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THE ROLE OF ECONOMIC INCENTIVES AND DISINCENTIVES IN EFFECTING STATE BEHAVIOR

by

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Abstract

This paper provides a critical historical evaluation of three general types of economic incentives and disincentives which have been used to influence state behaviour: (i) treaties concerning trade and international property rights of foreign capital, (ii) various status incentives from joining economic clubs like the EU and WTO and (iii) various forms of econonic sanctions including econonmic conditionality of the World Bank and IMF.

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Introduction

In this paper we examine three general types of economic incentives and disincentives which have historically been used to effect the behavior of states. These are the (i) treaties concerning both trade and international property rights of foreign capital; (ii) various status incentives from joining economic clubs like the EU and the WTO; (iii) various ancient forms of economic sanctions and the new form of economic conditionality tied to the loans made by the World Bank and the IMF.

The chief economic purpose of these measures has been to create a liberal international economic order (LIEO). Political purposes until recently were mainly subserved through economic sanctions : against Rhodesia for declaring UDI, South Africa for its apartheid policies, Iraq after the Gulf War and most recently India and Pakistan for their nuclear explosions. But the other economically motivated incentives and disincentives have also increasingly been used to promote the political values of the West : bilateral and multilateral foreign aid programs during the Cold War, the recent spread of conditions concerning domestic governance in the operations of the World Bank and the IMF, and the growing demand for the introduction of labor, environmental and human rights standards in the operations of the WTO.

To judge the efficacy of these various measures , Section I outlines a very simple analytical framework. Section II then examines the success of these different instruments in the 19th century when the first LIEO was created. This will underline both the strengths and weaknesses of these instruments, for we know that despite the global spread of the LIEO, it slowly began to unravel from about the 1870's. The third section examines how a new LIEO was reconstructed after the half century of economic and political mayhem spanning the two World Wars of this century. The fourth section looks more closely at the specific instruments that have been used for both political and economic ends and to see whether they could be useful in preventing deadly conflicts .

I. A SIMPLE ANALYTICAL FRAMEWORK

To provide some form of analytical framework it is natural for an economist to think of these measures as ways in which particular undesirable social equilibria are sought to be changed into more desirable ones. The notion of 'equilibrium' has been succinctly described by Frank Hahn as a state where self-seeking agents learn nothing new so that their behavior is routinized. It represents an adaptation to the economic and political environment where the messages received from the environment "do not cause agents to change the theories they hold or the policies which they pursue". If the environment changes, the human beings will in the subsequent period of adjustment have to abandon past theories, as these would now systematically be falsified. To survive they must learn through a process of trial and error to adapt to their new environment. We will then have a new social equilibrium where agents having adapted themselves to the new environment find "their expectations in the widest sense are in the proper meaning not falsified". In this context the purpose of the incentives and disincentives we will be considering can be looked upon as changing the economic and political environment so that the human agents in States- the relevant unit of analysis for our purpose- have to change their beliefs and hence their behavior, leading to a new social equilibrium.

Moreover, as I have argued elsewhere (Lal (1998)) it is useful to distinguish between two major types of beliefs relating to the environment: <u>material</u> beliefs which are related to ways of making a living, and <u>cosmological</u> beliefs relating to how we understand the world around us and how we view our lives- or in Plato's words "how one should live". There is considerable evidence that material beliefs are more malleable than cosmological ones, and this will, as we shall see, provide an important guide in judging the success and failure of the various measures to influence the behavior of states.

There is one other general point. We can think of various changes in international regimes which will change the general environment for everyone, this will then lead self-interested States to change their behavior as a suitable adaptation to this environmental change. In this case where there is a <u>general</u> change in the incentives and disincentives for particular types of behavior, we will need to see what were the means adopted to change the environmental parameters effecting all countries which led to this changed behavior. In addition, even when the general environment has changed there maybe some countries whose behavior may seem to be inappropriate or insufficiently adapted to the new environment. Here we shall consider <u>specific</u> incentives and disincetives targeted at particular States to alter their behavior.

II. THE 19th CENTURY LIEO

The 19th century LIEO was created under British leadership after its repeal of the Corn Laws. Within the half century thereafter there was virtually free mobility of commodities, capital and labor. For our purposes the relevant question is how the British norm of an economic policy of economic freedom (misguidedly called laissez faire) spread world wide, and what were the incentives and disincentives which led to free trade and the protection of foreign capital.

(1) <u>Free Trade</u>: Apart from the political economy reasons

for Britain's adoption of free trade (see Hecksher) there were also intellectual reasons which changed the climate of opinion from the previous support for mercantilism to that for classical liberalism and free trade (see Irwin). Ideas and interests were thus equally important in changing the material beliefs as I have called them of Britain. But how did this change in material beliefs spread to the rest of the world?

Britain during the Chancellorship of Gladstone adopted the recommendation of economists that free trade is in the national interest and hence even if other countries are protectionist, it behoves us to unilaterally adopt free trade to serve national welfare. But this example of the unilateral adoption of free trade was not followed by other countries. In France, Napoleon III who had come to power in a coup d'etat in 1851, decided to befriend Britain. "This was partly to gain political status and diplomatic respect" (Cameron, p.277). Also there was a strong current of opinion seeking to reverse the traditional protectionism of the French and embrace economic liberalism. The economist Michel Chevalier persuaded the Emperor that a trade treaty with Britain would be desirable, as under the new constitution while the legislature had to approve any domestic law the Emperor had the exclusive right to sign foreign treaties, which had the force of law. Having failed to convince the legislature- because of domestic vested interests- to reform tariff policy, Napoleon was persuaded that a treaty with Britain was the only way to introduce the economic liberalism he sought. Chevalier used the good offices of his friend Cobden to persuade Gladstone of the desirability of such a treaty, because the policy of unilateral trade liberalistion followed by Britain was not viable in the face of domestic protectionist pressures in France. Thus was the Cobden-Chevalier treaty of 1860 born. An essential feature of the treaty was the most-favored nation (MFN) clause . As Britain, having unilaterally adopted free trade had no tariffs to bargain with other protectionist countries, it was left to the French to sign a string of treaties with other European countries- all embodying the MFN. Subsequently this network of trade treaties, each embodying the MFN principle led to a general reduction of tariffs and to virtual free trade in Europe during the 1860's and 1870's. But with the 'Great Depression' of the 1870's both the intellectual and domestic political climate changed and the era of creeping protectionism began, leading ultimately to the destruction of the LIEO with the onset of the First World War.

