

Responding to Globalization

Edited by

Aseem Prakash and
Jeffrey A. Hart

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Responding to Globalization

The new challenges and opportunities created by the spread of globalization have reshaped both institutional and individual responses to this phenomenon. This comprehensive analysis of the way in which governments and firms have responded to globalization examines closely the options available to both, and the historical and institutional contexts to the strategic decisions made.

Responding to Globalization draws together a panel of international experts in a conceptually rigorous examination of the profound impact of globalization. Subjects covered include:

- The international monetary system after the euro
- The response of the Japanese software industry to globalization
- The dynamics of globalization strategy in South Korea
- Australian integration into the global economy
- The impact on China and Russia in their move towards a market economy
- Institutional transitions in Yugoslavia and Bulgaria
- Latin American corporate strategies

This rigorous survey focuses on political, ideational and economic factors lying behind these responses to globalization. It is essential reading for all those interested in globalization, international business and international political economy.

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To our colleagues at the International Studies Association

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Preface

Economic globalization—the processes leading to the integration of final products, intermediate goods and factor markets across countries, coupled with the increased salience of cross-border value-chains in international economic flows—has generated much debate about its causes, extent and impact on business and public policy. This volume is the third in a series of three that examines its implications for governance structures across countries and issues areas.

We have been interested in understanding the changing nature of international political economy of which economic globalization is both a cause and a consequence. We began preliminary discussions on this subject in the Spring of 1995 focusing on four key questions: is economic globalization a fad, how best to conceptualize it, how did it originate, and what may be its implications? Subsequently, we added a fifth question: how to cope with globalization? To systematically examine these questions, we organized two joint panels, “Governance Structures for the Twenty-First Century,” at the San Diego convention of the International Studies Association, April 16–20, 1996, a workshop at Indianapolis, Indiana October 12–13, 1996, and another workshop in Alexandria, Virginia July 31–August 1, 1998. Three edited volumes have emerged from these deliberations: the first volume, *Globalization and Governance*, from the San Diego conference and the Indianapolis workshop; the second and the third volumes, *Coping with Globalization* and *Responding to Globalization*, from the Alexandria workshop. These volume are multi-disciplinary, with the authors representing the disciplines of political science, economics, law, international business, and business strategy.

Globalization and Governance focuses on how economic globalization impacts the extant governance institutions at multiple levels of aggregation. *Coping with Globalization* seeks to understand how governments and firms can cope with globalization across issue areas. *Responding to Globalization* examines how different countries have responded to the challenges of increasing levels of global economic integration.

Unlike many other works examining responses to globalization, *Responding to Globalization* advocates neither resisting it nor embracing it. At least in the short-run, globalization is not *pareto superior*: there are “winners” and “losers.” A focus on the strategies adopted by actors to influence the distribution of costs and benefits is crucial to understand the

political economy of globalization. This volume, therefore, examines how globalization impacts a given actor's set of opportunities and threats, why actors choose specific strategies, what political, ideational, and economic factors are behind these choices, and how the historical and the institutional contexts impact these decisions.

The bulk of the financial support for the Alexandria workshop was provided by the Center for the Study of Global Change, Indiana University, Bloomington. We received additional support from the School of Law, East Asian Studies Center, Department of Political Science, Center for the Study of International Relations, Center for International Business Education and Research (all Indiana University), The Elliott School of International Affairs, School of Business and Public Management (The George Washington University), and Center for International Business Education and Research (Purdue University). Matthew Krain provided valuable administrative and organizational support.

The following presented papers at the Alexandria workshop: Alfred C. Aman, Jr., Marie Anchordoguy, Reba A. Carruth, Nazli Choucri (in absentia), Benjamin J. Cohen, Beverly Crawford, Michele Fratianni, Jeffrey A. Hart, Robert T. Kudrle, Stephanie A. Lenway, Chung-in Moon, E. Philip Morgan, Sylvia Ostry, John Ravenhill, Fernando Robles, Alan M. Rugman, Steven Solnick, Debora L. Spar, Steven Weber, and Dali L. Yang. The workshop participants received valuable comments from the following discussants/session chairs: Howard Beales III, Thomas L. Brewer, Nathan Brown, John Daniels, Herbert J. Davis, Bruce Dickson, Harvey B. Feigenbaum, Kenneth Flamm, Jeffrey A. Hart, Virginia Haufler, Peter J. Katzenstein, Matthew Krain, D. Jeffrey Lenn, Catherine L. Mann, James R. Millar, Theodore H. Moran, Susan M. Phillips, Adam S. Posen, Aseem Prakash, Pradeep Rau, John Ravenhill, Scheherazade S. Rehman, Susan Sell, David Steinberg, and Susan J. Tolchin. In particular, we are indebted to Peter J. Katzenstein who carefully read and commented on every paper.

The papers were revised in Fall/Winter 1998. Two book manuscripts, *Coping with Globalization* and *Responding to Globalization*, were submitted for review in January 1999. Based on the feedback from the anonymous reviewers, the papers were revised again in Summer 1999 and the revised manuscripts were accepted for publication in August 1999.

As we look back, editing this volume has been a very enriching and intellectually stimulating experience. We thank the authors for bearing with us in terms of repeated revisions and for their intellectual guidance.

This volume is dedicated to our colleagues at the International Studies Association who have inspired us by their stellar research and provided a scholarly environment for the systematic examination of complex international issues.

Aseem Prakash and Jeffrey A. Hart
August 1999

Responding to globalization

An introduction¹

Aseem Prakash and Jeffrey A.Hart

The processes of economic globalization—the increasing integration of input, factor and final product markets across countries coupled with the increasing salience of multinational enterprises' (MNEs) value-chain networks in international economic flows—are reshaping policy landscapes. This volume examines the strategies of governments and firms to respond to the opportunities and threats created by these processes. The pace, depth and impact of globalization is uneven within and across countries and industries. Though globalization is neither inexorable nor inevitable, there is sufficient evidence to suggest that it is causing long-term structural changes in the world economy (Hirst and Thompson, 1996; Strange, 1996; Rodrik, 1997; for an opposing view, Chase-Dunn, 1994). Globalization has both economic and non-economic dimensions, but this volume focuses on the responses to economic globalization only while acknowledging that the non-economic dimensions pose policy challenges for business and public policy.²

Cross-border economic linkages have existed for centuries. The trading exploits of Marco Polo and the sea-based trade between the Indus Valley and the Mesopotamian civilizations are well documented. Based upon indicators such as the ratio of exports to gross domestic product (GDP) and the levels of capital flows, some suggest that cross-national linkages were more salient on the eve of World War I than they are now (Rodrik, 1997). The Great Depression and World War II reversed such trends. International economic flows picked up in the 1950s, 1960s and 1970s, primarily through expansion in foreign trade. Since the 1980s, the depth and pervasiveness of cross-border economic linkages have accelerated, this time led by the MNEs. Thus, globalization differs from previous experiences of market integration in terms of the expanded role of the MNEs (Cox, 1993).

One indicator of the MNEs' key economic role is the rising level of intracompany trade that now exceeds arm's-length trade (\$5.3 trillion versus \$4.8 trillion in 1993; UNCTAD, 1996). The value chains created by MNEs now span multiple countries, often in multiple regions of the world, accounting for about 7 percent of world GDP (5 percent in the mid-1980s) and one-third of world exports (about one-quarter in the late 1980s)

(UNCTAD, 1998). Traditionally, the global presence of MNEs was equated with the aggregate level of foreign direct investment (FDI); the latter surged from \$1 trillion in 1987 to \$3.5 trillion in 1997 (UNCTAD, 1998). However, the level of FDI incompletely reflects the extent of MNE activities since MNEs can access foreign markets through a variety of alternative routes, such as alliances, joint ventures, and dedicated sub-contractors that do not require transfers of capital across borders. International production by the foreign affiliates of MNEs currently outweighs worldwide exports as the dominant mode of servicing foreign markets (\$9.5 trillion versus \$6.4 trillion) in 1997. Understanding the linkages between the occurrence and efficacy of these alternatives to FDI and technological, institutional, structural and cultural factors is an important research area in the study of MNEs.

Is globalization different from internationalization? Milner and Keohane (1996) employ the term “internationalization” to describe the changes generated by reductions in transaction costs that increase the cross-border flows of goods, services and capital. Others, however, distinguish globalization from internationalization, both at the country and firm levels. International firms still fly the home-country’s flag. Critical functions—R&D, systems of innovation and corporate finance—continue to carry the imprints of the MNEs’ home countries. National governments still have incentives to be defenders and promoters of both domestic firms and home-based MNEs. Global firms, in contrast, are not associated with or dependent any particular country. They represent a form of “footloose capital,” locating their critical activities in countries that best serve their interests (Ohmae, 1991).³ Many MNEs still are not *global* in this sense but rather *international* in their orientation and activities.

A similar distinction may be made at the country-level between an international and global economy (Metaph and Michalet, 1978, cited by Mittelman, 1996). In an internationalized economy, nation-states continue to define political and economic spaces. Security issues requiring active state involvement remain important in world affairs. Cross-national trade and investment flows are regulated by the state, or supranational institutions established by them. In contrast, production in a global economy is organized in cross-border value-chains largely outside of the control of national governments. A globalized economy functions in a post-Westphalian paradigm where governments lack the capacities and willingness to enforce policies even within their jurisdictions. The primacy of “methodological nationalism,” therefore, does not hold in world affairs and governance is articulated at various levels of aggregation, the national level being one of them (Cerny, 1997; 1999).⁴

Instead of taking sides in the globalization versus internationalization debate where both are treated as *end-states*, this volume views globalization as a *process* of market integration, primarily through the establishment of geographically dispersed value-chains. If internationalized and globalized

economies are conceptualized as end points of a continuum, most countries and MNEs are between these extremes, depending on the policy arena or industry sector. The power of governments has diminished in certain areas but governments still have effective instruments to respond to globalization (Hirst and Thompson, 1995; Boyer and Drache, 1996; Cohen, 1996; Evans, 1997). MNEs still largely retain their national character (Pauly and Reich, 1997; Prahalad and Lieberthal, 1998) even though their critical functions are being spread across countries. The Westphalian system has weakened but the post-Westphalian world order has not yet appeared.

MNE-led global market integration suggests that key decisions on resource allocation are increasingly taken within firms, not by markets or state planning agencies.⁵ This does not imply either that the state is withering away, that a “borderless world” (Ohmae, 1991) is on the horizon, or that the Westphalian era has come to an end. As the recent crises in East Asia, Russia and Latin America suggest, governments still play important roles in market and corporate governance.

At least in the short-run, increased global market integration is not *pareto superior* to the status quo. That is, there are “winners” and “losers” across countries (Prebisch, 1950), sectors (Midford, 1993), firms (Milner, 1988), and factors of production (Rogowski, 1989), and the losers are not always compensated for their losses by the winners so that any aggregate gain benefits everyone to some extent (or at least leaves them no worse off). Because of this, there are many political actors with a stake in pointing out the potential harm done by globalization in the absence of better global governance. For example, French Prime Minister Lionel Jospin recently observed that:

In wanting ‘less state’ we allowed the development of jungle...where we wanted to have ‘more freedom’ we allowed the installation of the law of the strongest... These crises carry with them, in my eyes, three lessons: capitalism is unstable; economics is political; and globalization calls for regulation...the globalization of economic activity demands ...an equivalent globalization of politics.

(*Wall Street Journal* 1998: A18)

The impacted actors have incentives to address the consequences of market integration and to proactively influence the terms of their future engagement with it. A satisfactory political economy of globalization will deal with the strategies adopted by various stakeholders to influence the distribution of costs and benefits. Such an approach is crucial to explaining and understanding responses to globalization. This volume, therefore, addresses the following questions:

- How does globalization affect a given actor’s (government’s and firm’s) set of opportunities and threats? Six of the eight chapters focus

primarily on governments and the remaining two (Chapters 3 and 6) on firms.

- Why do actors choose specific strategies in responding to globalization?
- What are the political, ideational and economic factors behind these choices?
- How do the institutional contexts impact these decisions?
- What is the role of history in influencing their choice and efficacy?
- What general lessons can be learned from specific cases or sets of cases?

Theoretical framework

To structure discussion, we propose a framework (see Figure 0.1) in which globalization processes are treated as exogenous variables that impact firms and governments, thereby creating incentives to respond to them. Though not discussed in this volume, in the long run, the policy responses themselves may affect the pace and extent of globalization processes.

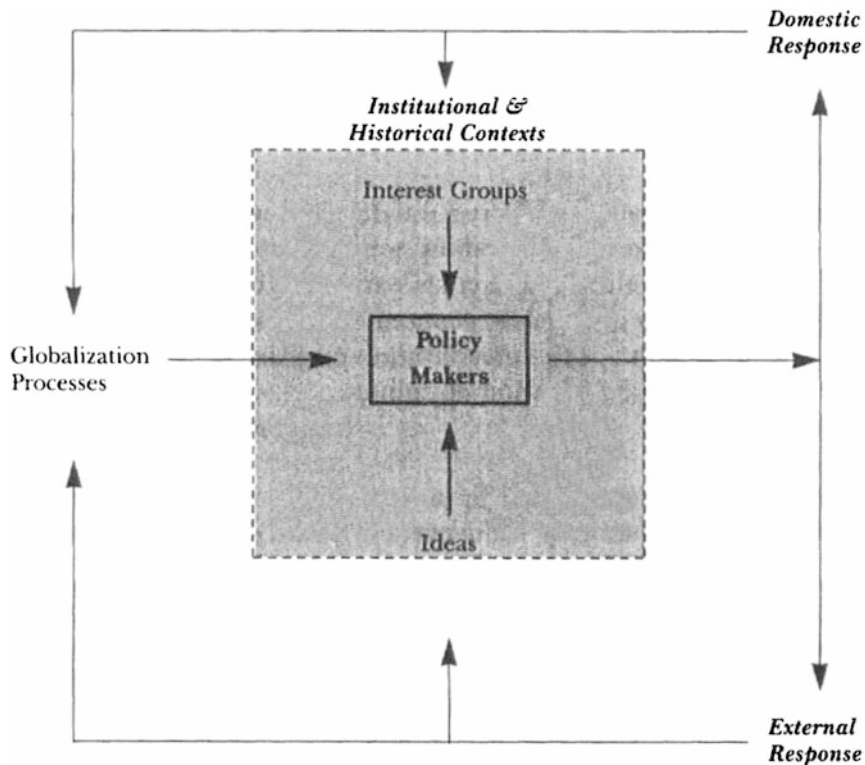


Figure 0.1 A framework for globalization processes.

Institutional contexts and responses to globalization

The impact of globalization on the domestic political economy is mediated through domestic and international institutions. For example, if governments rely on private bankers and stock markets for their borrowing needs rather than on multilateral agencies, they are more susceptible to the credit ratings of Moody's or Standard and Poor's. As a result, governments may have less autonomy in deciding on the pace of and instruments for domestic "reform." Similarly, a country's membership in the World Trade Organization (WTO) and its predecessor the General Agreement on Tariffs and Trade (GATT) may prevent governments from raising tariffs in response to rising imports.

Domestic institutions are also important since they may shield (or expose) some sectors of the economy more than others from (to) globalization processes. For example, if the wages of organized labor are fully indexed to inflation, trade unions may oppose currency depreciation less forcefully. Domestic antitrust policies (and now, external ones as well) may impede domestic firms from using mergers and acquisitions as strategic tools for responding to globalization processes.

Historical contexts and responses to globalization

Policy responses are path-dependent; that is, history plays an important role in shaping choices in the present and in the future. History affects the perceptions of interests, costs and benefits of policies, and the appropriateness of specific ideas. History is also embedded in institutions. Since this volume investigates responses of governments and firms to a major structural discontinuity in the world economy—globalization—historical contexts in which these policies are articulated need careful examination. Historical contexts can take many forms such as the legacies of: Communist rule and central planning in China (Chapter 1), Russia (Chapter 7), Yugoslavia and Bulgaria (both Chapter 8); ethnic conflicts in Russia, Yugoslavia and Bulgaria; the rise of the developmental state in Japan (Chapter 3) and South Korea (Chapter 2); import substituting industrialization in Australia and Latin America (Chapters 4 and 6); and regional cooperation in Western Europe and Latin America (Chapters 5 and 6). These legacies were important in shaping governmental and firm-level responses.⁶

Within these institutional and historical contexts, ideas and interests critically impact policymakers' choice of strategies. By ideas we mean notions about the origins and impact of globalization and appropriate responses to it. Interests connote the perceptions of interest groups regarding the costs and benefits of globalization for their members. The roles of ideas and interests are discussed further below.

Ideas and responses to globalization

Ideas are beliefs held by individuals.⁷ Political ideas are beliefs that are put forward publicly as part of a public political discourse. Many argue that the dominance of political ideas about the desirability and efficacy of market-based integration has been critical in furthering globalization (Polanyi, 1957; Scott, 1997). In particular, the role of the global media industry and the “new media order” has been highlighted (Poster, 1995; Babe, 1996; Perry, 1998). MNEs and developed countries are viewed as major beneficiaries of globalization because they monopolize cross-border information, trade and investment flows. The contention is that this monopoly is employed to legitimize market integration. Power, defined here as the ability to shape preferences and outcomes, is being exercised subtly to shape political discourse. Gramsci (1988), in particular, distinguishes hegemony from dominance. Hegemony reflects and advances the interests of the hegemon. What distinguishes hegemony from dominance is how these interests are advanced. A hegemon is successful in presenting its interests as if they were universally desirable. Such interests, therefore, tend to be accepted uncritically and consensually. Market integration, adherents of the Gramscian view argue, represents a new form of hegemonic domination since the discourse is dominated by its proponents (particularly MNEs and financial traders) who emphasize its inevitability and the potentially universal benefits of adapting successfully to it. The domination of specific kinds of ideas about roles of markets and governments in allocating resources, therefore, becomes the defining influence in responding to globalization (Mittelman 1996; Douglas, 1999).

The flow of ideas is indeed important in shaping identities and giving legitimacy to market integration. In this volume, ideas are incorporated into the equation in two places. First, they are embedded in the flows of factors, inputs and final products and hence do not have an independent ontological status.⁸ Notions of corporate governance are embedded in FDI flows (for an excellent discussion, see Kester, 1996). Similarly, ideas about desirable life-styles and consumption patterns are embedded in the cross-border flows of entertainment products (Appadurai, 1996; Watson, 1998).⁹

However, significant variations remain within and across countries on the desirable consumption patterns, the role of government, the trade-off between environmental issues and economic growth, and the architecture for corporate governance. Along with globalization and the emergence of supranational identities as embodied in the euro (Fратиanni, Chapter 5), there is a rising tide of localization manifesting in resurgent civil society and ethno-nationalism (see Crawford’s Chapter 8 on this subject). The global information infrastructures that enable MNEs to reduce transaction costs of managing their value-chains and permit their managers to leverage a global mind-set, also empower local groups to network and assert their identities.

In this context, it is instructive to trace the relationship of globalization to managerial orientations. Globalization can be viewed as having two components: first, market integration (similar to the definition of globalization adopted in this volume); and second, the evolution of a global mindset among key decision-makers.¹⁰ International business literature, in particular, gives importance to managerial orientations. Perlmutter (1969) differentiates among three categories of managerial attitudes and orientations: ethnocentric, polycentric and geocentric. Employing this classification, one could hypothesize that managers in international firms have polycentric perspectives while in global firms they have geocentric attitudes.

This leads to a familiar chicken-and-egg issue. Are firms globalized because managers have geocentric attitudes or vice versa? We believe that a specific orientation is not the defining feature of or the causal variable for globalization. It is a response to globalization processes. As Robles argues in Chapter 6, managers in many Latin American firms are now increasingly adopting a regiocentric mind-set, thereby viewing Latin America as the relevant economic landscape for their firms. They believe that a regiocentric orientation gives them a competitive advantage over MNEs whose managers have geocentric or ethnocentric mind-sets and cannot, therefore, meet the idiosyncratic challenges of the Latin American markets.

Nevertheless, ideas alone provide under-specified explanations of policy outcomes. With competing sets of ideas, strategic choices of policymakers in response to pressures from interest groups play important roles in privileging one set of ideas over others (Hall, 1986; Mendelson, 1993). Thus, ideas and interests together, in given historical and institutional contexts, provide a better specified explanation of how policymakers respond to globalization.

Interests and responses to globalization

By redefining economic and political spaces (cultural space as well, but that is outside the ambit of this project), globalization may weaken “domestic bargains” between labor and capital, between financial and non-financial capital, between agricultural and non-agricultural sectors, among ethnic groups, and between central and local governments.¹¹ It is often noted that globalization is eroding the power of governments, at least in the economic sphere. Inasmuch as governments were the guarantors of domestic bargains, such compacts are enfeebled, thereby necessitating a realignment in or restructuring of the domestic political economy.

Many structures of corporate governance represent bargains between labor and capital, as well as between financial capital and managers. For example, the *keiretsu* system in Japan is predicated on an implicit bargain between labor and capital, whereby, in exchange for lifetime employment guarantees and gradually rising wages, labor gives up the right to undertake industrial actions. Similarly, the close nexus between the lead *keiretsu* bank

and manufacturing firms ensures that firms have easy access to longterm funds in exchange for accepting the bank's influence on corporate strategy. Globalization processes are weakening such bargains. In response to continued recession in the Japanese economy and the economic crisis in East Asia, Japanese firms have begun to lay off employees, and banks have become less forthcoming in providing new credit to manufacturing firms, including fellow *keiretsu* members. In general, economic integration provides asymmetric benefits within and across countries and hence puts stress on domestic bargains. As Katzenstein (1985) has argued, domestic bargains in the small open economies of Europe were designed precisely to cope with fast changes in the world economy. Some bargains, however, are more fragile than others. As recent changes in Japan, Korea and Germany indicate, the post-war bargains between labor and capital are under severe stress.

What are the defining feature of domestic politics in response to market integration? The usual suspects are factors of production (Rogowski, 1989), sectors (Midford, 1993), and firms (Milner, 1988). Further, non-governmental groups that apparently do not derive any material rewards or bear costs are important players. The incentives and abilities of various groups to influence policy response is critically dependent on the distribution of costs and benefits of globalization—the more concentrated are the benefits or the costs, the greater are the incentives to organize.

Foreign and transnational interest groups may also impact domestic bargains and how policy makers evaluate various strategies. Examples of such groups include non-governmental organizations, international aid agencies, international organizations, and foreign governments. The lowering of information exchange and organization costs due to the telecommunication revolution, particularly the Internet, has played a key role in enabling such groups to network and to influence domestic policy debates. The roles of aid agencies in Yugoslavia and Bulgaria (Crawford, Chapter 8), non-governmental organizations, particularly human-rights organizations, in China (Yang and Su, Chapter 1), international organizations, particularly the IMF, in South Korea (Moon, Chapter 2) in impacting domestic politics are noteworthy.

Major themes

This volume examines the response to globalization in countries in the midst of major structural and institutional transitions: from planned economies to market-based ones (China, Russia, Bulgaria and Yugoslavia), from import substitution policies to liberal ones (Latin America and Australia), from developmental state paradigm to Anglo-Saxon corporate governance (Japan and South Korea), and from country-level strategies to regionallevel responses (Latin America and Western Europe). These transitions, that could be exorable and reversible, set the institutional and historical contexts

in which policy responses evolve. We do not take a normative position regarding their desirability. Our effort is to understand why and how policymakers choose one set of policies over others in responding to globalization.¹²

From planned economies to market-based economies

One of the significant structural changes in the international political economy is the acceptance of market-based systems across countries to allocate resources. Centralized planning has few defenders left. This transition manifests in the rejection of the Communist system in the transitional economies of China, the former Soviet Union, and Eastern and Central Europe. It also manifests itself as support for deregulation, privatization and “reinventing government” in the United States and Western Europe. The degree of change, and the success in achieving societal objectives such as maintaining economic growth and reducing unemployment, varies across countries.

