

EMBARGOED UNTIL 7.00 PM WEDNESDAY 9 DECEMBER 1998

GREENWICH FINANCIAL SERVICES CLIENT FUNCTION

**GLOBALISATION, ASIA, AND IMPLICATIONS
FOR NEW ZEALAND**

ROGER KERR EXECUTIVE DIRECTOR NEW ZEALAND BUSINESS ROUNDTABLE	AUCKLAND 9 DECEMBER 1998
--	-------------------------------------

GLOBALISATION, ASIA, AND IMPLICATIONS FOR NEW ZEALAND

Globalisation is a word that we have all become familiar with over the past decade. Recently I came across a passable description of the phenomenon. It reads as follows:

Modern industry has established the world market ... [which has] given a cosmopolitan character to production and consumption in every country. ... [I]t has drawn from under the feet of industry the national ground on which it stood. All old-established national industries have been destroyed or are daily being destroyed. They are dislodged by new industries, whose introduction becomes a life and death question for all civilised nations, by industries that no longer work up indigenous raw material, but raw material drawn from the remotest zones; industries whose products are consumed, not only at home, but in every quarter of the globe. In place of the old wants, satisfied by the productions of the country, we find new wants, requiring for their satisfaction the products of distant lands and climes. In place of the old local and national seclusion and self-sufficiency, we have intercourse in every direction, universal interdependence of nations.

Who wrote this?, you may be wondering. Candidates that come to mind might be critics of globalisation like John Kenneth Galbraith, Noam Chomsky or our very own Jane Kelsey. Perhaps the language gives it away: the writer was Karl Marx (with his co-author Friedrich Engels) in *The Communist Manifesto* of 1848.

Three points are worth making about Marx's account of globalisation.

First, he was in no way opposed to it. To the contrary, Marx saw that the growth of modern industry in the previous hundred years had created "more massive and more colossal productive forces than have all preceding generations together". It had drawn "even the most barbarian nations into civilisation" and "rescued a considerable part of the population from the idiocy of rural life". Marx did not want to stop globalisation, but he thought its benefits flowed disproportionately to bourgeois capitalists rather than oppressed workers and he wanted private property abolished so that the benefits could be enjoyed by all. Faith in the unfortunate experiments that Marxism spawned largely came to an end when the Berlin Wall fell in 1989.

Secondly, Marx's observation reminds us that globalisation is by no means new. As David Henderson, a former senior OECD official, put it in a study for the Business Roundtable last year entitled *New Zealand's External Economic Policies*:

The outstanding historical case of full integration is that of the United Kingdom in relation to the international economy over the period from 1850 to 1914. By mid-century the United Kingdom had established virtually full freedom, not only of trade and capital flows but also of migration, and this regime was effectively maintained up to the outbreak of the First World War. During this same period, in the world economy more generally, capital flows were almost wholly free (and exchange controls unknown), immigration controls were light or non-existent (though tending to increase), tariffs and trade preferences were mostly moderate (though also on an upward trend, from the late 1870s), and non-tariff barriers to trade were negligible. Hence the period provides a leading instance of unilateral full integration of a single country within a generally liberal international economic order such as may now be in course of being realised once again.

It is interesting to note some of the features of this nineteenth century liberal international order. In the decade prior to 1914, Britain's net foreign investment was 8 percent of its gross domestic product (GDP) and half of its gross national savings. By 1914 a third of Britain's capital stock was invested abroad, a proportion of national wealth dwarfing anything seen anywhere today. Late last century citizens could travel from London to Moscow without a passport, and take up residence anywhere along the way. And by comparison with the twentieth century, the second half of the nineteenth century was an era of international peace.

But this liberal stance did not survive the advent of the First World War, which propelled collectivist experiments around the world. It was dealt a further massive blow by the Great Depression of the 1930s. A third point to take from Marx is his belief that capitalism was subject to periodic crises which would ultimately lead to the breakdown of the system. To many people the 1930s depression seemed like the fulfilment of Marx's prophecy. It intensified the trend towards state intervention and cast a shadow over political and economic thinking in New Zealand and many other countries for another 50 years.

