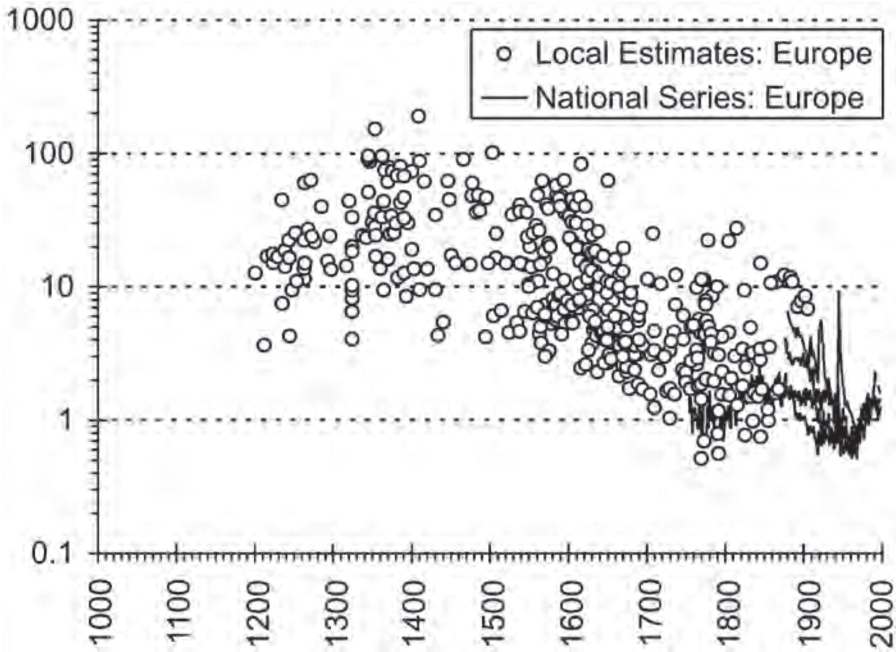
7 ASIAN VALUES VERSUS WESTERN VALUES (INSTITUTIONAL CONTINUITY VS. TRANSPLANTATION OF FOREIGN INSTITUTION)

Colonization of Sub-Sahara Africa, North and South America, Australia and to a lesser extent – South Asia led to complete or near-complete destruction of traditional (community) structures that were only partially replaced by the new Western-style institutions. Among large geographical regions, only East Asia, MENA and to an extent South Asia managed to retain traditional community institutions despite colonialism. It could be hypothesized that those countries and regions that preserved traditional institutions in difficult times of colonialism and imposition of Western values retained a better chance for the catch-up development than the less fortunate regions of the world periphery, where the continuity of traditional structures was interrupted. Transplantation of institutions is a tricky business that works well only when tailored to local traditions, so that it does not interrupt institutional continuity (Polterovich, 2001). Otherwise it leads either to complete elimination of the local structures (US, Canada, Australia) or to a non-viable mixture of old and new institutions that is not very conducive to growth.

If institutional capacity of the state is defined as the ability of the government to enforce rules and regulations, one of the natural measurement indicators is the murder rate. Crimes are registered differently in different countries – higher crime rates in developed countries seem to be the result of better registration of crimes. But serious crimes, like murder, appear to be registered quite accurately even in developing countries, so international comparison of the murder rates is well warranted.

It took Western countries 500 years to bring the murder rates from about a hundred to just several (1 to 3) per 100,000 inhabitants (fig. 11). Even in the 17th century the murder rates in Western Europe were generally exceeding 10 per 100, 000 of inhabitants – more than in many developing countries with the similar level of GDP per capita today. In fact, among developing countries today we find two major patterns – low murder rates (1-3 per 100,000 inhabitants) in Eastern Europe, China and MENA countries (fig. 12), and high murder rates (15-75 murders per 100,000 inhabitants) in FSU, Latin America and Sub-Sahara Africa (fig. 13). India (5.5 murders), South East Asian countries (about 10 murders, with the exception of Philippines, where the rate is 21) fall in between the two groups. The argument is that countries that preserved collectivist institutions (East Asia, MENA countries, India) were able to retain institutional capacity of the state, whereas countries that eliminated these institutions while only partly replacing them with an individual accountability system (FSU, Latin America and Sub-Sahara Africa) paid a high price in terms of diminished institutional capacity. Eastern Europe (with the exception of FSU states) could be the exception that proves the rule – it went through a period of low institutional capacity – high murder rates in the 15-17th century, like Western Europe (although direct evidence here is lacking – all observations for fig. 6 are from Western Europe – England, Belgium, Netherlands, Scandinavia, Italy).