The transitional economies face unique problems in responding to globalization. Most of them are undergoing transitions from an authoritarian to democratic systems. They do not have adequately developed systems of market and corporate governance. Market-based processes work efficiently when transaction costs are low, property rights are clearly defined and are easily enforced (North, 1990). Since transitional economies have had little (recent) experiences in managing private property-based systems, contract law and other types of commercial law are not well developed. Workers and managers trained to work in collective and state-owned enterprises are generally ill-prepared to function in a market economy. After an initial spurt in privatization of state-owned enterprises and new legislation to establish a legal framework for a private property-based market, progress toward further expansion of the domestic private sector generally slows down. Thus, policymakers in transition economies are constrained by the historical and institutional legacies of central planning and authoritarianism in devising successful strategies for responding to globalization.

Among the transitional economies, China has done relatively well in facing the challenges of globalization. To a significant extent, the Chinese government has retained the necessary autonomy to decide on the pace, sequencing, and choice of policy innovations. As Dali Yang and Fubing Su point out in Chapter 1, one of the most visible features of Chinese engagement with the global economy is the increased inflow of foreign direct investment (FDI). In recent years, China has emerged as the second largest recipient of FDI behind the United States, attracting \$45.3 billion in 1997 (UNCTAD, 1998). As discussed previously, the increasing salience of FDI as part of the establishment of international value-chains by MNEs is one of the distinguishing features of market integration since the 1980s. Other

indicators of China's integration with the world economy are also impressive. Its foreign trade has risen nine-fold since 1980: from \$38 billion to \$325 billion in 1997, excluding Hong Kong. Its trade-GNP ratio has risen from 10 percent in 1978 to 40 percent in 1995. Clearly, foreign trade and investment have been major engines of economic growth.

Yang and Su examine the changes in government strategies and the debate on "national" industries in the light of growing FDI. They contend that with increasing levels of FDI flows and other forms of market integration, China has "normalized" in that its leaders have shed the revolutionary rhetoric and now talk about respect for international norms and market rules. Notions about profits and becoming rich are no longer derided as unhealthy capitalist influences. To institutionalize its increasing engagement with the world economy, China has entered the World Bank, the International Monetary Fund (IMF), the Asian Development Bank, the Asia-Pacific Economic Forum (APEC), and is negotiating membership in the World Trade Organization (WTO). Thus, as part of its response to globalization, China is seeking to change the institutional context of its engagement with the global economy.

China seeks to acquire foreign technologies while preserving the existing political system and controlling the pace and extent of institutional change. Instead of a "shock therapy," it is slowly dismantling the huge and inefficient public sector. The legacy of colonial exploitation and instability also makes the leadership careful in selecting policy instruments and accelerating the pace of change. The party apparatus and the Peoples Liberation Army (PLA), in particular, are powerful interest groups against quick changes.

The effectiveness of China's policies has varied over time. When market-oriented reforms were initiated in the early 1980s, few investors came. As the economy grew and reforms speeded up, China's attractiveness for FDI increased, giving China some leverage over these flows. The leverage was limited, however, as the Chinese leadership found out while adjusting its investment policies in the mid-1990s. Nevertheless, Yang and Su contend that the central government appears to have succeeded in having MNEs bring technology and know-how into China. They also examine Chinese policies to meet its growing energy shortage, especially its forays in the international oil business. They suggest that Chinese policies are designed to tame an unruly market, not to supplant it. Their overall conclusion is that China has responded to globalization by speeding up economic reforms, especially in terms of forcing the Chinese government and firms to meet international competition and play by the market rules.

Globalization poses special challenges for the transition economies that are also undertaking the task of nation-building. This volume examines three such countries: Russia, Bulgaria and Yugoslavia. These countries were under Communist rule and composed of multiple nationalities and ethnicities. One of the benefits of the spread of Communism was supposed to be the

transcendence of national differences. What this meant in practice, however, was an effort to enforce a regime of centralized political authority, linguistic uniformity (e.g. the “Russification” of the Soviet Union), and religious suppression. The legacy of the Communist rule and of (suppressed) ethnic conflict, and the ongoing transitions from authoritarian systems to democracies, significantly constrain the choice of policy instruments and the pace of their implementation in response to globalization.

Steven Solnick (Chapter 7) examines the special challenges for Russia posed by globalization in the attempts to redefine the boundaries of its public and private spheres. In post-Communist countries, the collapse of the centrally planned economy created an institutional context where the role of the state was unclear and the transnational entities often enjoyed greater legitimacy than domestic governments. In Russia, this crisis has been deepened by the internal divisions of the federal polity: the central state must redefine itself on the world stage while simultaneously renegotiating the division of powers with subnational governments.

One of the hallmarks of a well-functioning market economy is competitive markets. Since such conditions were difficult to establish quickly in domestic markets, the Russian “reformers” sought to use international competition as a proxy by making their national currency fully convertible. This, however, led to unforeseen consequences such as large currency devaluations that were harbingers of a larger trend toward macroeconomic instability (high inflation rates, high unemployment and low economic growth). Though increased international capital inflows offered a quick and effective route to injecting new capital into the economy, some state enterprises were sold at very low prices in local currency terms, leading to a nationalist backlash. In their attempts to solve an economic problem, the reformers created a political problem. Further, since the welfare system was administered at the workplace under central planning, privatization left laid off and unpaid, but still employed, workers without social safety-nets. Thus, as the institutional context in post-Communist Russia changes through privatization or simply through closing down state and collective enterprises, new domestic bargains must be negotiated as the previous ones have lost relevance.

Solnick identifies five elements of the “Russia syndrome” that significantly impact the abilities of the Russian economy to coherently respond to globalization. The first is the fragmented economic space due to disruption of the vertically integrated production chains that were deliberately spread all over the former Soviet Union. One of key requirements of well-functioning markets is low transaction costs, a point also made by Fratianni (Chapter 5) in his examination of the prospects of the euro. A fragmented economic space clearly made firms in Russia less competitive by making them high-cost producers. Second, there was a strong need for capital to modernize and restructure the economic base. Capital could come either from domestic savings or from foreign inflows. Due to

severe economic dislocation and persistent government deficits, investment from the private sector has been crowded out by government borrowing and foreign capital flows were not sufficient to meet the requirements of modernizing the economy.

Third, a weak legal culture and a lack of institutions for enforcing contracts created a high-risk environment for foreign capital. Solnick contends that Russian businesses were more constrained by corrupt bureaucrats and the Russian mafia than by market risks. The fourth element is the slow evolution of Russian identity in a post-imperial world. As Solnick points out, the national anthem that is supposed to epitomize the national identity, still has no lyrics. This lack of coherence is reflected in a variety of policy arenas, and consequently, Russia is unable to respond adequately to the pressures from the global economy. Finally, the fifth aspect is the unwieldy federal structure that consists of twenty-one ethnically-defined republics and sixty-eight other subnational governments. The central government's failure to secure a sustainable tax base has ushered in a chronic fiscal crisis while the processes of globalization make it harder for central state actors to consolidate control over economic and political resources. If officials at the center fear that globalization will relegate them to the margins, they may be tempted to launch a preemptive strike against liberalization. On the other hand, if transnational actors provide adequate assurances that the central governments will remain essential participants in any significant cross-border transfers of capital, labor, or goods, the officials could provide valuable support for institutionalizing the processes of market integration.

Any analysis of strategies to respond to globalization in states like Russia must be sensitive to the shifting perspectives of different actors. Solnick examines four key groups of actors—federal officials, regional officials, financial-industrial groups, and citizens—with particular attention to issues of foreign ownership of privatized industrial assets and foreign participation in the exploitation of valuable natural resources. He suggests that domestic politics is structured around the following issues: What is at stake in the trend towards globalization? What are the particular challenges and opportunities confronting each group as a consequence? And how do the strategies of one group for coping with these phenomena alter the incentives perceived by other groups?

In Chapter 8, Beverly Crawford examines the challenges posed by globalization for Bulgaria and Yugoslavia, which are attempting to create nation-states in the face of “identity politics.” Conceptually, her chapter investigates the broader question of whether globalization hastens social disintegration and exacerbates social conflict, and, if so, what potential strategies might mitigate its role in social disintegration. The global imperatives of “state shrinking,” economic liberalization and fiscal reform have clearly affected social integration throughout the world. Particularly throughout the post-Communist world, the transition from central planning

to a market economy and the pressures of liberalization have weakened the state's capability to allocate resources and to meet the obligations of past domestic bargains that contained potential social conflicts (also see McGinnis, 1999). In those places where ethnicity and religion had been previously politicized, struggles over declining resources often resulted in communal violence as old institutions were dismantled and old social bargains broke down.

Thus, the forces of globalization can have a dual negative impact on state and society. They can weaken those state institutions that ensure social peace and can cause distinct cultural groups in multi-ethnic societies to suffer disproportionate economic hardships. Under the disintegrating power of these two forces, "ethnic entrepreneurs" can emerge to articulate grievances and to create a parallel political authority among distinct cultural groups. This can mean that culture becomes the primary political cleavage in society, and that cleavage, combined with the weak legitimacy of established authority, can lead to violent social conflict.

Crawford compares the responses of Yugoslavia and Bulgaria to the disintegrating forces of globalization. She shows how Bulgaria's institutions responded well to globalization and avoided social disintegration, while Yugoslavia's policy responses exacerbated the problem of social fragmentation, leading to a violent cultural conflict. The two countries are strikingly similar in terms of historical legacies, social composition and economic structure. Both suffered from the legacies of Ottoman rule that left Muslim enclaves within largely Christian populations. Both suffered the economic and political distortions of Communism's command economy layered over ethnically-segmented markets. In both countries, ethnicity and religion were highly politicized. Even during Communist rule, participation in the global economy left their economies with high foreign debts and highly uncompetitive industries. In both countries, the economic hardships associated with the fall of Communism and an opening to the international economy fell disproportionately on politicized cultural groups. Both experienced struggles over the allocation of declining resources in the wake of Communism's collapse, both emerged from the Communist period with politically charged ethnic competition, and both saw the rise of "ethnic entrepreneurs" who attempted to usurp political authority in the face of weakened political institutions. Indeed, Muslim minorities in Bulgaria had been systematically oppressed during the Communist period, while in Yugoslavia they had been given increasing autonomy. Yet Yugoslavia erupted in violent conflict, while Bulgaria did not.

The former Bulgarian Communist regime was the guarantor of a domestic bargain between the Bulgarians and the Turkish and Pomak minorities that provided the minorities with economic security. Ethnic Turks were concentrated in the tobacco industry. The state purchased tobacco from them, thereby ensuring full lifetime employment. With the fall of

Communism, however, the inefficient and uncompetitive tobacco industry was privatized, and its failure in global markets left the majority of Turks unemployed and destitute. This created an opportunity for Turkish political entrepreneurs who sought to mobilize the Turkish population against the liberalizing policies of the new regime by labeling unemployment as ethnic “genocide”. Crawford notes that in its aid policies, the West has (unfortunately) focused exclusively on the protection of collective human rights, while the economic situation of minorities has worsened.

In Yugoslavia, federalism before the fall of Communism, and the failure to institute a competitive political system that transcended ethnic identities after 1989, exacerbated ethnic tensions in the face of growing international pressure. Historically, the system of regional resource allocation had provided ethnic entrepreneurs with tangible resources to build political support. Further, Yugoslavia was also handicapped in that Tito, a critical guarantor of the domestic bargain in terms of ensuring a balance of power among the various nationalities, was no longer alive to oversee the transition from Communism to a more plural order.

In effect, Crawford explores the role of globalization in cultural conflict by looking at both its differential impact on diverse cultural groups in multicultural societies and its impact on the state’s ability to support institutions that provide social order or repress dissent. She contends that the institutions of political participation and resource allocation are the crucial factor affecting social integration, and key institutions differed in Yugoslavia and Bulgaria. Globalization is a “trigger” for cultural conflict, but not an underlying cause. Responding effectively to globalization can attenuate social conflict but not erase it. However, policy response should establish or strengthen institutions that ensure that social cleavages are cross-cutting and not mutually reinforcing.

The developmental state and responding to globalization

The recent crisis in East Asia has led policy scholars to re-examine various models of economic development, especially the efficacy of the so-called “developmental state” in promoting economic growth. It has forced business strategy scholars who were proclaiming the superiority of “alliance-capitalism” over the Anglo-Saxon version to re-examine the strengths and weaknesses of the various architectures of corporate and market governance. The East Asian Tigers had been praised for their agricultural reforms, export-orientation, and investment in human capital. Their rise from relative poverty in the 1950s to affluence in the 1990s was impressive. Though some predicted that their growth would decelerate due to the lack of technological innovations and productivity growth (Krugman, 1995), the timing and ferocity of the crisis came as a surprise.

It started as a crisis in Thailand and was dismissed as “a cyclical correction that is not expected to be deep or prolonged,” by IMF Managing

Director Michel Camdessus (*Wall Street Journal*, 1998:A18). Instead, it turned into a crisis of staggering magnitude affecting most of the countries of the world. Consider, for example, the size of recent IMF-negotiated assistance packages for various East Asian countries: \$ 18 billion for Thailand, \$43 billion for Indonesia, and \$57 billion for South Korea. And as the Asian flu spread to other parts of the world, Russia was promised assistance of \$23 billion and Brazil \$30 billion. The IMF has committed about \$171 billion over a period of 15 months for fighting what was initially described as a cyclical correction.¹³

The economic downturn in South Korea, perhaps the most ambitious of the East Asian Tigers, raises important questions for scholars of international political economy. In Chapter 2, Chung-in Moon examines the dynamics of globalization in South Korea. Korea has traditionally been known as the hermit kingdom. Its modern history has witnessed many struggles between reformers favoring interaction with the outside world and the conservatives favoring a closed door. The legacy of Japanese colonial domination strengthened nationalism and xenophobia, and the continuing conflict with Communist North Korea reinforced both. Thus, South Korea had a unique foreign policy combining Communist containment and economic nationalism pursued jointly by a state focused on national security objectives and a “private” sector deeply collusive with state actors. Although the government aggressively promoted exports, it continued to support an import substituting industrialization policy until quite recently. South Korea’s economic success could be attributed to strategic industrial policy managed by a coalition of state and business actors (Haggard, 1990; Wade, 1990).

Success breeds its own problems. There are diminishing returns to economic nationalism, especially in an era of increasing globalization. There were some structural problems as well—the most serious being the burgeoning domestic and external debt (external debt grew from \$44 billion in 1993 to \$153 billion in 1997) due to high financial leveraging of the major manufacturing firms (the largest of these are called *chaebol*). The Korean government controlled the preferential allocation of credit to the *chaebol* through a sort of “window guidance” familiar to students of both the French and Japanese economic systems. Banks were instructed by the Ministry of Finance to make credit available for purposes deemed to be in the national interest. This was done initially to allow Korean firms to deepen the industrialization that had occurred as a result of the adoption of import substitution policies. The government indicated its preferences and thereby absorbed some of the risks that the private firms assumed when they borrowed funds from the banks. This system permitted the larger firms to invest first in heavy industrial production (ships, iron and steel, etc.), then in consumer durables (automobiles, refrigerators), and most recently in high-technology electronics (DRAMs, liquid crystal displays).

The *chaebol* system permitted the firms to make risky long-term investments, but it also prevented them from correctly gauging the demand for final products. As a result, manufacturing firms often invested in extremely capital-intensive industries that were plagued by overcapacity. A prime example of this was Samsung's decision in 1997 to invest in high-volume automobile production. Capital-intensive industries have high break-even points and a slight drop in demand can cause major liquidity and solvency problems. Currency depreciation (from 808 won/dollar in 1993 to 2,000 won/dollar at its lowest) added to the *chaebol's* woes by sharply raising the value of foreign debt carried by these firms. However, due to excess capacity worldwide, many firms were unable to export their way out of their predicament. Currency depreciation also created problems for the banks who saw the value of the assets pledged by manufacturing firms as collateral drop sharply. After a series of unexpected bankruptcies, banks' earnings declined suggesting that some of their outstanding loans to the *chaebol* might be non-performing. Banks became more and more concerned about lending additional money to highly leveraged domestic firms. As they cut back on their lending, the consequent credit crunch unraveled the industrial system. Further, the reluctance of banks to discount corporate bills caused a severe liquidity crisis for small firms that had traditionally relied on discounted corporate bills and promissory notes for working capital requirements.

Moon contends that prior to the crisis, globalization was used as a slogan to connote rising level of exports; reforming the domestic economy was not on the agenda. Attesting to the importance of the impact of ideas on policy outcomes, in 1994, President Kim Young Sam adopted globalization (*segyeohwa*) as a slogan to capture the imagination of the masses, especially because the previous slogans relating to democratic reforms were perceived as being stale. In the quest for making South Korea a member of the prestigious Organization for Economic Cooperation and Development (OECD), President Kim also ushered in a series of new economic liberalization efforts. The increasing levels of international trade gradually exposed South Korea to internal and external pressures (primarily, American bilateral pressures) to open and liberalize. Financial liberalization led to the accumulation of short-term foreign debt to finance long-term investments—always a risky proposition.

The resultant economic crisis that began in 1997 posed significant challenges to extant systems of market and industrial organization, particularly the *chaebol* system. Moon's conclusion is that South Koreans now realize structural limits to mercantilism and that a deeper integration with the world economy that requires reforming domestic economic institutions is unavoidable. The newly elected government of President Kim Dae Jung that assumed office in 1998 represented a coalition of mid and western regions, workers, and small and medium firms. The previous coalition served the interests of eastern regions and big business. Thus, if

responding to globalization required restructuring the *chaebols*, perhaps the current president is in the best position to do so. This was, however, impeded by the fact that there were no clear domestic winners, at least not in the short term, from domestic restructuring who could champion the painful process. On the contrary, there were only losers that had significant incentives to mobilize and oppose dismantling of the existing system that had elevated South Korea from the “periphery” to the “core.”

The economic fortunes of the East Asian Tigers and Japan are intertwined. The Asian Tigers have mimicked the Japanese developmental state model with varying degrees of success. Though Japan’s current economic woes predate the Asian crisis, they have been accentuated by it. Many attribute the continued economic crises as a symptom of Japan’s inability to shed the developmental state model and adopt a market-based system for resource allocation. The *keiretsu* system that enabled Japanese managers to think long-term and invest in projects with long-gestation lags, is now viewed as stifling risk-taking and overly insulating the managers of firms from market realities.

In Chapter 3, Marie Anghodoguy explores the Japanese response in the software industry to processes of globalization. The software case is important for several reasons. It is a technologically advanced industry, deemed by Japanese leaders to be key to Japan’s future economic success. Yet it is struggling in both operating system and applications software because of the continued reliance on the traditional approach to creating a comparative advantage—boosting economies of scale and focusing on manufacturing expertise to cut costs and increase quality—that worked well in manufacturing industries such as autos, steel and semiconductors. In contrast, the success of US firms is largely due to entrepreneurial efforts in a market-oriented environment sensitive to consumer needs and to their control of dominant standards. Thus, the Japanese software industry is grappling with pressures to converge with the Anglo-Saxon market-based capitalism. Observing the policies they adopt in software provides an important opportunity to understand how the Japanese government and firms currently view the strengths and weakness of Japanese capitalism relative to that practiced in the Anglo-Saxon world.

Anghodoguy lays out two indicators for measuring convergence. The first, technological convergence, measures the degree to which Japanese software companies have responded to international competition by offering products based on international standards. The second, market convergence, reflects the degree to which the state and firms rely on the market to determine products and prices. Needless to say, convergence on these criteria is critically influenced by interests of the major domestic actors and the acceptability of the notion that Japan needs to change its existing system of corporate, market and political governance.

The Japanese form of capitalism was created within a given institutional and historical context. After World War II, the Japanese economy was in

ruins. Japan had not been able, even during the war, to catch up with the West in industrial production. The system that was established after the war was designed to permit the Japanese economy to become an industrial powerhouse by reducing the risk assumed by private firms in investing in capital-intensive production methods. We have already told much of the story in discussing the rise of the *chaebol* system in Korea. The main difference is that Japan was first and Korea was a later imitator. The East Asian countries are often compared to “flying geese:” Japan was the lead goose, Korea was a follower.

The Japanese form of capitalism that evolved after World War II led to unprecedented levels of prosperity. It survived the challenges created by increased energy prices in the 1970s by transforming itself into a slightly different system, less dependent on “administrative guidance” from the state and more dependent on developing a consensus between managers of private firms and government bureaucrats. As Anchordoguy points out, Japan had little experience domestically with “markets”; rather, it had networks of established customer relationships. Further, the Japanese state did not function as an umpire and maintainer of the market system, the necessary attributes of the Anglo-Saxon model. Thus, in grappling with globalization, Japan was forced to rethink and re-evaluate its historical institutions of economic and political governance.

Based on the two indicators, Anchordoguy examines whether Japanese software producers and the state have responded to global pressures by moving away from institutional arrangements and practices that manage market competition toward reliance on relatively unfettered market forces to determine the types, quantity and price of products offered. Her conclusion is that in spite of some progress towards convergence, much remained to be achieved. The Japanese government continued to use market forces to achieve specific outcomes but did not rely on them for key decisions of resource allocation. The role of path-dependency, the power of interest groups that benefitted from the status quo, and an unease about jettisoning a system that brought Japan unprecedented prosperity and helped in rebuilding its war-torn economy, were important constraints preventing market convergence.

From import substitution to liberalization in Australia

East Asia and Australia are often viewed as jointly constituting a potential regional bloc, one of the three pillars of the so-called triad. No longer viewing itself primarily as an outpost of the West, Australia has steadily and consciously expanded its economic linkages with East Asia. As John Ravenhill points out in Chapter 4, in the early 1980s, Australia had one of the most insulated economies in the OECD. He contends that the most fundamental idea shaping the Australian identity was the consciousness of vulnerability, primarily due to its isolated geographic position. Unlike

many small industrialized economies of Western Europe where corporatist structures were employed to adjust to shifting demands of international markets (Katzenstein, 1985), the compromise between labor and capital in Australia was predicated on insulating domestic groups from international forces. This compromise was also influenced by their desire to avoid the class conflict their ancestors had experienced in nineteenth-century Britain. Thus, the state was given the role of arbiter between labor and capital.

The government followed a policy of “protection all around” in which every factor of production was insulated from international competition by an array of mechanisms. The manufacturing sector was protected by import tariffs. Small farmers were compensated for the high costs of manufactured goods through price stabilization programs, subsidized inputs and government-financed R&D. The policy of “protection all around” seemed to work well, especially in developing the infant manufacturing sector. The growth of agricultural protectionism and food crop self-sufficiency worldwide, coupled with the slowing of demand for minerals following the oil price rises in the 1970s, weakened Australia’s traditional export sectors. This led to a substantial deterioration in the country’s terms of trade in the first half of the 1980s. Slow rates of economic growth forced the government to address the challenges of economic integration. The Australian government in the 1980s dramatically changed its economic strategies at multiple levels—domestically, regionally and in global multilateral institutions. The unifying thread was the emphasis placed on liberalization. Domestic industries were exposed to international competition through a lowering of tariffs. At the regional level, the government engaged in activist diplomacy in pursuit of trade liberalization through the construction of new regional economic institutions. At the global level, the government promoted trade liberalization in the Uruguay Round through its establishment of the Cairns Group of agricultural exporting countries.

