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Productivity Commission

The World Economy in the New Millennium: A New Golden Age?

Deepak Lal

Richard Snape Lecture
30 November 2006
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Productivity Commission

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Deepak Lal

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Foreword

Richard Snape capped a long and distinguished career as Professor of Economics at Monash University with a new and accomplished career at the Industry Commission and then as Deputy Chairman of the Productivity Commission. In the eight years that he spent at the Commission before his untimely death in October 2002, he played a pivotal role in overseeing our research program, as well as participating in major public inquiries.

This is the fourth in a series of lectures in memory of Richard Snape. With Richard's own interests and high standards in mind, the lecture series elicits contributions on important public policy issues from internationally recognised figures, in a form that is accessible to a wide audience.

We have been fortunate to have Deepak Lal as this year's lecturer. Professor Lal's status in the field of development economics, and the breadth and importance of the issues he raises, are strongly in keeping with the objectives of this series. Moreover, like his eminent predecessors — Max Corden, Anne Krueger and Martin Wolf — Deepak was also a friend and professional associate of Richard Snape.

I am grateful to Deepak Lal for agreeing to come to Australia to present the Richard Snape Lecture for 2006.

Gary Banks
Chairman

November 2006

RICHARD SNAPE 1936 – 2002

Richard Hal Snape was Deputy Chairman of the Productivity Commission and Emeritus Professor of Monash University. He was a Board Member of the Australian Research Council, Fellow of the Academy of the Social Sciences in Australia and a Distinguished Fellow of the Economic Society of Australia.

DEEPAK LAL

Deepak Lal is James Coleman Professor of International Development Studies, University of California at Los Angeles, Professor Emeritus of Political Economy, University College, London and former Research Administrator at the World Bank. He is an adjunct scholar at the Cato Institute, and a member of the Mont Pelerin Society. He is also on the Board of the Liberty Institute, New Delhi, the Free Market Foundation, Johannesburg, the Liberty Institute, Warsaw, and the European Center for International Political Economy, Brussels.

Professor Lal has held positions with the Indian Foreign Service, Oxford University, University College London and the University of London where he was Professor of Political Economy from 1984–93. He has served as a consultant to the Indian Planning Commission, the ILO, UNCTAD, OECD, UNIDO, the World Bank, and the ministries of planning in Korea and Sri Lanka.

Professor Lal is the author of numerous articles and books on economic development and public policy including *The Poverty of Development Economics*, (with H. Myint) *The Political Economy of Poverty, Equity and Growth*, *Unintended Consequences* (based on his Ohlin lectures) and the recent *Reviving the Invisible Hand*.

The world economy in the new millennium: a new golden age?¹

Richard Snape was part of the generation of distinguished Australian economists who provided the theoretical tools, empirical evidence and through their public advocacy the means to fight the rampant post Second World War *dirigiste* impulses in the international economy. Their success in their home land is now self evident. But their ideas have had a much wider influence in promoting the neo-classical resurgence in international and development economics which has provided the underpinnings for the current period of what I prefer to call globalizing capitalism. So I am delighted to be able to honor Richard's memory in this prestigious lecture series.

In this lecture I want to paint a picture with a very broad brush encompassing centuries and civilizations to answer the question of my title. To see this I need to look back briefly to see how the global economy got to where it is, and also to try and read the tea leaves about its future. Thus, my theme will be about the prospects of an ancient process (globalization) and a modern set of institutions (capitalism) which are transforming the world. I begin with the new.

1 The origins of capitalism

Capitalism is a highly contested term, but economic historians are agreed that the rise of the West from a host of probably richer ancient agrarian Eurasian civilizations was associated with the rise of capitalism. But, as the French economic historian, Jean Baechler (1975) argued, the specific features which, for instance, Marx and Weber identified as the distinctive features of capitalism are to be found in all the ancient civilizations. Thus we know from Assyrian tablets dating from the 20th and 19th centuries BC that various features of capitalism — markets, profit seeking, banking, bills of exchange, and business firms for example — were to be found in ancient Mesopotamia as well as in all the ancient agrarian civilizations.

¹ This lecture is based in large part on my recent book *Reviving the Invisible Hand — The Case for Classical Liberalism in the 21st Century*, Princeton University Press, 2006.

But all these agrarian civilizations looked upon the agents operating these capitalist institutions — the merchants and traders — as a necessary evil. For, commercial activities were universally held in low esteem. Being intermediaries in the economic process, the merchants produced nothing in a tangible way, and were looked upon as parasites, satisfying the demands of a tiny urban elite by transferring the rural surplus produced by those who wielded the plough to feed the warriors and priests in the towns. Primarily devoted to profit, they became immensely rich, but their wealth was not matched by social acceptance or political power. It was subject to continual predation by the State.

This predation was popular. For, the merchant capitalists were a minority in most agrarian civilizations. Their calling necessarily involved assuming risks and valuing novelty: uncommon behavioral characteristics in settled agrarian communities, which over the centuries had learnt and adapted to the cyclical risks associated with the local climate and other quirks of nature. This learned behavior was fixed through social custom — what I term the ‘material’ beliefs of a culture (Lal 1998). Novelty seeking and risk taking would have endangered these socially accepted ways of making a living. The periodic raids on its merchants’ wealth by the predatory state would not have been unpopular in these ancient agrarian civilizations. Though these maverick capitalists existed in all the ancient Eurasian civilizations, it was only in one that they came to be given their head, and their novelty-seeking and risk-taking behaviour eventually became the norm. This marked the emergence of capitalism, which Schumpeter (1950) memorably and properly described as a system of creative destruction. This led to the Great Divergence between the West and the Rest.

My own story of this rise is outlined in my book *Unintended Consequences*, where I contend that it was due to a legal revolution in the 11th century, when Pope Gregory VII in 1075 put the Church above the State and, through the resulting Church-State, created (as Harold Berman (1983) has shown) the whole legal and administrative infrastructure required by a fully-fledged market economy. Many of the specific institutions of capitalism, as we have seen, predate this Papal Revolution. But they were insecure and most often based on the trust engendered within the extended families of traders and merchants. Nor did they have the legal protection of the State, which looked upon them as milch cows for their predatory purposes. Gregory VII’s Church-State provided a legal bulwark and administrative system whose reach, unlike most of the political states, covered the whole of Western Christendom. The Church’s authority over States was being enforced by its power of excommunication, which threatened not only the souls of the rulers, but also their estates, as it gave their subjects the right to rebel. The Church-State allowed the novelty-seeking and risk-taking capitalists to pursue their enterprise over a

larger space with a myriad of strangers. In my view it is properly looked upon as initiating that capitalism which has changed the world.

