*Deepak Lal*

# THE THIRD WORLD AND GLOBALIZATION

ABSTRACT: *Many in both developed and developing countries fear global economic integration. But developing-country fears of volatile capital flows are unfounded, as are developed-country fears of pauper wages due to low-cost imports. Demands for "ethical trading" are as misplaced as the fears of Third-World cultural nationalists that globalization will destroy their valued ways of life.*

Globalization[1] is the process whereby national commodity and capital (but currently, not labor)[2] markets are being internationally integrated. It continues a trend that was halted at the beginning of the twentieth century, when the liberal international economic order (LIEO) created under British leadership after the repeal of the Corn Laws broke down as a result of the two world wars and the Great Depression.

After the Second World War a new LIEO was constructed under U.S. leadership, first for trade in commodities, and then, gradually—as exchange controls were removed in most OECD countries—for the movement of capital. The developing countries that had participated in the first LIEO, however, by and large stayed out of the new LIEO until the debt crisis of the early 1980s, and the end of Communism in 1989, led them to abandon the inward-looking policies regarding both trade and capital flows that had been in place since the Great Depression.

The Asian financial crisis again raised questions in the Third World

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countries about the wisdom of the openness to globalization they so recently adopted. In this article I first examine the effects on the Third World of participating in the global economy, and then I turn to the fears globalization has generated in both developing and developed countries, particularly in light of the Asian crisis.

## *The Benefits of Globalization*

The argument for free trade in both goods and capital is simple and powerful. For the inhabitants of each and every country, foreign trade expands current and future consumption possibilities by increasing the availability of foreign goods. Despite various attempts to find exceptions to this rule, the only one that has stood the test of time is the so-called "optimum tariff" case first adumbrated by J. S. Mill—but its practical relevance is severely limited.[3]

Britain was the first country to understand the case for free trade, which it adopted unilaterally in the mid-nineteenth century. Its example spread to much of the globe, and by about 1870, much of the Third World had also been integrated into the world economy—in many cases under the force of imperial arms. This led to intensive economic growth in many of these areas for the first time. Intensive growth, which leads to a sustained rise in per-capita incomes, is to be distinguished from extensive growth—where output and population grow in tandem, so that per-capita income is constant—which was the norm throughout human history.

One may further distinguish two types of intensive growth, Smithian and Promethean (Lal 1998b). The first occurs when gains from trade result from a widening market, as emphasized by Adam Smith. Historically, this occurred as areas with diverse resources were knitted (or forced) together into a larger common market, often through the use of military coercion, as in the Pax Greco-Romana, the Pax Islamica under the Abbasids, the Buddhist peace under the Mauryas in India, the Pax Tokugawa in Japan, and the extension of Sung rule to the Yangtze valley. But in these agrarian economies, as E. A. Wrigley (1988) has maintained, the possibilities for continued intensive growth always ran into the constraint of a fixed amount of land. The distinctive feature of the form of intensive economic growth engendered by the Industrial Revolution is that it provided a source of heat—charcoal—that substituted for products of the land, and a source of mechanical energy—fossil

fuel—that substituted for animal and human muscle. As the capital inheritance represented by fossil fuels is enormous, it enabled Promethean growth to occur first in the West and increasingly in many parts of the Third World and now, finally, in China and India. The sustained increase in per-capita income that Promethean growth allows has meant that the ancient scourge of mass poverty may be eliminated within the span of a generation (Lal and Myint 1996).

In the nineteenth century the integration of the Third World into the global economy promoted both Smithian and Promethean intensive growth. Smithian growth was widespead: many countries in the tropics came to specialize in producing and trading the mineral and agricultural products demanded by the industrializing West. But some Third-World countries, most notably Japan and India, also began to industrialize during this period, shifting from agricultural to mineral energy-using economies and touching off potentially unlimited Promethean growth.

When the first LIEO broke down, however, most of the Third World attempted to promote Promethean growth through variations on the forced industrialization first pioneered by the Soviet Union. The mixed record in terms of both growth and the amelioration of poverty resulting from these inward-looking policies, as well as the final collapse of the Soviet model, have erased the intellectual respectability such policies once had. Meanwhile, the outward-looking countries of the Pacific Rim used foreign trade—but not always foreign capital—to achieve unprecedented growth rates and reductions in poverty. The confluence of the failure of *dirigisme* and the success of the Asian Tigers has led to the general acceptance in the Third World of what has been termed the "Washington consensus" on development policy. Even such stubbornly *dirigiste* countries as China and India have found that once they began the process of economic liberalization so as to integrate themselves into the world economy, their growth rates accelerated.