Of course, what a massive amount of scholarship has established beyond reasonable doubt is that, far from showing that 'capitalism doesn't work', the Great Depression

was a colossal and tragic failure of government and public policy. As a 1998 study by Lawrence Reed entitled 'Great Myths of the Great Depression' summarises it:

The genesis of the Great Depression lay in the inflationary monetary policies of the US government in the 1920s. It was prolonged and exacerbated by a litany of political missteps: trade-crushing tariffs, incentive-sapping taxes, mind-numbing controls on production and competition, senseless destruction of crops and cattle, and coercive labour laws, to recount just a few. *It was not the free market which produced twelve years of agony; rather, it was political bungling on a scale as grand as there ever was.*

Against this background, it is extraordinary that some people – particularly the critics of globalisation – have rushed to paint the Asian economic crisis as another 'crisis of capitalism' and advocated many of the same mistaken moves towards autarchy that exacerbated the Great Depression. An extreme case is Tim Hazledine of the University of Auckland, who wrote earlier this year that:

Now is a very foolish time to be preaching the virtues of internationalism and globalisation, with all the repercussions of the collapse of the 'Asian Miracle'. Should it not occur to our leaders that, were we less dependent on investment and trade with these countries, both imports and exports, we would equivalently be more able to set for ourselves an economic course more resistant to buffeting from events outside our control?

Chalmers Johnson, an American academic who also espouses protectionist policies, has written that "if there's anything that's dead in the water in Asia right now, it's the idea of globalisation". Paul Krugman and George Soros have argued for capital controls, Bryan Philpott has recommended Keynesian interventions, Jane Kelsey views the APEC response of pressing on with liberalisation as the folly of "the New Zealand experiment writ large", and others have poured scorn on those who saw the Asian 'tiger' economies as holding lessons for economic success.

Much has been written on the Asian crises, and no doubt there will be more interpretations and insights in the years to come. I do not propose to traverse that ground here, but instead to concentrate on some aspects that seem relevant to economic debates in New Zealand. There are four basic points I want to make.

First, nothing in the present crises nullifies the achievements of the leading Asian countries in the post-war period. They have quadrupled living standards and lifted their populations from grinding poverty to average income levels that in some cases

far outstrip New Zealand's. That remains the case despite the present setbacks. Prosperity has been widely spread; the most competitive societies, such as Taiwan, have a more even income and wealth distribution than the welfare states of the West. And they have achieved economic success despite an almost complete absence of natural advantages in most cases.

Secondly, the Asian countries that attracted attention were Japan and then the four so-called 'tigers', Hong Kong, Singapore, Taiwan and South Korea. No one saw Indonesia as a model of development, despite its considerable achievements. Common to all the leading countries was a story of progressive economic liberalisation. A 1993 World Bank report put the emphasis on sound fundamental policies and increasing openness, although it concluded that in a few cases selective interventions had had positive results. Such interventions can work as long as the planners can simply imitate what has been successful elsewhere. But imitation is no longer possible for the advanced Asian economies, and in any event has led to huge over-capacities in industries such as electronics and cars. That is why the World Bank made a point of warning other countries against experimenting with selective interventions. The World Bank's verdict in its new report, *East Asia: The Road to Recovery*, is more outspoken: it argues that reliance on the visible hand led to bad governance, corruption and crisis.

A further point is that the freest and most flexible Asian economies appear to be weathering the storm best. The latest Heritage Foundation index of economic freedom ranks Hong Kong, Singapore and Taiwan in 1st, 2nd and 7th place respectively out of 154 countries; all three appear to be adjusting to the crisis, although Hong Kong's economic framework may be in some doubt in the longer run. Next come Japan in 14th position and South Korea in 24th place; both are more corporatist and rigid economies and are struggling to regain momentum. Malaysia and Thailand come further down still, and Indonesia is in 62nd place. Of this last group, only Thailand has reacted in a generally coherent and liberalising way, and appears to have the best prospects of early recovery.