This Papal Revolution's changing of the West's 'material' beliefs was preceded and precipitated by an earlier 6th century 'family' revolution of Pope Gregory the Great which changed the West's 'cosmological' beliefs (on 'how one should live') from the communalism of Eurasia, to individualism, particularly in the domestic domain concerning sex and marriage (Goody 1983). By promoting marriages based on the universal but ephemeral emotion of love, it went against the Eurasian pattern of arranged marriages, which eschewed a fickle emotion's threat to the settled families needed for settled agriculture. To counter this threat in the domestic domain, the Church created a fierce guilt culture (Delumeau 1990), which provided the West's moral moorings until the Darwinian and Freudian revolutions destroyed its bases of God and Guilt.

These twin Papal revolutions have cast a long shadow. Though temporally conjoined, the change in 'cosmological' beliefs promoting individualism (westernization) is not necessary for the change in 'material' beliefs promoting capitalism (modernization). It is the latter that globalization is spreading through the world.

2 Globalization

Globalization is an ancient cyclical process associated with the rise and fall of empires (Lal 2004). For, the essence of globalization is the creation of a common economic space amongst hitherto loosely linked or autarkic regions. The Pax generated by empires has provided this common economic space and led to those gains from trade emphasized by Adam Smith and thereby to what can be labeled Smithian intensive growth. At the beginning of the Christian era, the three major imperial civilizations of Rome, China and India had roughly similar standards of living (see table 1).

Table 1 **GDP and population for ancient powers, 0 AD**

	<i>GDP</i> <i>(in million 1990 \$)</i>	<i>Population</i> <i>(million)</i>	<i>GDP</i> <i>per capita</i>
Roman Empire	20 961	55	381
China	26 820	60	450
India	55 146	100	551

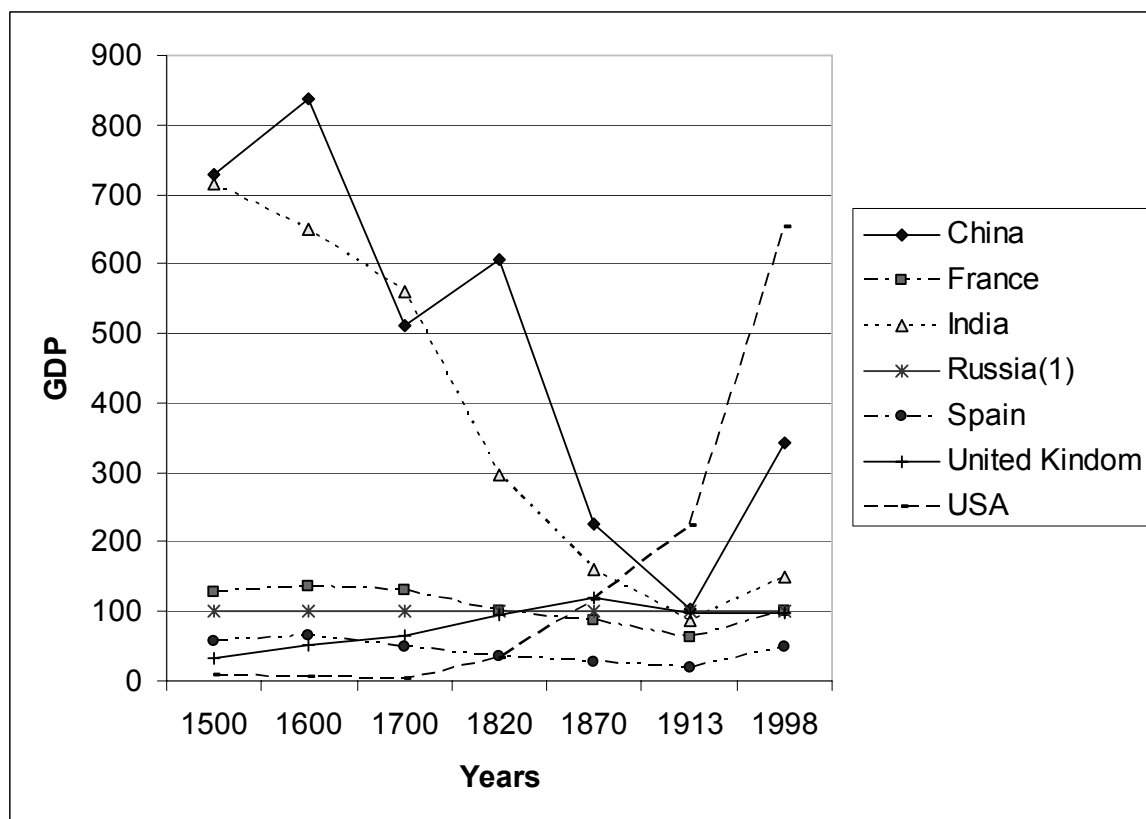
Source: Lal (2004), table 4.

Till the industrial revolution and the emergence of the British empire in the 19th century, the ancient empires were agrarian organic economies dependent on the products of land. As this was fixed and subject to diminishing returns, the Smithian impulse from greater economic integration petered out, and the ancient Eurasian imperial systems each had their economic climacteric — India about the 3rd century BC after its unification under the imperial Mauryas, and China in about the 11th century after the efflorescence under the Sung, based on linking the Yellow and Yangtze river valleys. Thereafter, each experienced extensive growth with output growing *pari passu* with population and a stagnant per capita income, with the Chinese per capita income higher than the Indian.

The Roman Empire reached its climacteric in the reign of Augustus (29 BC–14 AD). But with its collapse, Western Europe descended into a myriad of kingdoms which were ‘poverty stricken dung heaps compared to Rome’ (Finer 1997). It was only the Papal legal revolution of the 11th century and the creation of a transnational legal and commercial infrastructure for the market economy which gradually led to the rise of capitalism and the European miracle (Maddison 2001²). The other great agrarian civilizations — China and India — did not suffer any absolute economic decline. But with the slowly rolling Industrial Revolution — based on converting an economy based on the energy derived from the products of limited land to one which uses the unlimited energy provided by fossil fuels leading to Promethean intensive growth — they were slipping relatively to the countries of the West (see figure 1, which normalizes the GDPs of India and China and the major Western countries around Russia (with a value of 100) from 1500 to 2000).

² Also provides quantitative evidence that the Great Divergence dates to the 11th century.

Figure 1 GDP for major countries, 1500–1998^a



^a Russia = 100.

Data source: Lal (2004), derived from Maddison (2001) table B-18.

These ancient civilizations and other parts of the Third World were to experience the full force of the rising economic and military strength of the European gunpowder empires after the voyages of discovery in the 16th century. After the period of direct and indirect imperialism in the 19th century, it has taken nearly a century for these ancient civilizations to come to terms with the West. Since the 1980s they have joined the bandwagon of globalizing capitalism with impressive gains in their standards of living including of their poor. They are set, during the course of the 21st century, to be the main challengers to the Western supremacy promoted by the 11th century Papal Revolution, and today embodied in the new Rome — the USA.