As with the first LIEO, the new one offers the developing countries the hope of both Smithian and Promethean growth, depending upon their relative factor endowments. Free trade is the "handmaiden" of both types of intensive growth, to use the late Irving Kravis's (1970) felicitous term. Direct foreign investment, which transfers technology and skills, is an important additional agent of Promethean growth. The increasing integration of world capital markets through portfolio flows, moreover, has put an ever-tighter lid on the fiscal predatoriness of states, as their tax take is now limited by the mobility of capital. Increas-

ingly, the treasury or central bank may propose, but the global bond market disposes. This can only be beneficial, as states are increasingly forced to limit their "takings" to what is needed to finance the essential public goods that justify their existence.

Thus, if the new LIEO can be maintained, it offers the prospect (as did the first one) of a sustained period of universal prosperity and, perhaps, peace. But as in the late nineteenth century, there are many threats to the continuance of the benign processes of globalization.

## *Third-World Fears and the Asian Crisis*

The major fear in developing countries is that continuing globalization, particularly in capital markets, will lead to greater volatility and thereby reduce economic growth. The Asian financial crisis, which took the stripes off so many of the region's Tigers, intensified this fear, but it goes back a long way. Its immediate progenitor was anxiety about the short-term instability inherent in relying on exports of raw materials. But in a 25-country study covering the period since the Second World War, Hla Myint and I (Lal and Myint 1996) could find no statistical evidence that volatility in short-term growth rates affected long-run growth rates. This conclusion is consistent with numerous studies of the effects of export instability on growth. Thus, Hong Kong has had some of the most volatile annual growth rates amongst developing countries, while India has had some of the most stable; but the long-run growth performance of Hong Kong puts that of India to shame. Although there is undeniably greater volatility in the national incomes of countries integrating with the world economy, this need not damage their long-run growth prospects.

Does the Asian crisis portend a new, more dangerous type of instability? To answer this question we need to briefly outline the three causes of the crisis: the exchange-rate regime; domestic banking systems under the Asian model; and the actions of the IMF.

The first cause of the crisis was the quasi-fixed exchange rates maintained by many of the affected countries. In a world with a globalized capital market, only two exchange-rate regimes are viable: one in which a currency floats freely, and one in which it is rigidly fixed. Only these alternatives allow automatic adjustment to external and internal shocks without the need for any discretionary action by the authorities (Lal 1994, ch. 6). In a world where a highly decentralized but integrated

capital market instantaneously mediates these shocks, the authorities do not have the time or the means to obtain the information needed to make appropriate currency adjustments. They often end up doing more harm than good when they try to manage their exchange rates in the volatile and unpredictable global economy, as they can easily cause serious real exchange-rate misalignments.[4] An automatic adjustment mechanism is therefore preferable to a discretionary one.

In this context it is useful to see how and why the international monetary system evolved from the nineteenth-century gold standard to the quasi-fixed exchange rates of the Bretton Wood regimes, and to the mixed "non-system" that has since prevailed; and why, for the most part, deviations from floating rates cause most of the financial problems of the global economy.

## *Stable Currencies vs. Democratic Politics*

The gold standard became the international monetary system in about 1870 largely because fixed quantities of gold were exchangeable for the currency of Britain—the leading economic, political, and commercial power.[5] The Achilles heel of the gold standard (which also bedevils its modern-day equivalent, the currency board) was the rise of fractional-reserve banking, which allowed banks to finance more loans than the amount they had on hand in the form of deposits. The problem with this system was the danger of bank runs. To stop them, the central bank needed to act as the lender of last resort. But this sometimes meant that it had to extend credit beyond the limits consistent with the rules of the gold standard. The expedient used was to break those rules in the short run while adhering to them in the long run.