Protectionist coalitions in the US and Germany took up the ideas of Hamilton and List for 'infant industry protection',[1] which was even lent some support by J.S.Mill. He, following on

[1]see Rogowski for a political economy explanation using the Stolper-Samuelson theorem to explain the rise of these coalitions.

the work of Torrens, also challenged the doctrines of Ricardo of the desirability of free trade from the national view point, by emphasizing the 'terms of trade' argument for protection.(see Irwin). This began the gradual process whereby economic liberalism was gradually displaced by the creeping Dirigiste Dogma (see Lal (1983, 1994)). It was not till the refurbishing of the argument in favor of free trade (by decoupling it from that for laissez faire), with the development of the modern theory of trade and welfare in the 1960's that, the infant industry argument was finally laid to rest, along with others purporting to deal with what came to be called 'domestic distortions' in the working of the price mechanism, while accepting the terms of trade argument as the only remaining valid argument circumscribing the classical case for free trade.

We thus see that both ideas as well as status incentives led to the adoption of the MFN principle by France. The specific economic incentives provided through the subsequent network of treaties it initiated was responsible for changing the material beliefs of most of the world in the 19th century. But, as the events in the last part of the century show, this triumph was short lived. Whether ideas influence policy more than interest, as Keynes maintained, or whether it is the changing balance of domestic interest groups which is paramount, still remains controversial. But what is clear from this 19th century example is that, when the two are working in the same direction, and the prosperous who subscribe to free trade are sought to be emulated by late comers, a potent set of status and economic incentives can provide a powerful means towards the globalization of the free trade norm. We shall return to this theme in Section 4.

(2) <u>Protection of Foreign Capital</u>: The commercial treaties signed by European states also provided rules for protecting international property rights which "hardened into general principles of international law" Lipson (p.8) [2] These international standards built on the system of commercial law that had been created as a result of Pope Gregory VII's papal revolution in the 11th century, which established the church-state, and a common commercial law for Christendom (see Berman, Lal (1998)). The treaties of Westphalia (1648) and Paris (1763) further strengthened the economic rights of foreigners and their property abroad. The 19th century saw a culmination of this process with the security of foreign persons and their property guaranteed by every European state, by the US soon after its independence and by the new Latin American states after their wars of Independence. Crucial in understanding this extension of the international rule of law is that it covered what was previously

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[2] Lipson notes that these principles were: "foreigners were deemed subject to local laws, as they had been since the Middle Ages, but national jurisdiction over aliens and their property had to comply with a variety of international standards.

Christendom in Europe and in the new World, and the role of the medieval Catholic Church in providing the first "international" legal system.

As legal systems are in part derived from people's cosmological beliefs, as I have denoted them, it is not surprising that this common international standard was readily adopted in the lands where the people shared this common cosmological heritage. Matters were very different when it came to the areas with very different cosmological beliefs in the Middle East, and in Asia and Africa. Even there, the principle of reciprocity which had partly led the European states of the Middle Ages to accede to various international standards, was also behind the acceptance by the Ottoman Empire of various 'capitulation' treaties dating back to the 1500's. Through these treaties the Ottomans granted commercial privileges to the states of Christendom and in return Muslim merchants and other subjects of the Porte received protection for their goods and persons abroad. The Ottoman treaty of 1540 had the principle of reciprocal protection directly written into it.

With its growing economic strength in the 19th century, and worried about Russian expansion in the Eastern Mediterranean, Britain signed the Anglo-Turkish convention in 1838, which effectively opened up the Ottoman empire to European trade and investment. With the growing enfeeblement of the Ottomans, in time new arrangements arose concerning disputes with foreigners, whereby "international property rights were effectively guaranteed by the extra territorial application of European and American laws". (Lipson, p.14)

As the legal and political systems of different countries depend to a substantial extent on their cosmological beliefs, the European powers under British leadership found that, for the subsequent knitting together of an LIEO in parts of the world where the European cosmological beliefs were alien, to expand trade and investment they had to create systems of foreign concessions and extraterritorial laws as in the treaty ports of the Far East. Where, as in Africa, political arrangements were fragile the creation of political and legal structures which would serve commercial expansion led to difficult choices for the Victorians in integrating the agricultural periphery with the dynamic industrialism of the Center. (see Hopkins). "Their policies naturally aimed at a vast, global extension of commerce. At the same time, they tried to limit the direct imposition of political and military controls, which were expensive and difficult to manage" (Lipson, p.15). With the growing competition amongst the European powers for political control and commerce in the periphery, imperialism was the inevitable consequence. This in turn led to the sequence of events which resulted in the First World War and the destruction of this 19th century LIEO.

(3) Conclusion : It would seem therefore that, while it was relatively easier to extend free trade to the world on the principle of 'reciprocity', as there are reciprocal partners who

can benefit from the non-zero sum gains from trade, when it came to extending property rights of foreign capital in countries with very different cosmologies, some direct or indirect curtailment of domestic sovereignty in the periphery proved unavoidable, as these emerging markets were -unlike in foreign trade- merely recipients and not also suppliers of capital, and thus had nothing to reciprocate with. Only in Latin America could the capital supplying countries count on the acceptance of international standards based on common cosmological beliefs and thence an acceptance of European standards of behavior concerning the protection of persons and property . This 'normative' route towards the extension of international property rights was ruled out in other parts of the periphery because of the marked differences in cosmological beliefs. Thus, rather than through any system of economic incentives and disincentives the LIEO had in the final analysis to depend directly or indirectly upon Western arms!