3 The first liberal international economic order (LIEO)

The first truly global empire was created by the British in the 19th century. Its purpose, as Cain and Hopkins (2002) in their important book show, was to make the world safe for globalizing capitalism, by creating a global Pax policed by the Royal

Navy. From about 1850 to the end of the 19th century its economic policies created a new liberal international economic order (LIEO) based on the twin classical liberal principles espoused by the sages of the Scottish Enlightenment — David Hume and Adam Smith — of *laissez faire* and the acceptance of unilateral free trade. Its institutional pillars were provided by the gold standard and the creation of a transnational legal system protecting international property rights.

This 19th century period of globalization not only led to Promethean intensive growth in the industrializing North but also, through its growing demand for primary commodities, to Smithian intensive growth in the South. Though much of nationalist and Marxist hagiography has castigated this colonial division of labor as perpetuating the poverty of the South, in fact, compared with the previous millennia many parts of the Third World for the first time experienced intensive growth for a sustained period. Lloyd Reynolds (1985) in his survey of the economic histories of 41 developing countries dated the turning points when developing countries entered the era of intensive growth (with rising per capita incomes) as compared with the ubiquitous extensive growth of the past (when output growth just kept up with population) as shown in table 2. The 19th century LIEO was spectacularly successful in generating unprecedented intensive growth throughout the world.

But with the relative economic decline of the British by the end of the 19th century, and the failure of the new economic hegemon — the US — to accept the imperial burden of maintaining a global Pax, the 19th century LIEO ended on the fields of Flanders. It was not till the end of the Second World War, and the implicit recognition by the US, following the economic disintegration of the interwar years that it had now to maintain a global Pax that a second LIEO has been slowly constructed around US hegemony.

Table 2 A turning point chronology

1840	Chile	1910	Korea
1850	Brazil	1920	Morocco
1850	Malaysia	1925	Venezuela
1850	Thailand	1925	Zambia
1860	Argentina	1947	India
1870	Burma	1947	Pakistan
1876	Mexico	1949	China
1880	Algeria	1950	Iran
1880	Japan	1950	Iraq
1880	Peru	1950	Turkey
1880	Sri Lanka	1952	Egypt
1885	Colombia	1965	Indonesia
1895	Taiwan	–	Afghanistan
1895	Ghana	–	Bangladesh
1895	Ivory Coast	–	Ethiopia
1895	Nigeria	–	Mozambique
1895	Kenya	–	Nepal
1900	Uganda	–	Sudan
1900	Zimbabwe	–	Zaire
1900	Tanzania		
1900	Philippines		
1900	Cuba		

Source: Lal (2004), table 9 derived from Reynolds (1985), table 1, p.958.

4 The second LIEO

But though rhetorically espousing the twin classical liberal principles of *laissez faire* and free trade of its 19th century imperial predecessor, the US has not followed them in practice. This is because the US even in the 19th century never accepted the correct economic principle of unilateral free trade. It has always believed in reciprocity, incorrectly looking upon foreign trade as a zero sum, rather than a positive sum game. It has therefore used first GATT and now the WTO as its instrument for liberalizing foreign trade on a reciprocal basis. This was hugely successful, by bringing protection in the OECD countries for most commodities (excluding agriculture) to fairly negligible levels.

But recently it has turned against even this illogical multilateral process and has embraced various forms of bilateral and preferential avenues for liberalizing trade. As a clear-headed critic of this turn in US trade policy, Richard Snape (1996) rightly described, the growing number of preferential trading arrangements is leading to a ‘spaghetti bowl’ which can destroy the multilateral trading system. The US also created two other multilateral institutions — the World Bank and the IMF.

The former was required to deal with the closing of international capital markets to developing countries after their interwar defaults. The second was to supervise the gold-exchange standard which was established as a successor to the 19th century gold standard to create a system of adjustable peg exchange rates whose adjustments were supervised by the Fund.

The partial restoration of an LIEO by the US and its OECD partners led to a boom in world trade and income growth. But the Third World opted out. Haunted by its troubles in the interwar period, and mesmerized by the seeming Soviet success in the forced industrialization of a backward economy through Stalinist planning, aided and abetted by the new ‘development economics’, it blamed its continuing backwardness on the outward looking policies it had followed during the 19th century LIEO, and turned inwards. First, beginning with the Asian tigers, and after the deep economic crises caused in large part by their past *dirigisme* (Lal 1987), in the 1980s China, and Latin America and later in 1991 India embraced economic liberalization — however haltingly and incompletely — to join the bandwagon of globalizing capitalism. So the second period of globalization truly begins only in the 1980s. As in the first period of globalization in the second half of the 19th century, the Third World (outside Africa and particularly in Asia) has seen unprecedented economic growth which has led to the greatest decline in global poverty in history (Bhalla 2002). In the large, fast growing Eurasian civilizations of China and India there has been a dramatic reduction in poverty and the growth of a large middle class. In 1960, Surjit Bhalla estimates, only 6 per cent of the world’s middle class population was Asian; today it is 52 per cent. This is the miracle that globalization has wrought in the most populous part of the world. The world today would seem to be in a new golden age.

But, there are a number of distinguished voices who would demur. They are fearful of the purported instability of global capitalism. And there also continues to be opposition from a refurbished *dirigisme* in the West, and the continuing fear of cultural nationalists in the Third World that the modernization promised by global capitalism will also bring with it westernization and the loss of their souls.

5 Economists’ fears

I deal first, with the purely technocratic fears currently expressed about globalization by the clerisy. Unlike the 1950s and 1960s when it was against both free trade and open capital markets for the Third World, today there is a professional consensus on the virtues of an open trading regime. But, not on open capital markets.

Capital controls?

A series of debt crises since the 1980s — particularly relating to sovereign debt — have led to a questioning of a liberal order for capital flows, and raised the question of whether public action is required to prevent or mitigate them. Underlying the differences between classical liberals and various *dirigiste* viewpoints on the issue is a major division about the functioning of both the national and international macroeconomy. The classical liberals believe that a competitive macroeconomy, without barriers to adjustment erected by governments, will be self-correcting; the *dirigistes* believe that the inherent instability of the macroeconomy requires public intervention. The irony is that, whereas most governments have now virtually accepted the classical liberal viewpoint as regards the domestic macroeconomy by eschewing the Keynesian interventions commonly accepted in the two post-war decades, they are increasingly recommending various *dirigiste* means to ‘control’ the international macroeconomy.

Fluctuations in aggregate economic activity are not new. In the past, when most economies were agrarian, these fluctuations were due to annual variations in climate, particularly rainfall. With the advent of industrialization new sources of cyclical variation were introduced, caused both by the variations in investment — depending on the changing ‘animal spirits’ of entrepreneurs — and the short-run stickiness of money wages in industrial labor markets. The business cycle — whose ultimate causes are still disputed — came to characterize industrial economies. With the globalization of the 19th century these booms and slumps in the North also affected the South through the variations in the demand for its primary product exports. The Keynesian revolution held out the hope that activist fiscal policy could control the business cycle. But despite assertions by various politicians (most recently by Gordon Brown, the UK. Chancellor of the Exchequer in the late 1990s) that they had tamed the business cycle, it quickly taunted them by its reappearance. But there is considerable evidence that the post-war boom and bust cycles have been driven by public policy — largely through discretionary fiscal policy, even though the automatic stabilizers associated with public expenditure have moderated recessions (Romer 1999; Basu and Taylor 1999).