By the mid-1990s, the government’s emphasis on liberalization as the principal means of responding to globalization was increasingly under attack. High unemployment rates and a rising trade deficit in manufactured goods are forcing a reevaluation of the policies of the 1980s. Not surprisingly, economic liberalism is unpopular with the electorate. Ravenhill concludes by pointing out that Australia has yet to find a substitute for the “protection all round” doctrine to marry the twin objectives of integration with the global markets and domestic social cohesion.

Regional responses to globalization

Import-substitution was an attractive model to develop the manufacturing sector in many countries. As Ravenhill points out in his chapter on Australia,

after significant initial success, diminishing returns had set in by the 1970s. Latin America was undergoing something similar in the late 1980s and early 1990s: experiencing first the declining efficacy of import substitution and then embracing integration with the world economy. Importantly, as Latin American firms sought to become competitive in the world economy by, *inter alia*, tapping into regional economies of scale, they were also pushing for regional economic integration. Thus, the story of European integration is perhaps being retold in Latin America.

In Chapter 6, Fernando Robles suggests that trends towards the formation of a number of new regional trade blocs indicate that regionalism is emerging with a new force, perhaps as a strategic response to the pervasive and relentless process of globalization. After taking a back seat to multilateral efforts to increase trade and investment, regional trade integration has re-emerged as a viable way to shed the constraints of the import-substitution model while insulating powerful domestic economic interests from the competitive pressures of globalization.

This raises the questions of how regionalization relates to globalization. Specifically, is it a “building bloc” or a “stumbling bloc” for global integration (Gilpin, 1987; Lawrence, 1995; Ohmae, 1995)?¹⁴ Robles believes it is the former. Global market integration is unlikely to be uniform within and across countries; some countries (and sectors within them) in a given region may be more integrated regionally than they are with the rest of the world. Further, this could vary across industries. Regional integration could be the result of either “natural” causes such as geographical proximity or conscious policy mechanisms such as establishing trading blocs. Conscious regionalization, which could take the form of adopting regional corporate strategies, establishing regional trading blocs, and/or adopting a common regional currency, is therefore one category of strategy adopted by firms and governments to respond to globalization. However, as the regionalized economies mature and firms find that focusing on regional markets is not conducive to achieving full international competitiveness, regionalization could be expected to lead to globalization.

Regionalization strategies are supported strongly by elites in both private firms and governments in Latin America. Robles identifies two components of regionalism. The first component is economic regionalism, which is based on the desire of economic agents and nation-states to enhance the welfare of their members. The second component is a regional “mind-set” that results from sharing common values and beliefs which shape a vision of what regional members want to become.

Robles focuses on the second component and links it to the corporate strategies of Latin American firms. He contends that a new breed of Latin American corporations is making its mark in response to this new reality of more open economies, globalization and regional integration. These corporations are rapidly exploiting new technologies and other cost-saving techniques. They are leveraging their in-depth understanding of the region’s

intricate cultural fabric to compete with global firms and become regional players (at least) in niches neglected by their powerful global rivals. Although a few Latin American corporations are moving quickly to seize opportunities in an integrated American market, the large majority of companies operating in Latin America have not yet embraced a regional vision. These more locally oriented companies using corporate strategies which proved effective under import substitution and an era of weak regional collaboration are being challenged by both more regionally integrated firms and global corporations. Thus, Robles views regionalization as a conscious strategy of Latin American firms to leverage their superior knowledge of the region and to realize regional economies of scale while not overextending themselves by venturing into other regions where the systems of market and corporate governance are different. Further, this change in the mind-set has, to some extent, been accelerated by the formation of the Mercosur and other regional trading arrangements.

The European case is somewhat different from the Latin American one. Regionalism in Latin America overlaps with major political and structural changes in these countries: specifically, a transition from an import-substitution model to an export-led growth model and from authoritarian regimes to a more democratic ones. The members of the European Union do not face these challenges. Most West European countries have had relatively open economies since the 1960s as well as firmly established democratic systems.¹⁵ The European integration project predates the current concerns about responding to globalization. The European Iron and Steel Community, the precursor to the European Economic Community (EEC), was formed in 1952. The Treaty of Rome, which created the EEC, was signed in 1957. The Single European Act of 1987, which amended the Treaty of Rome, addressed the issue of trade impediments and took steps to facilitate greater access of national markets. It also made changes in the governance rules within the European Union, especially by limiting the use of unanimity rule that was stipulated in Article 100 of the Treaty of Rome. The 1991 Maastricht Treaty heralded the monetary and political union. It outlined a timetable for establishing a common European currency and an independent central bank when seven of the twelve EU countries meet criteria on inflation rates, government budgets and interest rates. Consequent to the successful meeting of these criteria (though fudged somewhat), the euro was launched on January 1, 1999.

Clearly, the European integration project had important political and security motivations from its inception. It was partly motivated by the desire of the West Europeans and the United States to permit Germany to recover economically without threatening its neighbors. It was also designed to satisfy the desire of many Europeans to have an alternative to the narrow and corrosive nationalisms that were responsible for the two great catastrophes of the twentieth century—World War I and World War II.

In Chapter 5, Michele Fratianni conceptualizes the euro as a regional

response to the challenges of globalization in the monetary sphere. He believes that the EMU and the euro will improve the abilities of the euro countries to respond to exogenous shocks for two reasons. First, the EMU will have fewer linkages to the outside world than the individual economies. Second, the domestic component of the EMU's financial portfolio will be larger than the domestic portfolios of the constituting economies, thereby insulating them from shocks in exchange rate fluctuations, especially between the dollar and the euro.

Currencies are now being internationalized for two reasons: "currency substitution" and "currency internationalization" (also see Cohen, 2000). The former means that a foreign currency becomes the *de facto* tender in the domestic economy, replacing the domestic currency. The "dollarization" of many transitional economies is an example of such substitution. Currency internationalization means that a given currency is used as a unit of account for international transactions by actors of different nationalities. With different currencies competing in the global market, central banks want to protect their monetary space for many reasons including the benefits of seigniorage. Currencies associated with inflationary economies (sometimes called "weak currencies") are deemed less desirable to hold and are more susceptible to being replaced by "strong currencies" (those associated with more stable economies) even in domestic transactions. Central Banks have strong incentives to ensure that the inflation rate in the domestic economy remains low in order to avoid "denationalization" of the domestic money supply.

Historically, there has been a positive correlation between the size of the economy and the transactional domain of the currency. On this count, the US dollar is privileged. To compete with the dollar, the smaller European economies joined together as a monetary union (EMU). Financial markets, however, have judged that a large EMU is likely to produce a weak euro. The announcements that the Maastricht convergence criteria will be "fudged" have been correlated with an appreciation of the US dollar vis-à-vis the German mark, the French franc, and the Italian lira, but not vis-à-vis the British pound.

The EMU will exert a strong centripetal force on domestic financial markets, endowing them with a depth and liquidity close to that of the United States. The levels of financial integration, however, will fall short of the levels prevailing in the United States. As Fratianni points out, the "Excessive Deficit Procedure" and the "Stability and Growth Pact" are poor substitutes for the lack of political integration. Historically, political unification has tended to occur before monetary unification. Further, the European Central Bank's attempts to serve the monetary needs of eleven sovereign countries will generate important political challenges, and many scholars have questioned the ability of the ECB to meet these likely challenges. Nevertheless, Fratianni believes that the EMU and the euro will fundamentally alter the international monetary system. Instead of an

unfettered domination of the dollar as an internal money, the euro and the yen will begin to play more important roles. Each of these currencies will form focal points to which clusters of domestic currencies will be attracted.

Structure of this volume

This volume has three parts. Part I analyzes the response of Asian Tigers, Japan and Australia to globalization. Dali Yang and Fubing Su (Chapter 1) examine China's integration with the world economy. Chung-in Moon (Chapter 2) discusses how South Korea has grappled with global integration both before and after the 1997 economic crisis. Marie Anchordoguy (Chapter 3) studies the response of the Japanese government and firms to globalization in the software industry. John Ravenhill (Chapter 4) examines how Australia has responded to globalization, particularly in relation to its manufacturing sector.

Part II focuses on regional responses to globalization. Michele Fratianni (Chapter 5) describes how the euro is a European response to multiple facets of globalization, including the dollarization of international economic activity. Fernando Robles (Chapter 6) analyzes how Latin American firms are adopting regional corporate strategies to respond to MNEs seeking to expand in the region.

Part III examines the response to globalization in three transitional economies. Steven Solnick examines Russia (Chapter 7) while Beverly Crawford compares the responses in Bulgaria and Yugoslavia (Chapter 8).

Notes

- 1 We thank the participants of the Alexandria workshop (July 31–August 1, 1998) and the anonymous reviewers for their input. Research and editorial assistance of Jun-ho Kim and Jennifer Baka is gratefully acknowledged.
- 2 From this point on we will refer to economic globalization as globalization. For a discussion on the various dimensions of globalization, see Prakash and Hart (1998; forthcoming).
- 3 For measuring the degree of internationalization/globalization of firms, see Kobrin (1991), Sullivan (1994); Ramaswamy, Kroeck and Renforth (1996); UNCTAD (1997); and Makhija, Kim and Williamson (1997).
- 4 In the context of domestic political economy, Ostrom, Tiebout and Warren (1961) have argued that public goods, governance function being one of them, can be provided efficiently at multiple levels, the country-level being one of them. Thus, methodological nationalism may not hold in the domestic political economy as well.
- 5 Transaction cost theorists differentiate firms from markets (Coase, 1937; Williamson, 1975). Markets are institutional arenas for exchange while firms are actors undertaking such exchanges. Firms arise to economize on high transaction costs of market-based exchanges.
- 6 There is a well-established literature on the impact of institutions on policy

decisions. The works are too numerous to be cited. Some key ones include Katzenstein (1985), Vogel (1986), North (1990), Ostrom (1990), Hart (1992). In the domestic political economy, public choice theorists have stressed the role of institutions in mediating between individual strategies and collective outcomes. For a review see, Mueller (1989).

- 7 Goldstein and Keohane (1993), in an attempt to structure the discussion on the impact of ideas on policy outcomes, identify three categories of ideas: “world views” such as the efficacy of centralized planning versus resource allocation by market-based processes; “principled beliefs” consisting of normative notions of right and wrong; and “causal beliefs” about cause-effect relationships rooted in shared consensus among elites. Constructivists would add beliefs about authenticity and identity to this list (Katzenstein, 1996).
- 8 An important area of future research is to examine how the variations in crossborder flows of ideas and information impact market integration. In such research designs, the flows of ideas are independent variables that impact levels of market integration (dependent variables). In this context see, Prakash and Hart (1999).
- 9 These trends are perhaps facilitated by the increasing acceptance of English as the language for international commerce. A recent article in the *New York Times*, “Berlin Has a Word for Its Ambitions: English,” describes the increasing acceptance of English in Germany:

As you drive past posters advertising Volkswagen’s “New Beetle” (not “Der neue Käfer”), you may hear a radio advertisement for an Audi that gives you “die power,” only to see a newspaper headline about Germany’s lack of “jobs” (forget “arbeit”) as the radio turns to a discussion of Berliners’ growing attraction for “the American way of life.”

English, of course, is advancing everywhere, propelled by the Internet and the dominance of American popular culture. It is the most widely studied foreign language in German schools, where most children start learning at the age 11. But its advance has been particularly marked here, strong enough to set off a debate on what it is to be German (1998: Al).

- 10 We thank Peter Katzenstein for this point.
- 11 We thank Peter Katzenstein for encouraging us to think in terms of the impact of globalization on various domestic bargains.
- 12 It could be argued that, instead of being the contexts through which globalization processes are mediated, these transitions are direct results of globalization. We thank the anonymous reviewer for this point.
- 13 Why did the crisis happen at all? Why in Asia? What explains its timing and the variations in its intensity across countries? Understanding such questions is a booming industry by itself. For an excellent compendium of writings on these subjects, see Nouriel Roubini’s website: <http://www.stern.nyu.edu/~nroubini>.
- 14 We thank Alan Rugman and John Ravenhill for encouraging us to clarify this point.
- 15 Spain, Portugal and Greece are the exceptions. Also, if some former Communist countries of Eastern and Central Europe (namely, Hungary, Poland, Slovenia, Czech Republic and Estonia) are admitted to the EU, the existing members will have to deal with their historical and institutional legacies. One way of dealing with such legacies has been to require the aspiring countries to meet stiff conditions that reflect that they have exorcized themselves sufficiently of these legacies.

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Part I

This part analyzes how East Asian countries and Australia have responded to globalization. Dali Yang and Fubing Su examine China's integration with the world economy. Chung-in Moon discusses South Korea's response to the pressures for global integration both before and after the 1997 economic crisis. Marie Anghodoguy, focusing on the computer software industry, studies the response of the Japanese government and firms to globalization. Finally, John Ravenhill examines the domestic political economy of Australia's quest to liberalize and yet maintain domestic cohesion.

Two decades after Mao's death, China has shed autarchy and embraced integration with the world economy. The most dramatic feature of Chinese economic policies has been the inflow of foreign direct investment (FDI). Yang and Su contend that with increasing levels of FDI flows and other forms of market integration, China has "normalized." Its leaders have shed the revolutionary rhetoric and have begun to respect international norms and market rules.

China started opening up with an objective of attracting foreign capital and technology while preserving the Chinese political system. The effectiveness of its policies has varied over time. When China initiated market-oriented reforms, few investors came. As the economy grew and reforms speeded up, China's attractiveness for FDI increased, giving China some leverage over these flows. The leverage was limited, however, as the Chinese leadership found out in adjusting its investment policies in the mid-1990s. The authors conclude that globalization has speeded up the reforms by forcing the Chinese government and firms to respond to international competition and to play by the market rules.

The post-World War II era has witnessed many changes in the international political economy, including the rise and the fall of the East Asian Tigers. These countries have been praised for their agricultural reforms, export-orientation, and their investments in human capital. The 1997 economic meltdown, therefore, took many by surprise. The economic downturn in South Korea, in particular, raises important issues regarding the long-term viability of the developmental state model. In this context, Chung-in Moon examines the dynamics of globalization in South Korea. He

contends that despite its outward orientation, South Korea remained a protectionist state. Its economic success could be attributed to strategic industrial policy and network synergy of state-business which manifested in a subtle form of (neo-) mercantile ideas and practices.

Prior to the 1997 crisis, globalization was used as a slogan to connote rising level of exports; reforming institutions of market and corporate governance, particularly the *chaebols*, was not on the agenda. The increasing levels of international trade and US pressure, forced South Korea to liberalize. However, it chose to liberalize trade and capital regimes, not the FDI regime. Consequently, it began to run a balance of trade deficit that was financed by unhedged short-term capital flows. The highly leveraged banks and manufacturing firms could not survive the rapid depreciation of the won. Moon's conclusion is that since South Koreans now realize the structural limits to mercantilism, deeper integration with the world economy by reforming domestic economic institutions is unavoidable.

One of the hallmarks of globalization processes is the increasing salience of high-technology sectors, especially the information technology industry, in both the domestic economy and international trade. Anchordoguy explores the Japanese response in the software industry to processes of globalization. The software case is important because, though it is a technologically advanced industry deemed by Japanese leaders to be the key to Japan's future economic success, it is struggling in both the operating system and applications software areas. She contends that the reason is the continued reliance on the traditional systems of industrial and market governance predicated on the *keiretsu*-system that worked well in traditional manufacturing industries.

It is contended that the pressures of globalization will lead to converging institutional structures across countries. On this count, the software industry is an interesting case because the pressures for convergence are very strong. Anchordoguy lays out two indicators for measuring convergence. The first indicator, technological convergence, measures the degree to which Japanese software companies have responded to international competition by offering products based on open, dominant standards. The second indicator, market convergence, reflects the degree to which the state and firms rely on the market mechanism to determine their products and prices. Based on these indicators, Anchordoguy examines whether Japanese software producers and the state have responded to global pressures by moving away from institutional arrangements and practices that manage market competition toward reliance on relatively unfettered market forces to determine the types, quantity and price of products offered. Her conclusion is that although there are indicators of progress towards convergence, much remains to be achieved. The Japanese government continues to use market forces to achieve specific outcomes but does not rely on them for key decisions of resource allocation.

East Asia and Australia have often been portrayed to jointly constitute a potential economic bloc, one of three pillars of the so-called triad. From viewing itself as an outpost of the West, Australia has steadily and consciously expanded its economic linkages with East Asia. John Ravenhill points out that, historically, Australia has been an insulated economy because of the policy of “protection all around.” The government sheltered domestic manufacturing and service industries behind high protective barriers and subsidized many operations of the primary sector. The growth of agricultural protectionism and food crop self-sufficiency worldwide, coupled with the slowing of demand for minerals following the oil price rises in the 1970s, weakened Australia’s traditional export sectors.

As a result of deteriorating terms of trade and slow rates of economic growth, the government dramatically changed its economic strategies in the 1980s, placing emphasis on liberalization. By the mid-1990s, however, liberalization as the principal means of responding to globalization was losing appeal. Due to high unemployment rates and a rising trade deficit in manufactured goods, economic liberalism is now unpopular with the electorate. Ravenhill concludes that Australia has yet to find a substitute for the “protection all round” to maintain domestic peace as well as to remain competitive in world markets.

1 Taming the market

China and the forces of globalization

*Dali L. Yang and Fubing Su*¹

China is no stranger to global interactions. The early Ming dynasty saw China launch grand seafaring ventures that predated those of Columbus and reached all the countries around the Indian Ocean and the China Sea. Neither was the Chinese mind as reclusive as the image of the Great Wall conjures up. Not only did the Chinese civilization lead the world in several historic inventions but it also adopted and adapted Buddhism as its leading religion. And at the time when the Pope was putting Galileo on trial in Rome, Jesuits were preaching the Galilean gospel in Beijing (Boorstin, 1983:62). From this perspective, China's isolation during the late Mao era was a historical aberration, forced by China's historic confrontation with both the United States and the Soviet Union.²

When China again started to reach out to Western markets after bouts of revolutionary self-destruction culminating in the Cultural Revolution, its leaders sought to take advantage of what the global market had to offer but avoid the pitfalls of capitalism. China would export in order to earn the foreign exchange needed to import Western equipment and other necessities. But the Chinese would continue on the socialist road under the leadership of the Communist Party.

Less than a quarter of a century after Mao's death, however, the color of China has changed from red to green. Over this period, China's leaders have gradually overcome their ideological reluctance and steadily liberalized the terms of China's participation in the global marketplace. China today is one of the world's top traders and favorite destinations for foreign direct investment. While the global market has presented challenges for China, it has also offered China's leaders avenues for diffusing social tensions and boosting regime legitimacy.

It is now trite to say that globalization, in terms of increased capital and production mobility across borders, imposes constraints on states. What is interesting is how the constraint operates and how the state copes with these constraints (Cohen 1996). Is China similarly constrained? Has the Chinese state been better able to dictate the terms of engagement than countries with smaller markets? Has the Chinese government been successful in its effort to trade market access for technology in bargaining

with multinationals? Will China seek to rewrite the rules of the global system to its liking as its economic might increases? In this chapter, we zero in on China's integration with the world economy and hope to shed light on these questions. Before we proceed further, we should admit that the discussion offered here is highly selective. It is focused on the political and economic aspects of China's integration into the global economy and does not discuss the impact of globalization on the transformation of state-society relations within China. We have also paid little attention to other and especially the cultural aspects of this process, which have recently received much attention in the literature on globalization (e.g. Appadurai, 1996; Watson, 1998).

We begin with an overview of China's integration with the world economy. Then we examine the evolution of China's foreign investment policies in order to assess the constraints on China. Next we examine Chinese government efforts to target foreign investment in specific industries and sectors. Overall, we argue that, as reforms and rapid economic growth increasingly made China an attractive destination for foreign direct investment, China has been able to gain some leverage over multinationals. Nevertheless, that leverage is not one-sided and unconditional and the Chinese government has had to curb its own arbitrary behavior and become more market-friendly. Finally we take a look at China's program to meet its growing energy shortage and find that China has aggressively entered the international oil business. But Chinese behavior in this vital sector is designed to tame an unruly market rather than supplant the market. In conclusion, we find that China has in two decades become one of the most important players in the global economy. This means that Chinese interests are increasingly enmeshed with those of the global economy, making China more willing to take on global responsibilities.

Integrating into the global economy

In some sense China's march into the global market is best viewed from the perspective of the consumer. Most American consumers have experienced first-hand the growing varieties of retail products that are made in China. While in the 1980s most Chinese-made products tended to be low-priced, in recent years more and more Chinese products have appeared with higher price-tags. Some Chinese manufacturers, such as the appliance makers Haier and Kelon, have started to move beyond being simple OEM (original equipment manufacturer) suppliers and have begun selling their products with Chinese brand names in American and European chain stores. In the meantime, the emergence of dominant domestic brands in China means that some foreign manufacturers are now willing to become OEM suppliers to Chinese brands.

The growing presence of Chinese producers in world markets is reflected in China's rising rank as a global merchandise trader. In 1980, China's

foreign trade volume was at 38 billion dollars (US). China ranked as the 28th foreign trader and accounted for less than 1 percent of the world merchandise trade. By 1997, China's merchandise trade volume, not including Hong Kong, had hit 325 billion dollars, ranking it as the world's tenth largest trader. Its share of world merchandise exports had risen to 3.3 percent (WTO, 1998).³ The depth of China's engagement with the world economy can also be measured by the ratio of trade to GNP. By this measure, China's trade dependency rose nominally from about 10 percent in 1978 to more than 40 percent in 1995, far higher than the average for large economies.⁴ Trade has been a major engine of Chinese economic growth. Moreover, exposure to international competition via international trade has had a significant impact on the improvement of productivity of both state-owned and non-state enterprises in China (Perkins, 1996).⁵

As China has traded more with the rest of the world, it has worked hard to attract overseas investors. Initially and through the 1980s, the flow of foreign capital into China was limited as the Chinese economy was caught between plan and market. Rapid growth and liberalization of the Chinese economy in the 1990s have made the Chinese economy a much more attractive investment destination. From 1993 to 1997, China was the second largest recipient of foreign direct investment, behind just the United States. Overall, it appears that the Chinese economy is now substantially more open to foreign investors than China's East Asian neighbors (Japan, Korea and Taiwan) at a comparable stage of development. According to Lardy (1994:66), China has had "one of the most liberal foreign investment environments in the developing world."

The importance of overseas investment to the Chinese economy cannot be overestimated. In 1997, 145,000 overseas-invested companies employed 17.5 million or 11 percent of China's non-agricultural workforce and produced 14 percent of the industrial output.⁶ They also generated over 12 percent of tax revenue and made more than 13 percent of total annual fixed-asset investment. Even more impressively, they accounted for 47 percent (US\$152.6 billion) of China's foreign trade volume in 1997, up from 26.43 percent in 1992. Most importantly, the overseas-invested businesses now account for even greater shares of the marginal increases in these indicators as China's state and collective enterprises have had much difficulty in recent years (*JJRB*, 7 January 1998). Investment from overseas now spearheads China's involvement in the world economy.

Indeed, the growing presence of multinational corporations in the Chinese market has marked the globalization that was lacking just a few years earlier (Simon, 1991). According to the State Planning Commission, about 300 of the world's 500 major multinationals have invested in China. As the number of multinationals in China increases, there has been a substantial increase of projects involving 10 million US dollars each (*Xinhua*, 23 January 1998; FBIS-CHI-98-023). Often the leading competitors on the Chinese market are the same ones as in other parts of the

world. In cellular communications, for example, Chinese producers must fight for a foothold amid the crossfire of fierce competition among Ericsson, Nokia, Motorola, Siemens, and other companies. Foreign investors thus not only bring in capital, technology, and management skills, but also force Chinese producers to reform or sink. As the *People's Daily* declared in the middle of the Asian financial crisis:

The use of foreign capital not only has made up for the shortage of funds for domestic construction, enhanced progress in industrial technology and improvement in operation and management as a whole, and promoted economic growth, but also has trained capable personnel, expanded employment, increased revenue from taxes, promoted import and export, increased foreign exchange reserve, and promoted the development at a deeper level of the economic structural reform and the updating of people's ideology and concepts.