Thirdly, although other factors including an element of contagion may have played a part, my reading and that of the World Bank today is that – like the Great Depression – the Asian crisis is primarily a government-made phenomenon. It appears to have had its origins in fixed and over-valued exchange rates and other

financial market controls, activist industry policies and the 'Confucian corporatism' that went with them, and a lack of transparency in banking and corporate governance. As John Goulter summed it up in the *Press* after a visit to Asia earlier this year:

The Asian miracle faltered not because its economies were too exposed or had embraced international competition too freely, but pretty much the reverse. People with any experience of business in Asia have been complaining for years about restrictive trade practices, 'crony capitalism' that has closed deals to outsiders and rigid control of economies by 'Think Big' governments.

It is also interesting that the World Bank, in analysing the roots of the crisis, is now focusing on the lapses in competition and openness in Asia which gave rise to corruption and political opportunism:

Corruption and poor institutional performance shoulder much of the blame for the crisis In the decades of extraordinary growth, corruption co-existed with reasonably effective institutions, from core macroeconomic management to schooling services. Now most observers are concerned that public institutions are largely ineffective and driven more by private gain than the public good

The World Bank is recommending institutional reforms such as less state involvement in credit allocation, proper bankruptcy law, reforms of banking regulation and reduced restrictions on foreign ownership.

Fourthly, in response to the crises, most Asian governments have set about trying to fix these mistakes. To the chagrin of the critics of globalisation, most have not reversed direction – instead they have floated their exchange rates and taken other steps towards liberalisation and regulatory reform. Malaysia is the main exception. Even Lee Kuan Yew has stressed the need to deregulate further, not to build higher fences. President Estrada of the Philippines also recently called for deeper reforms and rejected currency controls which in the Philippines had only promoted "corruption and the black market". Although the recent APEC leaders' meeting was no triumph, there was no abandonment of orthodox macroeconomic policies and no hint of departure from the principles of free trade.

Such reactions are certainly in line with modern economic insights. The heart of the APEC project is freedom of trade and investment. The weight of economic thinking

supports openness in both cases. This was true before the crises and remains so now.

In respect of trade, a great deal of economic research has documented the benefits of a liberal regime for economic growth. As David Henderson explains:

Standard economic analysis points to the gains that can be realised within an economy where people and firms can use the opportunities which openness provides – for specialisation in more productive lines, for more pervasive competition with the stimulus to good performance that this brings, and for access not only to wider markets but also to new ideas, information, methods, products and techniques. Over the past half-century, events and experience, and the further development of economic ideas which partly resulted from them, have given greater weight to this line of thinking, both within the economics profession itself and in public opinion more generally.

Support for such views is widespread and eclectic: Adam Smith, Marx and Keynes (despite some mid-life lapses) were all free traders. It should be incumbent on academics who dispute such conclusions (like Tim Hazledine, and Jane Kelsey if she claims economic expertise) to submit their theory and evidence to the scrutiny of their peers in recognised academic journals before expecting the public at large to accept them.

In respect of freedom of investment flows, the arguments are similar. Investors and savers both benefit when capital can be put to best uses at home or abroad. Open capital markets allow diversification and spread risk. Practically all developed countries have liberalised their foreign investment regimes and exchange controls in recent decades. There are occasional calls for a reversal of such policies, such as those by George Soros. There may be an element of self-interest in his views, however – many of his successes have come from outmanoeuvring governments and central banks maintaining fixed exchange rates and capital controls – and there is no sign that developed country governments are taking any notice of them. Liberalisation of capital flows in countries in the OECD area, and a growing number of others too, is here to stay.