This was possible because, before the advent of mass suffrage and the rise of labor parties and the welfare state, central banks needed to take account of no imperative other than maintaining long-run monetary stability, with full convertibility at the fixed exchange rate. Knowing this, foreign investors would invest capital in an economy with a faltering currency, hoping to gain from the eventual strengthening of the currency that they fully expected from the central bank. As Barry Eichengreen (1996, 32) puts it, "central banks possessed the capacity to violate the rules of the game in the short run because there was no question about obeying them in the long run." The end of these political circumstances, and the deflationary effect of a gold supply that was

expanding much more slowly than real economic output, led to the Depression of the 1870s and the eventual unravelling of the gold standard.

The quasi-fixed exchange rate system set up at Bretton Woods was an attempt to resurrect a version of the gold standard. This attempt foundered, as freeing trade led to free capital flows that subjected the quasi-fixed exchange rate to speculative attack. The result was that capital tended to flee faltering currencies rather than bolstering them. Today, with the global financial market instantly integrated by computer, there is no way to control the massive flows of capital without isolating one's economy from the enormous benefits of foreign investment.

With the demise of Bretton Woods, the problem of capital flight was joined by the danger of speculative attack against quasi-fixed exchange rates, as changing economic circumstances require *real* exchange-rate adjustments that induce changes in domestic wages and prices. Such changes are, however, now likely to encounter domestic political opposition, to which modern governments—unlike those of the nineteenth century—are likely to succumb. Indeed, the expectation that the authorities will blink under the pressure of domestic politics induces capital to flow out in anticipation of a devaluation. This expectation was borne out by the experience of many otherwise well-managed East Asian economies in the recent crisis. But the same political pressures that cause these problems would render commitments to fixed exchange rates unsustainable, so floating rates seem to be the only possibility under present circumstances.

The second cause of the Asian crisis was a systemic flaw in the "Asian model" of development. As seen most clearly in Korea but presaged by the development of Japan, this model closely linked the domestic banking system, industrial enterprises (particularly the biggest of them), and the government. In Korea, the government channeled subsidized credit to *chaebol* whose performance was judged not by market tests, but by adherence to bureaucratically determined export targets.

Korean *chaebol*, like Japanese *zaibatsu*, were government creations designed to help make the transition from the simpler manufactures, which can be produced by family-owned enterprises, to more complex products that require large and lumpy capital investments—beyond the financial means of owner-managers. There have been three routes to the requisite separation of ownership and management in the absence of developed domestic capital markets: public-sector industrialization, as

in Taiwan and India; direct foreign investment, as in Singapore; and the political creation of concentrations of private wealth in the form of state-subsidized family conglomerates, as in Korea and Japan.

The Korean/Japanese route can be fairly effective, as local mandarins, who have no way of affecting the foreign sales of the favored conglomerates, therefore cannot corrupt the distribution of subsidized credit, which is determined by adherence to export targets. Hong Kong, however, which relied on private forces of growth, enjoyed the highest efficiency of investment amongst the Gang of Four.[6]

The danger in the Korean/Japanese system is that, by making the banking system the creature of the government's will, it produces tremendous moral hazard in the domestic banking system. The banks have no incentive to assess the creditworthiness of their borrowers or the quality of the investments their loans are financing, since they know that no matter how risky and overextended their lending, they will always be bailed out by the government. This can lead in time to a mountain of bad debt and the de facto insolvency of a major part of the banking system, as has happened in both Korea and Japan.

Moral hazard in domestic banking systems under the Asian model has been aggravated by the actions of the IMF, combined with the entrance of foreign bankers. Foreign bank loans are usually denominated in dollars, so if the local currency depreciates relative to the dollar, local debtors become less able to match their income in domestic money against their dollar-denominated debt. Under normal circumstances, the resulting risk of default would limit foreign lending. But ever since the debt crisis of the 1980s, foreign banks facing defaults on their Third-World debt have argued that this poses a systemic risk to the world's financial system, and have demanded international bailouts to prevent such a catastrophe. The IMF has been more than willing to oblige, evolving from the manager of the now-defunct Bretton Woods system into the international debt collector for foreign banks, as well as an important tool of U.S. foreign policy.