III. RECONSTRUCTING THE LIEO IN THE TWENTIETH CENTURY

After the half century of economic and political disorder following the First World War, a new LIEO was painfully and slowly sought to be created under US aegis after the 2nd World War. The general pattern of this reconstruction is well known and can be briefly summarized.

The three pillars of the 19th century LIEO: free trade, free mobility of capital, and the gold standard had all been compromised if not completely abandoned by the end of the 1930's. The Bretton Woods agreement with its triplets -the World Bank, the IMF, and the still born ITO- provided the institutional framework for this reconstruction. As in the 19th century the establishment of free trade and international property rights of foreign capital were crucial, and we deal with each in turn. This, is followed by a brief description of the evolution of the international monetary system, particularly in view of the recent Asian and Russian crises as this is pertinent to the discussion of specific economic incentives and disincentives in the next section.

1. Free trade : The ITO being still born, the task of liberalizing trade fell to an inspired makeshift arrangement- the GATT (see Jackson). Even though the classicals had emphasized the desirability of a unilateral adoption of free trade by each country as being in its own national interest, so many exceptions and qualifications had seemingly crept in over the subsequent half century of economic thought, that it seemed foolish to many countries- not least the developing ones- to accept this classical case. The most serious and cogent exception being the terms of trade argument, whereby if a country has some monopoly or monopsony power in its foreign transactions (in either commodity or asset markets) , then in the absence of foreign retaliation it can garner for itself many of the potential cosmopolitan gains from trade by levying the so called optimum tariff to turn the

terms of trade in its favor.[3] If its trading partners retaliate, the final outcome in terms of the welfare gains and losses is indeterminate as the gains from trade shrink in the ensuing trade war. (see Johnson). Marshall had emphasized that the long-run elasticities of demand and supply for traded goods were likely to be high and hence there was not likely to be any sustainable gain from this type of protection. But in the short run these elasticities would be lower and hence the possibilities of gains or losses greater.[4] This meant that, as Lord Robbbins noted, particularly when the removal of existing protective structures is at issue:

"the politician would be courageous indeed who would risk a short-run loss by the unilateral lowering of tariffs. And if we take this into account and all the special pleading which can be mustered in support of special interest, it is not difficult to see where power to restrict exists, there it is often likely to be employed, and that a condition in which, without deliberate supra-national contrivance, there prevails a general absence of restrictions is not likely before the Greek Kalends" (p.262

GATT provided this supra-national contrivance. In its successive rounds countries have traded away their tariffs in a process analogous to multilateral disarmament. But until the 1980's this process of trade liberalization was largely confined to the OECD countries. They have succeeded in reducing their overt trade barriers to minuscule levels. Moreover, by adopting the 19th century MFN principle, this liberalization has covered a substantial part of world trade.

It is interesting to note that, as in mid 19th century France when Napoleon III was thwarted by domestic protectionist interests and found an interest -protected instrument in the Cobden-Chevalier treaty to liberalize trade, a similar purpose has been served in the US by the periodic granting to the President of the omnibus "fast track" authority to negotiate a trade treaty which can not then be taken apart by Congress. This

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[3] The recent strategic trade theory argument for government intervention in trade (see Brander and Spencer), whereby a country can through 'first mover' advantages shift the super normal profits in global oligopolistic industries to its own firms is just a variant of this classical terms of trade argument (see Baldwin)/

[4] Both points have been demonstrated in the oil market since the first oil shock of 1973. This action of OPEC can be looked upon as the levying of a common optimal tariff by oil exporting countries. Given the low short run elasticities, their short run gains were considerable (at the expense of oil consuming countries), but as Marshall would have predicted, these have all but been whittled away in the long run because of the higher long run elasticities of both demand and supply.

has allowed trade liberalization to be shielded from domestic vested interests. But, as the proliferation of various non-tariff barriers in the form of VER's and anti-dumping actions shows, these domestic protectionist pressures (in all developed countries) though muted have not been eliminated.

The establishment of the WTO and its codification of trade law as well as its system of panels to implement and adjudicate it, has for the first time provided a set of treaty bound international norms which have legal status as international law. But given the lack of any effective enforcement mechanism particularly against the largest trading countries, it remains to be seen if its findings will continue to be accepted in the long run. (see Jackson). This requires an internalization of these norms in the domestic politics of these larger countries, much as belief in free trade (and laissez faire) had become the commonly accepted policy of the UK for nearly a century.

The integration of developing countries into the global trading network can be divided into three phases. The first post war period till the mid 1960's saw most developing countries follow dirigiste trade and payments policies, which in most cases were an accentuation of trends which emerged when they had to deal with the breakdown of the 19th century LIEO into which most had been integrated. The example of Stalinist Russia and the rise of etatist Turkey gave a further fillip to ideas which were inimical to the economic liberalism of the 19th century. Planning and dirigiste trade and industrial controls were seen as the panaceas to foster rapid economic development as it was presumed had been achieved in Communist Russia. Many developing countries joined GATT but sought and obtained special treatment in the form of permission to maintain trade controls as well as privileged access to OECD markets through various schemes of special preferences.

In the mid 60's a few countries on the Pacific rim turned their back on this inward orientation, and their spectacular success in utilizing trade as a 'handmaiden of growth' gradually changed the development paradigm. In this task of intellectual conversion - changing the dirigiste 'material' beliefs which had dominated development policy in the post war decade- the World Bank and IMF in their role as policy advisors to the Third World played a major role, particularly in the 1980's.