(RMRB, 25 December 1997)

While China has been a top destination for foreign direct investment, its expanding economy and hefty foreign exchange reserves have also meant more Chinese companies are investing overseas. Most of the 6,000-plus Chinese investments overseas are concentrated in OECD countries. With some exceptions such as COSCO, these investments are generally small. Nevertheless, recently, major Chinese manufacturers in motorcycles, televisions and home appliances have started to set up manufacturing operations overseas, generally in developing countries (Southeast Asia, South Africa, Middle East, Latin America and Central Asia), in order to be closer to their product markets (*QB*, 15 November 1997:24). China's relative economic stability amid the Asian financial turmoil has also given Chinese companies greater elbow room in regional financial markets. For example, in January 1998, the Industrial & Commercial Bank of China and the Hong Kong-based Bank of East Asia Ltd. bought the Asian equities and corporate-finance businesses of NatWest Markets in order to beef up its investment-banking capabilities. The Bank of China was also known to have shown interest in the assets of the collapsed Peregrine Investment Holdings, though it did not work out a deal. Some Chinese scholars have explicitly called for China to take advantage of the depressed asset values in Southeast Asia and South Korea (Huang Weiping and Zhu Wenhui, 1998).

The Chinese government finally recognized the trend of growing Chinese investment overseas. Drawing on the findings of the Third Industrial Census, the State Economic and Trade Commission, in consultation with other government agencies, has drawn up a list of products, generally in light industry, machinery and electronics, in respect of which the Chinese government will encourage Chinese investors to move production overseas. To promote export of Chinese capital goods, the Chinese Eximbank will try to provide loans to machinery and

electronic manufacturers setting up factories overseas, or offer financial support to overseas projects contracted by Chinese companies (*FT*, 17 March 1998). Such investment overseas is likely to stimulate more trade flows (Encarnation, 1992).⁷

Channeling foreign investment

A review of changes in China's policies toward foreign investment underscores both the strengths of and constraints on the Chinese state. To begin with foreign capital did not rush into China immediately after China began to open up at the end of the 1970s and early 1980s. Overseas investors hesitated because the Chinese economy was dominated by the state sector and had at best a rudimentary and opaque regulatory framework. Even the special economic zones had trouble attracting foreign capital at first (Crane, 1990). In response, the Chinese government had had to make the Chinese investment environment more attractive by modifying its policies. Even then, through the 1980s most foreign investment into China came from ethnic Chinese living in Hong Kong, Macau, Taiwan and Southeast Asia.⁸ Overseas Chinese, building on ethnic networks that provided information and an additional measure of security, have channeled billions of dollars into China and laid the foundations for vibrant export industries (Weidenbaum and Hughes, 1996).

It was not until the first half of the 1990s that investor anxieties about China's investment climate were finally eased. As China's domestic economy became largely market-based, the Chinese government also steadily relaxed its policies for foreign investors by improving the regulatory framework and offering tax benefits (Shirk, 1994). The central government decentralized the power of approval over investment projects to local governments and only watched over large projects (especially those involving capital amounts of more than \$30 million). In the meantime, local governments vying for outside investments were caught in a game of competitive liberalization. They offered ever more attractive incentives to investors, including tax benefits, improvement in infrastructure, and easy regulatory policies (Yang, 1996). In response to China's improving investment climate and rapid growth in one of the largest consumer markets, a China fever developed and foreign investment in China jumped as investors from OECD countries feared missing out on a critical market of the future. Up until 1985, about 85 percent of FDI (excluding joint oil exploration) came from Hong Kong, Macau and Taiwan. Since 1992, that proportion has declined to 80 percent in 1992 and 59 percent in 1996.⁹ Meanwhile, investments from the United States, Japan and Europe have leaped. As mentioned earlier, China has been the largest FDI recipient among developing countries since 1993. China's current account balance improved dramatically.

While huge influx of foreign investment contributed to China's economic growth and strong export performance, it also engendered much concern about the impact of foreign investment on Chinese industries, especially since consumer product companies such as Coca Cola and Procter & Gamble rapidly gained market share at the expense of Chinese producers and brands. Faced with the onslaught of foreign competition, various affected enterprises, especially less efficient state-owned enterprises, expressed opposition to rapid liberalization and lobbied government officials for restrictions on foreign investors. While the industrial interests in the West may organize their lobbying activities through industrial associations and press legislators for policy change, their Chinese counterparts sought help mainly from government ministries, especially industrial ministries that had assumed the role of guardians of enterprises under their jurisdiction. In consequence, the politics of industry protection versus liberalization became a battle among central government bureaucracies and among regional governments. Led by the *Economic Daily*, the newspaper of the State Council, the Chinese press in 1995–97 fiercely debated on the virtues and harmful consequences of foreign direct investment. Many Chinese policymakers and commentators wondered aloud whether Chinese industry (*minzu gongye*) could survive the competition from multinationals armed with superior management, savvy marketing and mountains of cash, while Chinese companies, especially state-owned enterprises, were financially and managerially weak. Opponents of foreign investment policies, represented by narrowly defined ministries in light, heavy, and machinery industries, complained about preferential tax treatment for foreign investors and attributed their failure in market competition to the government's bias against state-owned enterprises, which not only had to pay a higher tax rate but also had heavy welfare burdens.¹⁰ They called for a correction in the FDI policy, leveling the playing field for all players rather than favoring foreign investors. There was also complaint that some companies exploited the policy to import goods for sale duty-free. Even those who saw the benefits of foreign investment were concerned that China might become overly dependent on foreign technology (Zhong Jingwen, 1997).¹¹ It was claimed that, without an indigenous ability to develop new technologies, China might be stuck in underdevelopment forever, seriously compromising China's interest in the event of war.

Supporters of foreign investment, represented by researchers at the Ministry of Foreign Trade and Economic Cooperation, were put on the defensive since most industrial ministries appeared to call for greater control over foreign investment. They blamed the shock to Chinese enterprises on their outdated operating mechanism (*CDBW*, 5 October 1997:1). One report, submitted for limited circulation among top decision-makers, also made explicit comparison of divergent performances between the internationally competitive home electronics industry and backward

automobile industry. The morale from this comparison was clear: competition from markets, multinationals in particular, could speed up the process of technological upgrading and rebuild stronger national industries, while protection and exclusion of foreign players would slacken Chinese enterprises' incentives for innovation.¹² Among the provinces, there were also serious policy differences. Until 1996, about 85 percent of FDI flowed into the coastal region, especially Guangdong, Jiangsu, Fujian and Shanghai. Those provinces were especially strong advocates for foreign investment, either to create new jobs or to help reform existing state enterprises. In contrast, the interior regions, which are still dominated by state enterprises, tended to favor more central control over FDI.

Faced with a flood of foreign investment (and thus growing bargaining power vis-à-vis multinationals) and a chorus of domestic critics, the Chinese government chose to tighten control in the mid-1990s; it could afford to be choosier among the large number of overseas investors. Even some local governments in China openly declared that they did not want just any foreign investment. In 1995, the Chinese government issued a set of guidelines on foreign investment that spelt out industries where foreign investment was to be encouraged, permitted, restricted and prohibited. Most significantly, the Chinese government decided to scrap the system that had exempted foreign investors from import tax and value-added tax on capital equipment in April 1996 and thus give domestic equipment producers greater protection.¹³ Domestic industrial producers thus won a round against the internationalists represented by the Ministry of Foreign Trade and Economic Cooperation (MOFTEC). Indeed, some industrial ministries proceeded to issue their own directives. In spring 1997, for example, the National Council of Light Industries decided to tighten macroeconomic control over foreign investment.

The restrictive policies did not immediately lead to a slowdown of FDI into China. Indeed, it produced a "gold rush" effect as many companies rushed into China to beat the April 1 deadline for tariff-free importing, making 1996 one of the best for China in attracting foreign investment. Once the gold rush effect was gone, however, China became much less attractive to foreign investors. International manufacturing companies now faced duties on capital goods imports of up to 40 percent of the equipment. High-tech investments, which China has worked hard to attract, were especially hard hit because they usually required imports of expensive equipment. GM, for example, complained that the cost of its billion-plus auto plant in Shanghai would increase by one-third without the exemptions.

The Chinese government's decision to tighten control over foreign investment coincided with a growing realization among multinationals that making money in the Chinese market was not as easy as anticipated. Indeed, the government policy reversal was seen as a striking evidence of China's meddling bureaucracy.¹⁴ The bureaucratic meddling, together with a patchy

legal system, rampant corruption, underdeveloped financial system, technology transfer requirements, slowing economic growth, and overcapacity in most products, made it hard for foreign investors who also had to deal with Chinese partners more interested in skimming a project. While Japan's direct investment in China peaked at 431.9 billion yen in the year ended March 31, 1996, it plunged to 282.8 billion yen the following year following the cancellation of preferential treatment (*WSJ*, 5 February 1998). By late 1997, major investors such as Ameritech, Bristol-Myers Squibb, Caterpillar and Whirlpool would either quit or scale down their involvement in the Chinese market. While these companies represented only a small fraction of the total number of foreign investors, their actions indicated the end of the romantic rush into China. After all, in the age of globalization, there was always another country that was eager to welcome your investment on your terms.

The Asian financial crisis, which made most other Asian countries cheaper to invest in, compounded the impact of Chinese government decisions since three-quarters of China's FDI have come from the rest of Asia.¹⁵ By fall 1997, the Chinese leadership saw the prospect of a precipitous decline in foreign investment: during the first ten months of 1997, pledged foreign investment dropped 35 percent from the year-earlier period. Full-year figures for 1997 were only slightly better. While foreign direct investment grew by 8.5 percent to 45.3 billion, contracts signed still showed a 24 percent decline from 1996 (State Statistical Bureau, 1998).

The decline was partly due to comparison with the high 1996 base figure and thus to be expected. Nevertheless, given the importance of foreign investment in China's economy, this precipitous decline in contracted FDI proved to be far more than the Chinese leadership had bargained for and Chinese forecasters suggested that FDI in 1998 could decline by a third to just 30 billion dollars. The Asian financial crisis not only shut off a major source of FDI but also forced even the most successful investors in China to sell key assets in order to support operations at home. For example, the Thai conglomerate Charoen Pokphand, known as Asia's chicken king in Thailand, China and Indonesia, is one of the largest and most successful investors in China, with assets valued at \$2 to \$4 billion. During the go-go years, CP ventured out of its core feed business into diverse industries ranging from drugs, beer, to petrochemicals and motorcycles. By 1998, however, CP was in retrenchment as its credit lines dried up at home amid the Asian financial crisis. Pressed by banks at home for repayment of about \$ 1 billion in foreign-currency debt, it put many of its Chinese investments up for sale, laid off hundreds of Chinese staff members, and jettisoned some money-losing joint ventures (Kahn, 1998).

Even before the Asian financial crisis erupted like a hurricane, the Chinese leadership had already made some concessions after the cancellation of preferential treatment had provoked an outcry from foreign investors and

prompted an intense lobbying effort by multinationals and the Association of Foreign-invested Businesses (Personal interviews, 1997). Foreign governments, such as Japan's Ministry of International Trade and Industry, also lobbied for the restoration of the benefit on behalf of business interests (*WSJ*, 5 February 1998). To soothe investors, the Chinese government allowed foreign-funded projects approved before April 1996 to continue to import capital goods tariff-free until all such equipment had been imported (*RMRBO*, 10 April 1997).

By late 1997, worries about the dominance of foreign investment in the Chinese economy, while still in existence, had become far less pronounced than just a year or two earlier.¹⁶ While multinationals had captured substantial market shares (but still less than majority) in cosmetics, detergents, beer and drinks, there was growing evidence that Chinese manufacturers were ascendant and dominated the consumer appliance and electronics market (televisions, refrigerators, air conditioners, videos, CD players and microwave ovens) (Yang, 1998). In competition some Chinese producers have gained strength. Indeed, for growing numbers of Chinese people, the distinction between foreign and domestic is blurred since multinationals have generated employment and taxes for the local economy and have generally been good corporate citizens in China.¹⁷

As the international economic environment deteriorated and Chinese economic growth was slowing down, the Chinese government scrambled to keep foreign capital flowing, especially since the Chinese leadership chose not to join in the competitive devaluation sweeping Asia and devalue the Chinese currency. This meant that China had to adopt other measures to accommodate foreign investors and keep up a steady flow of foreign investment. Fortunately, the increasing competitiveness of Chinese firms suggested that China could afford to keep on liberalizing its trade and investment regimes. In October 1997, China announced a reduction of tariffs to an average level of 17 percent from 23 percent. In December 1997, the State Council convened a National Conference on Using Foreign Investment, only the second such conference ever held during the reform era (the first was in 1983), and issued new rules to guide foreign investment. It was decided to resume tax exemptions for imported equipment for projects the government wanted to encourage, thus removing a major complaint of foreign investors. Unlike the blanket exemptions that had existed prior to April 1996, however, the new rules targeted the importation of more advanced technology and equipment as well as the development of the interior regions, while they broadened the scope of investments, promising favorable treatment to 270 of the total 329 industries listed (*WSJ*, 5 January 1998; *Xinhua*, 30 December 1997; FBIS-CHI-97-364). Unlike in the past, the tax exemptions extend to both foreign and domestic companies, thus providing a more level playing field. Key sectors on the list are high and new technology, transportation and telecommunications, electric power generation, aviation, oil and

petrochemicals, machinery and electronics. Other sectors include pharmaceuticals, medical equipment, textiles, metals and metallurgy, light industry and agriculture. Investment in the interior is, also encouraged. Taxes on some imports are kept to discourage the import of low-technology machinery and equipment that can be built domestically and to protect fledgling domestic industries.

The commitment to boost foreign investment is reflected in the spate of major projects announced in 1998. In February 1998, the central government approved a Royal Dutch/Shell joint-venture project to build a \$4.5bn petrochemical complex in southern China. The largest of its kind ever, this is one among a series of petrochemicals projects and goes a long way toward tripling China's ethylene production capacity by 2010 (*FEER*, 11 February 1998). The Royal Dutch/Shell deal was followed shortly by a major investment program by Eastman Kodak (more on this later). Moreover, the Chinese government has promised to continue the gradual liberalization of services and thus attract foreign investment into new sectors.¹⁸ It will also accelerate efforts to phase in national treatment to foreign-funded companies. This will likely lead to the equalization of the fees overseas investors and locals have to pay for utilities and property and of the different tax rates on foreign and domestic financial institutions.

A series of measures have also been adopted to boost China's export competitiveness. The Chinese government promised to continue reforms of the foreign trade system, including accelerating the process of approval for trade rights by enterprises. While trade rights were limited to state enterprises and foreign-invested enterprises, the government has started to offer qualifying private enterprises export rights and thus boost exports (*DJN*, 29 May 1998).

While the number of enterprises enjoying foreign trade rights will continue to expand, the scope of imported goods subject to quotas and licenses will be reduced and the approval for imports simplified. In general, efforts to control imports will be based on general principles, tariffs and technology standards rather than arbitrary and non-tariff barriers.¹⁹ On April 1, 1998, China abolished export quotas and ended export license requirements on twenty-seven types of products covering about 20 percent of China's total exports.

The Chinese government has also repaid overdue export tax rebates to Chinese companies, some of which had been outstanding since 1994. In 1997, China paid out 43.2 billion yuan in tax rebates for exports. The 1997 total, added to the 1996 total of 82.8 billion, has remedied billions of yuan worth of rebates owed to Chinese exporters since 1994 and 1995 (*DJN*, 2 April 1998). In October 1997, the State Administration of Taxation resumed the 9 percent value-added tax rebates for newsprint exporters (*Xinhua*, 8 December 1997). The rebate rates for textiles, China's largest exporter in 1997, was increased from 9 percent to 11 percent of the 17 percent value-added tax in 1998.²⁰ This was followed by

tax rebate increases for exports of a variety of other products, including textile machinery (from 9 to 11 percent), ships (from 9 to 14 percent), steel (from 2 to 11 percent), cement (from 2 to 11 percent), and coal (from 3 to 9 percent) (*CD*, 23 June 1998).²¹ Moreover, officials of the State Administration of Taxation have indicated that China is unlikely to annul preferential corporate taxation policies for overseas-funded enterprises before the end of the century (*CDBW*, 4 May 1998:1).

While export financing dried up in countries that were hard hit by financial crisis, Chinese banks authorized greater lending to exporters to counteract the impact of currency devaluation in the rest of Asia. The Export and Import Bank of China (Eximbank), for example, planned to increase loans to exporters by up to 60 percent to 24.3 billion yuan, with special attention to machinery and electronic products (*FT*, 17 March 1998).

These and other measures as well as China's economic stability, which persuaded some overseas buyers not to switch suppliers for fear of supply problems, have helped China avoid the steep decline in FDI and exports and foreign direct investment that some analysts had forecast.²² In conclusion, while China's market size has proved attractive to overseas investors, that attraction is not inherent. China could only raise the price of investing in China when the supply of overseas capital was plentiful. But such plenty was short-lived, with the exception of the mid-1990s, and China has had to work very much harder in order to attract overseas investors. In general, as China eagerly sought overseas investment and interacted with investors, it was China that changed to suit foot-loose investors and submit to the rules of global engagement. As the following section suggests, only in certain industrial sectors and under specific conditions has the Chinese state been able to extract important concessions from multinational corporations by combining liberalization and state control.

Bargaining with multinationals: trading market access for technology

The Chinese effort to combine liberalization with state control is noticeable and to some extent successful at the level of industrial sectors. Specifically, the central government delegated the power of investment approval to local governments for relatively small projects (those below \$30 million). Because of the intense local government competition for foreign investment, the delegation of authority to local governments has essentially been transformed into deregulation for relatively small foreign investors. Instead, the central government has chosen to focus its limited energy on a relatively small number of major investments in industries ranging from aerospace, automobiles, to petrochemicals and telecommunications. By requiring official approval for major projects in these industries, China has been able to extract better bargains from multinationals than would have been the case had entry into the Chinese

market been unfettered. Moreover, the administrative barriers to entry have also provided some limited breathing room for domestic producers who clamor for government protection.

The economic rationale for such limited state intervention is well developed in the literature on strategic trade and indeed has its intellectual lineage in the writings of Frederick List and Alexander Hamilton. Because of economies of scale, latecomers to technology-intensive industries such as automobiles and telecommunications face extremely high barriers to entry and generally have trouble coming up with the high initial investment and huge R&D spending that are needed to break into such industries. Governments may offer some help, such as access to credit and tax breaks for research and development, that may make it possible for indigenous firms in developing economies to overcome entry barriers and become genuine competitors in the marketplace. As economists such as Paul Krugman have been careful to point out, however, there is no guarantee that such state intervention will be successful. Moreover, there is always the danger that indigenous industrial interests will look upon government protection as an entitlement and use their political clout to perpetuate protectionist policies rather than strive for excellence on the marketplace.

In the Chinese case, government officials realized in the 1980s that China could not develop its indigenous industry simply by hiding behind tariff walls. Moreover, the importation of foreign technology, especially in the form of assembly lines and licenses, was of limited help in reducing China's technology gap with developed economies as long as domestic R&D lagged behind. Too often technology imports must be followed by more imports in order to keep up with the technology race. The best way for China would be to attract foreign investors to bring their technology to China and, through partnerships with Chinese firms or gradual diffusion, make China part of the global technology march.

Yet Chinese leaders learned the hard way that it was not easy to persuade foreign investors to bring their technologies to China, especially because China lacked a working legal system as of the early 1980s and generally required foreign investors to export their products. In consequence, as discussed earlier, leading multinationals stayed away from China through much of the 1980s. The political crisis of 1989 dealt a major blow to China's improving international image, prompting the Chinese leadership to be more willing to offer concessions to foreign investors. In the meantime, China's domestic economy had become largely market-oriented by the early 1990s (Naughton, 1995) and Chinese leaders were more willing to adopt market-based policies. The confluence of these two factors resulted in a foreign investment strategy of exchanging market access for foreign investment by multinationals. The Chinese government has promulgated guidelines for foreign investments that target specific industries as well as regions. For foreign investors eyeing the rapidly

expanding Chinese market, direct investment in China thus becomes an attractive and often a necessary option.²³ The spectacular negotiations that foreign multinationals such as GM, Ford and others have gone through to secure access to the Chinese automotive market clearly fit this logic.²⁴ In the rest of this section, we offer surveys of a number of other sectors to illustrate the patterns of interaction China has engaged with multinationals.

Aerospace: monopsony versus oligopoly

The market-for-technology strategy is probably nowhere as prominent as in the airplane industry. As the Chinese passenger travel boomed amid rapid economic growth, the Chinese airline industry, spurred by the rise of regional and local airlines, expanded with abandon, making the Chinese market one of the most coveted for passenger plane makers, especially Boeing and Airbus.²⁵ By 1998, China's civil aviation sector alone had already spent more than US\$18 billion on 387 Boeing and McDonnell Douglas airplanes. Airbus received orders for 92 planes, 47 of which were operational by mid-1998 (CD, 15 June 1998; 18 June 1998).

Instead of letting more than two dozen Chinese airlines negotiate separately with the plane makers, the Chinese government has sought to coordinate Chinese purchases, using such purchases as leverage in trade disputes and negotiations with the United States and Europe. For example, in advance of President Jiang Zemin's visit to the United States in the Fall of 1997, Zeng Peiyan, minister in charge of the State Development Planning Commission, led a procurement mission to the United States. The mission signed contracts and agreements valued at US\$5 billion, including aircraft purchase contracts worth more than US\$3 billion. Using monopsony in one of the largest aircraft markets, China has been able to extract more favorable deals from the world's oligopolistic commercial aircraft manufacturing industry as well as gain some diplomatic mileage out of these deals.

Yet China is not content to be just an aircraft consumer, especially as China's own aircraft manufacturers, which used to serve the military, have been desperately chasing civilian purchases. Thus it is not surprising that the Chinese government has sought to tie parts manufacturing and assembly with purchases. Such work not only lowers costs for manufacturers but also provides China with high-paying jobs and helps China upgrade its manufacturing capability. Under one package, the Shanghai Aviation Industrial Corp and McDonnell Douglas (which merged with Boeing) jointly assembled 35 MD-82 aircraft in Shanghai (CD, 18 June 1998). Similarly, as part of its strategy to fend off competition from Airbus, Boeing has contracted with Chinese enterprises to make the tail section for its 737 aircraft and certain types of cockpits.

Engine-makers have also become involved in various ventures to

cement their relationships with China. Rolls-Royce, which has supplied aero engines to China for more than 30 years, has set up three ventures in China. Its engine joint venture with the Xi'an Aero Engine Corp delivered its first components, including low pressure nozzle guide vanes and low pressure turbine blades for Rolls-Royce Tay engines, in 1988 (CD, 8 May 1998; 22 May 1998). Pratt & Whitney Canada, a subsidiary of United Technologies, and China National South Aero-Engine formed the Southern Pratt & Whitney Aero-Engine Company Ltd in 1998 to manufacture gas turbine engine components for Pratt & Whitney Canada (CD, 3 March 1998).