The recent turmoil in Asia and earlier episodes in Latin America have led some observers to suggest that developing countries – or at least those with fragile domestic financial sectors and incomplete transitions from the plan to the market –

should maintain some form of controls on short-term capital flows. There is general agreement that long-term direct investment is beneficial, but concern about so-called short-term 'hot money'. In the case of developing countries, the problem is compounded by the 'moral hazard' associated with the operations of the International Monetary Fund – in particular its willingness to bail out governments and even private banks. (Arguably the best solution to this problem would be to abolish the IMF.)

In general, I believe the case for maintaining even short-term capital controls is weak. Capital controls were one of the disastrous reactions to the financial market crisis of the 1930s, and exacerbated the depression. To be sure, issues arise about the method and sequencing of removing restrictions on capital flows, which New Zealand had to consider when it worked through a programme of dismantling interest rate and exchange controls, deregulating the banking sector, floating the currency and establishing a prudential regime. But capital controls of any kind are inevitably distorting and usually ineffective. Chile has maintained some capital restrictions but its short-term interest rates have been five times more volatile than interest rates in neighbouring Argentina which abolished all capital restrictions in the early 1990s. In the past year both Chile and Brazil, which also maintained restrictions, have moved to ease them.

A major problem with capital controls, as Asian experience has shown, is that governments can use them to rig markets for political ends. In a recent article in the *National Business Review* entitled 'Global capital: friend of masses, enemy of despots', Christopher Lingle pointed out that open capital markets provide citizens with a financial vote of confidence or no-confidence in their rulers. Echoing Marx, he wrote:

A spectre is haunting authoritarian regimes in East Asia and stalking inept leaders everywhere. That force is global capital ... the sum of actions taken daily by millions of individuals in placing money with local banks or mutual or pension funds.

And, contrary to Marx, Lingle pointed out that arguments that global capitalism only benefits the wealthy are contradicted by the fact that moves in the direction of the market have lifted a billion people above starvation over the past 30 years. Such

an immense gain for the poor, he maintains, is alone a sufficient argument for not changing the rules for the emerging global capitalism.

None of this is to argue, of course, that governments – authoritarian or democratic – have no choices about the internationalisation of their economies. Arguments that globalisation eliminates national sovereignty are quite overdrawn. Communities and nations are sovereign in creating the rules they wish to adopt. Governments retain wide freedom of action in matters such as defence, foreign policy, cultural affairs and legal systems, as well as economic policy. New Zealand remains as free as it ever was to borrow excessively, tolerate inflation, subsidise uncompetitive industries, and join or leave APEC. But governments have to live with the consequences of their actions, and we know that different rule systems produce very divergent economic outcomes. If you adopt Cuban rules, you get Cuban growth and child mortality; if you adopt Hong Kong rules, you enable millions of refugees to prosper. Power is inevitably constrained by what works and what doesn't in a world where individuals and organisations are free to respond to what governments do. And if a country attempts to seal itself from the world, like North Korea or Myanmar, the result is simply tyranny and poverty.

An increasing number of observers are suggesting that most East Asian countries are stabilising their financial systems and are poised to resume growth. I do not know whether they are right or not about the timing – banking crises leave a long trail of havoc in their wake. I think there is little doubt, however, that the most outward-looking Asian countries and those that are speeding up efforts to liberalise will recover fastest. Japan may be another story – I find it hard to understand why its latest attempt at Keynesian remedies will be any more successful than previous ones. I also suspect that China's still highly controlled economy and state-run banking system is a recipe for misinvestment of the kind seen in other Asian countries and possibly for similar convulsions further down the track – although the new Chinese leadership clearly recognises this problem and is starting to let state enterprises and banks go broke. But in general the things that have made for Asian economic success – small government, limited state welfare, low taxes, high savings, prudent monetary policies, openness to trade and sound education – have not gone away. If the present crises serve to strengthen the commitment of Asian countries to

such ideas and to hasten efforts to correct the mistakes, they may well emerge even stronger.

