

# **CHINA, GLOBALISATION AND NEO-LIBERAL DOGMA**

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## SUMMARY

The dominant policy prescription pursued by the multilateral and bilateral agencies and by many governments is for deepened participation in the global economy. The theoretical case for this policy agenda is based on three key assumptions – full employment; the immobility of capital; and resource transfers to facilitate restructuring and dynamic comparative advantage. Each of these assumptions defies reality, particularly with China's increasing participation in the global economy. The consequence is the growth of global excess capacity, declining prices of many manufactures (particularly those produced by low-income economies) and the growing unequalisation of incomes. These outcomes challenge the conceptual basis of neo-liberal theory, and call for alternative policy agendas designed to rebalance the structural mismatch between supply and demand, to encourage innovation and the growth of dynamic capabilities in low-income economies, and to manage global market access.

### Keywords

Globalisation

Poverty

Inequality

China

Trade liberalisation

Industrial policy

Fallacy of composition

## 1. INTRODUCTION

### 1. THE NEO-LIBERAL CASE FOR THE GAINS FROM OPENNESS

The Washington Consensus has gone through a number of revisions (Williamson, 1990; Kuczynski and Williamson, 2003). Although there is a danger of caricaturing it, there are some central elements which have endured and which reflect the agendas of key institutions of global governance (Rodrik, 2002; Chang and Grabel, 2004 ). A core component is the approach adopted towards insertion into the global economy, as reflected in the World Bank's 2002 report entitled *Globalization and Poverty: Building an Inclusive World* (World Bank, 2002). The Bank believes that the two billion people living in absolute poverty reside in countries reluctant to deepen their participation in the global economy. If globalisation deepens further, the argument goes, then eventually all (or nearly all) of the world's poor will be lifted out of absolute destitution. It argues the case both for further globalisation (notably through rapid growth in developing country exports of manufactures) and for a programme of policy reform which pushes marketisation and deregulation. In this view, globalisation "has generally supported poverty reduction" and "would not have been feasible without a wide range of domestic reforms covering governance, the investment climate and social service provision" (pp ix-x). Although the Bank recognises that there is some dispute about these issues, it pulls few punches - "the doubts that one can retain about each individual study threaten to block our view of the overall forest of evidence. Even though no one study has established that openness to trade has unambiguously helped the representative Third World economy, the preponderance of evidence supports this conclusion." (p. 37). Consequently, "[i]n sum, global economic integration has supported poverty reduction and should not be reversed" (p. xi).

The view that globalisation has broadly supported economic growth and poverty reduction is supported by the basic building blocks of much economic theory. The first of these tenets can be traced to Smith's views on the benefits of specialisation. The *Wealth of Nations* begins as follows: "The greatest improvement in the productive powers of labour, and the greater part of the skill, dexterity, and judgement with which it is any where directed, or applied, seem to have been the effects of the division of labour" (Smith, 1776: 13). For Smith, there were three components to this division of labour which facilitated productivity growth. The first was familiarity and specialisation of task by the individual labour; the second was that specialisation meant that workers did not waste time by downing tools and picking up new tools as they performed multiple tasks; and the third was the specialisation of machinery manufacture which led to the development of capital goods firms producing equipment to mechanise production.

A necessary corollary of this division of labour is the development of markets in which products can be bought and sold. (This, of course, lies at the centre of Smith's model of economic growth). For Smith, a key component of the link between markets and specialisation is scale – "as it is the power of

exchanging that gives occasion to the division of labour, so the extent of this division must always be limited by the extent of the market” (ibid.: 31). The larger the market, the greater the opportunities for specialisation and productivity gains.

Although Smith argued that international trade was an important component of economic growth, the benefits of specialisation and the division of labour *between countries* is most closely associated with Ricardo. In the theory of comparative advantage, Ricardo established the case for mutual gain through inter-country specialisation and international trade.

It is this combination of division of labour and inter-country specialisation in comparative advantage that provides the intellectual underpinnings for the mutuality of gains arising from globalisation. But, woven into this framework is a critical assumption that “markets clear”, that is, that what is produced is consumed in an unproblematic way. Ricardo was explicit about this, leaning on the work of the eighteenth century French economist Jean-Baptiste Say, who argued that supply necessarily creates its own demand - “In an economy with an advanced division of labour, the means normally available to anyone for acquiring goods and services are the power to produce equivalent goods and services. Production increases not only the supply of goods but, by virtue of the requisite cost payments to the factors of production, also creates the demand to purchase these goods. ‘Products are paid for by products’ in domestic as well as in foreign trade; this is the gist of Say’s Law of Markets”.<sup>1</sup>

A final plank in the construction of a case for the mutual gains arising from globalisation and specialisation is the argument that comparative advantage is dynamic, and this requires firms and countries to graduate from low-technology and labour-intensive sectors to higher-technology and more capital-intensive sectors. In the 1930s, the Japanese economist Akamatsu developed a “flying geese” model to describe the proposed dynamic trajectory of the region in Japan’s “Greater east-Asian Co-prosperity Sphere” (Akamatsu, 1962); more recently, Balassa developed the idea of a step-ladder, with second-tier newly industrialising countries filling the sectors vacated by Japan and the first-tier newly industrialising economies as their wages rose and as they, in turn, moved into higher technology sectors (Balassa, 1989).

## **2. QUESTIONING THE NEO-LIBERAL CASE FOR OPENNESS**

There are three critical assumptions in this neo-liberal schema. The first is the existence of full employment in both exporting and importing economies. Without this it makes less sense for each country to specialise in its area of comparative advantage, especially if (as in the case of Ricardo’s original – and fanciful - example of wine and cloth) a country has an absolute advantage across a range of products. A second linked and key assumption is in regard to the mobility of capital. Ricardo argued that if capital (and skilled entrepreneurship) was mobile, then in the case that a particular country had

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<sup>1</sup> This is Blaug’s summary of Say – Blaug, 1985: 149

unemployed resources and an absolute advantage in all products it “would undoubtedly be advantageous to the capitalists of England, and to the consumer of both countries, that under such circumstances, the wine and the cloth should both be made in Portugal, and therefore that the capital and labour of England employed in making cloth, should be removed to Portugal for that purpose” (Ricardo, 1817: 136). In other words, it would not only pay “Portugal” as an economic entity to produce all the products it needed, but also that it would provide English entrepreneurs with a higher rate of profit if they produced in Portugal and exported the output to England. And, third, although Ricardo was not explicit on this, the pursuit of the dynamic comparative advantage which Balassa and others argue is necessary for a win-win outcome to globalization, requires income transfers to facilitate producers moving from one activity to another.

How realistic are these assumptions in the contemporary world?

### *2.1. Questioning the assumption of full employment*

As we saw, Ricardo’s framework of comparative advantage explicitly rested on Say’s assumption of full employment. This assumption that labour markets have a tendency to clear continues into the twenty-first century, and is validated by Keynesian macroeconomic policies which have been so influential since the depression years of the 1930s. Keynes departed from the thinking of his day by problematising the phenomenon of unemployment. But he did so in a framework which saw unemployment as a manageable and *temporary* departure from a world of full employment. He argued that Say’s assumption that supply created its own demand was essentially true, but that there was often a temporary misalignment between supply and demand which required active state intervention to resolve.