Does macro-instability matter?

If booms and busts along a rising trend are endemic to the private capitalist economy, and public action is as likely to exacerbate rather than solve the problem, does this unavoidable macroeconomic instability matter? This is an old debate in the economics of developing countries. It was argued by many that, with their integration into the world economy, primary-product-producing developing

countries would suffer a retardation in their long-term growth rates from the income instability resulting from the fluctuations in their export earnings as the Northern economies waxed and waned. The detailed World Bank-sponsored comparative study of the post-war experience of 21 developing countries that Hal Myint and I conducted found that there is no relationship between the volatility of growth rates and their long-term trends. Instability in growth rates does not necessarily lead to poor overall growth performance (Lal and Myint 1996). Thus Hong Kong has had one of the most volatile of growth rates, while India one of the most stable in the post-war period. Yet this has not prevented Hong Kong from producing one of the most stellar post-war growth records, compared with India, whose low but stable growth rate has been the stability of the comatose.³

Underlying the interventionist view, which has resurfaced with the recent financial crises in emerging markets, is an implicit assumption about the omniscience of the authorities and the myopia of private agents. Any real world economy is likely to be subject to all kinds of unforeseeable changes. In the ancient agrarian economies this uncertainty was largely due to nature, most often the climate. A dynamic capitalist economy is subject to even greater volatility, due to shifting tastes, technologies and resources. Added to these are the shocks from domestic monetary and fiscal policies. Hence, there will be a constantly shifting notional ‘equilibrium’ of relative prices, including the real exchange rate (the relative price of non-traded to traded goods) as well as portfolio equilibrium in asset markets. These shifting equilibrium cannot be predicted with certainty by either Platonic Guardians or market participants. How will market participants react to this irreducible uncertainty? As these unforeseeable shocks lead to fluctuations in income and thence their consumption, private agents will attempt to smooth them through saving and investing when times are good and running these investments down and dis-saving when times are bad. In the absence of well-developed financial markets this ‘consumption smoothing’ was often done by hoarding precious metals in the form of jewels when incomes were unexpectedly high and selling them when income and consumption unexpectedly fell.

³ More recently Ranciere, Tornell and Westermann (2003), find a robust empirical link between higher growth and a propensity for crises (p. 2) In the light of the 1990s financial crises they consider the safe stable *dirigiste* credit path followed by India and the more risky private sector dominated unstable path followed by Thailand. They conclude Thailand has experienced lending booms and crises, while India has pursued a safe growth path for credit. GDP per capita grew by only 99 percent between 1980–2001 in India, whereas Thailand’s GDP per capita grew by 148 percent, despite having experienced a crisis (p. 3). Whilst, Khan, Prasad, Rogoff and Wei (2006), surveying the large number of cross sectional econometric studies find that though there is no robust link between financial liberalization and growth, there is little empirical support that capital account liberalization is the major problem behind developing country financial crises. It should also be said that these cross-sectional econometric studies, which have become so popular amongst the young remain deeply unconvincing, for the reasons set out about the similar literature on the link between freer trade and growth in Srinivasan and Bhagwati (2001).

It might be thought that the government acting as the agent of the people could do even better, particularly if financial and insurance markets are underdeveloped, by acting as the custodian of the public interest to perform this consumption smoothing. This was the justification provided for the many schemes to stabilize commodity prices or the incomes of producers of primary products in developing countries. The most famous of these were the various marketing boards that were created to deal with the gyrations of prices of primary products in world markets. Though fine in principle, these schemes invariably became predatory instruments for taxing domestic producers of primary products rather than stabilizing their incomes.

In fact we have a very important study of the coffee boom in East Africa in the 1970s by David Bevan, Paul Collier and Jan Gunning (1989). During this boom the policies followed by the two major countries benefiting from the boom — Kenya and Tanzania — differed markedly in the deployment of these unexpected rises in the profits of coffee production. In Kenya the rise in profits of coffee production associated with the rise in its world price was allowed to be retained by the peasants. In Tanzania it was in effect taxed away for ‘public’ uses. The outcomes could not have been more different though they are wholly predictable. The private Kenyan producers, seeing a temporary rise in their incomes and profits, saved and invested these temporary windfalls, to be used in a future rainy day to maintain their constant consumption levels, while in Tanzania the taxed profits were wasted on various inefficient public expenditure schemes and to maintain and expand the predatory bureaucracy.

There is further evidence that controverts the implicit assumption underlying *dirigiste* panaceas about the irrationality and myopia of private agents. As is well known, in terms of national income accounting, the current account of the balance of payments is equal to the difference between domestic savings and investment. In an open economy, the current account will thus reflect the consumption smoothing that domestic residents — both private and public — are undertaking in the face of various external and internal shocks to their income streams. The countervailing movements in the country’s capital flows, including changes in reserves (which from the balance of payments identity, is exactly equal to the country’s current account), being the means by which this consumption smoothing is undertaken through international capital markets. Thus with capital mobility, the current account serves as a buffer to smooth consumption when there are shocks to output, investment and government expenditure.⁴ In a study of 45 developing countries

⁴ This is the so-called inter temporal approach to the balance of payments of modern macroeconomics and is lucidly discussed in Obstfeld and Rogoff (1996). While Edwards (2004) provides references, qualifications and empirical evidence on the anatomy of current account imbalances around the world during the last three decades.

Ghosh and Ostroy (1995) found that in about two-thirds of their sample countries, private agents were able to fully smooth consumption in the face of shocks. Even more remarkable is a finding by the Reserve Bank of India (2004) that a simple ‘intertemporal consumption optimization’ model of India’s current account between 1951 and 2002 was able to explain the direction and turning point of the consumption-smoothing component of the current account balance fairly well.

The correlation coefficient between the optimal and actual current account balance is close to one. Thus, fluctuations in the current account balance in India are the outcome of residents trying to smooth their consumption paths when the national cash flow fluctuates. The result is noteworthy, given the restrictions on capital flows and the intermittent external shocks experienced. (Reserve Bank of India 2004)

Two lessons can be drawn which are relevant for the following discussion of financial crises and global imbalances. Firstly, and most important, private agents even in the poorest countries behave like *homo economicus*. They are perfectly able to take care of the volatility in their incomes caused by external or internal shocks. Public action, even if well intentioned, is unnecessary and could be counterproductive. As the instincts of most governments are predatory⁵ rather than benevolent, promoting government action to deal with the volatility of national income streams could do, as it has done, great damage to the welfare of their citizens: their prey. Second, the Indian example shows the leakiness of even the most draconian capital controls. Unless a country is willing to close its economy to both flows of trade and capital, in the long run it is not feasible to control capital flows.