This second period which also included the demands from the Third World for a NIEO, which was conceived as a redistributive global planned economic order, included the period of the OPEC oil price shock in 1973. Commodity power was supposed to fuel the NIEO. But with the eventual collapse of the oil price in the late 1970's and the unintended consequences of the recycling of the OPEC surpluses leading up to the 1980's debt crisis, as well as the desire to emulate the spectacular performance of the outward oriented economies of Asia, finally persuaded many Third World governments to alter their material beliefs. (see Lal-Myint (1996), Lal (1997)). Many developing countries adopted the unilateral reduction of trade barriers that the classical economists had shown best served the national weal.

With the collapse of the Berlin Wall, and the end of Communism in Eastern Europe, the collectivist experiments which had dominated the first part of this century finally came to an end. In the area of material beliefs the market has won world wide over the plan. Every country now seeks to join the world trading system to partake of the mutual gains from trade and the prosperity it promises. In that sense, not merely the preaching of some development economists and the multilateral Bretton Wood institutions, but also the disastrous experience with planning , not least in two of the largest developing countries- India and China- finally persuaded them too to eschew their past dirigisme and begin the process of economic liberalization in the 1980's. Once again ideas and interests have coalesced to promote global free trade.

But the process is incomplete. The former Communist countries and a number of developing countries, including for example Saudi Arabia, are still knocking on the door of the WTO. Their desire to join is partly based on the realization that a rule based system in which disputes are open to international arbitration offers a more secure future for their nascent trading economies against any predation by the rich and powerful. This was highlighted when the new nationalist government of the Bhartiya Janta Party, recently changed its tune on the benefits to India from the WTO. In opposition the party had been a vocal opponent of India's accession to the WTO, on the grounds that this was an imperialist plot to destroy Indian industry and culture. It organized large demonstrations where effigies of the then head of GATT Arthur Dunkel were burnt. But after the imposition of the mandatory sanctions by the US and Japan on official financial flows to India after its nuclear blasts, the BJP realized that its accession to the WTO had made any extension of the sanctions to trade virtually impossible. So even its hardliners have given up their campaign to leave the WTO!

If these instrumental reasons provide positive incentives for many developing countries to adhere to the WTO, there are also status incentives for countries like China which wish to join. The importance of this incentive is vouched for by the immense diplomatic effort the Chinese put in- alas in vain- to gain accession to the WTO, so that they could be one of its founding members. But the so far infructuous attempt by China to attain entry comes up against an old barrier- their legal system. With the extension of the GATT which covered only trade in goods, also to include the agreements on services and intellectual property- the question of protecting foreigners property rights embodied in patents and copyrights has become important.

Western legal systems, and those infected by them eg. the Indian, who have to an extent internalized these foreign cosmological beliefs, have elaborate means to preserve these rights, embodied in their rule of law. One essential and unique element of the Western legal tradition as opposed to the traditional pattern which existed in the rest of Eurasia is the separation of the judicial and executive functions of government.(see Lal 1998). Governmental executive decisions are contestable in civil courts, which provides the foundation for the rule of law and the right of liberty and justice. It implies equality in the eyes of the law, judicial ignorance of complainants, and the ideal that economic relations are based on contract not status. India as a result of the reforms of Cornwallis in the 19th century has a legal system based on these norms, and has not as a result found it difficult to accede to the legal 'cosmological' belief system underlying the WTO. By contrast two of the major Eurasian civilizations- Chinese and Islamic- have very different legal 'cosmological' beliefs, and it is this which has made both Chinese and Saudi accession so problematic as they fear that without some concessions from the current WTO membership, the existing legal obligations of the WTO could require an overhaul of their domestic legal systems and thence their cosmological beliefs.[5] Some other method - for instance international arbitration- will have to be allowed for these countries to accede to the WTO as long as they find it difficult or their trading partners do not find it credible that they will able to incorporate WTO law into their domestic legal systems. But at least for the Chinese this must raise the fear of extraterritoriality , and the humiliation of the indirect imperialism it led to in the past.

Further problems for the WTO and for harmonious relations in international trade are likely to arise if the current attempts by Western countries to write in environmental, labor and human rights codes into the WTO are pursued. Though couched in the language of universal values this call for so-called "ethical trading" reflects the culture specific "habits of the heart" of the West (see Lal 1998a). It is likely to be resisted by the Rest, and can only be the source of future discord. It could ,through the bad temper it generates, gradually lead to a similar slow unravelling of the current LIEO as of its 19th century predecessor.

Note also needs to be taken of the recent trend towards creating trading blocs. Though many supporters of the multilateral trading system fear

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[5] But there is no reason, as the examples of Hong Kong and Singapore show, why countries of Sinic culture cannot adopt the commercial legal codes of the West for instrumental reasons while retaining their other cosmological beliefs (Lal 1998). Also as Baum and Shevchenko report for this project there has been some changes in recent Chinese administrative law and attempts made to enforce intellectual property rights, but as they note "standards for protection are yet not well integrated in the enforcement system", which remains politicized.

that these bilateral arrangements could lead to "trade diversion", one of the major advantage of these blocs as seen by their advocates is that they can both encourage further trade liberalization in Third World countries, and more important tie future governments to the mast so that they do not backslide into some form of protectionism. There is some evidence from the experience of the Mediterranean members of the EEC which supports this judgment.

Thus, in their massive comparative study on liberalizing foreign trade, Michaely, Papageorgiou and Choksi (1991), noted that trade liberalization undertaken within the context of such an association should make it more persistent.

