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Nationalism: Conceptual Issues and  
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**Globalization, Openness and Economic Nationalism;  
Conceptual Issues and Asian Practice.**

by

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## **Abstract**

This paper considers the question of economic nationalism through the lens of economic openness. Complete economic openness, which connotes close or total integration of a country with that of the world economy, is the antonym of economic nationalism. The paper argues that economic openness is a multi-dimensional concept. A country can be open, or not so open to all or some of the following: trade, exports, imports, finance, science, culture and education, migration, foreign investment, investment by its citizens and companies abroad, among other things. There is no economic theory that suggests that a country has to be open in all dimensions simultaneously. Given its economic and geo-political situation, a country may choose to be open in some areas and not in others. The paper examines the analytical question: what is the optimum degree of openness for an economy? This theoretical framework is used to illustrate and explain the Asian experience, specifically of Japan and Korea. The implications for policy for these and other national economies as well as those for the global economy are outlined. The main policy message of the paper is that countries should seek, whenever they can, “strategic” rather than close integration with the international economy. In that sense economic nationalism, notwithstanding globalization is still the order of the day in many Asian countries. They need to maintain national control over volatile capital movements and prudently regulate the financial sector in the national interest.

## **I. Introduction**

This paper considers the question of economic nationalism through the lens of economic openness. Complete economic integration, which connotes close or total integration of a country with that of the world economy, is the antonym of economic nationalism. The paper argues that economic openness is a multi-dimensional concept. A country can be open or not so open, in all or some of the following directions: trade, exports, imports, finance, science, culture, education, migration, foreign investment, investment by its citizens and companies abroad, among other things. There is no economic theory that suggests that a country has to be open in all dimensions simultaneously. Given its economic and geographical situation, a country may choose to be open in some areas and not at all, or only partially in others. The paper examines the analytical question: what is the optimum degree of openness for an economy? This theoretical framework is used to illustrate and explain the Asian experience, especially that of Japan and Korea. The implications for policy for these and other national economies as well as those for the global economy are outlined. The main policy message of the paper is that countries should seek, whenever they can, 'strategic' rather than 'close' integration with the international economy.

At the simplest level a policy of total autarky is not necessarily one that coincides with economic nationalism. National economic benefits may increase with some trading compared with no trade at all. Orthodox economists would argue that a nation's gains from trade with the rest of the world are best enhanced by the policy of free trade. This proposition which has long been a bedrock of orthodox economics is challenged in this essay in relation to its theoretical basis and its application in the real world. It is argued that there are only narrow circumstances in which the orthodox proposition is either analytically or historically valid.

## **II. Optimal degree of openness and economic planning**

In principal, one can approach the problem of defining the optimal degree of openness in two mutually non-exclusive ways. To start with, an obvious method is to use the theory

regarding national planning. This involves drawing up a suitable model for the economy that would include the specification of an appropriate social preference function (or more generally, a functional), along with the relevant constraints.<sup>1</sup> These constraints will typically consist of the quantification of opportunities to transform primary factors into desired commodities through either production or trade. Boundary conditions could be inserted to lend the results a greater degree of realism. The “optimal degree of openness”, or the concept of economic nationalism as defined in this paper, will follow as a consequence from the exercise of constrained maximization. The analysis can be cast in static or dynamic terms. The solution variables involve production and /or investment levels by sectors as well as exports and imports. They can be stated as time paths if the relevant model is a time-phased one.

Typically such exercises are carried out in real terms and leave the set of complementary monetary magnitudes undetermined. These are usually worked out with the help of a macro-economic model. There is a considerable literature on this subject and with increasing ability to handle complex optimization models on more powerful computers, it led to some improvements compared with the initial exercises carried out by Chenery, Bruno and several others in the late fifties.

However, there may be many reasons to believe that the approach is not entirely satisfactory. While a planning approach does avoid easy and facile identification of the optimal degree of openness with a regime of “ free trade” it suffers from a number of limitations. First of all, the postulate of a scalar maximand may be quite inappropriate unless the degree of homogeneity is extended to future generations as well, not a very realistic assumption, to put it mildly. Secondly, the analysis cannot take into account issues connected with irreversibility over time excepting by resort to very ad hoc procedures.

Thirdly, the only bit of connection of this approach with history is through initial

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<sup>1</sup> This part of the paper is based on and updates unpublished notes written by the late Prof. Sukhamoy Chakravarty (an eminent economic planner) and myself. Interested readers may obtain a copy of these notes by application to the author and to the World Institute of Development Economic Research (WIDER), Helsinki.

specification of vectors of primary factors, which are easily quantifiable. There are no simple and convenient ways of quantifying the states of knowledge to the community or its degree of absorptive capacity if inflows of factors from the outside world are considered to be relevant.

Fourthly, national planning models are rich in details for a single country. However to be operationally, meaningful they have to assume that the rest of the world is either going to stay constant or change only in a predetermined way. Strategic choices are excluded.

Structural changes arising from conjunctural shifts in the world economy may also not come out from the model results as sharply as one would like.