Financial crises and ‘global imbalances’

There seems to be an emerging consensus that to avoid the financial crises of the last two decades, countries need to eschew *sovereign* borrowing in the form of bank loans and bonds denominated in foreign currency, as they expose the borrowing country to both ‘income’ and ‘foreign currency’ risk; if such *private* borrowings are made, their foreign currency risk should be hedged; countries should adopt flexible exchange rates and follow sound macroeconomic and structural policies. This is a lesson that many developing countries seem to have painfully learnt.

⁵ My model of the predatory state was introduced in Lal (1984), ‘*The Political Economy of the Predatory State*’, DRD Discussion Paper No. 105, World Bank, Washington DC. It was used in Lal and Myint (1996) and in Lal (1998; 2004; 2005a), to explain the political aspects of economic outcomes across time and space as well as the rise and fall of empires. The nomenclature and aspects of the model have been rediscovered (eg by the late Mancur Olson) or adopted by many in the social sciences without due acknowledgment as is increasingly the practice among the young!

But, a new sceptre has appeared to haunt those perpetual worriers about the global macroeconomy: global imbalances. This gives me a tremendous sense of *déjà vu*. In my 1990 Wincott lecture (Lal 1990⁶) I had examined the case for international coordination to deal with the purported ‘global imbalances’ of the 1980s, and found it wanting. Though fortunately there is no longer a call for the equivalent of the formal Louvre and Plaza Accords of the period, there are nevertheless exhortations from the world’s great and the good to China to raise domestic consumption and to appreciate its exchange rate; for the US to raise its low savings rate, smother the purported bubble in its housing market and reduce its fiscal deficit; for Europe to reform its inflexible labor markets and to reflate the Eurozone; for Japan to open up its economy to foreign investment, and so on. Though no doubt these purported problems may be of concern to the citizens of the respective countries being lectured to, should they be of concern to the rest of the world? The discussion of ‘global imbalances’ implicitly assumes that they are, because of the supposed spillover effects of these various domestic policies and behavioural outcomes on the global economy. But what are these spillover effects and should internationally coordinated public policy or international moral suasion be used to counter them?

To answer this question it is useful to look upon the global economy, in the second period of globalization since the 1980s, as an integrated economy, where governments, central banks, households and firms in each nation are all distinct economic agents acting in their own perceived ‘self interest’, with their own objectives. The international markets for goods and assets will co-ordinate these myriad decisions into changing relative prices, which at the national level will be reflected in changing macroeconomic variables like interest rates, real exchange rates, and savings rates. With both public and private agents maximizing their own perceived interests, this decentralized international system is exactly like a market system. The changes in prices and outputs that arise as a result of the different actions of the these agents are exactly like the increase in demand, say, for shoes within a national economy, which *ceteris paribus* raises the price of leather and hence affects the financial circumstances of the purchaser of handbags. The macroeconomic international spillovers are exactly like those affecting the handbag buyer, which (in the economist’s jargon) are ‘pecuniary’ externalities mediated through the price mechanism and of no significance for the efficiency of the economy. They are synonymous with market interdependence and the price system and irrelevant for public policy — in contrast with ‘technological’ externalities like smoke from a factory which are not mediated through the price mechanism and could require public action. In fact public policy should *not* attempt to offset these pecuniary externalities as they are the essence of a dynamic market economy. They

⁶ Lal (1990) also dealt with the environmental scares which have now become even more strident. I don't deal with these in this lecture but on this new secular religion see Lal (1995 and 2002).

are not a sign of any ‘market failure’. As at the national level so also at the international level there is no need for any further harmonization or co-ordination than is provided by the market.

What then are we to make of all the prognostications of various pundits on these ‘global imbalances’? They are like the numerous stock brokers’ reports trying to foretell market trends based on what each claims are ‘fundamentals’. But we know that at best they are looking through a glass darkly. No doubt it is a useful intellectual exercise, trying to explain a particular macroeconomic conjuncture (like the developing reverse yield gap in the US) by international variables, which will undoubtedly be of interest to punters as they decide on their portfolio choices. These *local* ‘imbalances’ may also be of concern to particular economic agents. As a taxpayer in California and the US, I am naturally concerned about their respective fiscal deficits because of their implications for my future taxes. But for the rest of the world these are only of interest if they are holders of the relevant debt instruments financing them. They are not a *global* concern.

The social question

The 19th century LIEO was gradually undermined by an era of creeping protectionism after the ‘Great Depression’ of the 1870s. Unlike the globalization seen in previous empires, when the trade promoted was largely in non-bulky and luxury non-competing goods (because of high transport costs), the LIEO established by the British was accompanied by a marked fall in transport costs and, with the growing integration of the Atlantic economies, led to the convergence of commodity prices and the prices of factors of production (land, labor and capital) as the Hecksher-Ohlin model would predict (see O’Rourke and Williamson 1999). This meant that, in relatively land-scarce and labor-abundant Europe, wages would rise and land rents fall, while in the relatively land abundant and labor scarce United States the converse would happen, with land rents rising and wages falling. As capital was also relatively scarce in the US and Germany till the late 19th century (in contrast with Britain), the interests of both capital and labor would be in favor of protection in the US and those of land and capital in Germany, following these effects of globalization on income distribution.

These predictions are borne out by the political history of these two countries (see Rogowski 1989). In the US, the landed interest, which was particularly dominant in the Southern plantation economies, could be expected to be in favor of free trade, whereas the interests of the growing industrial labor force and capitalists on the eastern seaboard of the North would be in favour of protection. The Civil War led to the victory of the North, and protection. The ensuing agrarian discontent coalesced into the Populist movement which among other demands also wanted free trade. But

by the end of the century the US was becoming a relatively capital-abundant country and, with a lag, this led American business leaders to see foreign trade not as a threat but as an asset. Both Theodore Roosevelt and Woodrow Wilson emphasized tariff reform, which Wilson actually delivered.

In Germany, the ‘grain invasion’ from the New World threatened the owners of the scarce factors in the country – land and capital. They combined in the so-called ‘marriage of iron and rye’ which introduced protection, while ‘German labor strongly and consistently endorsed free trade,’ (Rogowski 1989, p. 40) choosing to fight a class war by embracing socialism. By 1890, however, as Germany’s rising wealth turned it into a relatively capital-abundant country, this marriage of ‘iron and rye’ began to fray. Thus began a move towards the low tariffs advocated by labor, which were introduced after the Reichstag elections of 1912.

Britain, alone among the relatively land-scarce, labor-abundant European countries did not turn to protection in the later part of the 19th century. This was because it was also capital-abundant relative to land, and the combined forces of labor and capital had defeated the protectionist interests of land at the time of the Corn Laws. By the time of the European ‘grain invasion’, the share of agriculture in British employment was low enough not to have enough political voice to get protection.