There is, however, an alternative body of thinking on labour markets which instead of assuming a systemic tendency towards full employment, argues that there is a systemic tendency towards a reserve army of labour. This is to be found in the writings of classical economists such as Malthus and Marx. It was Marx in particular, who argued that technological change would lead to a disproportionate saving of labour inputs as output grew much more rapidly than labour demand. But the labour-surplus economy is also a central component in the W. A. Lewis model. Lewis argued that in most developing countries there was a dual economy – one segment comprised a modern sector with near-full employment, and the second comprised a sector characterised by heavily disguised unemployment, where people undertook all kinds of work at very low (and often zero) productivity. Lewis believed that over time the modern sector would seep up labour from the secondary low-productivity sector, and that in the long-run there would be a tendency towards full employment. This, he believed had occurred in the rich countries who, faced with a labour shortage, could either encourage immigration (which he thought politically unlikely) or export capital to countries which continued to have a labour surplus – “When the labour surplus disappears our model of the closed economy no longer holds. [However] in the real world ... countries which achieve labour scarcity continue to be surrounded by others which have abundant labour .. available .... at a subsistence wage” (Lewis, 1954: 435).

Lewis's analysis of cane sugar showed that despite sustained productivity growth, wages of sugar workers failed to grow between 1870-1954 due to reserve army of labour. One final observation of Lewis is worth keeping in mind – his model, he argued, only applied to unskilled labour, since it was evident to him that skilled labour was indeed a scarce input, both in rich and poor countries.

To summarise Lewis, in a closed economy there may be circumstances in which labour markets become tight. But once global barriers are reduced, either migrant labour saturates the labour market in countries formerly characterised by near-full employment, or imports from labour-surplus economies have the same effect. The net effect of either of these outcomes will be to depress the incomes of all of those whose livelihoods depend on the work which can be performed by this surplus labour force. This may either be because wages in the formerly tight labour market are depressed, or because the global labour pool forces widespread unemployment.

Our argument is that this is precisely what is happening in the current phase of globalisation, and that the full effects of what will become a major phenomenon are only being hidden in the rich countries by the trade deficits which allow labour to be absorbed into the non-traded service sectors of the rich country economies. Moreover, the spectre of a global reserve army of labour is emerging to affect medium- and long-term employment and wage rates as the large labour surplus in China, India and elsewhere is made available to support global production networks.

Let us consider the evidence, beginning with the recent period. A striking feature of the massive recent expansion in manufacturing output and trade globally has been that it has been a process of jobless growth. More than that, as we shall see, it might be termed a process of job-destroying growth. From the perspective of the high-wage economies this is perhaps not surprising, since they have been experiencing linked processes of offshore-outsourcing and labour-saving technical change. But it is surprising when, as in the case of low-income exporters of manufacturers, employment-displacement is associated with a very rapid growth of industrial production and manufactured exports.

During the 1990s there was a vigorous academic debate amongst economists as to how much the job-loss in the US and the EU was due to trade with developing countries. Authors such as Wood had argued that much of this job-displacement (and the concomitant worsening of income distribution) was due to the rapid rise in imports from developing countries (Wood, 1994). The riposte to this trade-based explanation was that it was rapid labour-saving technical change rather than the rapid growth of imports in labour-intensive sectors which explained the loss of jobs in manufacturing (Lawrence and Slaughter, 1993). In fact these two explanations are not entirely disconnected, because to some extent the spur for labour-saving technical change was the growing threat of import competition.

Whatever the reason for this job-displacement in manufacturing, it has indeed been significant. Table 1 shows that in the largest 14 OECD economies – the economies with high-wages threatened by imports from low-wage economies – employment in formal-sector manufacturing fell by eight percent between 1995 and 2002. But what is perhaps even more surprising is that contrary to expectations, there was an even more significant fall in employment in China (by 15 percent), and by 20 percent in the third largest developing country manufacturing sector (Brazil). The overall picture for these 17 largest manufacturing economies was a decline in total employment in formal sector manufacturing from 200m to 176m, a fall of 12 percent in seven years.

Table 1: Employment in formal sector manufacturing

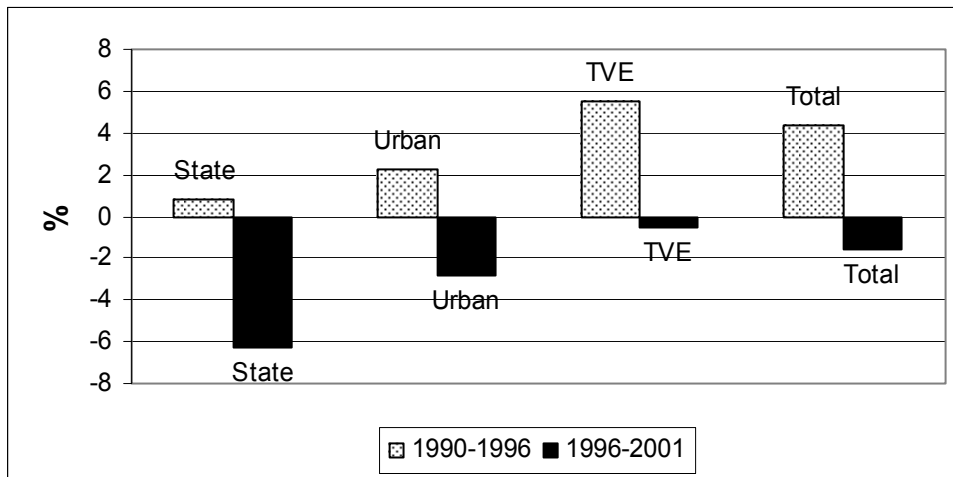
	Employment ('000)				Index of employment (1995=100)			
	OECD 14*	China	India	Brazil	OECD 14*	China	India	Brazil
1995	85,623	98,030	6,500	9,438	100	100	100	100
1996	84,508	97,360	6,800	8,739	99	99	105	93
1997	83,003	96,120	6,900	8,381	97	98	106	89
1998	81,728	83,190	6,800	7,882	95	85	105	84
1999	81,266	81,090	6,700	7,420	95	83	103	79
2000	81,486	80,430	6,600	7,478	95	82	102	79
2001	80,535	80,830	6,400	7,565	94	82	98	80
2002	78,761	83,080	6,500	7,556	92	85	100	80

\* US, Canada, Germany, UK, Japan, Russia, Italy, France, Taiwan, Korea, Spain, Netherlands, Austria, Sweden.