FIGURE 11
Long term homicide rates in Europe per 100,000 inhabitants[7]



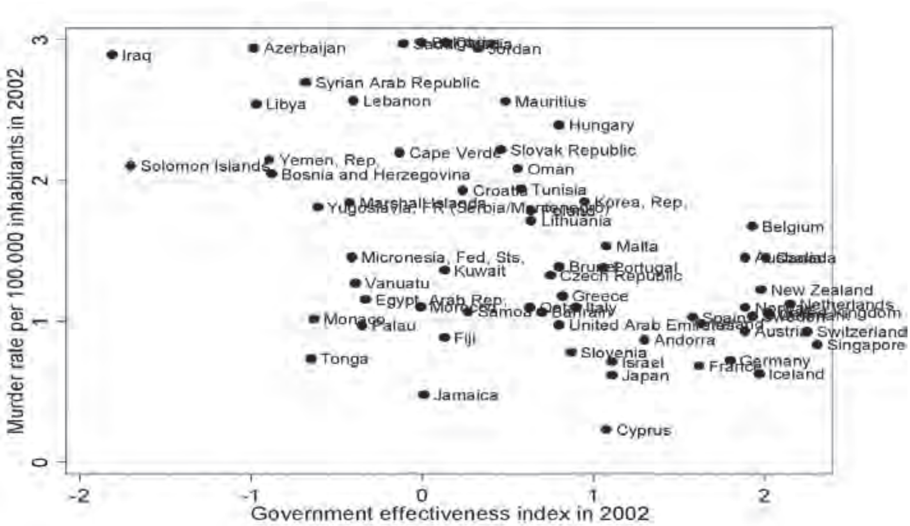
Source: Eisner (2003).
Note: [1] All 398 local estimates of the database of the history of homicide. National Series for Sweden, England and Wales, Switzerland and Italy.
[2] Overall trends in homicide rates. All pre-modern local estimates and four national series.

Another evidence of the cost of breakdown in institutional continuity comes from data on income inequality in pre-modern societies. The destruction of communal, collectivist institutions that was first carried out in Western countries in the 16-19th century was accompanied by an increase in income inequalities (fig. 14). The available data (Milanovic, Lidert, Wlliamson, 2007) suggest that in England, Holland and Spain in the 18th century Gini coefficient of income distribution was at a level of 50 and even 60% - an extremely high level according to today's standards and, most probably, according to the standards of the distant past (35-40% in Rome in the 1st century and in Byzantine in the 11th century – fig. 14)[8].

7. Overall trend in homicide rates, all pre-modern local estimates and four national series. Note: All 398 local estimates from the History of Homicide Database; national series for Sweden, England and Wales, Switzerland, and Italy.
8. Very high income inequalities in low-income countries mean that a lot of people find themselves in extreme poverty, below subsistence level, which leads to high mortality.