Is a similar backlash against the current process of globalization also likely? In answering these questions it is worth emphasizing that despite the economic illogicality of the GATT and WTO process — based on looking at trade as a zero sum game — it has been successful in removing the worst forms of protection. The US led this multilateral process and its domestic politics did not become an impediment. It is since the 1980s that the US seems to have turned against this process. Why?

The answer lies in developments in the US labor market. From the late-1970s till about 1992 there was a fall in US real wages. Thereafter they have stagnated. The lowest-paid male workers have seen their wages fall by about 10 per cent between 1977 and 1995. These wage trends in turn have led to an increase in inequality (in family income) since 1973, as compared to the positive trends in all these variables in the earlier period — the so-called Golden Age — from the end of the Second World War till the oil price rise in 1973. As the US economy became increasingly integrated into the world economy during the later period, there is a perception that globalization — particularly through trade and overseas investments by multinationals — accounts for these trends.

But the second period has also seen a profound change in the international division of labor. This is the result of the third industrial revolution associated with advances in communications through the spread of computers and the development of the

internet. There is a continuing and unsettled debate about the causes of the stagnation in the wages of low-skilled workers in the US. (or historically high unemployment rates — which is the other side of the same coin — as in Europe). There are some who argue that these trends are due to the integration of low-wage countries like India and China into the global economy. Following from the Samuelson-Stolper theory, unskilled labor-intensive imports into the US will hurt the relatively scarce factor of production in the US, which is now unskilled labor. But, if this trade effect is the cause for these wage trends, then it would have to work through a fall in the domestic relative prices of labor-intensive goods. There seems to be little evidence that this has happened — mainly because various forms of protection have kept up the domestic prices of unskilled labor-intensive goods. For, in the HOS trade model, relative factor prices are determined by relative commodity prices. If the latter do not change, neither can the former. The other cause for the observed wage trends could be technical change. If there has been technical progress in the sectors that use skilled labor intensively, then even if commodity prices are unchanged, the real wage of unskilled workers must fall. Hence, it has been argued that technological change is the main cause of these trends.

The question — whether low-skilled wages are now set by those of Chinese and Indian coolies, or are stagnant because of technological changes in the West — is unlikely, in my view, to be resolved, because of a massive structural change taking place in the global economy. This is as momentous as the first Industrial Revolution. Sir John Hicks maintained that its major characteristic was that it substituted fixed for circulating capital in the processes of production — as the ‘factory’ replaced the ‘putting out’ system in producing cotton textiles. The current structural revolution can be characterized as the replacement of human for fixed capital, as epitomized by the communications revolution in the West.

The second Industrial Revolution relied on long production lines to manufacture mass consumer goods. It has been called ‘Fordism’ in recognition of the revolution in standardized mass production of consumer durables achieved by Henry Ford. Today much of the consumer goods industry seems to be going ‘bespoke’. It produces differentiated versions of the same good more closely tailored to differing individual tastes. Variety rather than standardization is the name of the game in this ‘designer’ world of commodities in the affluent West. Shifts in its variegated tastes are increasingly reflected in changes in differentiated products to meet this volatile demand. Meanwhile, most heavy industry is moving to the South, as many of the larger Third World countries increasingly have a comparative advantage in its products.

Moreover, there is a further twist to this emerging international division of labor. In the 19th century, North-Western Europe and later North America specialized in the production of manufactures and experienced Promethean growth. While the South — which included most of the post-war developing world as well as land abundant countries of new settlement like the US, Argentina and Australia — specialized in the production of primary commodities and experienced Smithian intensive growth. In the current LIEO there is a three way international division of labor. The North now specializes in the skill-intensive end of manufactures and services. The labor-abundant countries of Asia, India and China, specialize in unskilled and semi-skilled manufacturing and services. Both the North and emerging Asia are experiencing Promethean intensive growth: one based on the inexhaustible supply of new ideas and technology produced by human capital, the other on the relatively unlimited labor and energy available to fuel industrialization. Finally, the land-abundant countries of Latin America and (hopefully) Africa again find that their 19th century pattern of specialization in providing primary products to the burgeoning industries of China and India is once again yielding them spectacular Smithian intensive growth. Thus, the much derided ‘colonial’ pattern of trade is alive and thriving, except it now applies to countries within the Third World!

A new sub-division of the 19th century international division of labor of the North, based on ‘outsourcing’ and ‘just in time production’ — reminiscent of the old national ‘putting out’ systems — is emerging. The ‘design’ and ‘sales’ capacities which are human-capital intensive are located in ‘rich’ countries. They then have ‘virtual factories’, with their production bases spread across the world, which use modern telecommunications to convert these ‘designs’ into the differentiated ‘bespoke’ consumer goods increasingly demanded by consumers in the West⁷.

One feature of this outsourcing is that the activities outsourced are those facing a higher relative wage for unskilled and semi-skilled labor at home than abroad. Thus the assembly of components or the performance of simple repetitive tasks will move to lower labor-cost developing countries. This is happening in the factories of Southern China and the call centers in India. This outsourcing reduces the demand for unskilled and semi-skilled labor in much the same way as if these workers were replaced by automation. Hence outsourcing has an effect, similar to skill-based

⁷ The North is coming to own ‘virtual factories’. This was the name given to his enterprise by a young and very rich entrepreneur I met in California. He is in the business of producing consumer goods. His virtual factory consists of a few bright youngsters sitting in front of computers in San Francisco. They have contacts and communicate electronically with the major stores and designers in the US, as well as with production facilities strung out all over the Asian Pacific Rim. With the volatile and highly differentiated tastes of consumers, the stores take orders for highly individualized products which are then produced ‘just in time’ by the cheapest facilities the ‘virtual factory’ can find in Asia. The virtual factory provides the ‘head’ for the parts of the ‘body’ scattered all over the developing world.

technological change, in reducing the demand for unskilled relative to skilled labor within an industry.

In this brave new world of the virtual factory where most trade is in intermediate goods, instead of being competing explanations for the increased wage differential between unskilled and skilled labor in the North, trade and technology are in fact complementary. Both trade and technology will thus put a premium on skills in the West. A signal for the acquisition of these skills is a widening of skill differentials and the stagnation of the wages of the unskilled, as is evident in the US. If, as in Europe, the labor market is inflexible, the result will be rising unemployment. But once incentives created to acquire skills lead to the necessary accumulation of human capital, the levels of living of even those on the lowest rung of the current income distribution should rise. This process will however take time, just as happened to British living standards in the 19th century, when the previous major structural change was taking place. It appears from a still unsettled debate that these living standards took a long time to rise (Crafts 1985) as, for instance, the handloom weavers of the old ‘putting out’ system were converted into the factory workers of the modern age.

It was this, so called, ‘social question’ which in part led to the unraveling of the 19th century LIEO. The redistributive and egalitarian politics arising from the rise of Demos undermined that belief in classical liberalism which underlay the intellectual underpinnings of the LIEO. Today there is less danger that the ‘social question’ in the current phase of globalization will undermine the new LIEO. This is for two reasons.