Source: Calculated from Carson, 2003

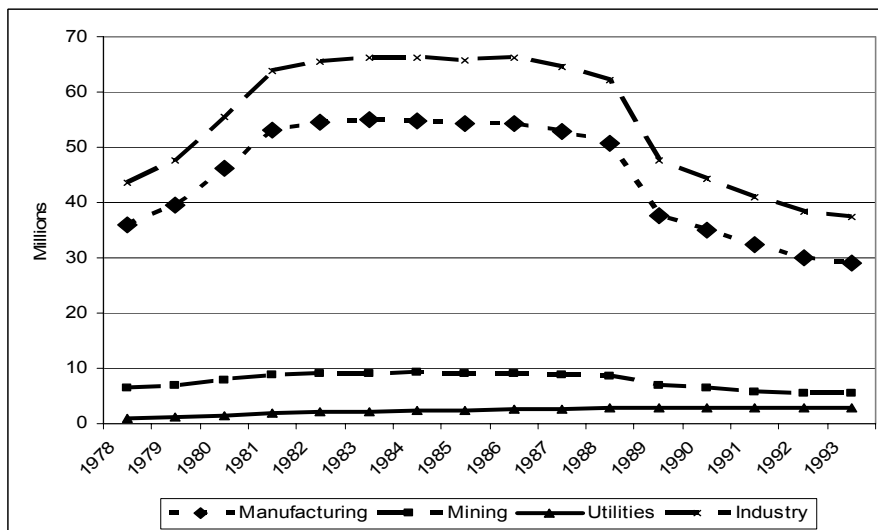
The picture for China is particularly surprising since it has been such a successfully growing economy. It is also a particularly important economy due to its size, with a formal sector employed labour force larger than that in the combined 14 largest OECD economies. Figure 1 shows how the rapid growth in employment during the first half of the 1970s gave way to a process of employment displacement during the 1990s, particularly in state-owned enterprises and township and village enterprises (TVEs). Figure 2 shows that as China entered the global economy after the early 1980s, this labour displacement was particularly acute in manufacturing. But it is also evident in mining. Even these numbers underestimate the extent of real labour displacement in China, since many people in the state-owned and township and village enterprises remain on the books but are effectively unemployed. This is because there remains a residue of enterprises which continue to keep workers on their payroll (so that they can get access to social security services) even though there is no sense in which they are actually working productively (Gu, 2003).

Figure 1: China's growth in employment (% p.a.).



Source: Rawski, 2003

Figure 2: The evolution of sectoral employment in China, 1978-1993 (million workers)



Source: Rawski 2003

Nevertheless, despite this widespread job-displacement in manufacturing, unemployment has not surfaced as a major issue in most of the high income world. After all, the US economy, the world's largest, continues to experience relatively low rates of unemployment, as does the UK and (to a lesser extent) the EU. Although the rate of unemployment grew in most of the major OECD economies during the early years of the 21<sup>st</sup> century, this was nowhere near the rates of the depression years in the 1930s when unemployment reached and often exceeded more than 20 percent of the active labour force.

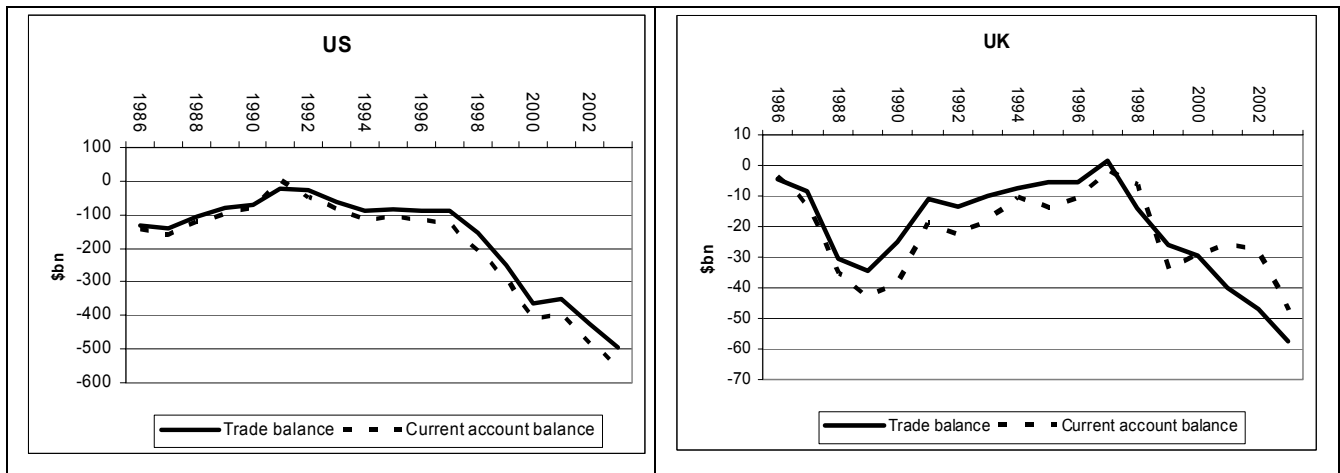
However, this rosy picture on employment is masked by an important structural feature of the global economy, in that two of the very largest



economies (the US and the UK) have been fuelling both domestic and global employment growth through a rapid descent into balance of trade deficits (Figure 3). Moreover, despite earnings on the export of services, in both the US and the UK there have also been sustained balance of payments deficits. This has been particularly evident for the US, where the deficit on the current account increased rapidly from around two percent of GDP in 1997 to more than five percent in 2003; in the UK, the current account deficit averaged more than two percent of GDP between 1999 and 2003. The growth of these trade and payments deficits coincides with the massive growth in China's manufactured exports and India's service sector exports (largely of software) during the 1990s. It is notable that the US trade deficit in 2002 of \$424bn was almost as large as its total manufactured exports (\$569bn) and significantly exceeded the total of China's manufactured exports (\$293bn) and those of Japan (\$388bn).

These trade deficits have allowed consumers in these two countries to go on a buying spree. In the US, for example, on aggregate, from the late 1990s, private consumers have been spending around five percent more than they saved, and net personal savings rates in the UK have also fallen. Much of this consumption boom has been in labour-intensive personal services and this has helped to maintain domestic employment, despite the decline in manufacturing employment. But it has also helped to sustain employment in those countries exporting to the US and the UK (particularly in Asia, and especially in China), as well as in other countries (such as continental Europe and in east Asia) who have exported machinery and equipment and other inputs to those countries with sustained trade surpluses. In effect, these balance of payments deficits have had the same effect on an international plane as the Keynesian deficit-financing used by governments to stimulate domestic demand during the Great Depression of the 1930s. Were the surplus countries such as China, Japan and India to "cash-in" these surpluses (leading perhaps to devaluations of the dollar and sterling, or through other measures to reduce demand, and thus for imports), then domestic demand – and employment – in the US and the UK would fall. (This is analogous to governments deciding to balance their books after a sustained period of deficit financing). The sustained nature and size of these savings and balance of payments deficits in the US and the UK are such that this situation cannot continue. The short- and medium-term prognosis on global employment is thus not good.

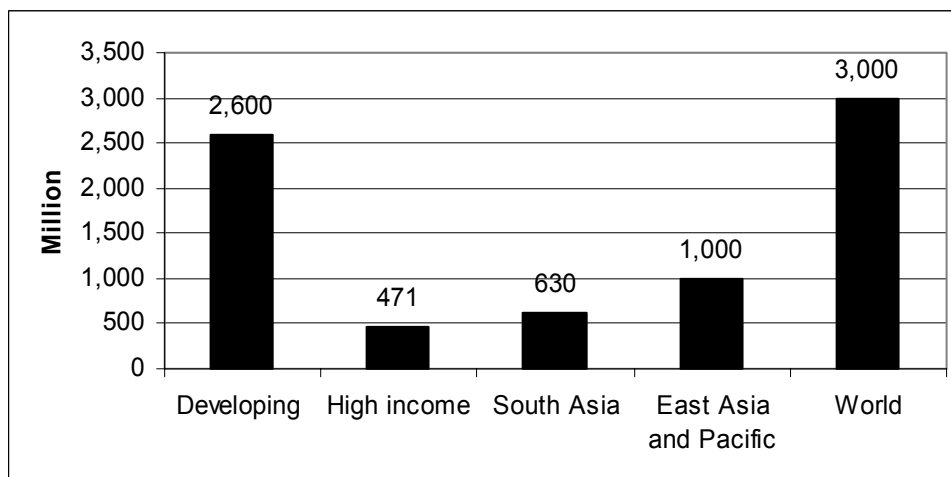
Figure 3: Balance of trade deficits, US and UK, 1986-2003.