Over the long term, China also harbors ambitions of becoming a competitive manufacturer in some segments of the commercial aircraft market. It already exports small passenger planes whose traditional makers in the West are driven out of production by liability claims. The Harbin Aircraft Manufacturing Corp (HAMC) had exported more than eighty of its 19-seat Y-12 light general purpose aircraft to eighteen countries by 1998. In 1998, HAMC clinched a deal with the Canadian Aerospace Group to supply up to 200 Y-12IV planes over a ten-year period (CD, 8 April 1998). It is also known that China wants to break into the regional jet airliner market by setting up a multinational venture to produce planes with about 100 seats. It is an indication of China's market clout that, when reports of such a plan surfaced, the world's major aircraft makers jostled to become joint venture partners.²⁶ In effect, China is offering access to its domestic market in exchange for state-of-the-art manufacturing and design know-how.²⁷

Telecommunications: market competition as leverage

Developments in the telecommunications industry show patterns that are similar to aircraft manufacturing: dramatic growth in newly installed telephones and wireless telephony and thus the need for state-of-the-art equipment, particularly digital exchanges and wireless infrastructure that China was hard pressed to produce. Most telecommunications projects are large and need the approval of the Chinese bureaucracy, including the Ministry of Posts and Telecommunications (MPT) and State Planning Commission.²⁸ In contrast, even though the multinational corporations are each quite large, they come from different countries including the US, Canada, Japan, Sweden, Belgium, Germany and Finland and have not been able to present a unified negotiating stance vis-à-vis the Chinese government but instead have competed among themselves for slices of the Chinese market. Each of them thus has had strong incentives to ingratiate themselves with the Chinese government in order to secure market access even though none of them wants to part with key technologies to the Chinese side. In consequence, the Chinese government has been able to secure joint-venture manufacturing arrangements with some of the world's leading telecom equipment producers. Lucent Technologies, for example, had invested more

than 100 million US dollars in China by early 1998, setting up six joint ventures and two solely-owned corporations that together employed 20,000 workers. It introduced the 0.9-micron chip processing technology as well as key know-how in telephone switches into the Chinese market. Moreover, Bell Laboratories, the R&D arm of Lucent Technologies, set up two branches in Beijing and Shanghai in 1997 (*Xinhua*, 19 January 1998; FBIS-CHI-98-019). Another major case is Motorola, which has been a leading player in China's pager and cellular phone market. While Motorola certainly has corporate reasons for investing US\$1.2 billion in China, it is also widely known that the Chinese government has repeatedly urged Motorola to be a good corporate citizen and fully embrace the Chinese market. Partly to placate the Chinese government, which has regulatory power over Motorola's major products in China, Motorola has built a chip plant as well as beefed up manager training in China. More recently, Motorola has joined hands with Datang, a Chinese firm, to develop equipment based on its CDMA standard in an effort to trade technology for more equipment sales (*Economist*, 27 June 1998:65).

Because the barriers to entry are lower in telecom equipment than in aircraft manufacturing, the Chinese government has given strong support to domestic producers, calling on telecom operators to give priority to domestically produced equipment (*RMRB*, 3 November 1998). Support for domestic producers has not only translated into lower prices for procurement but also substantial improvement in the competitiveness of domestic producers. As late as 1995, China still imported 30 percent of the telecom network equipment. In 1996, however, Chinese companies (including joint ventures) produced 90 percent of the newly installed telecom equipment. Government officials suggest that the presence of domestic competition based on lower costs has kept equipment prices substantially lower than would have been the case had China relied on imports. Indeed, the expansion of domestic production capacity and competition has driven down the prices of program-controlled switches in China and is believed to have saved China hundreds of millions of dollars in procurement costs as it dramatically expanded its telecommunications network into the second largest in the world by 1997 (Yang, 1998).

Competition has speeded up the introduction of technology into the Chinese market as well. In cellular telecommunications, for example, the nationwide services have made the transition to digital GSM services. Several trial CDMA (Code Division Multiple Access) networks have been set up and are competing to make the technology a viable one in the Chinese market. Moreover, Chinese switching equipment producers such as Shanghai Bell and China Great Dragon Telecommunication Group Co Ltd have apparently gained technical prowess in competition and begun to capture some export orders for telephone exchanges (Yang, 1998). Meanwhile Chinese firms have also begun to enter the wireless infrastructure area. In spring 1998, the Datang Mobile Communications Equipment Co. was set

up in Shanghai through a joint venture between First Research Institute of Post and Telecommunications (42 percent), Shanghai Post and Telecommunications Equipment (40 percent), and the Academy of Telecom Technologies of Post and Telecommunications (18 per cent). This company hopes to produce GSM digital switchboards and equipment used in wireless telecom stations, which have so far been the preserve of Western telecom companies. The two research institutes were funded by the government during the Eighth Five-Year Plan period to pioneer the domestic production of equipment used on the 900/1,800 Global System of Mobile phones (GSM) (HKS, 10 March 1998).

Photographic film: using foreign investment to restructure state enterprises

Another highly visible case is the photographic film industry. China is still an under-photographed market. Less than one in ten Chinese households owns a camera; and the average family shoots only half a roll of film per year. Yet China is already the third largest film market in the world, with sales quickly approaching one billion dollars a year. If each family takes a full roll, that would be equivalent to adding an entire American market to the film industry (*The Economist*, 28 March 1998:60).

As in the rest of the world, Fuji and Kodak have become industry leaders while Chinese producers have gradually fallen by the wayside because of backward technology, poor capitalization and inadequate marketing. One after another, Chinese film producers joined forces with the giant multinationals to escape the fate of oblivion. The last remaining major Chinese film producer is Lekai Co., commonly known as China Lucky Film Co., which has about 20 percent of the local market. In consequence, there has been much discussion in the Chinese media about the prospect of China without an indigenous film producer and thus losing its national film industry to multinationals.²⁹ The general manager of Lucky claimed that competition from Lucky kept film prices within China much more affordable than had only foreign brands existed. He also argued that foreign control of Lucky would lead to difficulties for Lucky's suppliers and affect industries such as electronics, defense, and certain specialty areas that used Lucky's products (*JJRB*, 1 August 1996:1). The Chinese government was reluctant to let Fuji and Kodak to take over Chinese film-makers. Instead, foreign producers were asked to enter cumbersome and restrictive joint ventures with Chinese partners. Until recently, most Kodak films sold in China came through Hong Kong and were often smuggled in.

It was not until the much-heralded Fifteenth Party Congress of 1997 that the Chinese government finally relented. Kodak, which had until 1997 lagged behind Fuji, was, after four years of negotiations, allowed by the State Council to take over three obsolete Chinese film and photographic products companies for \$380 million. It would team up with

Shantou Era Photo Materials Industry Corp and Xiamen Fuda Photographic Materials Co as well as Wuxi Aermei Film and Chemical Corp to form two new companies to be controlled by the US side. Kodak promised to spend another \$700 million to modernize these companies. With the deal, Kodak gained the right to locally manufacture and distribute film and sensitized photographic materials, thus allowing it to escape the 40 percent import duties and gain a competitive edge over arch-rival Fuji (*The Economist*, 28 March 1998:61). Moreover, Kodak has also provided funds to three other money-losing Chinese film-makers in exchange for a promise not to tie up with a non-Kodak partner until 2001. In other words, Fuji will be locked out of similar ventures in China except through China Lucky Film, the only other and profitable Chinese film-maker that both Kodak and Fuji have sought to control.

So far, the Chinese government has refused to allow a foreign investor to take control of Lucky. Indeed, Lucky itself has been seeking a joint venture partner but has publicly resisted any deal that would mean loss of majority control (and its brand name) and has been supported by former premier Li Peng as well as premier Zhu Rongji and vice premier Wu Bangguo. While China has opened the door to Eastman Kodak, it has also worked hard to ensure the survival of Lucky. Lucky was promised an 800 million yuan (\$96 million) state capitalization, credits of 3.2 billion yuan and tax breaks on imported equipment, a concession usually reserved for foreign investment in high-technology industries, to help finance a major expansion project.³⁰ Lucky may also be granted special treatment in corporate income tax. At the start of 1998, through the intercession of premier Li Peng, Lucky converted into a shareholding company and listed on the Shanghai stock exchange, raising about 450 million yuan. In the meantime, Lucky has worked hard to improve management practices. It has broken down internal boundaries, strengthened its sales and service network that lagged behind its international rivals, as well as strengthened its research and development. Lucky hopes to have sales of 3.3 billion yuan by 2000 and 8 billion yuan by 2010 and sell one third of its products on international markets (Zhu Jianhua and Wen Hong, 1998).

It remains to be seen whether Lucky can survive independently. In fact it continues to search for a foreign partner but in the form of a joint venture or technology transfer. Yet the Chinese government's strategy in overseeing the photographic industry is also quite clear. Until 1997, China steadfastly resisted the multinationals to protect domestic industry. While the Kodak deals in 1998, with the blessing of incoming premier Zhu Rongji, marked a major turning point, they also are beneficial to the Chinese side in that the deals aided China's efforts to restructure state-owned enterprises. Kodak not only spent a substantial amount to purchase the assets of three ailing state firms (the Chinese side kept minority stakes) but also would continue to employ 2,000 workers who would otherwise have faced difficulties if the three firms had not survived. In other words, the Chinese government is

allowing multinationals to take control of firms in non-strategic industries in return for continued employment of state workers (Bacani, 1998). Such a strategy also allows the Chinese leadership to claim credit for opening up its domestic market and thus facilitate China's negotiations for WTO membership.

Soft drinks: multinational market leaders as corporate citizens

While the sort of bargaining between the Chinese government and multinationals is more common in manufacturing industries such as aircraft manufacturing, automobiles and telecommunications, occasionally such bargaining can also be found in relatively low-tech areas such as soft drinks.³¹ While Coca-Cola has gained preeminence in the Chinese market, it has nevertheless been mindful of Chinese concerns about the loss of national industry since many of China's own soft drink companies have joined hands with Coca-Cola to become bottling plants. Partly to burnish its political image in China, Coca-Cola (China) developed several brands of fruit-flavored and bottled tea drinks such as Tian yu di (heaven and earth) and Smart specifically for the Chinese market (*DJN*, 1 September 1998). In exchange for unimpeded access to the Chinese market, Coca-Cola, prodded by the Chinese government's National Council of Light Industry, gave the recipe for Tian yu Di to the Chinese government gratis to allay Chinese concerns about multinationals taking over native brands. The trademark was registered by the Tianjin Jinmei Beverages Ltd. Nevertheless, Coca-Cola saw this as a win-win situation because its bottlers will be doing the bottling.

Discussion

The sectoral surveys presented here should adequately convey the relatively strong bargaining position the Chinese government has enjoyed vis-à-vis multinational corporations. While they are not exhaustive, the surveys also suggest the conditions under which the market-for-technology is more likely to be successful for China. First, the domestic market must be sufficiently large to attract a number of multinational corporations. The industries generally have enormous economies of scale. Tariff and non-tariff barriers must remain sufficiently high in order that corporations find it economical to invest in domestic production.³² Second, there must be multiple players so that the host government can create a "musical chairs" situation (or divide and rule) and reward slices of the market to players who cooperate by making investments and transferring technology. Hoping to gain first-mover advantages, at least some of the multinationals are willing to meet the Chinese terms. Third, the government's bargaining position is especially strong in industries in which government procurements play a big role, such as automobiles, telecommunications

and aircraft manufacturing, making it possible for the central government to use directives to affect market conditions.³³ In contrast, while consumer electronics met these conditions in the early 1980s, they now have saturated markets and competitive domestic producers, and the Chinese government is content to take a more hands-off attitude toward these industries as of the late 1990s.³⁴ In some consumer sectors, however, foreign players such as Coca-Cola have become so dominant that they are willing to make some minor concessions to placate the Chinese government and critics of foreign dominance.

Three caveats immediately follow. First, the Chinese government's attention was largely focused on high-profile projects which also enjoyed various favorable treatment, including exemption from tariff duties on importation of equipment. The absolute majority of overseas investments, however, did not have to deal with the central government at all and were eagerly welcomed by local governments competing for such investments. Most importantly, even in the case of highly regulated industries, the trend has been toward more market competition, not less (Yang, 1998). Moreover, in industries such as home appliances and electronics, the competitiveness of Chinese firms has enabled the Chinese government to embrace openness.

Second, the fact that multinational corporations are producing in China rather than simply exporting its products there does not mean that they are losers. In most industries, technological progress is so rapid that limited technology transfers to developing countries do not jeopardize the technological leadership of multinational corporations. Meanwhile, access to foreign markets through investment will allow companies to recover research costs and devote more resources for new product development. Moreover, as multinationals increasingly plan their production and marketing globally, it may be in their interest to promote parts production and product design locally to tap the cheap labor, raw materials, talent and local knowledge in those developing countries. In the case of China, some multinational corporations may make location decisions that they would not otherwise make had there been perfect global factor markets. But China does not seem to behave much more differently than most others, including some European governments. Most importantly, the corporations make their decisions based on assessment of their self-interests and they are there to win profits rather than run corporate charities.

Third, even where the Chinese state bargains hard with multinationals, it would be wrong to assume the Chinese state is always strong. In fact, a strong state may be an over-simplified explanation without a clear understanding of the institutional arrangement (Doner, 1992). Indeed, even where the Chinese state presents a strong façade, as in telecommunications regulation, it is nevertheless subject to institutional conflicts and compromises among different interests. It is these conflicts, particularly among different parts of the bureaucracy, that have so far prevented the

passage of a Telecommunications Law and provided the institutional support for a competitor to China Telecom to emerge.

Securing energy and resources for growth

So far our attention has been on China's efforts to regulate the flows of trade and investment. Equally important, however, are the implications of China's rise for the global economy. In this section, we eschew the alarmist views (e.g. Bernstein and Ross, 1997) and instead offer an empirical examination of how China has so far coped with the resource constraints its rapid industrialization has caused. Such an exercise may offer useful insights into China's relationship with the international system.

In significant ways, the impact of China's economic growth on the global trade in resources can already be seen. Projections and speculations about China's demand or lack thereof routinely cause fluctuations in the prices of copper, grain, wool and other products, and have implications for other suppliers and consumers of commodities (Brown, 1995). Recognizing that resource dependence may imply vulnerability, China's government and industry leaders have in recent years began to adopt policies designed to alleviate China's vulnerability. Nowhere are such policies more apparent than in the oil industry, though similar but far less dramatic developments can also be seen in copper and iron ore.

Until the early 1990s, China had enjoyed a domestic surplus of oil production. Indeed, Mao's immediate successor, Hua Guofeng, had adopted a rapid industrialization program that rested on the sale of energy abroad to finance equipment imports. But rapid economic growth has increased demand while domestic supply has stagnated, as old oilfields such as Daqing have peaked and new fields in the western desert have yet to become major producers. In 1993, China became a net importer of oil and refined products. Since then, Chinese imports of crude and petroleum products have increased rapidly, partly in response to declining world prices. Crude oil imports, for example, rose from just 3 million tons in 1994 to 35.5 million tons in 1997.³⁵ In addition to increasing imports, China has stepped up efforts to boost its dwindling crude production to meet its growing demand. In 1997 crude production increased by 8.7 percent to 165.8 million metric tons (but only 17.6 percent higher than the 1992 level), a pace that is unlikely to be sustained (*DJN*, 4 February 1998).

With sustained economic growth, Chinese energy and especially petroleum demand is set to rise further over the long term, especially because China is finally seeing the emergence of private demand for automobiles.³⁶ This has elicited a two-pronged response from the Chinese government. Domestically, it has become more and more willing to invite foreign companies to invest in China's oil industry, although mostly in offshore and desert fields that Chinese companies find challenging. By the Fall of 1997, the China National Petroleum Corporation had signed thirty-six contracts

worth a total of \$790 million with oil corporations from nine countries and regions and the China National Offshore Oil Corporation had signed 126 agreements with oil companies from eighteen countries and areas to utilize \$5.38 billion of foreign capital (Han Zhenjun, 1997).

Since domestic production has stagnated, oil imports have become a fact of China's economic life. This represents a fundamental reorientation of China's emphasis on oil self-sufficiency, a legacy of the Maoist era when the Daqing oilfield was held up as a model for national emulation. Even though low prices have made oil imports relatively inexpensive in the 1990s, China's growing appetite makes dependence on foreign oil an uncertain prospect at best. As one Chinese study points out:

Oil is both a crucial strategic resource and one that is deeply affected by international economics and politics. Every world economic crisis, change in the world political order, and local conflict, particularly conflict in major oil-producing regions, affects the security of the oil supply.

(Lin Ye and Zhang Zhong, 1997)

Studies of Chinese foreign policy have tended to emphasize the potentially destabilizing consequences of China's growing dependence on imported oil. Many studies have pointed to the South China Sea as a potential flash-point as countries with competing claims for resources (primarily oil and natural gas reserves) may settle their conflicts by military means (Calder, 1996; Chang, 1996; Hyer, 1995; Ji Guoxing, 1998; Studeman, 1998; Valencia, 1995).

There is little doubt that China is not content with simply buying oil on the spot markets and subjecting itself to the gyrations of world oil markets, particularly if China relies on one oil-producing region and would thus be vulnerable to a blockade of any one shipping lane or an embargo on any one exporter (Rashid and Saywell, 1998). The sense of vulnerability does not have to translate into military action, however. Indeed, there is growing evidence that China has already chosen an alternative to military action by embarking on competition in the marketplace. Fortunately, the trend toward globalization and privatization has left room for China to satisfy its energy needs and ambitions in the international marketplace. So far, with the slump in world oil prices, oil producing countries such as Kazakstan have welcomed Chinese investments with open arms. While China continues to emphasize domestic production (including production in China's territorial waters), there will be active exploration of overseas operations in order to secure stable sources of energy supplies.³⁷ In short, the Chinese strategy now is to utilize both the domestic and international markets, thus marking the internationalization of China's oil industry.

Indeed, 1997 may be said to have been a watershed in China's energy policy: instead of simply buying oil on the world market, China has been

investing in oil fields worldwide. In order to secure energy supplies for its surging domestic demand, China will prefer to buy foreign oil that is produced by Chinese companies abroad. Chinese policy makers clearly assume that investment in foreign oil fields makes China less vulnerable to disruptions in international oil markets. On September 15 1997, a tanker carrying 60,000 tons of crude oil, the first tangible fruit of China's overseas expansion, berthed at the port of Qinhuangdao in China. This was the first shipment of the overseas-produced oil in the history of China's oil industry. By Fall 1997, the China National Petroleum Corp. and its engineering construction company had bought into oilfields in Canada, Peru, Thailand, Kazakstan, Venezuela, Malaysia and Pakistan.³⁸

China's sense of urgency is reflected in the huge investments it has made. In less than a year, during 1997, the China National Petroleum Corporation (CNPC) pledged more than \$20 billion US dollars for oil concessions and oil and gas pipelines overseas. It has invested in or conducted exploration in twenty-three countries. In addition to oil concessions in Azerbaijan, Kazakstan, Kuwait, Iraq, Sudan and Venezuela, it has also negotiated with Iran, Turkmenistan and Russia.

The most significant indication of China's strategic oil policy shift is seen in Central Asia, especially Kazakstan, which declared its independence from the Soviet Union at the end of 1991. Occupying a territory as large as Western Europe, this sparsely populated country of 17 million is home to vast oil and gas reserves but has been frustrated by its continued dependence for oil and gas exports on pipelines going through Russia. In September 1997, CNPC signed agreements with Kazakhstan to invest nearly \$6 billion in the Aktyubinsk and Uzen oilfields (the deal for Uzen was for 60 percent of the field). The Uzen oilfield is the second largest after Tengiz, with reserves estimated at 1.5 billion barrels. The agreement thus will provide China with a prime energy source in a neighboring country and outside the Middle East. It is a major step toward the CNPC's goal of having the equivalent of two 50-million-ton oilfields by 2010 (Li Yongzeng, 1998).

To win the Kazakstan fields over rivals such as Amoco, CNPC not only paid a premium price of about 30 percent more than its nearest rival but also promised to fund the building of two pipelines, a provision that US companies could not match for economic and political reasons (Rashid and Saywell, 1998). The Kazak-China pipeline, 3,000km (2,000 miles) long, would run from Kazakstan's western oil fields to Karamay in Xinjiang in northwest China and the other (250-km long) would be from Kazakstan to the Iranian border. The Kazak-China pipeline would have an annual capacity of 20 million tonnes (400,000 barrels per day) and be built over extremely difficult terrain (Reuter, 2 October 1997; *Xinhua*, 12 December 1997; FBIS-CHI-97-346). It would cost at least US\$3.5 billion, thus bringing the total price tag for China's Kazakstan commitment to \$9.5 billion thus far.³⁹ For established American multinationals such as

Amoco, Exxon and Texaco, China's aggressive entry into the international energy game means that they have to fight harder. Indeed, just as the Chinese government and especially premier Li Peng lobbied Kazakstan hard on behalf of CNPC, US Vice President Albert Gore also launched extensive lobbying efforts on behalf of US oil companies (Ottaway and Morgan, 1997).

While China has been paying top dollar for the investments, these investments may also make good business sense from a long-term perspective, as Chinese companies are investing at a time when oil prices are at their lowest in 1997–98. This behavior suggests that the Chinese companies assume either sharply increasing domestic demand at home or much higher oil prices in the future (or both).

China's entry into the international oil industry has geopolitical implications (Tsepkalov, 1998). In the case of Kazakstan, that oil-rich country found China, Russia and the United States competing for access to its resources. The deal allows Kazakstan to lessen its dependence on Russia for exports of oil and gas and, indeed, Russia is known to have opposed the Kazak-China pipeline. China's entry into the international oil exploration business thus strengthens the bargaining positions of the oil rich countries and provides countries such as Kazakstan with greater leverage and better prices.

But the Kazakstan case also shows that China can play tough in this arena of high stakes. In the words of one Chinese commentator, "China must not fail in Central Asia as this concerned the survival of the Chinese nation" (Liang Qiang, 1998). US competitors are not happy about the Chinese intrusion. On the surface, the US government has suggested China's participation in global oil and gas exploration provides welcome diversification from the Middle East, which the US also desires (Ottaway and Morgan, 1997). Nevertheless, because China deals with countries such as Iran and Iraq, which the US has sought to isolate, China's growing economic might will thus pose greater challenges for US foreign policy in these areas. In the Kazakstan case, the US is not only unhappy about losing the deal but is also concerned about the pipeline to Iran that might give Iran control over the flow of oil. Thus the China-Kazakstan deal pits China against both the United States and Russia commercially and strategically. For China, the Kazakstan deal not only secures a major source of oil but also serves Chinese domestic policy objectives in that interdependence between China and Kazakstan will make it less likely for the latter to support Muslim separatist activities in China, particularly among the Uighurs in Xinjiang.⁴⁰

Yet all the talk about geopolitical consequences does not obscure the fact that the major players have agreed to compete in the marketplace. Most importantly, the huge stakes that China has been willing to pay suggests that China's oil development strategy will be market oriented.⁴¹ After all, it is China's fear of political and military disturbances to the international oil

markets that has prompted the Chinese leadership to secure overseas oil holdings. In this sense, as in other industries, China is becoming an important player in the global system, but by following current rules, China's entry into the international oil industry thus serves to reinforce the existing order.

Participation in international competition has in turn hastened reforms in China's own oil industry, making China's state oil companies more like their global competitors. Until 1997, the Chinese industry was segmented between upstream extraction and downstream processing. Two majors, China National Oil and Natural Gas Corporation and the China Maritime Oil Corporation engaged in land and maritime oil prospecting and development. In the downstream oil industry, the China Petrochemical Corporation (Sinopec) had thirty-eight large refineries and over 80 percent of China's oil refining capacity. Sinopec also monopolized domestic sales of refined oil while the oil import-export trade was handled by the China National Chemicals Import and Export Corporation, the China Oil and Natural Gas Corporation, and Sinopec.