FIGURE 12

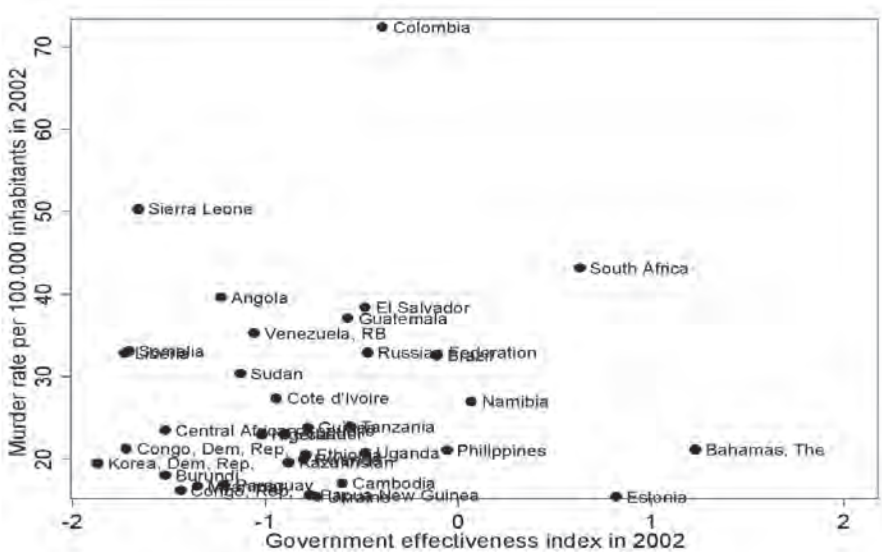
Murders per 100, 000 of inhabitants and government effectiveness index in 2002 – countries with 1 to 3 murders per 100,000 inhabitants



Source: World Bank; WHO.

FIGURE 13

Murders per 100, 000 of inhabitants and government effectiveness index in 2002 – countries with 15 to 75 murders per 100,000 inhabitants

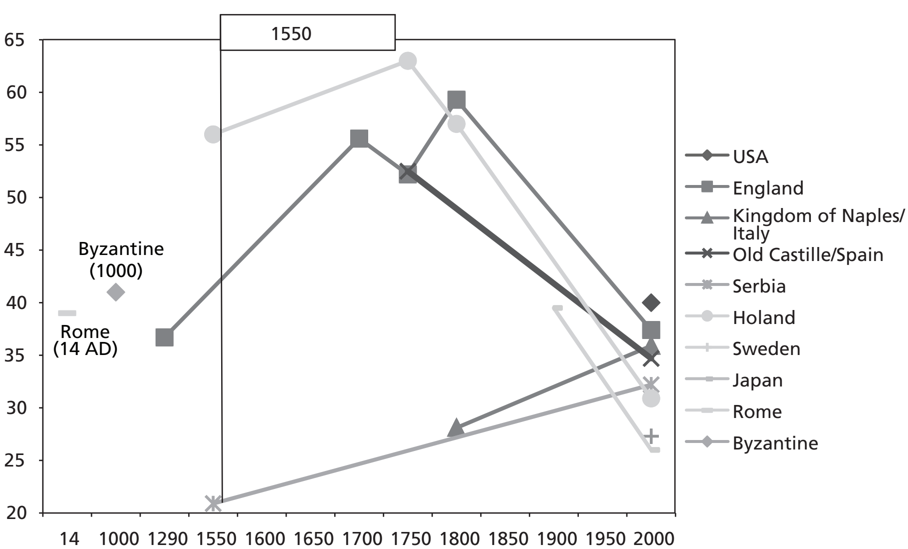


Source: World Bank; WHO.

The income inequality story for developing countries is quite consistent with the dynamics of institutional capacity: in SSA, LA, FSU, where institutional continuity was interrupted and institutional capacity weakened, inequalities increased and remain high today, whereas in MENA, EE, India and East Asia (especially until the 1990s) inequalities are noticeably lower (fig. 15).