If one were to take these criticisms seriously, then the alternative to planning exercises would be a somewhat looser but a more historically grounded approach which not merely emphasizes the advantages that are likely to accrue to a national entity from exploring opportunities to trade with the rest of the world but also emphasizes certain factors which may make it more vulnerable to outside influences. These may produce long term irreversible effects on the country's pattern of production and its ability to generate productive employment, etc

Such an alternative approach is quite consistent with the paradigm of classical economics, including in this respect not only Ricardo, but also Marshall in his capacity as a classical economist. Contrary to text book analysis it is important to emphasize here that Ricardo was much more concerned with the effects of foreign trade on the rate and pattern of accumulation, than with the mere demonstration of the theorem of 'comparative advantage', as an exercise in static optimization. When Ricardo pleaded for a greater degree of openness of the British economy, he was not being guided merely by his artificial example of trade in cloth and wine between England and Portugal, but because of the need to capitalize on the emerging features of the British economy in the light of revolution in textiles production. Marshall understood this very well when in his 'Memorandum on the fiscal policy of international trade', he wrote "The principles on which our present fiscal system was based sixty years ago seem to me to be not ultimate

derivative. They were obtained by applying certain truths, which are as universal as the truth of geometry or mechanics, to certain conditions which were transitional” (Marshall, 1926; p.386). He displayed a clear understanding of the historical specificity of maxims of policy of free trade which have been treated by many as ahistorical truths.

While Marshall clearly recognised how the changes in configuration of production forces can alter the degree and character of openness of the economy, Keynes, it would appear, was worried about a somewhat different set of factors when he was devoting his thoughts to working out schemes for post-war national reconstruction. This has to do with maintaining equilibrium in the balance of payments of different countries. As he once put it, “ To suppose that there exists some smoothly functioning automatic mechanism of adjustment which preserves equilibrium if only we trust to methods of ‘laissez-faire’ is a doctrinaire delusion which denigrates the lessons of historical experience without having behind it the support of sound theory” (Keynes, 1980; pp.21-22). Now it is clear that in history there have been periods, which as Keynes himself acknowledged, payments arrangements have worked out satisfactorily. This permitted large expansions of trade and trade-induced growth. However these have been episodes that have been characterised by the presence of suitable conjunctures, as the study of the economy for the period after the Second World War, the ‘golden age’, demonstrates (Glyn, Hughes, Lipietz and Singh, 1992).

A country wishing to open up when the conjuncture is adverse in Keynes’ sense (that different economies are characterized by ‘ persistent surpluses’ or ‘deficits’ without there being any mechanism to restore global equilibrium) may benefit much less and, in certain cases, may end up being much worse off than if its opening-up process were differently timed.

If timing makes a difference, and timing is indeed important, and if returns to scale are increasing, openness by virtue of assuring higher levels and growth rates of external demand may facilitate major structural changes in the economy and permit labour productivity and the per capita consumption level to increase over time. If on the other hand, the timing is wrong, a country may have to go through painful processes of

adjustment precisely because it is more ‘open’ than otherwise.

This would once again suggest that we ought to deal with the problem of openness in terms of rate and pattern of growth of output with due recognition to carry out structural changes as and when circumstances so warrant. These time-related and conjunctural specific aspects which have considerable bearing on the desirable forms of ‘openness’ lead us to adopt an approach which is different from that which is usually adopted in formal planning models.

### **III. Arguments for Free Trade - A Critical Review**

Arguments in favour of the ‘free trade’ position can be stated in a compact manner by referring back to the two “fundamental theorems” of welfare economics. These theorems become relevant to the present discourse if one realizes that ‘trade’ can be considered as a means of production. To bring out the relevance of these theorems to this analysis, one would further follow Arrow and Hahn (1971) in as much as one would assume that domestic factor supplies can be treated as factors ‘private’ to a particular group of firms. This is the device that they employ to handle problems related to foreign trade within the ambit of general competitive equilibrium analysis.<sup>2</sup> Factors as usual, can be treated as products with a negative sign. According to the first ‘welfare theorem’ a competitive equilibrium, in the absence of externalities and no satiation, constitutes a Pareto optimum. The so-called ‘Converse theorem’ is, however, more important from our point of view and makes much more stringent demands. According to this ‘Converse theorem’, otherwise known as the ‘second theorem of welfare economics’, Pareto-optimum can be realized as a competitive equilibrium in the presence of all round ‘Convexity’, provided suitable lump sum transfers can be arranged amongst the participants.

If these assumptions hold, then the second theorem is indeed a useful one from the planning point of view. If the economy is a small open one, and competitive equilibrium exists in the world at large, then the, country is better off under ‘free trade’ than under

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<sup>2</sup> See Arrow and Hahn (1971), They write “We will find it convenient to consider some commodities as being private to a firm or group of firms ( e.g. managerial ability or in the case of foreign trade, domestic

any restricted form of trade, let alone autarky. Only when the country is large enough to face downward sloping demand curves in the world market, it may be concluded that there is a first best argument for deviation from free trade. This is the essence of the so-called ‘optimum tariff’, argument. However, the result is applicable to a single country only if the rest of the world behaves as if it were passive and not engaged in retaliation in one form or other. On this argument, earnings of internationally immobile factors are in the nature of rents, that is they are price-determined. They can fall to zero, as in the case of domestically available unskilled labour, under inappropriate demand conditions. It is assumed, however, that national authorities can take care of this problem by arranging suitable domestic compensatory income transfers, a tall order indeed.