"In the experience studied here, the only relevant multinational trade agreement- the EEC- has been important, even vital, in the policy undertakings of four Mediterranean countries." This was largely because of the effect of both of providing support to liberalisers in these countries for continuing liberalization, as well as locking in each stage of liberalization to some extent. But given the mixed overall record of these countries in sustained liberalization, they conclude: "if any inference is permitted from this very limited scope of observations, it is that the framework of a multilateral commitment and the desire to share in a multinational agreement may contribute to the survival of liberalizations once some fundamental other elements are in operation: the external commitment may prevent minor and temporary aberrations. But when such fundamental components are absent, the multinational framework would <u>not</u> ensure survival" (p.53-4)

Thus interests (economic incentives) based on 'reciprocal' benefits, ideas which have changed material beliefs in the Third World from the instrumental rationality of planning to the market, as well as status incentives have all helped to resurrect the free trade component of the current LIEO. But the clash of cosmological beliefs which in a sense led to imperialism and the eventual destruction of the 19th century LIEO once again poses a threat to the new order.

(2) <u>Property rights and foreign capital</u> : The 19th century international standards protecting foreign capital -often enforced through extraterritoriality and direct or indirect imperialism- did not survive the rise of collectivism and nationalism in the third World. With the Soviet and Mexican revolutions, the legitimacy of these rules had begun to be questioned- not least in the Third World with the explicit introduction of etatist policies by Ataturk in Turkey as a means of economic development. Subsequently, there was a worldwide erosion of public acceptance of the sanctity of private property rights when faced with social policies designed to promote the general- usually nationalist weal. (see Lipson).

(a) Direct Investment:

With the establishment of Pax Americana after 1945, there was a partial restoration of these 19th century international property rights. But this did not extend to the Third World, which experienced an explosion of economic nationalism, as following decolonization, these new nation-states were determined to assert their rights of national sovereignty against any purported international property rights. Direct foreign investors, having provided more local hostages to fortune, bore the brunt of the most deleterious effects of this disintegration of the international legal order. Most developing country governments (and many European ones too) being both nationalist and dirigiste, sought to regulate, tax or nationalize particular foreign investments on grounds of national social utility rather than any particular antagonism to private property. This made it difficult for the US to identify expropriation of foreign capital with a socialist ideology, as the nationalization of foreign oil companies in the 1960's and early 70's by right-wing governments in the Middle East proved. With exchange controls ubiquitous in the Third World, short term capital flows were also effectively snuffed out. Official capital flows filled the breach. We examine them in the next section.

Ironically, the tide began to turn with the OPEC coup of 1973. As the owners of the OPEC surpluses were Third World creditors, the distinction between developed country capital exporters and developing country importers became blurred. Unlike the 19th century there was now the possibility of international standards emerging as the result of 'reciprocal protection' of property rights as in foreign trade. This process was further strengthened in the 1980's and 1990's by the evolution of many of the successful East Asian NIC's into important foreign direct investors around the world. A growing convergence in the interests of both developed and developing countries in protecting international property rights is now evident, and international institutions like the OECD and WTO are undertaking to develop a multilateral legal regime for capital flows to parallel that for trade in goods and services.

But there is a more fundamental change which has effected the material beliefs relating to foreign capital. With the end of collectivism and the recognition that foreign capital (particularly direct investment) can be an important aid to development, and the emergence of massive direct investment and portfolio flows to developing countries as part of an increasingly globalized capital market, most developing countries have learned that they have to follow policies of domestic fiscal and monetary rectitude to attract the foreign capital on which their prosperity increasingly depends. This means that rather than being the pariahs they were for most of the post war decades, foreign investors are now courted by the Third World.

This trend has been accentuated by a new form of international division of labor which is emerging in which the multinational firm is central. (see DeAnne Julius). Increasingly developed countries are moving from mass production of consumer goods -the so called Fordism- to producing differentiated varieties of the same good more closely tailored to differing individual tastes. This is leading to an international version of the old "putting out" system, where the 'design' capacity which is human capital intensive is located in 'rich' countries. They then have 'virtual factories' with their production bases spread across the world, which using modern telecommunications, convert these 'designs' into the differentiated 'bespoke' consumer goods increasingly demanded by consumers in the West. (see Rosecrance). To the extent that there is still a demand for the old Fordist industries these are moving to the developing world. In this brave new world where intra-industry trade is of growing importance, the multinational firm is an essential conduit not only of capital, but of technology, design and marketing. This increasingly means that unlike the extractive industries in which much foreign investment was to be found in the past, and which could be readily nationalized without much damage to the host country's prosperity, in the new world, alienating the multinationals is to forego participating in this new emerging international division of labor and the prosperity it brings. So once again there are incentives based on obvious reciprocal benefits which have made these international property rights more secure.

(b) Portfolio Investment:

We need to say something about short term portfolio flows, as in the light of the recent Asian and Russian crises many observers are suggesting that the financial integration which has taken place should be reversed. They commend countries like China and India which have maintained capital controls and hence weathered these recent storms better than their more open comprators. Chile's tax on short term capital flows is being commended just as Chile has given it up as being counterproductive!

First, it should be noted that, historically, whereas direct investments were protected from expropriation partly by internalized norms of behavior and partly through state sanctioned force majeure- as we saw in the last section- portfolio flows were protected primarily by private sanctions. Given the laissez faire policies of Britain, it refused to intervene in the many defaults on foreign bonds in the 19th century. Its attitude being succinctly expressed in a minute by Lord Palmerston in 1848: "The British government has considered that the losses of imprudent men who have placed mistaken confidence in the good faith of foreign governments would provide a salutary warning to others" (cited in Lipson). But the private lenders had a powerful weapon, the denial of access to the international credit market, enforced by privately organized bondholders, and the prospect of the defaulters financial assets abroad being subject to blockage and seizure. This meant that, both parties had an incentive to reach some sort of agreement on rescheduling . This pattern was repeated in the 1980's debt crisis and is likely to be repeated in both the Asian and hopefully the Russian cases. But there is one difference today which is relevant. The 'hands off' stance taken by the British government in the 19th century minimized what economist's call the 'moral hazard' of foreign lending. This has been exacerbated in the post war period by two major developments. The first is the spread of implicit or explicit deposit insurance against bankruptcy in nearly all banking systems, as contrasted with the situation in the 19th century. The second are the actions of the IMF which in its desperate search for a role after its raison d'etre was destroyed by President Nixon's closing of the gold window- which marked the demise of the Bretton Woods gold exchange standard- the IMF had been set up to supervise. We consider each in turn, and relate these to the recent Asian crisis.[6]