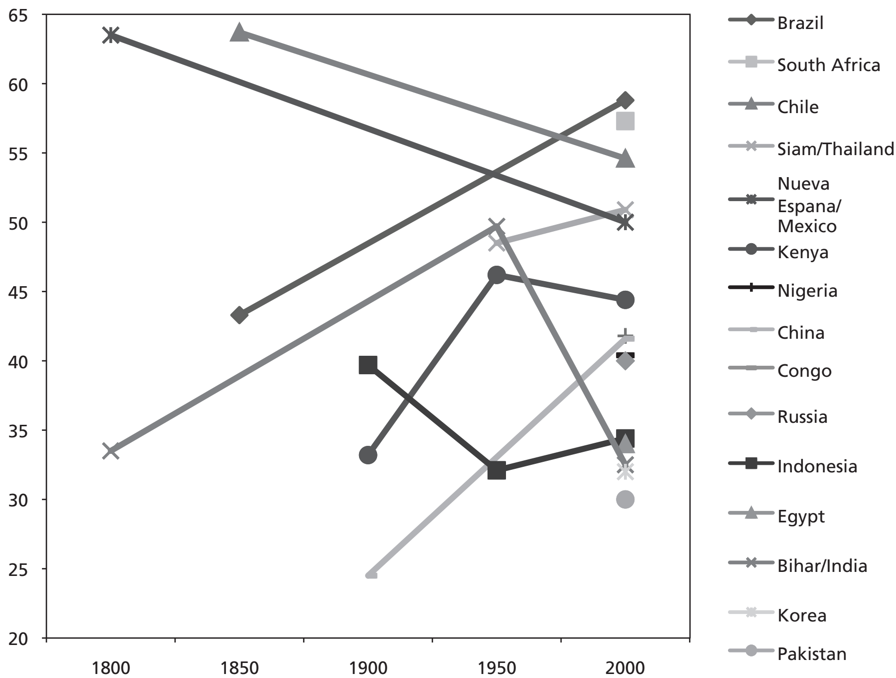
To summarize, there are two ways to escape the Malthusian trap: (1) eliminating collectivist institutions and allowing for the costly increase in income inequalities at the very early stage of development; (2) maintaining collectivist institutions and keeping income inequalities relatively low until slow technological progress and rise in productivity allows accumulating capital at a pace that surpasses population growth rates. The first way was taken by countries that are now called Western and was associated with dramatic social costs in the 16-18th century. Moreover, it was imposed on part of the developing world in the 19-20th century during the era of colonialism. Those developing countries that managed to resist and to preserve institutional continuity as well as relatively low inequalities (East Asia, MENA countries, India) did not gain much in terms of economic growth before the mid-1900s, but were better positioned to take advantage of growth opportunities as soon as natural increases in productivity allowed exiting the Malthusian trap. The other countries that destroyed their egalitarian institutions prematurely (replicating the Western path) experienced tremendous declines in institutional capacity and rise in inequalities.

FIGURE 14
Gini coefficient in developed countries, 1550-2000



Source: Milanovic, Lindert, Williamson, 2007

FIGURE 15
Gini coefficient in developing countries, 1800-2000



Source: Milanovic, Lindert, Williamson, 2007.

In India and SSA, this path was associated with periodic mass famines, which did not happen before colonialism due to even distribution of limited food resources by the community institutions[9]. In more developed LA countries, the growth rates in the XX century did not allow bridging the gap with the West (Argentina, a developed country in between the two world wars, even fell out of the club after the Second World War).

In short, premature dismantling of collectivist institutions, although it alloweds escaping the Malthusian trap, did now allow for healthy growth. "The frequent claim that inequality promotes accumulation and growth does not get much support from history. On the contrary, great economic inequality has always been correlated with extreme concentration of political power, and that

9. "… Even before the onset of the Victorian famines, warning signals were in place: C. Walford showed in 1878 that the number of famines in the first century of British rule had already exceeded the total recorded cases in the previous two thousand years. But the grim reality behind claims to "good governance" truly came to light in the very decades that Ferguson trumpets. According to the most reliable estimates, deaths from the 1876–1878 famine were in the range of *six to eight million*, and in the double-barreled famine of 1896–1897 and 1899–1900, they probably totaled somewhere in the range of *17 to 20 million*. So in the quarter century that marks the pinnacle of colonial good governance, famine deaths average at least a million per year (Chibber, 2005).

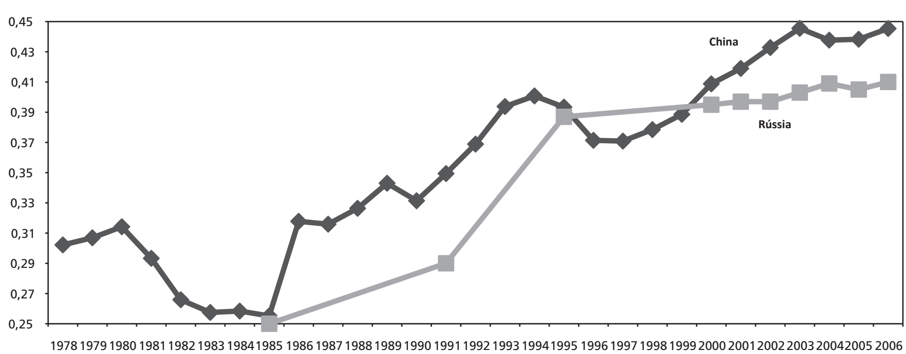
power has always been used to widen income gaps through rent-seeking and rent-keeping, forces that demonstrably retard economic growth" (Milanovic, Lidert, Wlliamson, 2007).