Source: [www.OECD.org](http://www.OECD.org)

The long-term prognosis is probably even worse. Figure 4 shows the size of the global labour force, from which it is evident that the number of people available to work in low-income economies dwarfs that in the high-income high-productivity economies. Much of this developing country labour force, as Lewis indeed argued, is either unemployed, or works at very low-productivity and is often in the informal sector. In many developing countries, the effective rate of unemployment is high. In some countries such as South Africa the effective rate of unemployment is more than 30 percent.

Figure 4. The global labour force (2002)



Source: World Bank World Development Indicators

But it is China, and to a lesser extent India, that the numbers are so startling. The two countries, have labour forces of 770 million and 470 million respectively. As we have seen, China's formal sector manufacturing employment is already larger than that of the 14 largest high-income economies combined. This is something less than 100 million jobs. Yet, a

variety of observers concur that there are something like 100-150 million people in China currently working at very low levels of productivity and who are waiting to be absorbed into the global economy. This surplus labour force, as can be seen in relation to Figure 4 is equivalent to more than one-quarter of the total labour force in all high-income economies. Yet this labour surplus does not show-up in Chinese labour statistics: "The officially released low (formal) unemployment figures, however, do not reflect the severity of the actual high unemployment ... [which] .. takes place in urban China not in the form of open unemployment, but rather in the form of lay-offs. Laid-off workers, according to an official definition, are those who loose (sic) their jobs as their employing units encounter economic difficulties, while still maintaining their nominal employment relationship with their employees" (Gu, op. cit: 2). Rawski concludes that "[e]xpansion of formal employment during the 1990s is entirely attributable to increases in rural jobs.. [and] employment prospects deteriorated dramatically after 1995, with large numbers pushed out of the formal sector" (Rawski, 2003: 4-5). One of the consequences of the opening-up argues Rawski, is that the barriers to domestic migration have dropped sharply, so that up to 100m people moved their place of residence during the 1990s.

The Chinese labour market is a segmented one. Recent figures (although the numbers should be treated with a great caution) suggest a conflicting picture on the evolution of real wages. Some observers conclude that the effect of this labour surplus has been to reduce wage pressures - "Unlike the situations in Japan and the newly industrialising Asian economies, where the supply of labour quickly hit the limits with wages shooting up, China's market wages for the unskilled labour in major manufacturing centres such as Guangdong have been stagnant at a subsistence level around \$100 a month for more than a decade" (Cheong and Xiao, 1993: 129). However others dispute this. In Guangdong in 2002, with a sample of 21,543 firms, (of which roughly half, 46.5%, were exporters), average wages were \$138, those for exporting firms were \$145, and those for non-exporters were \$120 (Rawski, personal communication). What appears to be happening is that enterprises which are moving into higher value added products and technologies are indeed raising wages in the coastal regions, albeit at a rate which is much lower than the growth in GDP. In addition, new migrant workers are streaming into the coastal regions and keeping marginal wages low in the coastal regions. At the same time, the vast interior is being opened-up, and new investments which require low wages to compete globally, are moving into the hinterland. A the Japanese managing director of a Chinese subsidiary observed - "If we run out of people we just go deeper into China" (Financial Times, February 4, 2003). It is this labour market segmentation which explains the fact that despite rising wages in some parts of the economy, the US International Trade Commission concluded that global apparel production was likely to shift to China when clothing protection is removed in the major high-income economies (USITC, 2004).

All of this accords with the Lewis (and indeed Marx's) model except that Lewis had argued that the reserve army would be gradually absorbed. If the numbers we have documented above are correct, this absorption will take a

very long time, particularly as technology is becoming ever more labour-saving in nature. But, secondly, Lewis also argued that this reserve army of labour was predominantly unskilled in nature, and it is here that the global picture is changing structurally. Many developing economies have invested substantially in skill development. For example, Table 2 indicates the extent of this skill development in China. Almost all children of school age are enrolled in schools, with high levels of progression to secondary and senior secondary schooling. The aggregate numbers having completed schooling are very substantial, and the quality of schooling (as reflected in teacher-pupil rates) compares well with many high-income economies. But China, although probably much more advanced than other low-income economies, is not unique. India has a long history of tertiary education, and this has been reflected in recent years by very strong growth of information technology exports. The consequence is that the job-displacement previously experienced by the manufacturing sector in the US has now begun to also affect professional services. As Figure 6 shows, whereas historically electrical engineers and computer scientists experienced an unemployment rate less than half that of the US labour force in general, by 2001 this pattern no longer held and they experienced similar rates of unemployment as in the economy in general. In other words, the reserve army of labour of Marx and Lewis is no longer confined to unskilled workers.

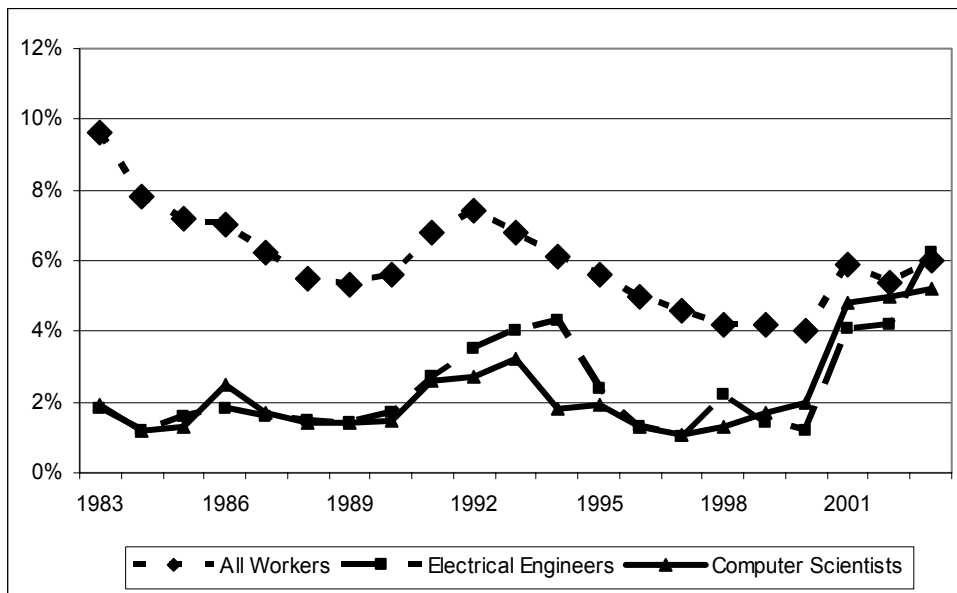
**Table 2: Development of the Chinese educational system, 1985-2002.**