If global allocative efficiency of given primary factors were the sole objective and if indeed costless inter-country and intra-country transfers were possible to the desired extent, then much of the discussion on commercial policy would become redundant. The fact that discussions on commercial policy are very much a live issue, and in fact by no means a settled one, would seem to suggest that the basic assumptions underlying the models are often violated in practice. What are the sources of major departures from the assumptions underlying the above theorem?

One very obvious violation is, of course, the lack of consideration given to an appropriate international policy framework governing transfer amongst countries and quite often, within countries themselves. Further, as Bhagwati et al. have argued if structural unemployment arises in an open economy aided or accompanied by significant wage differentials etc. that is no reason to interfere with commercial policy. These differentials are treated as domestic distortions that Bhagwati et al. conclude ought to be treated at their source. The Arrow-Hahn approach describing them as ‘private commodities’ makes their conclusion more transparent. However, in practice raising resources to finance transfer payments leads to very difficult problems for most developing countries.<sup>3</sup> Furthermore, it may be argued that even in the case of small open countries in the

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factor supplies”).

<sup>3</sup> See, Anand and Joshi V (1979), for pointing out the crucial role played by the assumption that government has complete control over the distribution of income in the context of Bhagwati-Ramaswami analysis.

absence of such transfers the potentially welfare improving effect of trade holds only if it is assumed that a situation of competitive equilibrium exists. We do not as yet have an operationally transparent set of necessary and sufficient conditions for the existence of competitive equilibrium. It is also known that negative external effects can cause departure from all-round convexity. Proofs of the existence of competitive equilibrium to situations involving non-convexities lack generality and are often highly restricted in nature.

The major reason for the breakdown of the convexity assumption is, of course, the widespread prevalence of increasing returns to scale. Numerous empirical studies have shown how important increasing returns arise not only on account of the presence of indivisibilities.<sup>4</sup> As Young and following him mature Kaldor repeatedly argued, departures from linear homogeneity could arise even in the absence of indivisibility. We may indicate below some of the leading cases of increasing returns that cannot be put at all easily under 'indivisibility' rubric.

- a) Kaldor's celebrated 'pipeline case', which has to deal with the existence of non-linearities between cost and capacity arising from the three dimensional nature of space. (Kaldor *op.cit.*, and Koopman, 1957)
- b) 'learning by doing' much emphasised by Arrow in relation to production processes, for which enough empirical evidence exists. This may also apply to the activity of consumption itself which is as much subject to learning process in certain cases as the activity of production, thus yielding one more first best argument for export subsidy (W. Mayer, 1984).
- c) Increasing returns accruing to the economy as a whole as argued by Allyn Young who based his theory of economic progress on this point. Young's argument gives rise to a theory of 'infant economy' which constitutes a considerable

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<sup>4</sup> This contentious issue, was first taken up in a debate between Edward Chamberlin and Nicholas Kaldor. Kaldor maintaining at one time that in the presence of all round divisibility, constant returns to scale must necessarily hold. He was to change his views very decisively on this point. See N. Kaldor, "The irrelevance of Equilibrium Economics", appendix on 'indivisibilities and increasing returns'. Kaldor very handsomely acknowledges there that Chamberlin was right on this point and he was mistaken.

generalisation of the Mill-Bastable case of an infant industry<sup>5</sup>.

If both consumers and producers learn over time, production processes deviate from linear homogeneity, and the economy as a whole develops in terms of a range of human skills as well as in terms of institutional arrangements, it is quite clear that we have moved a considerable way beyond the scope of two basic theorems of welfare economics.

What can be concluded in regard to ‘free trade’ policy in the light of pervasive increasing returns? Paul R. Krugman, who is a leading trade theorist and Nobel Prize winner, has in a survey article addressed himself precisely to this issue. (Krugman, 1987)

Krugman noted the work of Dixit, Spence, Stiglitz and others who tried to model trade in the context of Chamberlin-type imperfect competition along with the presence of increasing returns. He carefully noted that in the type of ‘second-best’ world which alone is relevant in the contemporary context, there is no automatic tendency for gains from trade to be realised. While the scope of gains from trade does not necessarily go down, the composition of trade changes significantly from inter-industry to intra-industry trade. Furthermore the need for government intervention can no longer be ignored. Thus, it is clear from his survey and references cited therein that the discussion of trade policy has taken a new turn in contrast to the earlier literature where increasing returns and market imperfections were often relegated in trade textbooks to the status of inessential modifications of the central argument couched in the context of the Heckscher-Ohlin paradigm.

While Krugman himself ends up with a justification for free trade, he noted that ‘this is not the argument that free trade is optimal because markets are efficient. Instead, it is a sadder but wiser argument for free trade as a rule of thumb in a world whose politics are as imperfect as its market’ (Krugman, 1987; p. 143).

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<sup>5</sup> Curiously enough, Young’s macro-economic increasing returns to scale is in basic sense, much closer to the original ideas of List, although List had stated his argument in opposition to what he understood to be the message of Smithian economics. Young, as is well known, described his own analysis as a variation on the theme of Smith that ‘division of labour is limited by the extent of the market’. Difficulty may in part be due to the fact that Smith’s argument on the division of labour are not fully congruent with some of his subsequent discussion on prices as allocation instruments.