The segmentation of oil production, refining, sales, and foreign trade served to hinder the emergence of domestic competition, which the Chinese leadership has gradually embraced by the 1990s (Yang, 1998). To promote domestic competition, the Chinese government in January 1997 authorized the establishment of Xinxing (New Star) Oil Co., which was backed by the Ministry of Geology and Mineral Resources at the time. Yet Xinxing, which had revenue of 3.8 billion in 1997 (*JJRB*, 17 January 1998:3), is a minor player at best compared with CNPC and thus has had little impact on domestic competition. Also in 1997, China Eastern United Petrochemical Corp. was formed by the merger of five petrochemical firms.

To fundamentally reshape the Chinese oil industry and suit the needs of international competition, the Chinese government in 1998 launched sweeping restructuring of the industry to create integrated companies with both upstream and downstream operations. Instead of the upstream and downstream segmentation, the Chinese petroleum industry was reorganized along geographical lines. After the reorganisation, CNPC is mainly responsible for exploring for petroleum and natural gas in the northern and western regions of China. It may also develop some petrochemical products. In contrast, Sinopec focuses on the eastern and coastal areas (*AFP*, 10 April 1998). With the reorganization, the two conglomerates will likely join the ranks of the world's 500 largest.

In short, while China's surging energy needs may presage conflicts, China's actions suggest that the Chinese leadership has found the solution in the marketplace. China's willingness to abide by the rules of the market does not mean that Chinese leaders are ready to embrace the borderless markets unconditionally. China's effort to gain control over sources of oil suggests that it continues to value traditional ownership and is willing to pay for such ownership. The point is not lost on multinationals. After all, as

global giants such as Caterpillar or CNPC have repeatedly found out, in tough, high-risk, high-opportunity markets, having a government providing support counts (Uchitelle, 1998). Nevertheless, China has in many ways become a status quo power as it spins a web of investments.

Conclusions

Two decades after Mao's death, China has shed its autarchic shell and embraced openness and competition (Yang, 1998). As a researcher from the Ministry of Foreign Trade and Economic Cooperation put it: "The national economy [of China] should be open; it should not discriminate against the globalized economy. The national economy is a part of the world economy; it is an extension of and a supplement to the world economy." (Liu Shu, 1997). At the time of Mao's death, a person making such a statement in China would probably land in political trouble. Today, global integration is the Chinese orthodoxy. The buzzword for China now is *jiegui* (literally, linking up the rail tracks), with China accepting international practices.

As China becomes more deeply integrated into the global economy, its behavior has also become more "normalized." Gone is the revolutionary rhetoric that China sported when it returned to the world stage in the early 1970s. It has entered the World Bank, International Monetary Fund (IMF), Asian Development Bank, Asia-Pacific Economic Forum (APEC), and is negotiating to join in the World Trade Organization (WTO). This further strengthens China's interests and stakes in an open global economy. Indeed, Chinese leaders regularly talk about China respecting international norms and playing by the global rules of the game (see, e.g., *QB*, 18 June 1998:4).

Our study of Chinese engagement with the outside concurs with earlier studies about efforts by the Chinese leadership to control the process (Pearson, 1991). Yet the effectiveness of Chinese bargaining has varied over time. When China had just started its market-oriented reforms, few investors came. As the Chinese economy grew and reforms speeded up, China's attractiveness as an investment destination increased, giving China some leverage over foreign investment flows. That leverage was limited, however, as the Chinese leadership found out in adjusting its investment policies in the mid-1990s. Nevertheless, the central government has targeted large foreign investment projects and appears to have succeeded in getting multinationals to bring technology and know-how into China. Globalization has therefore helped speed up Chinese reform by forcing Chinese companies to meet international competition in both international and domestic markets.

While foreign investment has heightened competitive pressures on domestic enterprises, the Chinese now recognize that the multinationals have been instrumental in upgrading China's technological level whether in consumer electronics, consumer durables or telecommunications (He Xi,

1998). The Chinese have gone far beyond just “crying wolf.” While they recognize the competitive dangers from the globalization of the Chinese market, the dramatic success of Chinese producers in the consumer electronics and consumer durables have convinced them that Chinese firms can become more competitive globally through competition. As one Chinese commentator suggested, China may have more successful companies as the Chinese open up further (He Xi, 1998). By the late 1990s, an economically rising China has become increasingly confident of its participation in the world economy.

China’s economic ascent has meant both opportunities and concerns for the international community. China’s reforms at home and interactions with the outside world since the 1970s suggest that China is increasingly becoming a responsible member of the global economic community. More evidence in support of this statement can be found in China’s recent forays into the international oil markets. Whereas some analysts have suggested that China’s surging energy demand may presage conflicts, China’s actions suggest that the Chinese leadership has found the solution in the marketplace here as well. And as China spins its web of international deals, the incentives for it to become a status quo power increase.

Fundamentally, even though China started the process of opening up with the express aim of making use of foreign technologies while preserving the Chinese system, increasingly it is behaving like a member of the global system. This is suggested by China’s quiet behavior in the IMF, the World Bank and other international economic organizations (Pearson, 1998). But the point is especially driven home by China’s performance during the Asian financial turmoil of 1997–1998. Like its more prosperous neighbors, China chipped in with funds to help bail out Thailand and Indonesia. Most importantly, in spite of domestic difficulties, China’s leaders stood by their pledge of currency stability after the collapse of the Korean economy in late 1997 rather than joining in the spiral of competitive devaluation that every Asian economy, including Japan and arch-rival Taiwan, took part in. While China’s actions served its own interests (such as helping Hong Kong maintain its currency peg to the US dollar and not increasing the debt burdens for Chinese companies loaded with foreign debt), they have provided relief to beleaguered Asian countries and won grudging respect internationally.

China has thus shown itself to be not just a free-rider on the trend toward globalization, but one that is willing to play by the rules and take on global responsibilities even as it aggressively tackles painful reforms at home. Indeed, Chinese officials, such as central bank governor Dai Xianglong, commented that taking into account other countries reflects “the ethics and morals that a big country like China should have.” In short, while China’s international behavior is still far from ideal, it has nevertheless stepped up to the role as anchor of stability for the Asian

economy, thus signaling its re-emergence as a regional and even global economic leader.

Notes

- 1 The authors are grateful to Bruce Dickson, Aseem Prakash, Jeffrey Hart, Peter Katzenstein and participants of the Globalization Conference for their helpful suggestions.
- 2 In the 1950s, China interacted extensively with the Soviet Union and Eastern Europe. Even during the Cultural Revolution, however, China continued to trade with the West via Hong Kong.
- 3 Hong Kong is treated as a separate trade area and ranked ninth in merchandise exports in 1997.
- 4 There is considerable debate on the meaningfulness of this measure owing to the difficulty of currency convertibility. For a discussion of these issues, see Lardy 1992, Appendix B. China's trade dependency ratio would decline substantially from the nominal terms if the GNP figure is adjusted for purchasing power parity. However, the robust growth trend remains.
- 5 Needless to say, foreign investment is distributed unevenly within China. Guangdong province, which borders on Hong Kong, had a trade volume of 130 billion dollars, or about 40 percent of China's foreign trade, in 1997. Every 3 percent increase in foreign trade translates into 1 percentage economic growth for Guangdong, versus 7 for China as a whole (*QB*, 10 March 1998:20).
- 6 The number of companies refers to those that commenced operations in China, not the number of registrations.
- 7 China's growing presence overseas has begun to attract attention from host governments. While the amount of Chinese investment in Britain has been rather small so far (19 million dollars as of June 1997 according to Chinese statistics, which clearly is understated), the British government has sent its Chief Executive of the Invest in Britain Bureau to visit China and offer seminars on investing in Britain and to introduce policies to guide Chinese investment in Britain. "Britain Seeking More Investment by Chinese Enterprises," *Xinhua in English*, September 9, 1997; FBIS-CHI-97-252.
- 8 It can be argued that the availability of investments from Hong Kong, Macau and Taiwan eased the fears of conservatives resisting overseas investment to some extent because such investments potentially facilitated China's unification with these entities by creating business interests that favored interaction with the Mainland.
- 9 Calculated from *Statistical Yearbook of China*, various years.
- 10 While SOEs had a 55 percent tax rate, foreign investors generally paid only 15 percent. This discussion draws on field interviews.
- 11 Major enterprises also sponsored studies by research institutes that criticized foreign investment. Some firms, such as the Jianlibao Group, a Chinese soft drink company, sponsored conferences calling for government protection of indigenous industries (personal interview).
- 12 Personal interview.
- 13 It should be noted that China's general tariff levels were also coming down. A major objective of the policy changes was to replace particularistic tariff exemptions with a uniform tariff system.
- 14 Municipal authorities in Beijing required McDonald's to pay some thirty-one taxes and fees each year, of which seventeen have since proven illegal (Harding, 1997).
- 15 Globally the big five developed economies (US, UK, Japan, Germany and

- France) accounted for 62 percent of the foreign investment up to the end of 1996.
- 16 For evidence of continuing criticism, see *Sing Tao jib Pao* (Hong Kong), January 27, 1998, p. 4; translated in FBIS-CHI-98-035, February 4, 1998. See also Chen Bingcai, Wang Yunguan and Yao Shumei (1998) for a summary of the harmful effects of foreign investment.
 - 17 Skillful marketing has also helped. Most Chinese consumers, for example, do not know that Sprite, called Xuebi in Chinese, is a Coca Cola product. In contrast, many Chinese products have foreign-sounding names.
 - 18 As in industry, government leaders are concerned that rapid liberalization may hurt the domestic service industry. However, the resilience of Chinese industry has convinced some Chinese economists that the introduction of competition may speed up reform of domestic firms and make them more competitive over the long term (*CDBW*, 6 April 1998:1).
 - 19 Report on Wu Yi's speech at the national conference on foreign trade, *Xinhua*, 8 February 1998; FBIS-CHI-98-039.
 - 20 For products using Xinjiang cotton, the rebate rate was increased from 9 to 17 percent.
 - 21 The new rebate rates became effective on June 1, except for textile machinery (January 1). Note that the highly competitive electronics and home appliance industries failed to secure increases in tax rebate rates.
 - 22 There have also been other measures. For example, following a precipitous plunge in Taiwan investments, the Ministry of Public Security significantly eased travel and residency rules for Taiwan investors in October 1998. As to forecasts on China's economic performance, they have predictably varied. A report in the *China Economic Times*, for example, said China's foreign direct investment could drop by a third to \$30 billion in 1998 from \$45 billion in 1997 (*CET*, 3 March 1998).
 - 23 Until very recently, Chinese tariff levels have remained quite high. A foreign producer thus fears conceding the Chinese market to competitors making direct investments in China.
 - 24 Because the auto industry case is so obvious, we have decided to focus on other sectors here, partly to provide more variations.
 - 25 In the aftermath of a string of accidents, Chinese air travelers have tended to favor travel on planes by the top plane makers and tend to avoid planes made in the former Soviet Union.
 - 26 In the Fall of 1998, Airbus dropped out of the project for financial reasons.
 - 27 For an extended treatment of this topic, see Wei-chin Lee, 1997.
 - 28 In 1998, the SPC became the State Development Planning Commission while the MPT was merged into the Ministry of Information Industry.
 - 29 Kodak approached Lucky in 1995 and offered to buy 80 percent of the company and make Lucky use the Kodak name. The offer was rebuffed (Bacani, 1998).
 - 30 The Ministry of Chemical Industry also lobbied for an anti-dumping law to protect the fragile domestic industry in 1997. But this would have been of limited usefulness as long as foreign films on the Chinese market were smuggled into China without paying tariffs (a smuggled brand name film sold for only one third to one half of its import price in Guangdong) (*CDBW*, 1 July 1997:1, 8).
 - 31 So far China has opened the door only slightly in the area of services.
 - 32 This means that the market-for-technology strategy may gradually disappear as China steadily reduces its tariff levels.
 - 33 In the automobile industry, the government's industrial policy links local content level with the level of parts imports so that automotive producers have strong incentives to boost the percentage of locally-produced parts.

- 34 Just a few years back, however, the Chinese government was much more active in this sector.
- 35 The State Planning Commission's Energy Research Institute forecast that China needs to import 30–50 million tons of oil and 20–40 billion cubic meters of natural gas by 2000. By 2010, oil import may surge to 90–170 million tons while natural gas imports is likely to rise to 50–80 billion cubic meters (Shuang Zhou, 1998).
- 36 Even with oil demand growing at only 50 or 60 percent of the rate of economic growth, the gap between domestic production and consumption is expected to increase steadily. Chinese forecasts call for China's oil imports to reach 40 million tons by 2000 and 80 million tons by 2010 (Han Zhenjun, 1997). In contrast, Xiao Guang Tong, president of CNPC International Kazakhstan, told the fifth annual KIOGE oil and gas conference in Fall 1997 that China would need to import 30 million tons of oil annually by 2000 and 40 million tons by 2010 (Reuter, 2 October 1997). Xiao's figures were at the 1997 levels. He probably offered these conservative figures in order not to alert international players. In the meantime, others have estimated that China will need to import 50 million tonnes of oil or about 30 percent of its needs annually by as early as 2000 (Rashid and Saywell, 1998).
- 37 China's domestic oil development strategy now calls for joint promotion of oil and natural gas output and more intensive use of new technologies (such as tertiary oil recovery) in order to maintain domestic output of 120 million tons of crude oil through the year 2000.
- 38 The China Petroleum Engineering Construction Co. had signed 230 overseas oil and technological service contracts and completed 1.6 billion US dollars worth of contracts (*Xinhua*, 16 October 1997; FBIS-CHI-97-289).
- 39 Even then, the pipeline will still only reach China's western border and is still about 2,000 km from the eastern coast.
- 40 During his visit to China in May 1998, Kazakstan's prime minister, Nurlan Balgimbaev, pledged to back Chinese efforts to fight separatism and said separatists would not be allowed to operate in Kazakstan. "Kazakstan's Premier Supports China In Separatism Battle," AP-Dow Jones, May 7, 1998.
- 41 There is thus a significant similarity with the US case, see Ikenberry, 1988.

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2 In the shadow of broken cheers

The dynamics of globalization in South Korea

Chung-in Moon

Despite the lingering Japanese colonial legacy, devastating impacts of the Korean War, and poor resource endowment, South Korea has transformed itself from one of the poorest nations to the 11th largest economy in the world in a relatively short span. Its dynamic transformation has underscored a convincing pathway to the core from the periphery. The developmental state, strategic industrial policy, and network synergy of the government and business were often singled out as secrets of South Korea's paramount ascension to the core, all of which were manifested in a subtle form of (neo-) mercantile ideas and practices. Its renowned outward-looking orientation notwithstanding, South Korea had long remained a protectionist state (Amsden, 1989; Wade, 1990).

But South Korea could not hide itself in the mercantilist closet any longer. Higher levels of economic development and industrialization as well as the increasing weight of trade in its economic life have gradually exposed it to internal and external pressures for a greater opening and liberalization. While bilateral and multilateral outside pressures have begun to crack the hardened outfit of mercantilism, internal pressures associated with eroding international competitiveness have heightened needs for liberalization and structural changes. South Koreans now realize not only structural limits to the mercantilist ethos, but also the fact that globalization is no longer a matter of choice, but an unavoidable reality.

As with modernization, however, globalization is not always a linear, evolutionary process, but it could be turbulent, traumatic and uncertain. The economic crisis in 1997 exemplifies the dark side of globalization *par excellence*. South Korea, once a proud nation of economic vitality, has degenerated into a fragile and depressed nation under the IMF economic trusteeship. Cheers of globalization, which were evidenced by the ratification of the Uruguay Round and the admission to the OECD, are now broken, and the despair and fear of corporate bankruptcy, unemployment and economic hardship is sweeping the entire society.

This chapter is designed to explore the dynamics of globalization in South Korea in the light of the recent economic crisis. The first section addresses some analytical issues pertaining to globalization. The second traces the challenges of globalization and managerial responses. The third section looks

into impacts of globalization on economic management and analyzes external determinants of the economic crisis in South Korea. Finally, the chapter deliberates on the consequences of globalization and new coping strategies under the Kim Dae Jung government, and suggests several theoretical, empirical and policy implications.

Two faces of globalization: spontaneous vs. managerial

Globalization is not simply an analytical construct, but a concrete, evolving reality. Thus, it is not easy to conceptualize the dynamics of globalization in a coherent manner. Its conceptualizations can vary by respective ontological, epistemological and normative positions (Prakash and Hart, this volume; Falk, 1997; Hirst and Thompson, 1996; Ohmae, 1990; Rodrik, 1997b; Germaine, 1997; Kofman and Young, 1996). Nevertheless, globalization can be best operationalized into two categories: one is spontaneous, and the other managerial (Moon, 1995:63–5).¹ While spontaneous globalization refers to the *sui generis* formation and evolution of global interdependence through the development of human civilization and expansion of global society, managerial globalization can be defined as states' and other agents' coping strategies to deal with opportunities and constraints emanating from spontaneous globalization. It can thus be seen as strategic responses to the natural expansion of global interdependence, interconnectedness and integration.

Spontaneous globalization

Spontaneous globalization is closely related to the development of technology and world capitalism. Growing economic interdependence and integration must be its most salient manifestation. Integration of market forces has taken place at all levels (Dickens, 1992). Globalization of production through multinational corporations (MNCs) has fostered the rise of “sovereignty at bay” (Vernon, 1971) and “borderless world” (Ohmae, 1990). As of 1995, MNCs accounted for quarter to a third of world output, 70 percent of world trade, and 80 percent of direct international investments (Goldblatt, 1997; Perraton, 1997). MNCs cranked out some \$7 trillion in sales through their foreign affiliates, an amount greater than the world total exports in 1995. And at the end of 1996, the MNCs' total stock of foreign direct investments stood at over \$3 trillion (Levinson, 1997). Such globalization of economic activities is a result partly of governments' policies on fiscal, foreign exchange rates, investment and wages. But more important are natural market forces involving product life-cycles, shifting market parameters, corporate strategies for survival and expansion, and related efforts to generate excess profits.

Global diffusion of production through geographic and functional division of labor has also integrated the movements of factors of production. Despite increasingly stricter regulations on immigration,

transnational movement of manpower has increased more than ever before. The trend can be attributed partly to growing regional integration such as the European Union and the North American Free Trade Area. But the law of supply and demand also matters. Defying legal regulations on immigration, market demand of manpower has precipitated and expanded inflow of foreign workers in select advanced industrial countries such as the US and Germany.

Capital and financial markets are also no longer confined to national boundaries (Cerny, 1994; Helleiner, 1994). Transnational networks of financial transactions have brought about profound impacts on the globalization of capital. The expansion of Euro-dollar markets, the advent of financial centers in such important cities as Hong Kong and Singapore, and synchronized electronic financial transactions on a global scale are testimonials to the new trend. The daily foreign exchange turnover has increased from \$15 billion in 1973 to \$1.2 trillion in 1995. Cross-border sales and purchases of bonds and equities by American investors have risen from the equivalent of 9 percent of GDP in 1980 to 164 percent in 1996 (Levinson, 1997). Technology has also rapidly globalized. Strategic alliances, joint-investments in research and development, and cross-licensing among multinational corporations, which transcend government control, underscore the triumph of technoglobalism over technonationalism (Candice, 1991; Westney, 1992).

Globalization of production cannot be separated from the expansion of international trade. The volume of world merchandise trade is now about sixteen times what it was in 1950, and the ratio of world exports to GDP has climbed from 7 percent to 15 percent during the period 1950–1996 (Levinson, 1997). In 1993, the total volume of world trade reached to US\$3.7 trillion, and it is expected to increase to US\$7 trillion by the year 2000 (Scott, 1993:33). The growth of world trade has accompanied deepening economic interdependence of nations as well as globalization of national economies. Unlike the past, today's economic interdependence is not a phenomenon confined only to OECD countries, but it has been extended to all the nations in the world. Autarky and self-reliance no longer exist.

In view of the above, spontaneous globalization can be regarded as grand historical processes that transform the world into organic and functional networks of complex interdependence by tearing down artificial national boundaries.²

It should be, however, noted that the process of spontaneous globalization is not always gentle, beneficial, and welfare-maximizing. On the contrary, spontaneous globalization can entail new constraints, challenges and penetrating traumas. It can jeopardize precious national values such as democracy, economic security, social stability and welfare, and state sovereignty (Mittelman, 1996; Rodrik, 1997a; Kim, 1998).

The most formidable threats of globalization can be seen in the economic

arena. Globalization can endanger national economies in three distinct ways. They are systemic vulnerability, relational sensitivity and structural dependency (Moon, 1995). Systemic vulnerability arises from the transmission of uncontrollable external shocks from the international economic system into the domestic economy (Keohane and Nye, 1977). Cyclical instability of the international financial and capital markets, roller-coaster effects in international commodity markets, unstable foreign exchange markets, and global diffusion of inflation are its classical sources. They are not man-made, but inherent in the structure and process of the world capitalist system. The more integrated into the international system, the more vulnerable. Nevertheless, economic superpowers such as the United States can cope with them more effectively by altering norms, principles and rules of the international economic system *per se*. But weaker nations cannot but internalize enormous social costs arising from the process of adjusting to these external shocks. Internal adjustment and the resulting social costs could eventually destabilize the domestic economy and politics. Chronic economic and political instabilities in many parts of the Third World can be ascribed in part to these type of threats associated with the globalization of national economies.

Relational sensitivity refers to impacts and related costs of bilateral pressures. They can usually be managed within existing policy frameworks, yet with high domestic adjustment costs (Keohane and Nye, 1977). This type of cost is more visible in trade than any other areas. A nation's trade relations cannot be constant even across partners and sectors over time. Trade relations are bound to be skewed and fluctuating, often leading to partner and item concentration. Such concentration and resulting partner and item dependence can weaken a nation's bilateral bargaining power, which in turn makes unavoidable domestic accommodation of external pressures. Recent American bilateralism presents a good example in this regard. As Japan, South Korea and Taiwan have enjoyed trade surpluses, the United States has pressed them to open their domestic markets and to correct unfair trade practices in an effort to reduce bilateral trade deficits. Such bilateral pressures can incur higher costs on domestic political and economic adjustment. Obviously, the more globalized one's economy is, the greater the level of relational sensitivity.

Structural dependency results mostly from the globalization of production. In search of low wages, new markets and a favorable business climate, multinational corporations shift their production sites from one country to another. In the process, they wield enormous political and economic influence by forming alliances with local capital and hosting governments (Evans, 1979). Such foreign capital penetration could not only limit hosting nations' political autonomy and economic sovereignty, but also distort the nature and direction of their economic development. Perpetual underdevelopment and inequality in Latin American countries are often attributed to their structural dependency on foreign capital.

Managerial globalization

Coping with vulnerability, sensitivity and dependency, which spontaneous (or economic) globalization accompanies, becomes important national tasks for most countries. Hence arises the relevance of managerial globalization. Its center stage is the state. Waves of spontaneous globalization have not yet swept away state sovereignty (Evans, 1997; Boyer and Drache, 1996). Facing the challenges of globalization, the state can take diverse managerial responses. It can defy, adapt, or accommodate them. Its strategic management can vary by domestic and international contexts. But options are very limited. No country can outright defy forces of spontaneous globalization. For most countries, options fall between adaptation and accommodation.