	1985	1990	1996	2000	2002
% of school age in primary education	96.0	97.8	98.8	99.1	98.6
% of primary school graduates entering junior secondary school	68.4	74.6	92.6	94.9	97.0
% of junior secondary school graduates entering senior secondary school	41.7	40.6w	48.8	51.1	58.3
Numbers in technical secondary schools	61,000*	1,567,000	3,348,000	4,125,000	3,962,000
Number of students studying abroad	2,124	2,950	20,905	38,989	125,179
Numbers with:					
University education			6,140,000		
Three years of college education			9,620,000		
Completing specialised secondary school			17,280,000		
Completing senior secondary school			263,000,000		
Completing junior secondary school			420,000,000		
Completing primary school					
Number of full time teachers					
Higher education	247,000	395,000	403,000	463,000	618,000
Secondary schools	3,171,000	3,492,000	4,040,000	4,723,000	5,030,000
Primary schools	5,499,000	5,582,000	5,736,000	5,860,000	5,779,000
Pupil teacher ratio					
Colleges and universities	5.0	5.2	7.5	12	14.6
Secondary schools	17.2	14.6	16.4	18.2	18.7
Primary schools	24.9	21.9	23.7	22.2	21
Number of books published	21,621	80,224	112,813	143,376	170,962

\* 1980

Source: China Statistical Abstract, 1997; China Statistical Yearbook 2003.

Figure 6. US unemployment rates, 1983-2003.



Source: Hira (2004).

## 2.2. Questioning the assumption of capital immobility

In Ricardo's world, countries continued to trade because investment was immobile. But if it were mobile, and if Portugal had unused resources, then Ricardo believed that capital would move to Portugal in the search for higher profits. The result would be expanding activity in Portugal, and declining production in England. Abstracting from this theoretical mind-construct of Ricardo, a similar story can be developed for the actuality of the contemporary world. Given the lower costs of production in a region – across a range of sectors – and given the mobility of investment capital, production will become increasingly concentrated geographically. In reality this has meant a flow of investment resources to the Asian region in general, and to China in particular.

Although much of the capacity expansion in low income economies in general and China in particular was financed domestically, a considerable proportion was externally sourced, by a combination of indirect private portfolio-investments into stock markets, and direct foreign investment into enterprises. For example, throughout this period, inward flows of investment accounted for more than 10 percent of all gross fixed capital formation in China. Table 3 shows the extent and distribution of these flows of foreign direct investment between 1991 and 2002. Following the 1997 Asian crisis, the proportion of FDI going to the developing world fell, as investor confidence was dented. But a striking feature of these investment flows was their concentration. For almost all of this period, more than half of total FDI going to the developing world went to Asia, and a rising proportion of this was directed to Hong Kong and China, playing a significant role in its expansion of manufactured exports.

Indeed, China and Hong Kong absorbed between one-third and two-fifths of all FDI going to the developing world for most of this period.

Table 3. The size and geographical distribution of flows of foreign direct investment, 1991-2002.

	1991-6 avr	1997	1998	1999	2000	2001	2002
World annual flow (\$bn)	254,326	481,911	686,028	1,079,083	1,392,957	823,825	651,188
Developing economies share of world total (%)	36	40	28	21	18	25	25
Africa as % developing	5.0	5.5	4.7	5.3	3.5	9.0	6.8
LAC as % developing	29.6	37.9	42.9	47.2	38.8	40.0	34.5
Asia as % developing	64.9	56.5	52.3	47.3	57.7	51.0	58.6
China and Hong Kong as % developing	34.5	28.8	30.6	28.3	41.7	33.7	41.0
India as % developing	1.2	1.9	1.4	0.9	0.9	1.6	2.1

Source: UNCTAD World Investment Survey (2003).

### *2.3. Income transfers to fund restructuring*

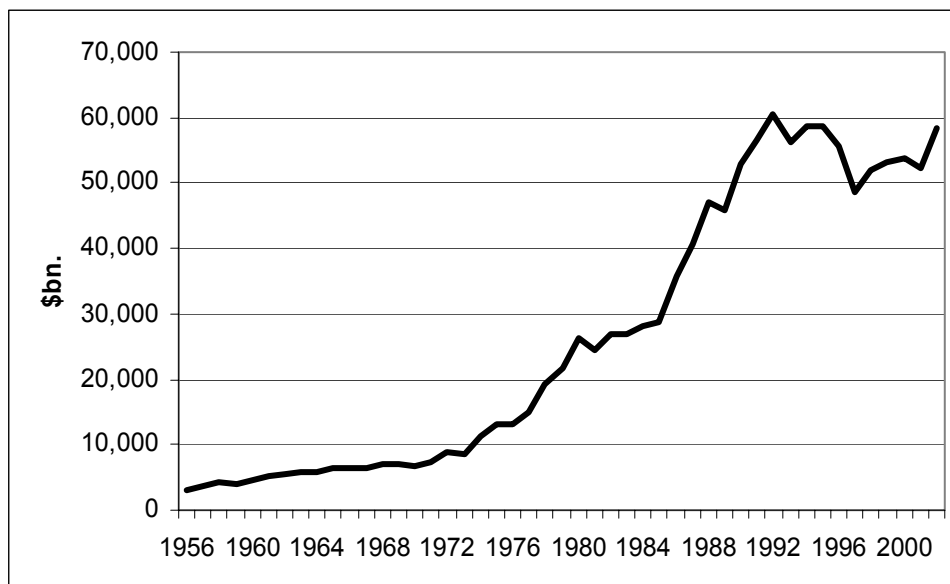
In a world of rapidly changing global specialisation, and even more rapidly changing technology, no country can hope to sustain income growth without the capacity to change. Such a framework includes the development of a stable macroeconomic operating environment with low rates of inflation, currency stability and affordable investment. It also requires the effective provision of resources required to cope with particular market failures across a range of sectors, for example in supporting training, research and development and investments in information technology. And, in some cases where governments are particularly effective, industrial restructuring can also be facilitated by sector-specific policies which target particular branches for concentrated support.

However, underlying these policies designed to promote restructuring - particularly in the case of the poorest countries - is the availability of a pool of restructuring funds which governments can draw on, which are not short-term in nature, and which do not have to achieve a commercial rate of return. Aid-flows – transfer from rich-country governments and international institutions to poor-country governments - potentially provide just this form of restructuring resource.