Unlike Russia after 1991, so far it seems like China in 1979-2009 managed to better preserve the strong state institutions – the murder rate in China is still below 3 per 100,000 inhabitants as compared to Russia with about 30 in 2002 and about 20 in 2008 (Popov, 2007c). True, in the 1970s, under the Maoist regime, the murder rate in the Shandong province was less than 1 (Shandong, 2005), and in 1987 was estimated at 1.5 for the whole of China (WHO, 1994). The threefold increase in murder rates during the market reforms is comparable with the Russian increase, although the Chinese levels are nowhere near the Russian levels.

There is, however, a major threat to China's seemingly flawless development path – growing inequality in income distribution (fig. 16). Unlike in the initial years of economic reforms (1979-85), inequalities have been growing since the mid-1980s, exceeding the level of Japan and South Korea and even the level of Russia, and approaching Latin American and African levels.

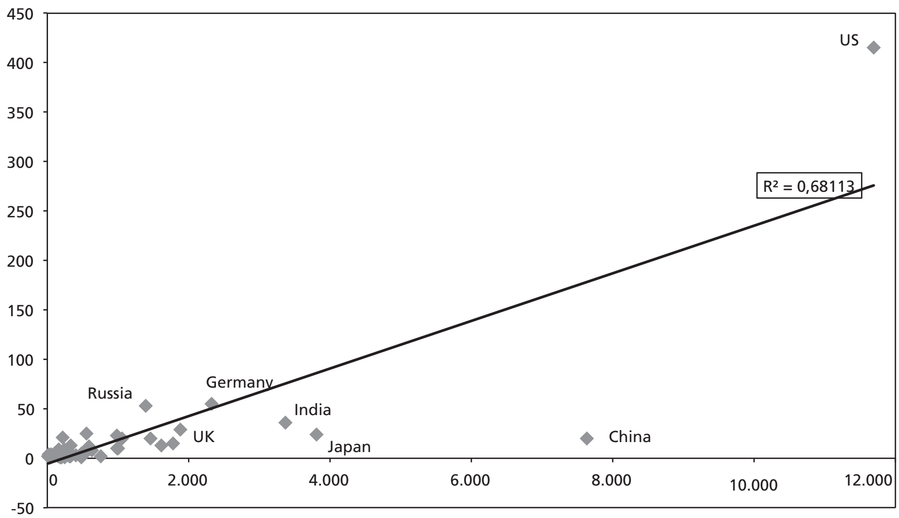
The number of billionaires in China is also growing fast: in April 2007, according to the Forbes list, China had 20 billionaires (fig. 17); in April 2008, before the collapse of stock prices, this number doubled, reaching 40. This was still below the Russian number (53 in 2007 and 87 in 2008), but if the trend continues, China may replicate Russia in the "privatization of the state" pattern.

FIGURE 16
Gini coefficient of income distribution in China and Russsia, 1978-2006)



Source: Chen, Hou, Jin, 2008; Goskomstat.

FIGURE 17
Number of billionaires in 2007 and PPP GDP in 2005 (billion $) by country



Source: <http://www.forbes.com/Forbes>.

8 CONCLUSIONS

To summarize, there are at least three reasons why many transition economies succeeded by pursuing policies that are so different from radical economic liberalization (shock therapy) that is normally credited for the economic success of Central European countries.