First, there are the differences in the ‘losers’ in the North in the two cases and the mitigating actions they can take to preserve their prosperity. While political action by threatened interest groups seemed inevitable to deal with the distributive consequences of globalization at the end of the 19th century, the situation is much more benign in the current phase of globalization. For, unlike the 19th century, when the losers could not acquire the material means to prevent their relative decline, they can do so today. The main losers in the North are the unskilled, and unlike the industrial factory workers of the 19th century who could not acquire the physical or financial capital to stem their relative decline in incomes, today’s unskilled can acquire the necessary human capital to share in the immense gains from globalization of their skilled compatriots in the North. Today, instead of agitation, the unskilled have hopefully learnt that to preserve their prosperity they need to go to school.

Second, and equally important, as most Northern economies become primarily service economies, many more workers will be working in areas where the products are sheltered from foreign competition as they are ‘non-traded’. A hairdresser in

South Central L.A. is not going to see his or her rates cut by competition from barbers in Bangkok. However, many of these personal services require not just acquired skills but also personal attributes like tidiness, punctuality, politeness and trustworthiness. Mothers are hardly likely to employ a member of the so-called ‘underclass’ as a baby sitter or housekeeper even if they were willing to accept the wages of a maid in India. The reform of Western welfare states, which have undermined the Victorian personal virtues in the underclass⁸, is required to help the potential ‘losers’ from the current processes of globalization.

As the required adjustments to the new international division of labor take place, we would expect that, as in the 19th century, there will eventually be a rise in real wages and fall in inequality in the US. This should ease the domestic pressures which have led to the incoherent trade policy the US has followed since the 1980s.

Adjustment assistance?

It has been argued that to facilitate the required adjustments in declining industries, governments should provide assistance from public funds to the losers of globalization. But, on classical liberal principles there is no case of compensation for losses arising in a competitive capitalist economy. The dynamics of such an economy, as Schumpeter emphasized, involve constant economic change embodied in new products, new technologies, and new sources of supplies. If those who lose in this competitive process were always to be compensated by the winners it would attenuate the very process of change. It would for instance require that the inventors and producers of the personal computer (PCs) would have had to compensate all the manual typewriter producers and their users for the creative destruction their product had caused. The dynamic change associated with the IT revolution which has markedly raised productivity would have been slowed and possibly prevented. Or, should those who have bought a share on the stock market, because they expected its price to rise, be compensated for their loss if the share price falls? In any dynamic competitive economy, whose essence is continual change, there will be innumerable losers and winners — most often impossible to identify. But these ‘losses’ are the result of the changing value placed in voluntary exchanges of the ‘labor’ and ‘capital’ specifically owned by the losers in a changing dynamic economy. They are not the same as the involuntary taking of someone’s property which constitutes theft. A prescription for winners to always compensate the losers in a competitive economy is one to preserve the status quo and to prevent the economic changes which lead to economic progress. It is the policy of the Luddite. The same arguments apply to the economic changes induced by import competition.

⁸ A fuller discussion of this is in Lal (1998 and 2006).

Apart from the unemployment insurance provided in most developed countries to deal with transitional unemployment, just as with domestic economic changes which inevitably create winners and losers, there is no case for any other compensation to the losers.

Corporate greed?

One of the worrying aspects of the worsening income distribution in the US, is the vast increases in the remuneration of corporate managers. Does this reflect an increase in corporate greed? With the separation of ownership from management, managers were prevented from milking shareholders in the Anglo-American model through the threat of hostile takeovers — hostile to the company's management but friendly to its shareholders. If a management were not maximizing shareholder value, and using the company's profits for its own ends, its share price would decline compared to other companies in the industry. A corporate raider could offer the shareholders a deal whereby he offered to buy their shares at a premium, and took over the corporation to serve shareholder rather than managerial interests. The existing management would of course be sacked. It is this market for corporate control which would control bad managers. Gordon Gekko is good for the market.

In the late 1950s to mid-1960s there was a fairly unregulated market for corporate control in the US. In the takeovers that ensued, shareholders received on average 40 per cent over the pre-bid price for their shares. But, following the howls of protests by threatened managers, the US Congress passed the Williams Act in 1968. This removed the highly profitable element of surprise in hostile takeovers and made it more expensive for outsiders to mount a successful bid. But, it did not kill hostile takeovers. There was a wave of hostile takeovers in the 1980s which restructured US business. Over half of US corporations became targets, while many others restructured to avoid becoming targets. This led the managements of the largest US corporations to petition state governments for protection from corporate 'raiders'. The legislatures and courts obliged, by allowing managers to protect themselves from takeovers with so-called 'poison pill' defenses. The number of hostile bids declined precipitously. The takeovers which took place were through friendly mergers. In these, the incumbent managers agree to cede control in return for lucrative consulting arrangements, stock or stock options in the acquiring company, generous severance packages and other bonuses. The managers in these mergers get the largest share of the premium being paid for control of the company rather than the shareholders. As hostile takeovers declined from 14 per cent of all mergers in the 1980s to 4 per cent in the 1990s, not surprisingly executive compensation soared.

Every statute, adjudication, or regulation that in any way inhibited the free functioning of the market for corporate control simply raised the real cost of ousting inappropriate managers. Dollar for dollar, every increase in those costs could be claimed by incumbent managers, either in greater rewards for themselves or in inefficient management policies. Until the real cost of wastefulness equals the cost of a successful takeover fight, they remain secure behind a legal barrier to their ouster, at least until the whole house of cards collapses. (Manne 2002)

This is, of course, the predictable outcome of regulations which seek to tamper with the free functioning of the market — in this case the market for corporate control. This attenuation of the market by making hostile takeovers more difficult was worsened by another feature of the post-war fiscal system — the double taxation of dividends. In both America and Britain the profits of corporations, which belong to shareholders, were first taxed through corporation tax. When part of these post tax profits were paid as dividends to share holders they were again taxed as part of their income. This greatly reduced the post-tax return to investors from shares in corporations. Most of their returns then depended upon rises in the share price, which in turn depended upon the reinvestment of the company's profits into new, and hopefully, profitable investments. One means of motivating managers to take account of shareholder value was to link their remuneration to stock options. Both managers and shareholders now had a common interest in seeing a rise in the company's share price. This gave an incentive to managers to manipulate their share price through the fraudulent practices shown up by the Enron and other scandals during the 1990s stockmarket bubble. But, though there is a lot of wringing of hands at these clearly illegal accounting practices, as my UCLA colleague Harold Demsetz (2003) notes, 'indeed I wonder just how many share holders might have objected to these misrepresentations if they had believed they would remain undiscovered.' The proposed removal of the tax on dividends in the US will help corporate governance, for with the tax on corporate profits still in place, it will provide incentives on managers to retain less of post-tax profits and pay more out in dividends, shifting resources from management to shareholder control.