During the late 1960s and early 1970s the rich countries committed themselves to increase aid-flows to the developing world in order to assist long-run growth processes. The spur for this was in part the massive transfer of resources from the US to Europe designed to aid reconstruction in the immediate post-war period – Marshal Aid Fund transfers to Europe accounted for more than two percent of US GDP between 1951 and 1955. Spurred by President Kennedy in 1961, the United Nations unanimously committed its rich-country member states to a flow of official, government aid equivalent to 0.7 percent of their GDPs. As Figure 7 indicates, however, after a period of growth between 1956 and the late 1980s, the absolute level of transfers of aid

from rich-country governments to developing countries actually fell during the 1990s. This occurred despite a growth in the GDP in rich countries, so that aid transfers in aggregate had fell from 0.33 percent of rich country GDP in 1986-1992 to 0.22 percent between 2000-2003. To make matters worse, much of this aid destined for “developing countries” was targeted at countries which met key strategic interests. For example, in 2003 the major beneficiaries of US aid were almost all a reflection of geo-strategic considerations – in order of importance they were Egypt, Russia, Israel, Pakistan, Serbia and Montenegro, Columbia, Ukraine, Jordan, Peru and Afghanistan.<sup>2</sup> Similarly, the bulk of EU aid is destined for the European periphery (North Africa and Central and Eastern Europe) rather than to those countries in greatest need. Compounding these problems, the developing world (and particularly those economies which require the greatest assistance with restructuring) are mired in debt, so that most of the new, incoming aid funds are destined for the repayment of past inflows (since much “aid” does not come in grant form, but as loans which need to be repaid).

Figure 7: Global aid flows to developing countries, 1956-2003.\*



\* Includes debt-forgiveness

Source: [www.oecd.org](http://www.oecd.org)

### 3. CHALLENGED ASSUMPTIONS: WITH WHAT CONSEQUENCES?

The unreality of these core neo-liberal assumptions has a number of consequences. Due to space limitations only three will be considered here, and briefly. (For more detail, see Kaplinsky, 2005). The first is the growth of global excess capacity, the second is the impact on the global price of

<sup>2</sup> <http://www.oecd.org/dataoecd/42/30/1860571.gif>.

manufactures, and the third is the extent to which it explains the differential fruits of globalisation.

### *3.1. Structural excess capacity*

As we have seen, the rising flow of investment ambitions in the developing world has coincided with the search for new production outlets by foreign investors and for new sources of supply by global buyers. The consequence has been a significant growth in capacity in many sectors which in many cases exceeds all feasible demand. For example, in the auto sector, global production capacity (65m units p.a.) exceeded global demand (48m units p.a.) by more than 25 percent in 2004.

There are two major reasons for this systemic overcapacity. The first, and narrower reason, is the political will which sustains sunken investments despite their low profitability (Brenner, 1998). This has been the case in a number of sectors in the rich countries. Most markedly it occurs in agriculture, where each of the major triad economies (the US, the EU and Japan) provide substantial subsidies and effective protection to domestic producers, forcing global prices down to sub-economic levels. But it also occurs in manufacturing. For example, in the steel sector, many governments have responded to the threat of job-displacement by providing various forms of protection, including in the case of the US through the use of anti-dumping tariffs despite the lack of evidence that countries were exporting to the US at prices below costs. The scrapping decisions which help to bring supply into balance with demand have thus been undermined by the adverse political reaction to capacity reduction.

But, more broadly, there are periods in history in which investment surges. This longer-run perspective on investment is most closely associated with the writings of Schumpeter and Freeman who provided a theoretical framework for explaining the longer-term rhythms of the global economy (often referred to as Kondratieff long waves) (Schumpeter, 1961; Freeman, et. al, 1982). They argued that these long-run investment surges were associated with major enabling technological innovations such as the railways in the nineteenth century, and information technology in the late twentieth century. But, more recently, Perez has provided a coherent explanation for the relationship between investment and production. She distinguishes four phases of each of the major technologically-based long waves. The first of these is that of "irruption", when the new technology arrives, generally with a "big bang", offering massive potential for use and profit. This is followed by a second phase, involving a frenzy of diffusion and a third phase in which this diffusion is extended. Phase four is one of maturity, when the potential of the previously new technology is diminishing and the gestation period of the new wave begins.

Why the distinction between the second and third phases if they both involve processes of diffusion? The answer is to be found, Perez argues, in the disjuncture between financial and productive capital. In the first phase there is a close correspondence between their interests. But towards the latter part of



the second phase they move out of synch – finance capital gets locked into wild speculation and we observe bubble-economies – the dotcom bubble of the late 1990s, and the bubbles of earlier long cycles (for example, canal mania and railway mania). This leads to a period of crisis, a turning point in which there is a recoupling between the needs of productive capital which now in the third phase harnesses a more modest financial sector for its own needs. Then, in the fourth phase, as the cycle matures, financial capital begins to separate out from the dominant technological paradigm and to search for new opportunities, facilitating the gestation and irruption of the new cycle.

Perez argues that the investment boom of the late twentieth and early twenty-first century is precisely this period between the end of the second and the beginning of the third phase of the cycles. Financial instruments have been created which provide virtually unlimited investment funds, supporting ventures which cannot conceivably be justified by historic returns on investment. Capital is thus widely available to support new ventures, funnelled either through the foreign direct investment flows or the indirect portfolio investment flows documented above, or through the creation of finance in countries such as Japan and China whose banking systems have lent money to enterprises which have no prospect of repaying their loans. Lack of effective bankruptcy laws in China (enabling the scrapping of excess capacity) mean that banks are reluctant to enforce liquidation since they will lose all assets. In 2002 the official figure for all China's bank loans showed that 23 per cent were non-performing, but the real figure was said to be around 40 per cent (Financial Times, 5<sup>th</sup> February 2003).

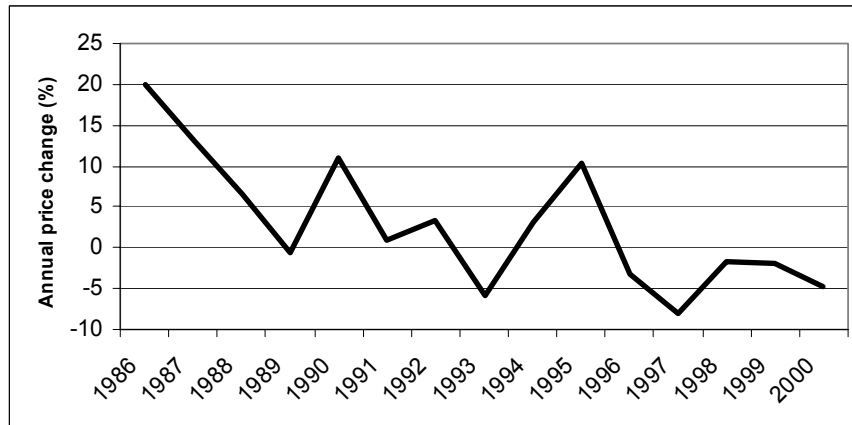
This overcapacity is reflected at a global level in a number of sectors. But it is in China where this frenzy of investment has been carried to the most extreme lengths, and where growing overcapacity is becoming a major problem. For example, in the first 10 months of 2002 China made 24m air-conditioners, but only sold 14m. At the same time, leading firms were expanding capacity even further – Midea, for example, doubled capacity from three to six million units in 2003. As a result prices fell at 15 percent p.a. and Midea increased its exports between 2001 and 2002 by 70 per cent (to \$340m) and planned to increase further to \$500m in 2003. In the production of microwaves where there was a similar pattern of excess capacity, prices fell from an average of Yuan2,000 (\$240) in 2001 to Yuan500 (\$60) in 2003. The price of a 29-inch colour television fell from Yuan6,400 (\$770) in 1997 to Yuan2,000 (\$240) in 2002, again on the back of excess capacity (Financial Times, 5<sup>th</sup> February 2003).