Adapting to or accommodating the challenges of globalization is contingent upon the dynamic interplay of ideas, interests and institutions (See chapters by Anchoroguy, Solnick, Yang, and Ravenhill in this volume). First, ideational changes are essential. No countries can cope with the challenges of globalization with closed, inward-looking, and xenophobic ideas. There must be open, outward-looking and universal ideas to adapt to or accommodate waves of spontaneous globalization. Second, ideas alone are not enough. The formation of new interests and underlying coalitions that can support opening up and liberalization is indispensable to the adaptation to and accommodation of globalization. It is so, precisely because the longer duration of closure and protection is likely to cultivate powerful domestic political coalitions that could resist the process of globalization. Finally, there needs to be a radical departure from the institutional inertia of the past, which is usually characterized by excessive regulation, extensive protection, and irrational modes of policy practices. Thus, rationalization, liberalization and deregulation emerge as the core of institutional restructuring to cope with the challenges of spontaneous globalization.

The dynamics of globalization in South Korea

Mercantile ethos and Korean development

Korea has traditionally been known as a hermit kingdom. Its modern history was littered with bloody struggles between reformers favoring open-door and conservatives favoring closed-door. Being a victim of forced opening and subsequent Japanese colonial domination, xenophobic perceptions has long socialized Korean minds (Cumings, 1994). Such inward-looking orientation cultivated an ideal niche for mercantile ethos that governed its economic management. Very few would refute the idea that rapid economic growth, assertive industrialization and the phenomenal expansion of manufactured exports in South Korea have

resulted from a rather unique pattern of economic management which combined Keynesian structuralism with strategic intervention via industrial policy. Amsden (1992) characterizes it as the epitome of the “late-industrialization” model, as opposed to the “Anglo-Saxon” one. Others have touted it as the prototype of the developmental state model or *dirigisme* (Haggard and Moon, 1983; Haggard, 1990; Johnson, 1987; Wade, 1990; Amsden, 1989). The Korean state was never a minimalist one, envisioned by neoclassical economists, whose role was confined to the provision of collective goods and to the facilitation of market mechanism through market-conforming policies. It even went beyond the Keynesian state of manipulating an arsenal of macroeconomic parameters. The Korean state was actively interventionist with its clearly defined objectives and preferences. It made strategic intervention in markets and mobilized and allocated resources in order to achieve them. The state and business maintained close ties, but not on an equal footing; the state was pace-setter and guide, while business followed. The state occasionally commanded and disciplined the private sector.

The late-industrialization model was justified in the name of developmentalism. The developmental ideology was framed around two normative goals: economic growth and national security. Political leadership in the 1960s and 1970s was obsessed with an imperative to expedite the process of modernization through export-led economic development. Escaping from poverty and economic backwardness was vital to legitimacy and popular support. Economic growth and industrialization were also interpreted as a solution to South Korea’s security dilemma. After the late 1960s, South Korea faced a deteriorating security environment. The old Japanese nationalist ideology of “rich nation, strong army (*Bukuk Gangbyung/Fukoku Kyoei*)” resurfaced as the dominant paradigm in South Korea, dictating the nature and direction of its economic management (Samuels, 1994). It was through political leadership’s blind obsession with the developmentalist ideology of growth and security that shaped and steered the mercantile nature of economic management after the early 1960s (Moon, 1999).

Economic management in South Korea undertook two distinctive patterns of defensive protectionism. The first involved the protection of infant industries through an import substituting industrialization strategy (ISI). As Robert Wade (1990) argues, despite public claims on an outward-looking development strategy, South Korea has relied heavily on ISI until the mid-1980s. Being a backward nation, South Korea could not catch up and compete with its major trading partners under free-market conditions. Thus, South Korean policymakers strongly believed that domestic markets should be protected until the national economy was strengthened and more competitive. It is in this context that the South Korean government made an extensive intervention in the economy by identifying strategic industrial sectors and mobilizing and allocating financial resources to them.

Domestic markets were to open only after the nation attained international competitiveness. As noted above, this approach was coined as the “late-industrialization” model.³

However, South Korea’s defensive protectionism was not limited to the infant industry protection alone. It has extensively practised both tariff and non-tariff barriers. Although successive rounds of multilateral trade negotiations within the framework of the GATT have reduced tariff levels over the years, South Korea, along with Japan, has become notorious for its extensive and aggressive application of non-tariff barriers (NTBs). NTBs in South Korea took two distinct routes. One involved the imposition of non-tariff barriers from the demand-side, and the other the adoption of industrial policies from the supply-side. Non-tariff barriers from the demand-side were designed to restrict import penetration through means other than tariffs. Some non-tariff barriers were permissive within the framework of GATT, but most were arbitrary as dictated by domestic politics. Outright import restrictions using the positive list system, quotas, government procurement policies, industrial standards, customs valuation, exclusive distribution networks, and bureaucratic red tape have all served as integral parts to non-tariff barriers.

Supply-side NTBs were also quite extensive, provoking frequent international trade disputes. South Korea blended the Listian model of late industrialization with an export promotion strategy. In doing so, the South Korean government aimed at enhancing international competitiveness by creating artificial comparative advantage through strategic industrial policy, while protecting domestic industries through an array of non-tariff barriers. Industrial targeting, subsidies, selective market protection, and artificial linkages between trade and industrial policy characterized this supply-side defensive protectionism.

In view of the above, South Korea was neither open nor liberal by Western standards. Its opening was, by and large, tactical rather than strategic, and protectionist institutional arrangements have been deeply entrenched. Open competition through fair and free trade was rather foreign to Koreans. Adherence to the late industrialization model was justified partly in terms of “catch-up” mentality and partly through the invocation of the Confucian Asian value that emphasized the importance of state authority in steering civil society and economy. Equally important was the formation of the developmental coalition between the state and big business, which was instrumental for sustaining the mercantilist foundation of the Korean economy from the mid-1970s to the mid-1990s. While the state rewarded big business through preferential allocation of credit, protection of domestic markets, and entry regulation of foreign equity capital, big business reciprocated the state and the ruling regime by making political contributions as well as serving as the principal agents of economic growth which were vital to regime legitimacy and survival (Moon, 1995). However, the mercantile ethos and practices could not last long. As

Table 2.1 Trends of export, import and ratio to GDP

(Unit: US\$ billions)

	<i>Exports</i>	<i>Imports</i>	<i>Trade</i>	<i>GDP</i>	<i>Trade (%)</i>
1960	0.03	0.34	0.37	2.0	18.50
1965	0.17	0.46	0.63	3.0	21.00
1970	0.84	1.98	2.82	8.1	34.81
1975	5.08	7.27	12.35	21.3	57.98
1985	30.28	31.14	61.42	94.3	65.13
1990	65.02	69.84	134.86	253.6	53.18
1994	96.01	102.35	198.36	380.7	52.10
1995	125.06	135.12	260.18	456.5	56.99
1996	129.72	150.34	280.06	484.4	57.82
1997	138.59	142.46	281.05	442.6	63.50

Sources:

(1) Exports & Imports 1960–1996, Bank of Korea; 1997, Ministry of Finance and Economy, Korea.

(2) GDP, Bank of Korea.

a developed trading state, South Korea began to face the brave new world of spontaneous globalization.

Spontaneous globalization and limits to mercantilism

The neo-mercantile path to economic growth has brought about double-binding outcomes. While forces of spontaneous globalization have subjugated South Korea to fierce international competition, the very economic success through unfair trade practices evoked enormous outside pressures for market opening and economic liberalization.

More than three decades of export drive have profoundly integrated the South Korean economy into a web of global economic interdependence. As Table 2.1 illustrates, total trade volume in 1965 was only a meager amount of \$630 million, accounting for 21 percent of GDP. But the figure increased to \$12.35 billion in 1975, \$61.42 billion in 1985, and \$260.18 billion in 1995 respectively. The trade volume rose more than twenty times within two decades. Since 1975, the trade volume has consistently accounted for more than 50 percent of gross domestic product, reaching 63.5 percent in 1997. In comparison with other countries, South Korea has become truly a trading state.

Capital and financial flows have also been remarkable. As Table 2.2 demonstrates, inbound and outbound foreign investments have been steadily rising. Total inbound foreign investment was \$1.97 billion in 1985, but rose more than ten times by 1996, reaching \$23.5 billion. Compared with foreign trade, its share in GDP remained minimal, representing 3 percent in 1985 and 4.8 percent in 1996. Outbound foreign investment also rose from \$591 million in 1985 to \$4.6 billion in 1996. But external borrowing rather than foreign investment has played a more important

Table 2.2 Capital inflows and outflows

(Unit: US\$ millions)

	<i>Foreign Investment into Korea</i>				
	<i>FDI from Korea</i>	<i>FDI into Korea</i>	<i>FIDI* into Korea</i>	<i>Total (FDI+FIDI)</i>	<i>FIDI/Total Investment (%)</i>
1985	591	234	1,737	1,971	88.1
1990	1,052	789	218	1,007	21.6
1994	2,461	809	8,147	8,956	91.0
1995	3,552	1,776	13,875	15,651	88.7
1996	4,670	2,325	21,183	23,508	90.1
1997	4,287	2,341	12,546	14,887	84.3
1997. 8	527	253	743	996	74.6
1997. 9	180	40	1,760	1,800	97.8
1997.10	332	150	885	1,035	85.5
1997.11	140	18	-1,481	-1,463	101.2
1997.12	483	204	-1,140	-936	121.8
1998. 1	124	43	308	351	87.7
1998. 2	307	177	1,873	2,050	91.4
1998. 3	360	146	690	836	82.5
1998. 4	239	177	3,650	3,827	95.4

Source: Ministry of Finance and Economy, Korea.

*Including investment into stock and bonds.

role in foreign savings. Reflecting this trend, South Korea's external borrowing rose sharply from \$467.6 billion in 1985 to \$1,544 billion in 1997 (see Table 2.5). Along with growing economic interdependence in trade and capital and financial flows, there have been salient changes in personnel flows.⁴ There were 370,656 inbound visitors and 84,245 outbound visitors in 1972. These figures increased to 3.07 million inbound visitors and 4.6 million outbound visitors in 1996. This is a result partly of the government's policy to liberalize overseas tourism for Koreans, which was strictly controlled in the past. In addition, communication networks have revolutionized the pattern of Korean life-styles.

Expansion of spontaneous globalization through increased economic interdependence exposed South Korea to structural limits of its own defensive protectionism through various negative boomerang effects. Extensive use of tariff and non-tariff barriers was effective in the earlier stage of economic development, but their prolonged utilization severely undercut South Korean firms' international competitiveness. Governed markets through industrial policies also accompanied the dilemmas of economic concentration, rent-seeking, moral hazard and subsidized risks, all of which undermined market mechanism and international competitiveness (Jwa, 1997). In other words, as industries became more mature, government's strategic intervention and market protection reached the point of diminishing return, turning into sources of major liabilities. It is

this internal contradiction of mercantilism that drove South Korea to search for alternative ways of steering its economy.

Outside pressures were also building up. Multilateral pressures became intensified, following the successful settlement of the Uruguay Round and the launching of the World Trade Organization (WTO). The restructuring of the GATT system was predicated on not only zero tariff, but also the removal of non-tariff barriers such as sanctions on unfair trade practices, stricter enforcement of anti-dumping and countervailing duties, correction of discriminatory government procurement policies, and elimination of NTBs involving industrial, health and safety standards. The WTO's strengthened enforcement capability no longer allowed South Korea to enjoy free-riding through an inertia-driven resort to NTBs.

American bilateral pressures also fundamentally constrained South Korea's mercantile practices. Since 1983, the United States has extensively applied bilateral pressures to correct South Korea's unfair trade practices as well as to open its domestic markets. The settlement of the Uruguay Round and the advent of the WTO did not dilute American pressures. On the contrary, the United States has been intensifying its bilateral pressures by invoking Super 301 on South Korea in such sectors as automobiles, steel and the service sector. American bilateral pressures, in tandem with multilateral ones, made it extremely difficult for South Korea to continue to rely on the traditional practices of export promotion and domestic market protection (Kim, 1996).

Globalization strategy: managerial responses

To respond to the challenges of spontaneous globalization and associated domestic and outside pressures, the Kim Young Sam government undertook a new strategic offensive. It was manifested in his *seggyehwa* (globalization) campaign (*Sechuwi*, 1998; Kim, 1998).⁵ The move reflected a major shift in the thinking of economic management from a defensive, mercantilist adaptation to external changes to a positive accommodation of outside stimuli. Globalization was more than a political slogan or an administrative guide for economic management. It has evolved into a new hegemonic ideology replacing the old developmentalism. The *seggyehwa* campaign set South Korea's ascension to a first-rate state in the twenty-first century as its principal goal, and identified productivity, flexibility, and fairness and autonomy as new guiding principles for national economic management. Its target was not limited to the economic domain, but extended to entire segments of society ranging from education, law and foreign policy to politics, culture, environment, and the quality of life.

As part of the globalization strategy, South Korea not only ratified the Uruguay Round, but also made a formal membership application to the Organization of Economic Cooperation and Development (OECD), both of which were predicated on the liberalization of trade, investments and foreign

exchange regimes as well as of the capital, financial and banking sectors (KOTRA, 1995). Economic liberalization under Kim was quite extensive in scope and ambitious in its implementation plans. In accordance with the settlement of the Uruguay Round, the Kim Young Sam government liberalized not only import markets for the manufacturing and service sectors, but also opened the agricultural sector where domestic political opposition was most fierce. In addition, all kinds of export promotion measures such as export subsidies and preferential allocation of credit were suspended. Industrial policy was realigned from sector-specific intervention to indirect and circumventive promotion through the provision of infrastructural and science and technology development (MTC, 1997). The only remaining NTB was import source diversification which was designed to correct chronic trade deficits with Japan by imposing an import ban on Japanese automobiles and electronic goods. At the same time, the admission to the OECD facilitated South Korea's financial and capital markets liberalization as well as liberalization of its foreign investment regime in accordance with the guidelines of the OECD's Multilateral Agreement of Investment (MAI).

Another related move was deregulation. South Korea began to realize negative aspects of the government's strategic intervention in the economic domain, which used to be considered a major source of international competitiveness in the past. However, strategic intervention was correlated with mounting regulations, undermining its international competitiveness. Deregulating economic life and correcting government failures were singled out as major targets of globalization. As part of this, the Kim Young Sam government undertook sweeping deregulation measures. During 1993–1996, 5,788 administrative, economic and business regulatory measures were selected as targets for deregulation, of which 4,648 items were deregulated, while 1,140 items were in the process of deregulation (Jwa and Kim, 1999:251).

Finally, rationalization constituted another important component of globalization. State intervention was gradually replaced by market principles. Institutional reforms aimed at rationalization and accountability were undertaken virtually in all sectors of the state and society, including financial and corporate reforms. Globalization became a new, omnipotent ideological tool of governance in the new era (see special issues on globalization, *Quarterly Sasang*, Winter 1994 and Spring 1995; *Sechuwui*, 1998).

However, it should be pointed out that the *segye-hwa* strategy was not a result solely of spontaneous globalization and outside pressures. Two additional factors explain such a radical shift. One is related to political symbolism. Democratization and related reforms began to lose popular appeals as South Korea reached the stage of democratic consolidation. They were taken for granted. The law of diminishing return prevailed. Globalization provided the Kim government with a new, timely political catch-phrase that

could replace democratic reform platforms. But the move was not limited to political symbolism, and also extended to a viable strategy for political maneuvering. Market opening in the age of infinite international competition could be politically suicidal. The case of the rice market opening underscored it. The Kim Young Sam government's deliberation on opening rice import markets as a way of accommodating the Uruguay Round settlement invited fierce domestic political opposition. Farmers, ruling and opposition politicians, mass media, and the popular sector, including even urban consumers of rice who could have benefited from its import liberalization, formed an extensive political coalition to oppose the liberalization measure. The Kim government was sandwiched between outside pressures for market opening and domestic pressures for market protection. Kim ultimately chose to open not only because of outside pressures, but also because of fear of retaliation on South Korea's manufactured exports. The move was justified in the name of *seggyehwa* (globalization).

Likewise, the Kim Young Sam government desperately needed a sweeping institutional, structural, and behavioral overhaul in order to cope with the new international economic environment as well as to minimize the domestic political backlash associated with it. Globalization served as the hegemonic ideology in the Gramscian sense through which liberalization, deregulation and rationalization could be implemented with minimal social and political resistance.⁶ As noted before, however, ideas alone are not enough. They should be backed by corresponding interests and power in order for them to be translated into a set of institutions and policies to be implemented. But the Kim Young Sam government lacked a coalitional foundation to implement the *seggyehwa* programs because of its ambitious and often contradictory pursuit of democratic reforms and globalization. While democratic mandates alienated big business and other conservative elements, the shift to globalization brought about opposition from the popular sector including labor and farmers. Thus, the Kim government failed to form a viable political coalition to push for the globalization reforms, which in turn resulted in an erratic sequencing of institutional arrangements as well as in delayed and often dismal implementation of the reform package (Mo and Moon, 1999).

Globalization and economic crisis

Profile of economic crisis

The Kim Young Sam government portrayed *seggyehwa* (globalization) as “the shortcut which will lead us to building a first-class country in the 21st century” (*Korea Herald*, January 7, 1995). The portrait proved to be false even before reaching the twenty-first century. A major setback to *seggyehwa* took place during his tenure. The sudden collapse of the Korean economy in November 1997 alarmed the entire world. After a series of financial and foreign exchange

crises, the Kim Young Sam government filed for national economic bankruptcy by asking the IMF (International Monetary Fund) for \$57 billion in bail-out funds on December 3, 1997. The myth of the Korean economic miracle was shattered, and national shame prevailed.

Table 2.3 presents data on the dark side of the Korean economy under the Kim Young Sam government. During his term in office, South Korea's foreign debts increased from \$43.9 billion to \$160.7 billion in 1996 and \$153 billion in 1997, while foreign reserve assets dwindled from \$20.2 billion in 1993 to \$12.4 billion in 1997. At the peak of the currency crisis, foreign reserves held by the central bank was less than \$8 billion, spreading the fear of default. With foreign reserves being depleted, the Korean currency rapidly depreciated. In 1993, the won/dollar exchange rate was KW808.1, but the Korean won devalued almost by two times by the end of 1997, posting the exchange rate at 1,415 won/dollar. At one point, the exchange rate reached 2,000 won/dollar.

More troublesome was the private sector. As Table 2.3 illustrates, the banking and financial sector as well as the corporate sector have shown the worst performance in recent history. The average annual stock price index, which is generally considered the most reliable barometer of economic vitality, was 808.1 in 1993 and 1,027.4 in 1994. But it continued to slide

Table 2.3 Selected indicators of financial and foreign exchange profile under the Kim Young Sam government

	1993	1994	1995	1996	1997
Foreign Debts (in US\$ billions)	43.9	56.9	78.4	160.7	153.0
Foreign Reserves (in US\$ billions)	20.2	25.7	32.7	33.2	12.4
Exchange Rates (US\$: KW)	808.1	788.7	774.7	844.2	1,415 ^a
Stock Price Index ^b (January 1980=100)	866.16	1,027.4	822.9	651	375
Non-performing Loans	2.4	1.9	2.3	2.4	4.8 ^c
Ratio of Dishonored Bills	0.13	0.18	0.2	0.17	0.24 ^d
Savings Rate (Private Sector)	26.7	26	25.7	23.7	
Kim's Popularity	88.3	55	44.9	28	13.9

Sources: Compiled from various sources:

Samsung Economic Research Institute, *Principal Economic Indicators* (November 1997); The Bank of Korea, *Monthly Report*; *Korea Money* (December 1997); *The Weekly Chosun* (January 1, 1998).

Notes:

^aAs of December 30, 1997.

^bAnnual average, but 1997 figure is for December 30, 1997.

^cFigure for 1997 is as of September 1997.

^dAs of September 1997.

down throughout 1995 and 1996, falling to 375 by the end of 1997, the lowest since the opening of the securities market. Falling stock prices amidst rapid currency devaluation drastically reduced the value of Korean firms' assets. According to an analysis by *The Financial Times*, total assets of all 653 Korean firms listed on the Korean Securities Exchange Market were estimated to be only 66.3 trillion Korean won as of December 1997, which was the equivalent of assets held by one European company, ING Group, a Dutch banking and financial firm ranked as the 70th largest firm in the world (*The Financial Times*, December 29, 1997).

Another important indicator of microeconomic health is the size of non-performing loans since it illustrates the magnitude of corporate bankruptcies. Total non-performing loans were KW2.4 trillion in 1993 and KW1.9 trillion in 1994. By the end of September 1997, it rose to KW4.8 trillion. Given the avalanche of corporate bankruptcies including major *chaebols* such as Hanbo, Kia, Jinro, Daenong, Newcore, and Halla,⁷ the size of non-performing loans must have been much higher than 4.8 trillion won. In fact, the IMF estimated that non-performing loans amount to KW 32 trillion, about 7 percent of GDP, in 1997 (IMF, 1997). A sharp increase in non-performing loans literally paralyzed the banking and financial sector, precipitating the financial crisis.⁸ Non-performing loans accounted for 6.8 percent of total bank loans as of the end of September 1997. In addition, most firms in South Korea, especially small and medium-sized ones, traditionally relied on the discount of corporate bills such as promissory notes in raising corporate funds. Thus, a high ratio of dishonored corporate bills implies a severe liquidity shortage and greater corporate delinquency. In the first three quarters of 1996, the ratio of dishonored corporate bills was 0.24 percent, a dramatic increase from 0.13 percent in 1993. Proliferation of non-performing loans amidst high dependence of Korean firms on bank loans has in turn led to the paralysis of the banking and financial sector.

The downfall of the Korean economy in the latter part of 1997 was so sudden and abrupt that it was like watching a surrealist movie. South Korea had been through a series of economic crises (1969–71, 1979–80) in the past, but no one expected such a shameful plunge.

What went wrong: trapping structure of globalization

What went wrong?⁹ Most attributed the genesis of the Korean economic crisis to domestic mismanagement. It was seen as a home-grown crisis (*The Economist*, November 1997). As Table 2.3 illustrates, beneath the “healthy fundamentals” of its macroeconomy, microeconomic foundations have slid into deep trouble.¹⁰ Declining international competitiveness, unruly corporate governance and bankruptcies, mounting non-performing loans and the paralysis of the banking and financial sectors, and extensive government failures have all contributed to the downfall of the Korean

economy (Mo and Moon, 1999; Moon and Kim, forthcoming). But equally critical was the backlash of hasty globalization. Unprepared and immature economic globalization has entailed an unbearable transitional trauma.

Eroding international competitiveness and financial and capital liberalization

One of the most visible impacts of globalization was the worsening balance of payments position. As shown in Table 2.4, opening domestic markets to foreign goods and services has accompanied mounting trade deficits. While exports were stagnant, imports soared. South Korea recorded a modest trade surplus (\$989 million) in 1993. But the trade balances began to deteriorate in 1994. The trade deficit rose from \$6.3 billion in 1994 to \$10 billion in 1995, \$20.6 billion in 1996, and \$8.4 billion in 1997. No doubt, unfavorable factor market conditions such as high wages, high capital costs, and high land prices were responsible for the declining international competitiveness and subsequent trade deficits (MTC 1997).