The moral hazard from deposit insurance occurs because this allows banks to over lend by making riskier loans in the knowledge that if these turn sour, their depositors will still be bailed out by the national authorities. In the case of the East Asian crisis this moral hazard was worsened by a distinguishing feature of the so called "Asian model" of development. A central feature of this model- as seen most clearly in Korea but presaged by the development of Japan- is a close link between the domestic banking system, industrial enterprises (particularly the biggest) and the government. The fatal flaw in this model, as the travails of Korea and Japan show, is that, by making the banking system the creature of the government's will, it accentuates the moral hazard that already exists because of deposit insurance. The banks have no incentive left to assess the credit-worthiness of their borrowers or the quality of the investments their loans are financing, as they know- no matter how risky and overextended their lending- they will always be bailed out. This can lead to a mountain of bad paper and the de facto insolvency of a major part of the banking system- as has happened in both Korea and Japan- not to mention the corruption that is inevitably involved in this form of 'crony capitalism'.

These domestic problems of the 'Asian' model were further aggravated by the actions of the IMF (beginning with the Mexican bailout) and the entrance of foreign banks as lenders in the newly liberalized capital markets in the region. Of the three types of capital flows that can be distinguished - direct foreign investment (DFI), portfolio investment and bank lending- the income and foreign currency risks of the first two types of flows is shared by both the lender and the borrower, as the 'investments' are denominated in domestic currency. By contrast, foreign bank loans are usually denominated in dollars and the

[6] The remainder of this subsection is based on Lal (1998b) and on D.Lal " Don't Bank on it Mr. Blair", The Spectator , London, 26Sept. 1998, pp.17-19.

interest rate is linked to LIBOR. This means that, if faced by a shock which requires a devaluation (in a floating rate regime) the domestic currency burden of the foreign bank debt rises pari passu with the changing exchange rate. If this debt is incurred by the private sector, this rising short term debt burden need pose no problem for the country. For, if the relevant foreign banks run, the borrowers can always default on their debt.

But now enter the IMF. The foreign banks faced by a default on their Third World debt have ever since the 1980's debt crisis argued that this poses a systemic risk to the world's financial system, and asked in effect for an international bailout to prevent this catastrophe. Since the 1980's debt crisis and most clearly in the Mexican crisis in the early 90's and the recent Asian crisis, the IMF has been more than willing to oblige. In its desperate search for a new role the IMF has increasingly become the international debt collector for foreign money center banks, as well as an important tool of US foreign policy- posing a serious threat of an economic nationalist backlash in the Third World. These actions of the IMF -ever since the 1980's debt crisis-have generated serious moral hazard in foreign bank lending. With the increasingly confident expectation that they will be bailed out via the IMF no matter what the quality of their lending to Third World countries, foreign banks have no incentive to act prudently in their foreign lending. When this international moral hazard is coupled with the domestic moral hazard associated with the politicized domestic banking systems of the 'Asian' model -as in Korea- there is double jeopardy. Foreign banks lending to domestic banks which know they will be bailed out will over-lend, leading to ropy investments and an eventual debt crisis for the country.

This is not the place to go into the reforms that are needed - not least in the IMF- to remedy this situation. What needs to be emphasized is that it is not short run portfolio flows in themselves which are destabilising, but the perverse incentives created which have made them so. There is however, a silver lining. The Asian crisis has put an end to the "Asian" model. Most of the effected countries have recognized that they need to create transparent and 'arms length' financial systems, similar to those in the previously derided Anglo-Saxon brand of capitalism, which it has now become evident is the only viable economic system to promote prosperity. Attempts by Prime minister Mahathir to buck this trend by Canute like trying to shut off the economy to capital flows are doomed to fail. In that sense the Asian crisis, far from providing a counter-example to the thesis that globalized capital markets impose restraints on predatory State behavior, only reinforces it.

(3) The International Monetary System : Another lesson that emerges from the Asian as well as the Mexican and earlier 1980's debt crisis is that, there are only two viable exchange rate systems in this new global capital market: fully floating exchange

rates, or rigidly fixed ones as in the currency boards of Hong Kong and Argentina. These are the only ones which allow automatic adjustment to external and internal shocks without any need for discretionary action by the authorities who do not have the time or the information to deal with the actions of a highly decentralized but integrated global capital market mediating these shocks. Their actions are often inappropriate leading to serious misalignments of the real exchange rate (see Lal 1980, 1998c).

In this context it is useful to see how and why the international monetary system has evolved from the 19th century gold standard to the quasi-fixed exchange rates of the Bretton Wood regimes to the mixed "non-system" since, and why except in exceptional circumstances a floating rate is now the least bad exchange rate regime for most countries.

The Gold Standard became the international monetary system from about 1870 largely because Britain, the leading economic, political and commercial power was on the gold standard. Britain itself had moved from the bimetallic standards which had been common in most of Europe and the US to a de facto gold standard as a result of the accidental fixing of too low a gold price for silver in 1717 by Sir Isaac Newton, who was master of the mint. As a result all the silver coinage, however debased, disappeared from circulation. Given Britain's preeminence in trade and capital flows, most countries chose to adopt Britain's monetary practice. This was a case of the incentive of emulation of the successful. "Out of these autonomous decisions of national governments an international system of fixed exchange rates was born" (Eichengreen)