### *3.2. The falling global price of manufactures*

Much of the second half of the twentieth century was a period of inflation in the global economy. Prices of most commodities rose, although the price rise was faster for manufactures than for primary products. By the 1990s, most economies had begun to get on top of high rates of inflation and for the OECD economies as a whole the rate of inflation at the turn of the millennium was less than 3 percent. What followed was a period of price deflation in

manufactures, beginning with a slowdown in the rate of inflation in the late 1980s, and then after 1998, in absolute nominal prices (Figure 8).

Figure 8: World Manufacturing Export Price, 1986-2000.



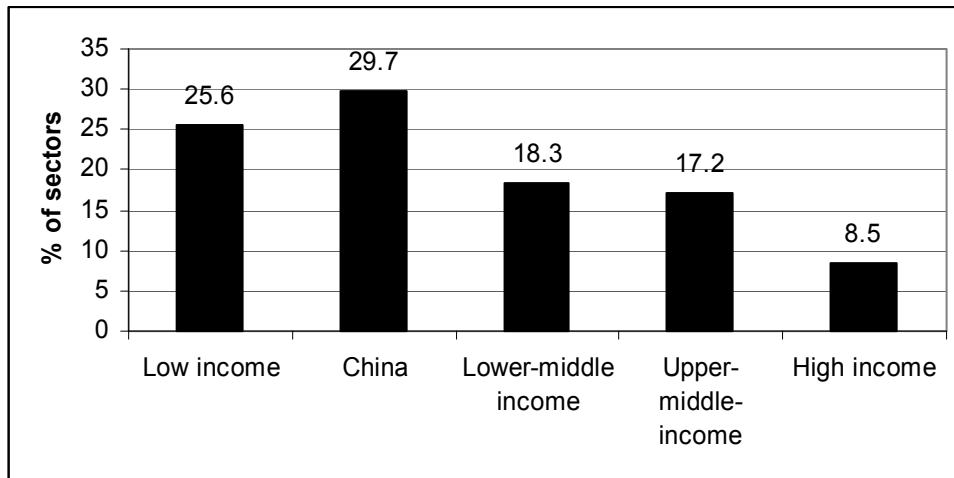
Source: Source: IMF, World Economic Outlook Database, September 2003

The literature on global prices is almost entirely based on the use of aggregated data, mostly using SITC 3- and very occasionally SITC 4-digit classifications. This is not adequate for a detailed examination of prices. The HS trade classification system introduced in the late 1980s has a much finer degree of disaggregation and provides greater scope for the detailed tracking of product prices. At the 8-digit level there are more than 10,000 different HS product categories. An analysis of these product categories tracked the extent to which prices of EU imports fell in the period 1988-2001 (Kaplinsky, 2005; Kaplinsky and Santos-Paulino, forthcoming). The EU provides a unique dataset on international trade and is large enough to use as a surrogate for the behaviour of global product prices.

Figure 9 presents the results of this analysis. It focuses on the major product-groupings (classified at the 8-digit level) imported into the EU where developing country exporters were prominent. It reports the proportion of the sectors for which the unit-price of imports from different income-groups (and China) fell between 1988 and 2001. It can be seen from this that in almost one-third of these sectors, the price of Chinese-origin products fell. In the case of products emanating from low-income economies, the proportion of product group in which unit-prices fell was around one-quarter. As a general rule, the higher the per-capita income group of the exporter, the less likely unit-prices were to fall. Thus, within a significant number of product groups, the prices of products exported into the EU by China and low income economies were more likely to decline than the prices of the same products-groupings sourced from other high income economies.

We draw two conclusions from this price analysis. First, the greater China's participation in global product markets, the more likely prices will fall. And, second, this seems to have a disproportionate impact on the low income country group who face intense competition from Chinese producers.

Figure 9: Percentage of sectors with negative price trends, 1988/9-2000/2001 by country groupings



### 3.3. *Gainers and losers*

In considering the incidence of gains and losses in the recent era of globalisation, we focus only on the differential in economic growth rates, classifying economies by their geographical region (see Kaplinsky 2005 for a more elaborate treatment). Table 4 shows the pattern of per capita income growth by these regions. The story is quite clear. East Asia appears to be a winner. South Asia does less well, but nevertheless achieves sustained per capita income growth. The significant casualties are Latin America and the Middle-East and North-Africa (a growth in the number of both the absolutely poor and low growth rates), and especially sub-Saharan Africa (large growth in the absolutely poor and declining per capita incomes for most of the 1980s and 1990s) and, to a lesser extent, Eastern Europe and Central Asia.

The notable performance of East Asian growth rates reflect in large part China's extraordinary growth of GDP (at around 10 percent annually) and manufactured exports (expanding at 17 percent per annum) after 1985. But it is more complex than this. Many of the raw materials, equipment and intermediate inputs underlying China's rapid growth (much of which is processed for exports to other regions) has been sourced from the East Asian region. China's trade deficit with East Asia grew from \$4bn in 1990 to \$40bn in 2002, and the region's share of China's merchandise imports grew from 55 to 62 percent in the same period (Lall and Abaldejo, 20024).<sup>3</sup> By contrast, the good performance of the South Asian region which reflects India's sustained and rapid growth, has not witnessed a similar process of intra-regional trade expansion.

<sup>3</sup>

Lall and Abaldejo, 20024

Table 4. GDP/capita growth rates (1995 \$PPP)

	1980s	1990s	1997-2002
East Asia & Pacific	6.2	7.1	5.6
Europe & Central Asia		-3.2	4.2
Latin America & Caribbean	-0.6	1.6	-0.4
Middle East & North Africa	-0.9	1.1	1.7
South Asia	3.3	3.4	3.2
Sub-Saharan Africa	-1.0	-0.6	0.6
World	1.6	1.5	2.0
China	8.3	9.3	6.7

Source: World Bank World Development Indicators (2004).

An indication of the potential impact of this East and South Asian competition on incomes in other developing countries can be gauged from recent Brazilian experience. A middle-income economy with a history of industrial production and manufactured exports. It has come to be caught in a pincer movement between competition from low-wage and efficient competitors from below, and higher-wage and efficient competitors from above. This has had important and adverse implications for the distribution of income amongst Brazilian wage earners. Comparing the period before and after 1992 (when trade was liberalised significantly and Brazil could be said to have decisively entered the globalising economy), the impact of this competition can be seen clearly (Arbache, Dickerson and Green, 2004). Between 1992 and 1999, despite an increase in the level of education in the labour force, real wages fell by 15.9 percent in traded sectors and 8.1 percent in non-traded sectors. The fall was greater the higher the degree of tradedness. The ratio of wages in the traded goods to the non-traded goods sectors was constant during the 1980s, with a value of 74 percent in 1992. But after its deepening participation in the global economy, this ratio fell to 69 percent in 1995 and to 64 percent in 1999. Moreover, although wages fell disproportionately in the traded- sectors, it also fell in the non-traded sectors, a consequence of declining wages and surplus labour in those sectors directly affected by imports. Significantly, the only category of the Brazilian labour force not to have experienced a decline in real income was the college-educated skilled group.