The perceived ills of Anglo-American shareholder capitalism shown up in the bursting of the 1990s stock market bubble are not therefore a sign of some decrease in corporate morality — though there have been some clearly illegal practices which are rightly being dealt with by the courts — but are due to the perverse incentives created for managerial 'rent seeking' by the regulations limiting hostile takeovers, and the unintended effects of fiscal policy through the double taxation of dividends. With the double taxation of dividends due to end, if all the regulations preventing hostile takeovers can also be repealed, the unregulated market for corporate governance would again provide checks on predatory managements. Executive compensation will begin to fall, accountants will have less pressure to

cook the books and the Anglo-American corporation would pursue the innovation, efficiency and profitability that has till now been its hallmark.

6 The enemies of globalizing capitalism

Globalizing capitalism is also opposed by two other major groups: the cultural nationalists in the Third World, who fear the westernization it may bring, and the *New Dirigistes* in the West, who bear the ancient hatred of capitalism on their sleeves. Why this continuing hatred of a system which promises unprecedented global prosperity?

It is the twin Papal revolutions we discussed earlier which have cast a long shadow. Though temporally conjoined, the change in ‘cosmological’ beliefs promoting individualism is not necessary for the change in ‘material’ beliefs promoting capitalism. It is the latter that globalization is spreading through the world.

But, since the Romantic Revolt against the Enlightenment, capitalism has been attacked for moral and aesthetic reasons. Both sets of its opponents see globalization as a Faustian pact, where prosperity is bought by losing one’s soul. However, unlike their 19th century predecessors, the *New Dirigistes* can no longer appeal to a socialist utopia to provide a middle way between the creative destruction of capitalism and the settled unchanging way of life of their agrarian past. They now seek to humanize capitalism through regulation and social cum moral paternalism. The demoralization of societies perceived as accompanying the rise of globalizing capitalism has been wrongly attributed to the instrument of their prosperity — capitalism — rather than the growing moral vacuum in the West.

The moral cement of non-monotheistic Eurasian societies was and is provided by conventions and traditions transmitted to the young through the moral emotions of shame and guilt. The West’s current ‘cosmological’ beliefs are incoherent: a mish mash of Enlightenment ideals of individual self-realization, standards of competitive success in an acquisitive society, and a residual of Christian belief in transcendental salvation (MacIntyre 1990). The cultural nationalists fear the global transfer of this demoralization, particularly in the domestic domain.

Eurasia’s wounded civilizations had three responses to the Western imperial impact. The first was to accept Western material beliefs whilst keeping their own cosmological beliefs (Meiji Japan). The second was to reject modernization for fear of westernization (Gandhi and Islamists). The third was to find a middle way between tradition and modernity through some form of socialism: the extreme Enlightenment version followed by Stalinist Russia and Maoist China, or the gentler Fabian version of Nehruvian India combining the rationalist manipulation of the

Enlightenment with the Romantic critique of the young Marx and the English socialists William Morris and R. H. Tawney. Its failure has at last led India and China to follow the Japanese path by recognizing that globalizing capitalism offers them the means for prosperity without losing their souls. This leaves the Islamists and the *New Dirigistes* who still hate globalizing capitalism for atavistic reasons.

7 Conclusions

It is time to sum up. In the 1980s I wrote a small book *The Poverty of Development Economics* urging the Third World to give up its misguided *dirigisme*. Events and ideas have made them heed the advice. I did not imagine that in the new millennium I had to write a book to urge the West to live by its classical liberal rhetoric. But, the US and EU refuse to adopt the correct classical liberal principle of unilateral free trade upheld by the UK in the 19th century, foolishly clinging to reciprocity in their trade policy. By contrast, an erstwhile Communist country, China, has carried out a massive unilateral trade liberalization over the last 20 years. Many Third World countries are fearful of following suit, as they would have nothing to bargain with the US and EU in the reciprocity game the largest trading entities still insist on playing. Thus the promoters of the new liberal international economic order (LIEO) have paradoxically become its weakest adherents.

A second paradox is that, as the former repressed economies of the Third and Second Worlds are gradually adopting the other dyad of the twin classical liberal policy of *laissez faire*, there has been hardly any change in the bloated size and role of government in the US and EU — the erstwhile rhetorical champions of free markets and limited government intervention. Again by contrast, China, a supposedly socialist state, has the freest labor market in the world in its burgeoning private sector.

Underlying both these paradoxes is the interaction of the income distribution effects of globalization with Demos. The short-term losers from globalization can use the political process to prevent or mitigate these changes at the expense of their own, and their compatriots, future standards of living. But, as the Northern losers in the new LIEO are the unskilled, there is a simple means for them to maintain and raise their incomes: go to school. This would allow them to participate in the emerging new international division of labor: with the highly skilled jobs of the ‘head’ in the North and the low- and semi-skilled jobs of the ‘body’ in the South — mainly in Asia, whilst the natural-resource-rich countries of Africa and Latin America specialize in primary commodities. The skills needed in the North include, not only those which are increasingly in demand in the production of traded goods, but also the inter-personal skills which are important in the production of non-traded

services in the North. With the growing awareness of the unintended consequences of the welfare state on personal behavior, belated attempts have begun to reverse the policies begun by Bismarck in Germany, Lloyd George in Britain and Roosevelt in the US.

The necessary reforms are made more difficult by pressure group politics and the gradual though subtle shift, in many countries of the North, from representative to participatory democracy. The growing influence of virtually continuous opinion polling on public policy leads to populist pressures reflecting changing, ephemeral passions. The rational considerations of alternative policy choices by the people's representatives in a democracy is replaced by implicit or explicit referenda where emotion and 'spin', not reason, determine the outcomes. It is ironical therefore that the current panacea for development is the spread of democracy in the Third World.

The final paradox is that the transnational institutions the US created to promote its LIEO are now dysfunctional (Lal 2005b). It is the very success of the World Bank and IMF in bringing much of the Third and Second Worlds into the globalization process which has made them redundant. The IMF, created to manage the Bretton Woods quasi-fixed exchange rate system, lost its rationale after the world moved to various forms of flexible exchange rates. It then found a role in managing various financial crises, but the moral hazard this has fostered has brought this role too into question. The World Bank lost its financial intermediation role when the well managed economies of the Third and Second Worlds gained access to private capital markets. Its foreign aid role has been undermined by the manifest failure of 'conditionality' to change the behavior of predatory states. Instead it has become a purveyor of the '*New Dirigisme*', espousing all the soft causes promoted by the NGOs. Ideally it and its sister institution should be shut down, having accomplished their original purposes. This leaves the WTO. Till recently it has been spectacularly successful in promoting multilateral free trade. But with the US move to unilateralism and bilateralism in its trade policy, the WTO's role and usefulness is seriously threatened. The only hope is that the US, by giving up its illogical belief in reciprocity, will unilaterally adopt free trade, which might also shame the EU to follow suit.

It is time, therefore, for the North to put into practice the classical liberal principles it rhetorically espouses, and to resist many of the siren voices of the *New Dirigisme*. If this is done, there is no reason why the world should not see a global golden age in this millennium.

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