The main reason behind Krugman's cautionary ending is that sophisticated interventionism is likely to be a difficult exercise in political economy. However, in essence, it is difficult to expect, for the reasons that he has elaborated as well as for others discussed later, for the world trading system to gravitate to free trading as a generally accepted rule of thumb. Instead the argument is better viewed in terms of the need for 'managed trade'. However, it is necessary to explain this notion in a little detail.

There are several reasons why trade needs to be managed. These have to deal, in a basic sense, with the fact that 'openness' can be a mixed blessing. The point was well understood by John Maynard Keynes when he changed his position from being a champion of free trade to that of an advocate for 'national self-sufficiency', in the midst of depression during the 1930s.

'Openness' can be found to be a great advantage for an economy for any of the following reasons:

- a) It may enable a country to concentrate its relatively specialised resources in areas of production where the world demand is highly income and price elastic;
- b) it may lead to diffusion of knowledge of the kind leading to considerable upgrading of the quality of local factors of production;
- c) it may lead to sufficient competitive pressure to eliminate certain forces of what Leibenstein has described as X-inefficiency;
- d) trade may lead to changes in the distribution of income which can lead to a greater share of production accumulation in national income;
- e) Trade may facilitate what Schumpeter and, following him, Dahmen have stressed so much-namely an accelerated process of creative destruction;

In all these cases, we are assuming that payment arrangements are such that there is no sizeable deflationary bias in the world economy or in any of the leading countries. It was already noted in section II that Keynes was of the view that the classical theory of equilibrating payments arrangements was gravely deficient. The Bretton Woods system was meant to provide a mechanism that coordinated high levels of effective demand amongst trading countries. The system lasted over the period 1945-71 in the “mutilated” form that was acceptable to the major parties involved. Since then the world economy and its institutional arrangements have evolved. In the normal situation, and before the current crisis, the beneficial effects of ‘increased openness’ may be considerably attenuated due to deflationary adjustments, especially by developing countries, since surplus countries have been lending their ‘finance’ to richer deficit countries whose savings fall considerably below their investment requirements.

The neoclassical argument that ‘capital’ being more scarce in developing countries, the latter will offer a higher rate of return to attract capital from the metropolitan countries is conceptually flawed one. In an interesting article, entitled, “ the need for a reconsideration of the theory of international trade”, John Robinson pointed out the nature of the fallacy involved. If, nevertheless, during the 19<sup>th</sup> century, the system operated in a manner that gave a semblance of plausibility to this classical theory, this was because the assumptions underlying the theory were not often fulfilled. As she put it, “ There was enough unemployment to keep money wage rates in check. There were massive migrations reallocating the supply of labour between countries of low and high economic opportunity; and there was a continuous, though fluctuating, flow of international investment. (Robinson, 1973)

Furthermore, it is important to bear in mind that there are situations in which increasing the openness of the economy may harm the quality of locally available factors. This leads to the opposite syndrome to that which we mentioned earlier. For example the adverse impact of British cotton textiles on Indian cotton weavers in the 19<sup>th</sup> century and the British experience of de-industrialization in the 1960s and 1970s are cases in point. Hirschman in particular has expressing strong concern on this matter. He was not alone in made a distinction between ‘specialisation along commodities lines’ and

“specialization along factor of production lines” (Hirschman, 1971; pp 228-229). He remarked that very few countries would ever consciously wish to specialize in unskilled labour, while foreigners with a comparative advantage in entrepreneurship, management, skilled labour, and capital would take over these functions, replacing inferior local talent. Hirschman was obviously assuming that the country in question was open not only on the trade side but also with respect to factor movements- a phenomenon that occurred through foreign direct investment. This occurred in the 19<sup>th</sup> century on a large scale in tropical countries when their so called ‘comparative advantage’ in certain cash crops began-a phenomenon that was repeated in the 1960s through the medium of multi-nationalism corporations specialising in the export of labour-intensive manufactures through their offshore locations.

Generally, it has been seen that ‘openness’ works positively if the phenomenon of ‘learning’ from contacts with the rest of the world are suitably institutionalised, and through suitable adaptation on the policy side involving appropriate government interventions which make the domestic economy more responsive to change. The experience of Japan and that of the Asian NICs would seem to suggest that home market expansion can often trigger off growth-promoting investment which then leads sequentially to import and export substitution on highly efficient lines. In its turn, home market expansion may have much to do with increases in food productivity level. Arthur Lewis also strongly underlined the importance of food productivity growth as a method of overcoming the terms of trade loss suffered by many tropical countries that concentrated their exports of beverages, etc. to cater to metropolitan market.

In the absence of a growing home market accompanied by suitable diversification of the industrial structure, the effect of ‘openness’ can at best be a ‘once-for all gain’ from increased openness. On occasion it may lead to a subsequent accentuation of the economic difficulties of the country that which liberalized its trade and investment policies in the expectation of sustained growth but without adequate preparation on the knowledge absorption side.

M. Kalecki referred to the situation as ‘perverse growth’, which has been experienced by

certain oil-exporting countries in recent years as. In neo-classical trade literature, this is sometimes called the 'Dutch disease', but the phenomenon that we are referring to here is much more intimately connected with shifts in distribution of income favouring luxury consumption which is often highly import-intensive in contemporary developing countries.