First, optimal policies are context dependent, they are specific for each stage of development and what worked in Slovenia cannot be expected to work in Mongolia. *Second*, even for countries at the same level of development, reforms needed to stimulate growth are different; they depend on the previous history and on the path chosen. The reduction of government expenditure as a share of GDP did not significantly undermine the institutional capacity of the state in China, but in Russia and other CIS states it turned out to be ruinous. It is the growth diagnostics that should reveal the missing ingredient for economic growth. And most important, introducing this "missing ingredient" should not result in the destruction of other pre-conditions for growth. The art of the policymaker is to create markets without causing government failure, as happened in many CIS countries. Finally, *third*, and probably most important, countries that until today have never really departed from the collectivist institutions were able to maintain low income and wealth inequalities. These are China (the short-lived westernization attempt of 1840s-1949 was aborted) and East Asia in general, India and MENA. On the contrary, countries that willingly and unwillingly (colonialism) transplanted Western institutions (LA, FSU, SSA) chose to replicate the Western exit from the Malthusian trap and ended up with high income inequalities and apparent lack of institutional capacity.

In a sense, China found another and more painless exit from the Malthusian trap. Western countries broke traditional collectivist institutions at the low level of development (16-18th century) and experienced a painful redistribution of income in favor of the rich (rising income and wealth inequalities) – this allowed raising the share of savings and investment in income, *K/L* ratio and productivity, but only at a price of high income inequalities that were extremely costly for low-income countries (increase in mortality). China retained traditional institutions and low income inequalities for nearly 500 years more than the West – until technical progress allowed increasing productivity and the share of investment in income without causing mass deprivation of the masses.

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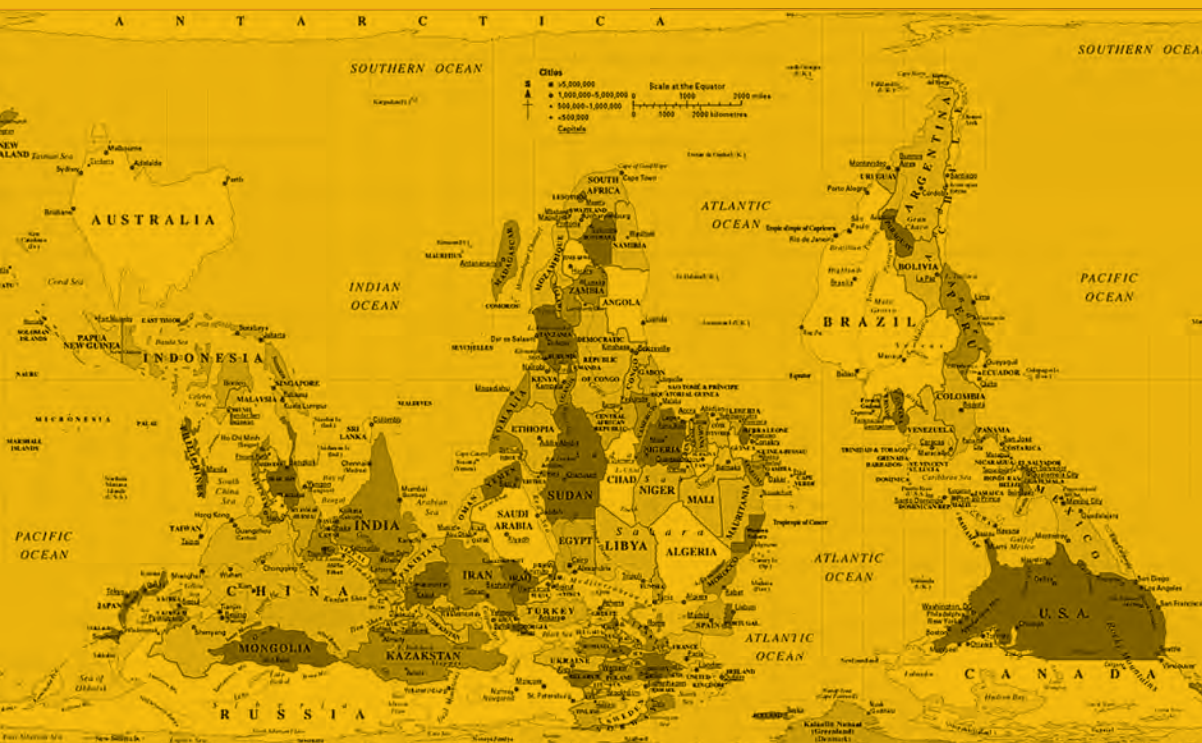

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