## 4. SO WHAT?

What implications can we draw from this analysis of the limitations of the neo-liberal framework underlying the drive for marketisation and openness? We draw two conceptual conclusions, and a number of related policy conclusions

### *4.1. Conceptual issues*

The neo-classical schema rests on key assumptions, of which the capacity for markets to clear is critical. Due to space constraints, we have considered these assumptions largely in relation to labour markets (both skilled and to a lesser extent unskilled labour), but this is a surrogate for productive and innovative capacity. China's growing dominance in the global market for many manufactures rests not only on its labour force, but also on its capacity to draw-in investment, to provide effective policy support, to make infrastructure work, and to provide other inputs required to grease effective production. I have argued, that the global availability of these productive capacities far exceeds feasible effective demand and that this is a systemic problem. The consequence has been either to exclude many producers in other parts of the world from the fruits of market extension and globalisation or to diminish the incomes which they receive from participating in the global economy. So far this has largely affected economies in SSA and Latin America, but it is an increasing problem in Central Asian and Eastern Europe, and in a number of manufacturing sectors in the high-income economies. Moreover, to the extent that China (and India) become sources of knowledge-intensive innovative capabilities (as is increasingly the case), the growth of these competitive capabilities threatens the incomes of knowledge-intensive sector workers in high income economies as well.

The second related conceptual conclusion concerns the determinants of global poverty. The neo-liberal framework argues that global poverty is residual. As globalisation extends, so the poor will be gradually absorbed into the global labour market and drawn out of poverty. The analysis offered above offers a different explanation, at least for many of the poor (both relatively and absolutely poor) in SSA and Latin America, but also in other regions. For them, poverty is relational to globalisation, that is, it is a direct outcome of global processes. Excess global production capacity means that they either produce in sectors subject to intense competition and falling incomes (for example, coffee and many labour-intensive manufactures), or that they lack the capacity to participate in any meaningful way in global markets.

### *4.2. Policy issues*

If this neo-liberal schema does not provide for sustainable income growth, what are the broad policy issues which need to be addressed?

The first is the need to manage the relationship between supply and demand in a manner which recognises this as a structural rather than a Keynesian cyclical issue. The proponents of the open-economy schema argue that the problem of excess capacity will be readily resolved, for a number of related

and complementary reasons. It might result from greater inward-orientation in China and India which will expand their domestic consumption. Another possibility is that as demand in the US, the UK and other high-income markets contracts, so the demand by China for inputs from other countries will increase. Further, it is possible that renewed redistributive global Keynesianism (that is, significantly expanded aid transfers to poor economies) will enhance consumption power in currently stagnating low-income economies. These developments, it is argued, will enhance demand and bring Say's Law into operation at a global level.

But there are a number of problems which throw cold water on this outcome. For one thing, there is little sign of the political commitment required to reverse – and *significantly* alter – the trajectory over the past two decades of a decline in real resource transfers to poor countries to allow for a major expansion in global demand from low-income economies. Moreover, to the extent that these income transfers involve redistributed consumption from the north to the south (rather than global Keynesian deficit financing), there will be no augmentation of global demand, merely a change in its composition. For another, China and India are so large – together accounting for around 40 percent of global population – that the reserve army of labour which we have observed is currently evident at the global level, will also manifest itself at the sub-continental level. In other words, they will have difficulty balancing consumption and production domestically, even as they turn their economic trajectory into a more inward focus. We have no reason to suppose that the systemic trajectory towards excess capacity and the breakdown of Say's Law will be altered in the context of domestic market expansion in China and India.

A second set of policy prescriptions affects policies towards innovation. Whatever the supply-demand balance at the macro level, all countries require the capacity to innovate. In a world of excess capacity, competition intensifies and sustainable income growth – whether it occurs in the context of global openness or more restricted trade environments – requires the capacity to produce efficiently and to innovate effectively. The greater the capacity to appropriate rents in these productive and innovative activities – that is, to produce and innovate more effectively than competitors – the greater the likely rewards. Here, as in the case of the management of the global economy, the neo-liberal framework breaks down. There is abundant evidence that the development of dynamic capabilities in production cannot be delivered by markets alone. It is true that states have failed in “picking the winners” but so too have markets (Rodrik, 2004). Thus, effective innovation requires a holistic approach, encompassing a vibrant private sector and effective policy support. Lall and Teubal provide a helpful architecture for this policy framework (Lall and Teubal, 1998; see also Barnes, Kaplinsky and Morris, 2004), distinguishing between functional macro policies, horizontal cross-sectoral policies targeting generic market failures, and vertical sector-specific policies. It also requires that economies develop effective processes of innovation, crossing over sectoral boundaries, and often requiring facilitation by the national or regional government (Kaplinsky and Morris, 2001; Rodrik, 2004).

But, thirdly, there is the issue of policies towards openness. Effective innovation regimes do not work for all producers in an open economy and excess capacity and heightened competition lead to the consequent marginalisation of many producers. For these producers, two strategic approaches are indicated, both challenging the central tenet of the current phase of globalisation – market-access. The first is to argue the case against openness in external markets. Instead of the *level* playing field much in demand in the development community and policy circles, what poor producers requires is exactly the opposite. They need an *uneven* playing field, but one which is tilted in their favour. They require preferential access in external markets, often at the expense of other low-income, but more competitive developing economies. For example, further expansion of clothing exports to high income economies can no longer be achieved (as it was during the 1990s) by displacing producers in these consuming countries – it is now a battle against other developing economies, most notably China and India (who the USITC judges to have an absolute advantage in most product categories). Special and Differential Treatment must endure, even if it is to change in nature as different low-income economies show differential capabilities over time.

The second challenge to global openness arises in relation to access to low-income economy markets. Since these economies cannot compete with production from China, India and other newly dynamic low-income economies, they may need to reintroduce forms of protection which they have been forced to yield over the past two decades of neo-liberal reform. But if they are to do so, they will need to learn the lessons from a previous era of import substituting industrialisation. In many cases, domestic markets are too small to allow for either the reaping of scale economies (of scope and in production) or effective competition. Thus, in the absence of integration into global markets, there will be a need to foster sub-global openness with economies at a similar stage of competence, and probably within their geographical regions (to allow for the regional externalities which are such an important component of modern competitive production). And they will also need to attune their policy agendas to the competences of their state sectors since weak state bureaucracies are unable to cope with the detailed and prescriptive policy regimes used so successfully in Korea and Taiwan during the 1960s and 1970s.

These policies to manage the supply/demand relationship, to support the development of innovation and dynamic capabilities and to restrict market access challenge neo-liberal dogma. They follow from a critical examination of key theoretical assumptions – the *ceteris paribus* of economic theory – in the neo-liberal schema. But they also challenge the inability of this theoretical framework to contextualise policy prescriptions. Instead of a homogeneous one-size-fits-all agenda, policy needs to be nuanced, heterodox and contextual. This is not to argue that these revisionist policies are without costs, or simple. For one thing, a reduction in openness taxes consumers, forcing them to pay more for often inferior products. Similarly, matching the degree of policy nuance with state competences is a torturous path. But who said that the policy challenge was simple? And can we really continue in good

faith with the alternative of pursuing a path of market-led global integration which systematically excludes so many from the fruits of specialisation and productivity growth?



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