It is important at this stage to pinpoint the phenomenon of learning over time as a more relevant paradigm for development gains through trade as distinct from the neoclassical emphasis on exploitation of arbitrage opportunities. John Stuart Mill was fully aware of this dimension in his classical writings on the subject, as was Alfred Marshall whose 'Memorandum of Fiscal policy of International Trade' was mentioned earlier. More recently, L.L. Pasinetti has always been very emphatic on this point. (Pasinetti, 1981; Chapter 11)

To drive home this point, it is worth quoteing the following paragraph from Pasinetti, "The primary source of international gains is international learning (not international trade), where firms in one country are challenged by lower-priced products from abroad. They will either learn how to cut down costs or close down. Some of them, at best, may learn and survive. Furthermore, when a new product is invented in one country, the very first thing that all other countries will try to do is to learn how to make the product themselves (by buying licenses and paying royalties, if necessary). Only in the temporary learning period, or in the period which may sometimes be quite long in which internal demand is not yet big enough to allow the minimum scale required by the new methods, will normally be produced in all countries. The case of agriculture and mining is quite different" (Pasinetti, 1981, *op.cit*, p.259).

Enough has been said to suggest that while the classical and neo-classical arguments for 'free trade' suffer from serious conceptual and operational difficulties, there are indeed substantive benefits from 'economic openness' which are more robust than the traditional neoclassical arguments. However they can be realised only in specific world economic conjuncture coupled with an appropriate set of domestic policies that go considerably beyond the limits of commercial policy as traditionally defined. Two well-documented

historical episodes where trade and growth-promoting forces interacted in a positive manner were connected with the hegemonic roles played by Britain and US respectively. It has been pointed out by economic historians that Britain's decision to adopt 'free trade' as the major thrust of their commercial policy helped to trigger the secular boom of the second half of the 19<sup>th</sup> century. But with changes in geo-political situation, coupled with altered industrial leadership consequent on the maturing of major new innovations during the second Kondratieff, as described by Schumpeter, led to severe strains towards the end of the 19<sup>th</sup> century, and led to the violent demise of the system.

The financial and trading openness for developing countries recommended as panacea in the present world situation is based on a completely ahistorical understanding of growth problems in an increasingly interdependent world, an understanding which, on its own logic, is by no means free from difficulties as analysed earlier. It is therefore essential that we attempt to analyse the forces which lent the so called 'golden age of capitalism' its dynamism along with incipient disproportions.

#### **IV. Openness: "Close" versus "Strategic" Integration with the World Economy**

The above historical and conceptual analysis of economic nationalism, identified here with the optimal degree of openness may be illustrated by considering the post World War-II East Asian economic history.

##### *(a) Degrees of openness of the East Asian economies<sup>6</sup>*

The virtues of openness, international competition, and close integration with the world economy, are stressed in several World Bank flagship publications and in the writings of orthodox economists. By the same token, these scholars also warn against the harm done by economic nationalism (protection, import controls, industrial policy measures to subsidise specific activities, restrictions on entry of foreign multi-nationals, among other things). The paragraphs below outline empirical evidence bearing on these issues.

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<sup>6</sup> This section of the paper is based on, and updates material from Singh, 1995

To illustrate, the Japanese economy operated under rigorous import controls, whether formal or informal, throughout the 1950s and 1960s. As late as 1978, the total imports of manufactured goods into Japan were only 2.4% of GDP. The corresponding figures for manufactured imports for the United Kingdom and other leading European countries were at that time of the order of 14 or 15% of GDP. During 1950-70, the Japanese domestic capital markets were highly regulated and completely shut off from the world capital markets. Only the government and its agencies were able to borrow from or lend abroad. Foreign direct investment was strictly controlled. Foreign firms were prohibited either by legal or administrative means from acquiring a majority ownership in Japanese corporations.

With respect to the questions of exchange rates and distortions, the Japanese Government maintained exchange controls and kept a steady nominal exchange rate with respect to the US dollar over almost the whole of the period of that country's most rapid growth (1950-73). Purchasing power parity calculations by Sachs (1987), using Japanese and US price indices, show a 60% real appreciation of the exchange rate during 1950-70.

Thus, despite the strong export orientation of the Japanese economy, it was far from being open or closely integrated with the world economy during the period of its fast growth. During that period because of its relatively low level of per capita income it could be considered more like a developing country than it did subsequently (Singh, 1997). The stories of Taiwan and South Korea, subject to certain modifications, also point in the same general direction of strategic rather than close integration with the world economy (Amsden, 1989 and Wade, 1990).

*(b) Protection and export promotion: alternative interpretations*

What was the role of this high degree of protection in the East Asian economies? Orthodox economists acknowledge the facts of this protective regime but essentially argue that this was generally a negative influence, which was kept in bounds only by the government pursuit of export targets, and export "contests."

This interpretation has serious shortcomings. First, as noted earlier, generalized protection was one of the mechanisms used by the Japanese and the Korean governments to alleviate the balance-of-payments constraint. Second, and equally significantly, there are both analytical and empirical reasons for the view that protection played an important, positive role in promoting technical change, productivity growth and exports in these countries. To appreciate how protection worked at a microeconomic level, consider the specific case of the celebrated Japanese car industry. Magaziner and Hout (1980) point out that government intervention in this industry was characterized by three major goals; discouragement of foreign capital in the Japanese industry and protection against car imports, attempts to bring about rationalization of production, and assistance with overseas marketing and distribution expenditure (p.55).