Reactions in this direction can be seen elsewhere. In a recent article on Latin America, *The Economist* suggested that:

In several countries, financial stress is in fact likely to stimulate swifter market reform. Brazil's government at last this month won congressional approval for its much resisted pension reform. It plans new laws to make the labour market more flexible. Ecuador, like Venezuela an oil exporter, this year embarked on a long-postponed stabilisation programme, involving privatisation and an IMF agreement. Chile has approved a law to cut its already low import duties. Several countries, including Guatemala and Argentina, are pushing on with privatisation.

In the light of these reactions, the notion that is sometimes put about in New Zealand that moves here and elsewhere in the direction of economic liberalisation have been 'extreme' and that 'the pendulum is swinging back' seems quite without foundation. Sadly, the truth is that New Zealand is now lagging as an economic reformer.

The Asian experience highlights the enormous benefits of New Zealand's earlier reforms in helping it to withstand the recent international turbulence. The clean float of the currency has meant that any would-be speculators are not betting against the central bank but against other players in the market – thus New Zealand has not been a happy hunting ground for the likes of George Soros. The commitment to price stability and an independent central bank have been major assets. The greatly reduced level of public debt has helped sustain investor confidence. The privileges and favouritism of the Muldoon era – New Zealand's equivalent of crony capitalism – are no more. Our banks face market disciplines. Without an open and transparent financial system and a much improved fiscal position, New Zealand would be faring much worse than it is.

But the Asian crisis holds other lessons for New Zealand. One is that it is easy for a country to fall from grace. A consequence of globalisation that cannot be denied is that the margin for policy error is now much narrower. One might have thought that the property market bubble in Hong Kong – partly due to government land controls – was not necessarily a capital crime, but Hong Kong has not escaped a

hammering. New Zealand's margin is now too narrow for comfort. Thanks to the policy slippage of recent years – particularly the massive growth of government spending and the failure to maintain international competitiveness – we have a current account deficit of Asian proportions, a high level of external debt and a downgraded credit rating. We are unduly vulnerable to further possible shocks from abroad, such as a slump in Japan, turmoil in China or a large fall in the US stockmarket.

But the final and most important lesson from Asia is not a new one. It concerns the ongoing quest for higher living standards. This is a quest that has no end, so long as people look for improvement in their lives. Improvement depends on adaptability, on the kind of economic environment favourable to innovation and change which has been the source of Asian dynamism and progress. New Zealand resisted change for many years, and the leading Asian countries and many others overtook us. We embraced it for a time with the economic reforms of the 1980s and early 1990s but then decided continuing adaptation was too hard and opted for another of our perennial teabreaks. Asian countries appear to be facing up to the need for further restructuring, while some in New Zealand talk about reform fatigue and call for a moratorium on change. If governments heed their calls they should not complain when living standards stagnate, unemployment rises, and our best and brightest leave for Australia or further afield.

For the reality of globalisation today, just as in the nineteenth century, is that capital and increasingly labour move to where the opportunities are greatest – and they do so faster given modern information, transport and communications systems. New Zealand has done little to adjust to events in Asia, barring some minor reductions in government spending plans. Large tracts of the economy such as those occupied by state and local government enterprises and single desk producer boards remain closed to international influences and investment. The opposition parties are promising policies which are backward and inward looking: I know of no economist who believes they would be positive for growth. Meanwhile other countries, including many in Asia, are pressing on with reforms and improving the prospects for their citizens.

Earlier this year, the Geneva-based World Economic Forum published its global competitiveness report for 1998. Two years ago it ranked New Zealand in 3rd place

in an international survey of economic competitiveness, calling it a star. Last year we had fallen to 5th place, and we are now down to 13th. Just last month *The Economist* published a survey evaluating the best countries in the world in which to conduct business. New Zealand fell from 7th position in the previous league table to 15th place. Australia is now ahead of us, and many European countries are moving up because of their improved macroeconomic performance and continued deregulation. These are just the latest of many indicators over the past 5 years that New Zealand has been losing ground after its earlier achievements. The warning bells are getting louder. But is anybody listening?