There was however an Achilles heel in the Gold Standard- and which bedevils their modern day equivalents: currency boards. This was the danger posed by the rise of fractional reserve banking. Financing loans (which were the relatively illiquid assets of such banks) with deposits (which were their liquid liabilities) exposed the system to bank runs. To stop such runs the central bank needed to act as lender of last resort. But this could imply that it had to extend credit beyond the limits consistent with the rules of the Gold Standard. The expedient used was to break the Gold Standard rules in the short run while adhering to them in the long run. This was credible, because unlike today, domestic politics - before the advent of mass suffrage and the rise of labor parties and the welfare state- did not require the Central Bank to take account of any other domestic economic goals apart from maintaining monetary stability, with full convertibility at the fixed exchange rate, in the long run. This credibility meant that the system was bolstered by stabilizing capital inflows when the currency was weak during a panic, as foreign investors hoped to gain from the eventual strengthening of the currency that they fully expected the Central Bank to ensure. As Eichengreen puts it :"central banks possessed the capacity to violate the rules of the game in the short run because there was no question about obeying them in the long run" (p.32)

It was the disappearance of this domestic political feature underpinning the gold standard, as well as the deflationary bias of a system in which the world's money supply was rigidly tied to a slowly and randomly expanding gold supply, at a time when output was rising much faster , which led to the Great Depression of the 1870's- which finally put an end to this system.

The attempt to resurrect something similar to the gold standard in the quasi- fixed exchange rate system set up at Bretton Woods, floundered on its premise that while freeing trade and maintaining convertibility on the current account, the capital account could be controlled and managed by distinguishing between long term (good) and short term (bad) capital flows. As was soon apparent, after the progressive liberalization of foreign trade, such capital controls were ineffective as capital could be moved through the process of 'leads and lags' in the current account. There were many other problems with the system which need not concern us here, so much so that observers like Eichengreen rightly conclude that it is amazing it lasted as long as it did.

With the move to floating rates, first, among the major industrial countries and now increasingly in developing countries, the dilemma posed to any fixed exchange rate system by the lack of credible commitment by the authorities to the fixed rate in the face of domestic pressures, also means that unlike the Gold Standard period, the authorities during a domestic banking panic can no longer count on stabilizing capital inflows. They are also always in danger of a speculative attack, as given changing economic circumstances the requisite <u>real</u> exchange rate adjustments require domestic wages and prices to change. Effecting such changes is always likely to be subject to domestic political pressures, to which- with the demise of the belief in 19th century economic liberalism- the authorities are likely to succumb. In fact expecting the authorities to blink under the pressure of domestic politics, capital will flow out in anticipation of a devaluation. This was borne out by the experience of many otherwise well managed East Asian economies in the recent crisis.

It would seem ,therefore, that just as in the first LIEO- largely because of domestic political factors- an international monetary system based on fixed exchange rates was viable, in the new LIEO because of the changed domestic political factors, which Eichengreen calls the shift from classical to embedded liberalism, the only viable international monetary system is one of floating exchange rates. Moreover, this 'non-system' as it has been dubbed (see Corden) also has the advantage for international relations, that being decentralized, it does not require the international co-operation, and the potential for discord that creates , of a fixed exchange rate system. We can expect to see this 'non-system' being increasingly accepted as part of a new consensus on 'material beliefs' around the world.

IV. SPECIFIC INCENTIVES AND DISINCENTIVES

So far we have, by and large, looked at general changes in the climate of opinion, which have indirectly effected State behavior in the economic sphere. We now examine specific incentives and disincentives which have sought to effect the behavior of particular States, given the existing climate of opinion.

There are two broad types of specific incentives and disincentives we discuss in this section. The first concerns economic sanctions, the second various forms of economic conditionality attached to the official capital flows from multilateral agencies like the World Bank and the IMF, and bilateral foreign aid programs.

(1) <u>Economic Sanctions</u>: As we saw in the second section, in the 19th century, state economic sanctions were not used. Instead direct or indirect imperialism was the means used. It was with President Wilson, that economic sanctions were accorded pride of place after World War I as the cornerstone of the new rule-based international system. They were a dismal failure. In the post war period, economic sanctions have been used to subserve a plethora of foreign policy goals. The most detailed analysis of their efficacy by Hufbauer et al finds that they have been inefficient and ineffective in serving their goals. Before 1973, they found that they contributed successfully to foreign policy goals 44% of the time , but have only been successful 24 % of the time since. The costs of these blunt instruments to the countries implementing the sanctions are high. Thus Hufbauer and Winsten (1997) estimate that in 1995 the US lost 200-250,000 export jobs due to sanctions. The humanitarian costs to the targetted populace are generally also very high, with often little success in achieving their objectives. Thus the FAO has estimated that as a result of the Iraqi sanctions 500,000 Iraqi children have died from malnutrition and disease, (Hufbauer & Winsten) and Saddam Hussain is still in power. Given these unintended consequences of economic sanctions they have become something of a paper tiger, as witness the failure of the threat of sanctions as well as their imposition in changing the behavior of India and Pakistan as regards their nuclear tests.

By analogy with the development of smart weapons which allow enemy targets to be hit with minimal use of men and materiel, Hufbauer and Winsten, argue for the use of smart economic sanctions which are targeted at the elites of 'rogue' nations. This would mean that the general populace would be spared and the elite responsible for the bad behavior would be hit. The general economic sanctions, which they describe as being analogous to carpet bombing, would only be used as a precursor to military action.