The government imposed comprehensive import controls and adopted a variety of measures to discourage foreign investment in the car industry. Quotas and tariffs were used to protect the industry; the former were applied throughout the mid-1960s, and prohibitively high tariffs until the mid-1970s. Moreover, the government controlled all foreign licensing agreements. To make technology agreements more attractive to the licensor, it guaranteed the remittance of royalties from Japan. The policy stipulated, however, that continued remittances would be guaranteed only if 90 per cent of the licensed parts were produced in Japan within five years. This is about as powerful a domestic content arrangement as one can get.

More generally, protection provided the Japanese companies with a captive home market leading to high profits which enabled the firms to undertake higher rates of investment, to learn by doing and to improve the quality of their products. These profits in the protected internal market, which were further enhanced by restrictions on domestic competition not only made possible higher rates of investment but also greatly aided exports. Yamamura (1988) shows how these protective policies gave the Japanese firm “a strategic as well as a cost advantage” over foreign competitors. In other words, protection, export promotion and performance standards were complementary policies.

(c) *Foreign direct investment*

An important feature of both the Japanese and the Korean industrial policy has been the discouragement of foreign direct investment (FDI). Available statistics indicate that among developing countries, Korea was second only to India in its low reliance on FDI inflows. Foreign capital stocks totaled just 2.3% of GNP in 1987 in Korea, above the 0.5% estimate for India, but far below the levels of 5.3% for Taiwan, 17% for Hong Kong, a massive 87% for Singapore, 10% for Brazil and 14% for Mexico UN (1993). In the view of the World Bank economists, this discouragement was a self-imposed handicap which was compensated for only by the fact that both Japan and Korea remained open to foreign technology through licensing and other means. This raises the question that if the Japanese and the Korean governments were as efficient and flexible in their economic policy as the Bank economists themselves suggest (to account for their long-term overall economic success), how is it they have persisted with this apparently wrong-headed approach for so long?

An alternative interpretation is that the approach was perhaps not so wrong-headed. It was “functional” within the context of the overall industrial policies which the two countries were pursuing. First, it would have been difficult for MITI or for the Korean authorities to use “administrative guidance” to the same degree with the foreign firms as they were able to do with the domestic ones. Second, as UN (1993) emphasizes, there is a link between the national ownership of the large Korean firms (Chaebols) and their levels of investment in research and development. Korea has, in relative terms, by far the largest expenditure on research and development (R & D) among developing countries: 1.9% of GNP in 1988, compared with 1.2% in Taiwan (1988), 0.9% for India (1986) and Singapore (1987), 0.5% for Argentina (1988), 0.6% in Mexico (1984) and 0.4% in Brazil (1985). The country’s performance in this area outstrips that of many developed countries (e.g., Belgium, 1.7% in 1987), but is of course still below that of industrial super powers, Japan and Germany, each at 2.8% in 1987.

Third, Freeman (1989) stresses another important advantage of the policy of mainly rejecting foreign investment as a means of technology transfer. This, he argues, automatically places on the enterprise the full responsibility for assimilating imported

technology. This is far more likely to lead to “total system improvements than the ‘turn-key plant’ mode of import or the foreign subsidiary mode.”

(d) *Price distortions*

Bank economists in their econometric analyses in recent publications use a quantitative measure of openness- the degree to which the relative domestic prices in an economy differ from international relative prices. On that measure, it turns out that both Japan and Korea were among the least open economies (Miracle Study, p.301). Relative prices in these countries were more distorted than in Brazil, India, Mexico, Pakistan and Venezuela, often held up by the Bretton Woods institutions as prime examples of countries which do not “get the prices right.”

To sum up, the experience of Japan and Korea comprehensively contradicts the central theses of many World Bank Reports that, the more open the economy, the closer its integration with the global economy, the faster would be its rate of growth. During their periods of rapid growth, instead of a deep or unconditional integration with the world economy, these countries evidently sought what might be called strategic integration, i.e. they integrated up to the point that it was in their interest to do so as to promote national economic growth. Such space for economic policy interventions is unfortunately much less available for today’s developing countries.

## **V. Economic Nationalism and Free Capital Flows.**

More than restrictions on free trade, economic nationalism in Asian countries today arguably manifests itself most through limitations on the free movement of capital. This is a highly controversial subject where there is strong disagreement between heterodox and orthodox economists and where there is perhaps the greatest disconnection between economic theory and actual events in the real world. Neoclassical theory suggests that the flows of external capital should be equilibrating by helping to smooth out a country’s consumption or production paths. However, in the real world, exactly the opposite appears to happen. Capital account has been associated with serious economic and

financial crises in Asia and Latin America in the 1990s. The proponents of neo-classical theory argue that the case for free capital flows is no different from that for free trade. The former could simply be regarded as a form of inter-temporal trade.