The crisis in Indonesia provides the clearest example of the metamorphosis of the IMF. Before the Thai crisis hit the region, the Indonesian economy had been fairly well managed despite the "cronyism" of its brand of capitalism. It had provided exceptional growth rates, with a sensible deployment of its oil revenues—unlike, for instance, Nigeria—and had made an impressive dent in Indonesian poverty.[7] At the time of the Thai crisis, Inodnesia's economic funda-

mentals were sound: it did not have a massive trade or budget deficit, it had a flexible exchange rate, and its debt burden was not onerous.

In reaction to the Thai crisis, however, the foreign banks that had lent to the Indonesian private sector called in their loans, leading to a depreciation of the rupiah and a massive increase in the domestic currency costs of servicing foreign-currency-denominated loans. Normally, many of the borrowers would have had to default, hurting the mainly Japanese and American lenders. But enter the IMF. Under pressure from the governments representing these lenders, the Fund deemed such defaults too risky to the world financial system; so, in effect, it forced the Indonesian government to assume the bad debts. IMF funds will repay the foreign lenders, and the Indonesian government will have to repay the IMF out of its tax revenues. Thus, the Indonesian people are required to bail out the foreign banks.

With the increasingly confident expectation that they will be rescued by the IMF no matter what the quality of their lending to Third-World countries, international banks have, since the 1980s, lost all incentive to exercise prudence. When this international moral hazard is mixed with the domestic moral hazard associated with the politicized banking systems of the Asian model, the result is a disastrous witches' brew. Foreign and domestic banks alike know they will be bailed out if they overlend, so they have no reason not to do so, raking in interest on their loans in the meantime.

## *First-World Political Opposition*

In the developed countries, the major threat perceived from globalization is that trade with the Third World will undermine the wages of less-skilled workers—and their mass unemployment, as in Western Europe. Whether this threat is real is a matter of ongoing debate. But it is more than conceivable that the problem is a massive structural change that is as momentous as the Industrial Revolution. Sir John Hicks (1979) characterized the dominant feature of the Industrial Revolution as the substitution of fixed for circulating capital, as the factory replaced the putting-out system. The current structural revolution can be characterized as replacing fixed with human capital, as epitomized by the communications revolution in the West.

While many of the larger Third-World countries increasingly have a comparative advantage in heavy industry, in the production of con-

sumer goods the current tendency is toward different versions of the same product so as more closely to tailor it to different individual tastes. Variety rather than standardization is the name of the game in the affluent West, accommodating shifts in consumers' variegated preferences. A new international division of labor—reminiscent, in fact, of the old putting-out system—is emerging, in which design capacity, which is human-capital intensive, is located primarily in the richer countries, which use modern telecommunications to convert their designs into differentiated consumer goods.

The predictable result of this new industrial revolution is stagnation in the wages of the unskilled—and rising unemployment where wages are kept artificially high, as in Europe. These results should motivate workers to acquire human capital (e.g., education), and once they do, their standard of living should start to rise again. But this process will take time (even in nineteenth-century Britain, during the first Industrial Revolution, it appears that living standards took a long time to rise as, for instance, the handloom weavers of the putting-out system became the factory workers of the modern age). While this change is taking place, the voices of various forms of economic nationalism will try to mobilize political proponents of support to preserve old ways of making a living by blaming the plight of the low-skilled on globalization. The protectionist results of such political pressures can easily encourage—and be encouraged by—the economically uninformed sympathy of more affluent First-Worlders for the plight of Third-World sweatshop workers. By using international organizations, trade sanctions, and "ethical investing" to impose "humane" labor and environmental standards on the Third World, compassionate residents of the First World unintentionally rob the world's poorest of their comparative economic advantage and doom them to continued poverty by pricing them out of the world market.[8] And since the real beneficiaries of such policies are the relatively well-off low-skilled workers of the West, it is not unlikely that Third-World politicians will be able to mobilize popular support by depicting globalization—that is, globalization as modified by First-World politics—as a conspiracy against the Third World.

## *Globalization and Religious Cosmologies*

Third-World economic opposition to globalization may find ready allies among those in the Third World who view globalization as a form

of cultural imperialism that undermines their ancient and cherished ways of life.