The smart sanctions would involve the multilateral civil and criminal banning of the relevant elites by putting them on a life-long international black-list, subject to seizure of assets abroad, refusal of visas to their children for education abroad, and make them subject to criminal prosecution if they ever leave their borders. But even here their effectiveness will depend upon the extent to which the relevant elites wish to maintain their personal foreign links, and to keep assets abroad. Such an approach might work as it seems to be doing, partially, in the case of Nigeria, but not when dealing with autarkic elites or those with antagonistic cosmological beliefs like those in North Korea, Iran or Afghanistan, or the Tamil Tigers. Though for the latter denial of access to foreign funding might be a powerful disincentive.[7]

(2) Official Flows and Conditionality[8] : Foreign aid as a form of capital flow is novel both in its magnitude and global coverage. Though there are numerous historical examples of countries paying bribes or reparations to others, the continuing large-scale transfer of capital from official sources to

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[7] The case of the Tamil Tigers reminds us that many of today's deadly conflicts are civil wars. In most cases, as for instance in Sri Lanka, the causes of the civil war were not economic. In an interesting statistical exercise, Collier and Hoeffler (1998) find that four variables, initial income, ethno-linguistic fragmentation, the amount of natural resources and initial population size are significant and strong determinants of the duration and probability of civil wars. The higher the per capita income the lower the risk and the larger the population the greater the risk of civil war. Increased natural resources increase the risk but at a high level the risk falls. The most interesting finding is that the relationship of ethno-linguistic fragmentation to the risk of civil war is an inverted U shape. The most homogenous societies as well as the most fragmented are least at risk of civil war. The greatest risk is when countries are polarized into two groups. In a presentation at the "War and Peace" colloquium at UCLA (Nov.1997) Collier argued that ex ante conditionality as an inducement doesn't work to prevent civil wars just as it does not for changing economic policy. Again, as foreign aid works best when the policy environment is good and if growth is likely to reduce the incidence of civil war it will be best to concentrate aid on those countries prone to civil war which have a good policy environment. He instead recommended changing borders, eg. combining Uganda and Rwanda making them more economically diverse and thus reducing the risk of civil war. The second is joining clubs of regional governments which can act as agencies of restraint. Europe since the 2nd World War provides a shining example.

[8] This section is based in part on Lal (1996) and on Collier et al. (1997)

developing countries is a post-Second War phenomenon. Its origins lie in the breakdown of the international capital market in the inter-war period, as well as the rivalry for political clients during the Cold War.

The first of these factors provided the impetus for the creation of the World Bank by the Bretton Woods conference to provide non-concessional loans to developing countries which were shut out of Western capital markets, especially the largest -the US. This was the result of widespread defaults in the 1930s on Third World bonds, and the imposition of so-called 'blue sky' laws by the US which forbade US financial intermediaries from holding foreign government bonds. Meanwhile, European markets were closed through exchange controls- in the UK till 1979. In this environment, official flows to LDC's at commercial interest rates, as was intended in the charter of the World Bank's parent- the International Bank for Reconstruction and Development- would have been justified purely on grounds of economic efficiency, as intermediating the transfer of capital from where it was abundant to where it was scarce.

This purely economic case was buttressed by political and later humanitarian justifications for confessional official flows.

The political objectives of these official flows were not well served. Peter Bauer's long standing critique that rather than serving Western political interests, these flows instead fostered the formation of anti-Western coalitions of Third World states seeking bribes not to go communist, has been vindicated. Moreover, as a statistical study by Mosley concluded: "as an instrument of political leverage, economic aid has been unsuccessful" (p.232).

The changing humanitarian and economic objectives of foreign aid have also not been achieved by and large. (see Lal(1996) for details). This has led over time to the development of varied and more stringent forms of conditionality, all aimed at changing state behavior. But, as the detailed analysis of this 'conditionality' by Collier et al. concludes, by and large, it has been unsuccessful. It is useful to examine the causes of failure and success as these are relevant to designing future conditionality.

Collier et. al. distinguish between a number of different objectives that conditionality has subserved. The first, is inducement: getting government's to do something they would not otherwise do. The second, is selectivity: aid is only given to countries which already have a good policy environment as this raises the productivity of the aid dollar. The third is paternalism: the donor tries to get the money spent on particular goods and services it favors. The fourth is restraint :a mechanism of commitment whereby a government may seek to protect a reversal of reforms by future governments by agreeing to an aid package conditional on these reforms being sustained. This differs from inducement primarily because in this case of disinducement there is no policy disagreement between the donor and recipient. The fifth is signalling: an aid program may signal good behavior by the recipient which could reduce private sector decision costs and thus stimulate investment.

The dominant motive, of inducement, has by and large failed. (see Killick). Attempts by donors to 'buy' reform have led recipients to raise their 'price' by exaggerating the political and social cost of reform. The inducement objective conflicts with the other objectives, and in some countries (eg. President Moi's Kenya) the same reform package has been sold to the multilateral agencies thrice, with little or no delivery.

Given this failure of promise-based aid, attempts have been made to make it performance-based, through short lease lending based on tranches which are only released on meeting certain performance criteria. This has failed because often the penalty is not commensurate with the triggering policy failure and the suspension of aid could lead to a crisis threatening debt service which would hurt the lender. So the penalties are seldom imposed. Most seriously, such short leash lending implies that, donors not recipient's own the reforms, and this can create domestic political resistance to the completion of the reforms.

For these reasons Collier et al come out in favor of a system of aid which is tied to a few major economic outcomes, such as growth performance, judged in terms of the performance of comprators. This would reward the good performers, and deny aid to those with bad policies, thereby eschewing the vain hope of trying to bribe the 'unconvinced'. This is likely to create incentives for the 'bad' to emulate the 'good' in the hope of getting future foreign aid.

(3) Conclusion : The role of general economic sanctions in altering state behavior seems limited. Smart sanctions targeting the elite may be more successful. But, even here, if there is a clash of cosmological beliefs, such that the elite does not want to participate in Western life in any way, then their role will be limited.

Equally economic conditionality has not been successful when it has sought to 'buy' reform. It has been more successful in 'locking in' reforms, and there is a case for providing incentives through emulation by rewarding countries with a good ex-post economic performance with foreign aid.

But, as we saw in previous sections, the general incentive to participate in the global economy as a means to prosperity remains of considerable importance. Even though the specific incentives and disincentives of World Bank and IMF conditionality may have been unsuccessful, their role in propagating the "Washington consensus" in the realm of material beliefs has been of importance in changing the global climate of opinion and hence the environmental parameters in which particular countries take their economic decisions.

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