### ***V.1. The case for Capital Account Liberalisation***

The case for capital account liberalization was authoritatively put forward by Stanley Fischer, the former Deputy Managing Director of the International Monetary Fund, in the following terms:

- that the benefits of liberalising the capital account outweigh the potential costs;
- that countries need to prepare well for capital account liberalization: economic policies and institutions, particularly the financial system, need to be adapted to operate in a world of liberalized capital markets; and
- that an amendment of the IMF's Articles of Agreement is the best way of ensuring that capital account liberalization is carried out in an orderly, non-disruptive way, so as to minimize the risks that premature liberalization could pose for an economy and its policymakers. (Fischer (1997))

The background to Fischer's statement was a proposal by the IMF Interim Committee at the 52<sup>nd</sup> Annual Meeting of the IMF and the World Bank in Hong Kong in April, 1997 at which the Committee proposed an amendment to the Fund's Articles of Agreement to extend the Fund's jurisdiction to capital movements. This amendment would make the liberalization of international capital movements a central purpose of the Fund. As Fischer puts it: "**In a nutshell, the prime goal of the amendments would be to enable the Fund to promote the orderly liberalization of capital movements.**" (Fischer, 1997, p.12. Emphasis in the original).

It will be appreciated that under the original IMF Agreements the Fund was mandated to

promote only current account liberalization. It had no jurisdiction over a country's capital account except "the right to require countries to impose capital controls in certain contexts." However, as Fischer admits: "De facto, the Fund has become increasingly involved in helping member countries liberalize in a manner that does not undermine economic and financial stability."

Fischer suggests that, at a theoretical level, capital account liberalization would lead to global economic efficiency, allocation of world savings to those countries best able to use them most productively, and would thereby increase social welfare. Citizens of countries with free capital movements would be able to diversify their portfolios and thereby increase their risk-adjusted rates of return. It would enable corporations in these countries to raise capital in international markets at a lower cost. It is suggested, moreover, that such liberalization leads to further development of a country's financial system which in turn is thought to enhance productivity in the real economy by facilitating transactions and by better allocation of resources. Some argue that free capital movements will help increase world welfare through another channel, namely the transfer of resources from ageing populations and lower rates of return in advanced countries to younger populations and higher rates of return in newly industrialising economies. Such resource transfers will be Pareto optimal as both rich and poor countries would gain.

Summers (2000) succinctly sums up the core point of the orthodox perspective as follows: "... the abstract argument for a competitive financial system parallels the argument for competitive markets in general... Just as trade in goods across jurisdictions has benefits, so too will intertemporal trade and trade that shares risks across jurisdictions have benefits."

However orthodox economists also recognise that there are risks attached to capital account liberalization. Markets sometimes overreact or react late or react too fast. However, as Fischer notes "While I believe we sometimes see examples of market overreaction and unjustified contagion effects, I also believe that capital movements are mostly appropriate: currency crises do not blow up out of a clear blue sky, but rather start as rational reactions to policy mistakes or external shocks. The problem is that ,once

started, they may sometimes go too far." (Fischer, 1997; pp 4-5) In general, Fisher believes that capital markets serve as an important discipline on government macro-economic and other policies "which improves overall economic performance by rewarding good policies and penalizing bad." (Fischer, 1997; p 4)

These arguments for capital account liberalization are initially considered at a relatively abstract level in the next section and then in relation to empirical evidence in the following section. The first important point to note is that, as in the case of the neo-classical argument for free trade, the maintenance of full employment and macro-economic stability constitute an important prerequisites if the benefits of a globalised capital market are to be reaped. Specifically, as Rakshit (2001) suggests, the theoretical model of the beneficial effects of free capital movements makes the following assumptions:

- 1) resources are fully employed everywhere;
- 2) capital flows themselves do not stand in the way of attaining full employment or macroeconomic stability; and
- 3) the transfer of capital from one country to another is governed by long-term returns on investment in different countries.

The question whether these assumptions are likely to be valid under the current global economic regime is examined below.

## ***V. 2. The Case Against Free Capital Flows***

The theoretical case *against* the view that unfettered capital movements are essential for maximising the gains from trade in goods and services and for promoting world economic welfare has been made by a number of economists from different schools of thought. First within the neoclassical tradition itself, Stiglitz (2000) argues that the concept of free movements of capital is fundamentally different from that of free trade in

goods. Capital flows are subject to asymmetric information, agency problems, adverse selection and moral hazard. Although such problems may occur also in trade in goods and services, they are intrinsic to financial flows and are far more important.

Importantly, there are also diverging views about the price formation process in asset markets such as the stock markets and the currency markets. Orthodox economists subscribe to the theory of efficient markets. Whereby, prices are a collective outcome of actions of a multitude of individual economic agents whose behaviour is assumed to be based on utility maximisation and rational expectations. This price formation process is thought to lead to efficient prices in these markets. A powerful counter-view was that put forward by John Maynard Keynes (1936) in chapter 12 of the *General Theory* and which is encapsulated in his well known "beauty contest" analogy which highlights the role of speculation in determining asset prices.

Thus, in Keynesian analysis, which was subsequently formalized in theoretical contributions, price formation in asset markets may often be dominated by speculators or 'noise traders' in modern parlance. Moreover, theoretical work on Darwinian selection mechanisms indicate that the Friedman (1953) assertion that rational investors will always wipe out speculators is far from being valid in all states of the world.