People's ways of life are ultimately grounded in what I will call their cosmologies: their views of the purpose and meaning of life.[9]

The great Eurasian agrarian civilizations had more similarities than differences in their cosmological beliefs, which can broadly be described as "communalist." The hunter-gatherer whose egoism would have been tempered only by the reciprocal altruism that stems from playing repeated Prisoners'-Dilemma games with the same people would be dysfunctional in the new environment of settled agriculture, which increased the size of social groups and thus the number of strangers one would encounter. As if to reduce the resulting cost of policing transactions, which would have dissipated the mutual gains from cooperation, agrarian civilizations internalized restraints on antisocial action through cosmologically based moral codes that, when inculcated from infancy, made people ashamed to act against the interests of the community. Similarly, commerce that is motivated by unmodified self-interest also threatens communal bonds, so agrarian civilizations took a dim view of merchants and markets, tolerating them as at best a necessary evil. In both of these respects, the cosmologies of agrarian civilizations were not conducive to promoting intensive economic growth.

I have argued elsewhere that the rise of the West depended on its break from this agrarian past, as a result of the twin revolutions of Pope Gregory the Great in the sixth century and Pope Gregory VII in the eleventh century (Lal 1998b). The former inadvertently promoted the independence of the young. Subsequently, however, the Church reacted against the individualism Gregory the Great had triggered by emphasizing Original Sin in a manner that kept antisocial behavior in check by means of guilt. It was only much later, with the Scientific, Darwinian, and Sexual revolutions, that Western morality began to deviate radically from its agrarian cosmological roots.

Gregory VII brought the Church into the world with his proclamation that the authority of the Church trumped that of the state. Eventually—and, again, unintentionally—the church-led state created the legal, commercial, and institutional infrastructure for a market economy and Promethean growth.

The effects of the two papal revolutions need not be conjoined, as they happened to be in Europe. The institutional modernization that, in Europe, stemmed from Gregory VII's innovation can now be brought about through the deliberate adoption by the Third World of

market mechanisms, while the cosmological modernization inaugurated by Gregory the Great's reforms need not be accepted. The prospect of becoming wealthy without losing their souls is therefore open to non-Western cultures.

Among the features of Western culture that may thereby be rejected are individualism, universalism, egalitarianism, and the democracy that flows from these values. Christianity and Islam (and, in some respects, Judaism) differ from the other great Eurasian religions in demanding the free individual acceptance of religious doctrine; in proselytizing for the accepted doctrine; and in positing a single God, compared to whom all men are spiritual equals. If economic globalization is psychologically linked to the Western cultural agenda that descends from these distinctive features, there will be all the more reason for the Third World to reject it.

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The newly resurrected liberal international economic order promises unprecedented prosperity for the entire globe. But its triumph is even less assured than was that of the first LIEO: the modern states in whose hands its fate rests are much more susceptible to popular pressures that might strangle its growth. The globalization of the economy is by no means inevitable. First it has to survive the politicization of society.

## NOTES

1. This article is based in part on three earlier articles, Lal 1998c, 1999a, and 1999b.
2. There is unlikely to be a restoration of the free mobility of labor that characterized the nineteenth-century LIEO, as immigration controls are now ubiquitous—largely because the welfare state has created property rights in citizenship. This naturally leads to restrictions on immigration, since immigration creates new citizens with an automatic right of access to the resources of existing citizens through the transfer state.
3. The optimum tariff aims to turn the terms of trade in a country's favor, so that it can garner a larger share of the cosmopolitan gains from free trade. But if other countries retaliate, the shrinking of these cosmopolitan gains in a trade war may well leave the country initiating it worse off than it was before levying the optimal tariff. See Lal 1983 for a discussion of various arguments for *dirigisme* and why they have been found wanting.
4. The real exchange rate is defined as the ratio of the domestic price of traded to nontraded goods. The price of traded goods is determined by the nominal

exchange rate, linking it to the real exchange rate. In adjusting to shocks, it is changes in the real exchange rate that are relevant, but these are not under the control of the authorities, who can, in a managed exchange-rate system, merely affect the nominal exchange rate. See Lal 1997, 144–47, and Lal 1994, ch. 13.

5. Eichengreen 1996 provides a succinct history of the international monetary system.
6. See Lal and Myint 1996, ch. 3 for details.
7. See Lal and Myint 1996.
8. See Lal 1998b.
9. See Lal 1998a.

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