Further the critical school emphasises that financial markets are particularly prone to co-ordination failures and often generate multiple equilibria, some good, some bad. In the absence of appropriate coordination by the government or international authorities, an economy may languish in a low-level equilibrium trap, producing sub-optimal output and employment levels.

The post-Keynesian economists (see for example Davidson, 2001) take a more radical stance. They put forward analyses and evidence in favour of Keynes' thesis 'that flexible exchange rates and free international capital mobility are incompatible with global full employment and rapid economic growth in an era of multilateral free trade'. These economists also challenge the orthodox presumption that transparency and availability of more information would make the financial markets less prone to crisis. They point out

that the crises are fundamentally due to the fact that the future is uncertain and people have different perceptions about it.

Keynes was very sceptical about the ability of the world economy under a regime of free trade and free capital movements to maintain balance of payments equilibrium between countries at full employment levels of output. As Felix (1998) notes, 'Reflecting views then dominant among Anglo-Saxon economists, the Bretton Woods Accords were devised around the basic thesis that free international capital mobility is incompatible with the preservation of reasonably free trade and full employment.'

Thus, the orthodox theory that financial liberalization leads to global economic efficiency based on the analogy with free trade is flawed on several counts. Within the neoclassical tradition itself, it is the intrinsic nature of financial contracts which differentiates a market for the latter from that of ordinary goods in international trade: financial instruments are characterised by asymmetric information between borrowers and lenders and since such transactions take place over time they are also subject to time inconsistency problems. These in turn generate moral hazard, leading to contagion and multiple equilibria which can produce pathological outcomes. The Keynesian and the post-Keynesian emphasis is on inherent uncertainty about the future, on speculation and the macro-economic co-ordination failures at both the national and international levels to which financial markets are particularly prone.

## **VI. The Asian Crisis and Capital Account Liberalisation**

The Asian crisis of the late 1990s provides almost a laboratory experiment for examining the role of capital account liberalization in causing or exacerbating that region's severe economic downturn. Drabek and Williamson (1999) provides evidence to suggest that countries which did or did not have economic crisis were differentiated only by whether or not they had liberalized their capital accounts. Most economists would now agree that even if premature financial liberalization without adequate prudential regulation was not the root cause of the crises in countries such as Thailand, Korea and Indonesia, it greatly

contributed to the occurrence of the crisis and to its depth. Indeed, the economic fundamentals prior to the crisis of the affected countries were better than those of India, but the latter country was spared the crisis because of its control over the capital account. Similarly, China managed to avoid the crisis and continued to have fast economic growth. China also had only partially but by no means fully liberalized its capital account.

It is argued by some that, even with the acute economic crisis of 1998-1999, Korea with its economic openness was a much more successful economy over the long run than India. This argument has some plausibility but it overlooks the crucial fact that Korea's outstanding industrialisation record over the previous three decades was not accompanied by a liberalized financial system but rather by a highly controlled one. However, when the system was liberalized in the 1990s it was followed by an unprecedented crisis (see, also, Demetriades and Luintel, 2001).

Singh (2002) and Arestis and Singh (2010 forthcoming) provide a summary review of empirical evidence on capital account liberalization, capital inflows, the growth of GDP and its volatility in developing countries. The review suggests that there is a close and robust relationship between liberalization and economic and financial crises. In the circumstances of developing countries there are also strong analytical arguments for both its existence and robustness. On the other hand, the available evidence does not indicate that free capital flows necessarily lead to faster long-term economic growth for the typical developing country. In view of these facts, Stiglitz (2000) is fully justified in his criticism of the IMF for its promotion of capital account liberalization. Not only is there no adequate theoretical or empirical case for such espousal of capital account liberalization, there is in fact a strong case against it. Indeed the economic crises and the instability which capital account liberalization are seen to generate, may compromise a country's future economic development by inducing capital flight and lowering domestic investment and long-term economic growth.

## **VII. Conclusion: Economic Nationalism and Globalization**

Economic nationalism, we have seen earlier in our discussion of trade openness, is most useful when the world economy is growing slowly and has little prospect for dynamic growth. On the few occasions when the world economy is growing fast or has the prospect of growing fast (due for example to technical progress) pursuit of economic nationalism may turn out to be a costly mistake. However, as far as free flows of capital are concerned, economic nationalism is likely to be a powerful weapon in general to prevent harm to the national economy. There are relatively few conjunctures when economic nationalism with respect to capital flows may do more harm than good to developing countries. In this context, it is important to observe the form economic nationalism has taken in response to the Asian crisis of the late 1990s. In view of the immense difficulties caused by capital flows, or the lack of these during the Asian crisis, one would have expected Asian countries to seek a regime of capital controls in place of that of free capital movements. However, apart from Malaysia, most countries did not abandon financial or capital account liberalisation. In most cases, they did not increase but neither did they reduce it significantly. Instead, they chose to defend themselves against unwanted capital movements by building up reserves through current account surpluses. Such economic nationalism has proved to be most useful to developing countries during the current global financial crisis: the surpluses and reserve accumulations have been helpful to many countries in reducing the negative impact of the crisis and to recover faster than other countries.

In conclusion, economic nationalism remains a useful concept even under globalization but its practical policy application requires a careful analysis of national and international economic trends.

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