But equally critical was the structure of vulnerability embedded in export composition. Since South Korea adopted the big push strategy in the mid-1970s, its exports have been characterized by an extremely high degree of item concentration. In 1996, semiconductor chips, automobiles, steel, shipbuilding and petro-chemical products accounted for almost 60 percent of its total exports. But these sectors are quite vulnerable to international market conditions such as sharp price changes. For example, semiconductor chips have become the leading export item since 1994, recording an export amount of \$22.1 billion in 1995. The semiconductor export boom was instrumental in boosting the entire national economy. But worldwide overinvestment in production facilities and subsequent overcapacity and steep competition plummeted the price of 16D ram chips, decreasing South Korea's semiconductor chips exports from \$22.1 billion in 1995 to \$17.8 billion in 1996 and \$17.4 billion in 1997 (MTC, 1997:541). Excessive export dependence on memory chips, which was vulnerable to international market changes, and underdevelopment of the

Table 2.4 Exports, imports and total external liabilities

(Unit: US\$ billions, %)

	1994	1995	1996	1997	1998.1-5
Export	96.0	125.0	129.7	136.1	558.7
(Rate of increase)	(16.8)	(30.3)	(3.7)	(5.0)	(5.7)
Import	102.3	135.1	150.3	144.6	39.8
(Rate of increase)	(22.1)	(32.0)	(11.3)	(-3.8)	(-35.9)
Balance of trade	-6.34	-10.0	-20.6	-84.5	16.0
Total external liability	56.8	78.4	1,04.7	1,208.0	125.2

Source: Ministry of Commerce, Industry & Energy.

import intensive non-memory sector virtually crippled the semiconductor industry in South Korea. Automobiles, steel and shipbuilding were also subject to the dilemmas of global surplus capacity and heightened international competition. Likewise, international market changes placed profound constraints on South Korea's exports, contributing to worsening trade deficits and eventually to the genesis of the economic crisis.

Another significant impact of globalization was a skewed access to international finance and capital. In coping with current account deficits, South Korea relied more heavily on external borrowing than on foreign equity capital. As a result, total external liabilities increased from \$56.8 billion in 1994 to \$104.7 billion in 1996 and \$154 billion in 1997 (see Table 2.4). Aggressive financial and capital market liberalization, which was undertaken as part of the *seggyehwa* strategy, facilitated overseas borrowing by Korean banks and firms (Dornbush and Park, 1995; Hahm, 1995). Yet the capital and financial liberalization did not correct the traditionally skewed pattern of external financing (Chung, 1998). While old mercantilist templates such as various restrictions on foreign investment, prohibition of land-holding by foreigners, and an array of bureaucratic red tape depressed the inflow of foreign equity capital, foreign loans grew exponentially as a result of the financial and capital market liberalization (Jwa and Kim, 1999).

The composition of foreign borrowing was more problematic. As Table 2.5 demonstrates, short-term loans constituted the lion's share of external financing. In 1985, short-term loans accounted for only 23 percent of total external liabilities. Since the globalization campaign, however, its share rose to 53.5 percent in 1994, 57.8 percent in 1995, and 58.2 percent in 1996 respectively. In good times, borrowing short-term loans does not pose any problems. It can be beneficial on several grounds: favorable interest rates, enhanced capital mobility, and stabilizing effects. But in hard times, short-term liabilities could become self-defeating because of the panic potential they entail.

Short-term liabilities and financial panic

Radelet and Sachs (1998) attribute the essential elements of the Korean crisis to the role of financial panic. They argue that macroeconomic and microeconomic foundations in South Korea were fragile, but not enough to warrant a financial crisis of the magnitude that took place in November 1997. It was the large-scale foreign capital inflows into financial system that became vulnerable to panic. Financial panic usually takes place when short-term creditors suddenly withdraw their loans from a solvent borrower under the following three conditions: first, when short-term debts exceed short-term assets; second, no single private-market creditor is large enough to supply all of the credit necessary to pay off existing short-term debts; and finally there is no lender of last resort as a solvent borrower (Radelet and

Table 2.5 Total external liabilities

(Unit: US\$ billions, the end of period, %)

	1985	1989	1990	1991	1992	1993	1994	1995	1996	1997
Total	46.7 (8.6)	29.3 (-5.7)	31.7 (7.9)	39.1 (23.5)	42.8 (9.4)	43.8 (2.5)	56.8 (29.6)	78.4 (38.0)	104.7 (33.5)	154.4 (47.5)
Short-	10.7 (23.0)	10.9 (37.3)	14.3 (45.2)	17.2 (44.0)	18.5 (43.2)	19.1 (43.7)	30.3 (53.5)	45.3 (57.8)	60.9 (58.2)	68.4 (44.3)
Overseas	11.2 (11.0)	26.3 (10.4)	26.8 (1.9)	27.1 (1.3)	31.7 (16.7)	36.0 (13.5)	46.5 (29.3)	61.3 (31.9)	69.9 (14.0)	- (-)
Net	35.5	3.0	4.8	11.9	11.1	7.8	10.3	17.0	34.7	-

Source: Bank of Korea.

Notes: (1) Total External Liabilities are based on IBRD standards until 1996; Total External Liabilities are based on IMF standard in 1997.

(2) The figures in () are the rate of increase compared to the previous year.

Sachs, 1998:3-4; Stiglitz, 1998; Dornbusch and Park, 1995; for a dissenting view, see Choe, Kho and Stulz, 1998).

Empirical evidence seems to support the panic thesis. In the first half of 1997, South Korea enjoyed a high degree of normalcy. But the chain reaction of bankruptcies of major *chaebols* starting in September 1997, and the mounting size of non-performing loans, and the weakened positions of Korean banking and financial institutions, triggered the panic behavior on the part of the international investment community. International lenders began to refuse the roll-over of short-term debts held by Korean banks and firms. The roll-over rate plunged from an average of 90 percent before the crisis to the 30 percent level during the crisis, aggravating the situation. In December 1997, roll-over rate hit rock bottom at 26.3 percent. Since the onset of the crisis, South Korean borrowers had to pay back a monthly average of \$10 billion. Yet, the Bank of Korea did not have sufficient reserves to cope with the recall of short-term loans by international lenders. At the end of October 1997, usable foreign reserves were \$22.3 billion, and dwindled further to \$7.2 billion by the end of November. The Bank of Korea was not in the position to cope with repayment of short-term loans, and the Korean economy was on the verge of virtual default (*Munhwa Ilbo*, Dec. 15, 1997).

Borrowing new money was equally difficult. The total overseas funding Korea raised in October was a paltry \$300 million, less than a quarter of the monthly average of \$1.3 billion between July and September (Lee, 1997:16). What became worse was the high-interest premium placed on Korean borrowers. For example, Korean Development Bank's global bonds, which had the same credit rating as the Korean government debt, were treated as junk bonds with US Treasury yields plus 350 basis points (Lee, 1997:16). Overseas credit crunch, coupled with high premiums, hit Korean merchant banks very hard, producing negative amplifying effects with a dangerous speed.

The panic also appeared in equity capital markets. As Table 2.2 shows,

there was an exodus of foreign investors from the Korean stock market. In November alone \$1.48 billion was withdrawn from the stock market. In December, an additional \$1.14 billion was withdrawn, plummeting stock prices. On a separate front, in anticipation of a further won slide, domestic players continued to hoard dollars. Capital flight and dollar hoarding compounded the Korean economic crisis.

In sum, failure to roll over short-term debts, low foreign reserves, and abrupt capital flights gave birth to financial panic, deepening the economic crisis in South Korea.

Why panic: contagion, credit-rating game, and government failures

Then, why panic? It resulted from an odd combination of contagion effects, poor international credit rating and government policy failures. Contagion effects refer to the spread of crisis from its initial sources to other innocent victims through either structural interconnectedness or breakdown of shared trust by the international investment community (Schwartz, 1998:2). The Korean financial and foreign exchange crisis could have been averted if it were confined solely to South Korea. But this was not the case. South Korea was virtually swept into the vortex of crises that had already taken place in Southeast Asia and elsewhere. Thailand's foreign exchange crisis in July, the Indonesian economic crisis in August, and the Hong Kong stock market crash in October have spread panic among international investors and lenders. Their fear was not necessarily psychological. Newly emerging economies of Asia were already interwoven into intricate webs of interdependence. One country's crisis was bound to spread the virus of economic malaise to others through structural interconnectedness. Japan was a linchpin in this entanglement. But Japan was also struggling with its own financial and banking problems with the astronomical amount of non-performing loans. It was in this regional setting that international investors and lenders lost credibility in South Korea and rushed to recall their short-term loans (Bank of Korea, 1998:17–21).

Crisis could have been prevented or avoided if it were properly predicted. But there was a total failure in early warnings of the South Korean economic crisis. Early warning efforts are usually operationalized in terms of international credit ratings. Two leading international credit rating agencies, Standard and Poor, and Moody, committed two cardinal sins (Radelet and Sachs, 1998:11–12; Fitch IBCA Sovereign Comments, Jan. 13, 1998). First, they failed to signal increased credit risk until after the onset of the crisis. Both agencies gave a very high credit rating on South Korea until the very last moment before calling for the IMF rescue financing on November 21. For instance, while Moody downgraded its credit rating on South Korea's long-term debts from A1 to A2, and on short-term debts from p1 to p2 on October 27, Standard and Poor downgraded its credit rating from AA—to A+ on long-term debts and from

A1+ to A1 on short-term debt on October 27 (KIEP, Briefing, June 30, 1998). Despite the downgrading, both agencies gave relatively good ratings. Furthermore, credit risk ratings remained unchanged through 1996 to September 1997. Such poor early warning precipitated the panic among international lenders and investors.

Second, rating agencies' aggressive downgrading after the crisis compounded the crisis even further. At that point, rather than helping creditors assess future risk, the downgrade simply pushed interest rates higher and added to the panic (Radelet and Sachs, 1998:11). For example, Moody downgraded South Korea's long-term credit rating from A3 to Ba1 (junk bond level) and its short-term rates from P-3 to NP (junk bond) within eleven days from December 10 to 21. Standard & Poor also made the same mistake of downgrading its credit rating from A+ to BBB—(long-term) and from A1 to B+ (short-term) within a month (KIEP, 1998). The mistakes by the credit rating agencies amplified a vicious cycle of the economic crisis. These mistakes can be attributed to several factors: failure to recognize risk associated with short-term debts; failure to take into account total external debt by focusing primarily on public sector external debt; underestimation of transparency in policy and data; over-estimation of the sophistication of Asian policymakers; failure to pay attention to banks' or corporate soundness; and underestimation of contagion effects (Fitch IBCA Sovereign Comment, 1998; Kanter and Packer, 1996:37-54).

Government failures also factored into the Korean fiasco. Apart from structural failures rooted in the late-industrialization model such as instrumentalization of banks for state industrial policy, the Korean government made several critical mistakes in dealing with the economic crisis (Moon and Kim, forthcoming). First, a rigid management of the foreign exchange rate policy backfired. As early as June 1996, pressures for devaluation of the Korean currency were mounting, but the government did not take any measures. Fear of inflation and disciplining the corporate sector through a strong won prevented the South Korean government from undertaking the timely devaluation of the Korean currency. But more critical was political lobbying by banks, firms and state enterprises who benefited from heavy foreign borrowing. A strong won allowed them to make windfall profits by taking advantage of huge interest rate differences at home and abroad.¹¹ Overvaluation of the Korean currency depressed exports, while encouraging imports, eventually contributing to worsening balance of payments.

Second, there were grave decisional mistakes in the process of the crisis (*Donga Ilbo*, April 11, 1998). At the end of 1996, the current account deficit reached 5 percent of GDP, and foreign reserves held by the Bank of Korea were \$30 billion which could pay for only three months worth of imports. Despite such indicators, the government was optimistic about the future by citing the health of macroeconomic fundamentals. More importantly, at the height of the crisis (November 11-21), the Bank of Korea's disposable

foreign reserves were downsized to \$19.5 billion. Yet, the BOK wasted \$6.7 billion in defending the Korean currency. Consequently, foreign reserves dwindled to \$12.7 billion by the end of November, aggravating the crisis. The worst mistake was the loss of timing in calling for the IMF rescue financing. Since mid-October, IMF officials were urging the South Korean government to ask for rescue financing. But the Korean government wasted almost a month. It was partly because of bureaucratic politics, and partly because of political factors. Those surrounding president Kim Young Sam did not want him to be a disgraceful president who filed for state bankruptcy.

Finally, the government's failure to monitor and supervise played an important role in precipitating the crisis. Financial and capital liberalization in 1994 triggered an overseas rush by Korean banking and financial institutions (Chung, 1998). Although they were inexperienced in international banking and finance, they aggressively ventured into high-risk, high-yield capital games. They were even investing with borrowed short-term loans in such high-risk bonds as Southeast Asian national bonds, Russian national treasury, and Latin American Brady Bond (Chung, 1998: *Chosun Ilbo*, January 8, 1998). When these countries got into trouble, Korean banks and financial institutions lost their money. Deep and mobile international capital also made it difficult for the Korean government to track capital movements. Apart from short-term loans, local financing by overseas subsidiaries of Korean big business and payment guarantees by their headquarters in Seoul could not be accounted either. In a sense, the Korean economic crisis was a crisis of monitoring, supervision and accountability. The fact that official government figures on foreign debts emerged in March 1998, more than three months after the peak of the crisis, underscores the gravity of government failures.

In view of the above, the economic crisis in South Korea cannot be ascribed solely to endogenous variables. Exogenous variables, which are derivatives of unprepared globalization efforts as well as erratic sequencing of opening and liberalization, dealt a critical blow. Indeed, the South Korean economy was trapped in spontaneous forces of globalization. Financial and capital market liberalization without corresponding domestic institutional reforms, failure to attract foreign equity investment and excessive dependence on short-term loans, transmission of systemic vulnerabilities resulting from regional financial and foreign exchange crises, and limits of human and government adaptation to deep and mobile movements of international capital, have all served as forceful catalysts for the outbreak of the economic crisis in South Korea.

Consequences of globalization and new coping strategies

The South Korean case eloquently proves that globalization is not an assured pathway to a bright future. It can be a traumatic process of uncertainty and downfall. But it is necessary to bear in mind that an

economic crisis is not the end-state of globalization in South Korea. It has far-reaching political, social and international implications, producing a new combination of winners and losers and shifting political alliances (Gourevitch, 1986; Rogowski, 1989; Frieden, 1991; Garret, 1995; Rodrik, 1997b; Kim, 1998).

The most significant outcome of the economic crisis can be found in the political arena. Kim Dae Jung, the candidate from the New Party for National Congress, won the presidential election held on December 18. Kim's election marked the first peaceful transfer of political power in the political history of South Korea. Regional cleavages and related political coalition played the pivotal role in his election. But were it not for the economic crisis, his victory might have not been possible. Kim skillfully exploited economic policy failures under Kim Young Sam and the ruling Grand National Party in his election campaign. Kim's election has brought about a sea change in Korean politics. The old ruling coalition framed around the eastern region, big business and conservative forces has been replaced by a new coalition comprising the mid and south-western regions, small and medium business, and workers.

The economic crisis has made ideological chaos more pronounced. Greater openness and liberalization, which were embodied in the evangelic gospel of Kim Young Sam's globalization, turned into the source of popular discontent and cognitive dissonance. Old nationalist and mercantile sentiments are gradually resurfacing. Widespread folk theories of American conspiracy, revival of public campaigns to boycott imported goods, implicit and explicit resistance to mergers and acquisitions of Korean firms by foreign investors, and occasional violent attacks on foreign-made cars are indicative of new sentiments in South Korea (*Asian Wall Street Journal* Feb. 27, 1998; *Joong Ang Ilbo*, Feb. 28, 1998). However, public fear of another economic crisis is serving as an effective deterrent to violent burst of nationalist sentiments. If structural adjustment measures fail, and unemployment becomes more pervasive, the anti-globalization mood could easily turn into street demonstrations and violent protests. The current leadership could join the ranks and files of defiant forces. Being a long-time proponent of the mass participatory economy, President Kim Dae Jung was forced to accommodate neoconservative reform platforms as dictated by the IMF (Dae Jung Kim, 1985). Failure to overcome the current economic crisis could return him to the popular, nationalist stance as way of revitalizing his political legitimacy and regime stability.

Unlike previous adjustment experiences, no domestic winners have emerged from the current crisis (Moon, 1988). Out of thirty *chaebols*, more than ten went bankrupt. The remaining ones, including the big five, are also going through extensive restructuring and downsizing. The myth of "Daemabulsa" ("too big to die") no longer holds valid. The severe credit crunch has virtually wiped out small and medium-sized firms. Workers are the hardest hit. The unemployment rate has reached a record high of 7

percent as of July 1998. Two million workers are unemployed, and the figure is likely to rise since a great majority of firms will be going through massive corporate restructuring and lay-offs in months to come. The middle class, the backbone of Korean society, is also in trouble. Unemployment, wage cut or freeze, increased tax burden, depreciation of stock and real estate prices have stripped the middle class of its wealth, income and savings (*Joong Ang Ilbo*, July 13, 1998; *Chosun Ilbo*, June 1, 1998). The only winners are the foreign investors. Low currency value, low real estate markets, low wages, and undervalued stock prices have made South Korea a new haven for international investments, mergers and acquisitions.

Finally, the crisis placed South Korea under the IMF economic trusteeship. Structural dependency on the IMF has not only limited the scope of policy maneuvers, but has also severely tarnished Korea's national pride. Globalization has left painful scars on its economic sovereignty and autonomy. Koreans now designate December 2, the day on which an agreement on the IMF bail-out was signed, as the second national shame day, only after August 29, the day Korea was annexed by Japan in 1910.

But the crisis was not the end of history. On the contrary, it offered a new momentum for completing unfinished tasks of the Kim Young Sam's *segye-hwa* strategy. Upon his inauguration, president Kim Dae Jung immediately undertook new coping strategies to deal with the economic crisis. Being driven partly by external pressures embodied in IMF conditionalities and partly by domestic mandates for recovering from the economic crisis, president Kim accelerated the process of globalization through deeper and wider economic reforms for liberalization, rationalization and deregulation (ROK Government, 1998).

Liberalizing financial and capital markets has been most pronounced. In order to foster inflows of foreign equity capital, the Kim Dae Jung government took several drastic measures. First, the foreign exchange regime was changed from a positive-list system into a negative-list system and all capital account transactions are to be liberalized. Second, all ceilings and restrictions on foreign investment in the local bond and short-term money markets, as well as on foreign equity ownership in the stock market, were eliminated. Along with this, foreign banks and securities companies are now allowed to establish fully owned banks and brokerage units in South Korea. Third, mergers and acquisitions of domestic firms by foreign firms are fully allowed. In addition, hostile takeovers through free acquisition of equity share of listed Korean firms for the purpose of managerial control, which were prohibited in the past, are also liberalized. Finally, foreign direct investment became completely liberalized with only a few remaining restrictions on industries related to national defense and cultural sovereignty, implying that 97 percent of Korea's industries are now completely open to foreign investment. The most interesting development is the lifting of the ban on foreigners' acquisition of land. The Korean government used to be most restrictive on foreign buying of local land due

to scarcity of land and the Korean people's attachment to land. But starting from June 1998, foreigners were allowed to buy land with almost no restrictions on space, purpose and qualification. These measures reflect South Korea's desperate need to induce more foreign capital in order to respond to the economic crisis.

Along with the capital and financial sector liberalization, trade has also been subject to a greater liberalization. As noted earlier, the only remaining controversial NTB was the import diversification program. But following the IMF recommendation, the South Korean government decided to phase out the program by the end of 1999. As a result, restrictions on eighty-eight items under the program will be lifted. In addition, foreigners were allowed to engage in security dealings, insurance, leasing, and other property-related business as of April 1, 1998 (KIEP, 1998:320).

Being keenly aware that the mismatch of domain between external liberalization and domestic institutional realignments was the primary cause of the economic crisis under the previous government, president Kim Dae Jung has also pushed for profound domestic structural reforms for the rationalization of the banking and financial sector as well as the corporate sector. While the previous government failed to accomplish the banking and financial sector reform in its five-year tenure, the new government under Kim Dae Jung completed the measure in less than six months after his inauguration. As a result of the big bang, two commercial banks were recapitalized, while fourteen merchants banks were either closed or suspended. In addition, one investment trust company and three securities companies were closed. Bankruptcy of commercial and merchant banks was unprecedented in South Korea.

A more impressive measure involved efforts to resolve the dilemma of non-performing loans (NPLs). Since the days of the Kim Young Sam government, NPLs emerged as the principal barrier to reforming the corporate as well as the banking and financial sector. Due to the potential for devastating domino effects of bankruptcy on big business and banking and financial institutions, the resolution of bad loans has been long delayed. In March 1998, the estimated total of bad loans of all financial institutions amounted to an astronomical figure of 118 trillion won (roughly \$84 billion) of which 68 trillion was core non-performing loans, while 50 trillion won was precautionary loans. The new government devised two channels through which NPLs are to be disposed. One is to make financial institutions themselves dispose of half of their respective NPLs by either selling off collateral or calling in loans, and the other is to make the Korea Asset Management Corporation to purchase the remaining half from financial institutions at an estimated market price. Under this scheme, the loss borne by financial institutions is to be resulted in the erosion of their capital base. The government has decided to support the recapitalization of financial institutions, contingent upon their own restructuring efforts. The success of the scheme is yet to be seen, but the measure has made it clear

that the government will make bold attempts to tackle the chronic problem of NPLs and that it will not tolerate moral hazard any longer by establishing a policy of no forbearance.

After lengthy negotiations, the Kim Dae Hung government was finally able to produce an agreement with the top five *chaebols* on corporate restructuring on December 7, 1998. Korea's five largest family run conglomerates—Hyundai, Samsung, LG, SK and Daewoo—agreed to sell their marginal and unprofitable units and to focus on their core business. They also agreed to eliminate cross-debt payment guarantees among affiliates by March 2000 and to reduce their debt-to-equity ratio to 200 percent by the end of 1999 by selling their marginal subsidiaries, attracting foreign capital, and group owners' contribution of their personal assets. The agreement also called for industrial realignment in seven sectors—petrochemicals, aircraft, rolling stock, power generation, ship engines, semiconductors and oil refining. Along with this, the *chaebols* agreed to enhance transparency in their corporate management by preparing combined financial statements beginning in 1999 and by improving accountability to shareholders. At the same time, they were placed under tight monitoring by not only creditor banks, but also the Financial Supervisory Commission and the Fair Trade Commission (*Korea Economic Update*, December 14, 1998). Its implementation is yet to be watched, but the landmark agreement is likely to reshape corporate landscape in South Korea.

As a way of rationalizing domestic economic foundation, the Kim Dae Jung government has successfully undertaken a big bang on the banking and financial sector and a big deal on *chaebols*. In tandem with these economic reform measures, the Kim Dae Jung government has initiated a national movement for rebuilding Korea (*Je 2 Konkuk Undong*). Globalization items such as the pursuit of universal globalism, diffusion of global standards in economic and social life, and extensive deregulation and government innovation are incorporated into the core agenda of the national movement. In view of this development, globalization is likely to be accelerated under the Kim Dae Jung government.

The Kim Dae Jung government was able to accomplish the previous government's unfinished tasks of globalization in less than a year. How could it be possible? The very economic crisis blessed Kim Dae Jung. His aggressive pursuit of globalization reforms and some visible signs of economic recovery deterred the spread of nationalist sentiments that surfaced immediately after the crisis. And opening, liberalization and neoconservative ideas have become the dominant paradigm in Korean society. The economic crisis has also contributed to diluting political opposition. The Hannara Party, the largest conservative opposition party, could not defy or oppose the Kim's economic reform drive not only because of ideological convergence, but also because of fear of public critiques on political gridlock. Having been accused of the primary cause of the economic crisis, big business was in no position to organize and mobilize

political opposition to the Kim Dae Jung government either. The popular sector including labor could be a source of more profound political challenge to him. But acute economic crisis and a widespread sense of job insecurity followed by corporate bankruptcies and lay-offs have made them calm, at least for the time being. It is through the crisis that the Kim Dae Jung government has been able to formulate and implement reform measures without any significant political opposition. In this sense, the economic crisis has served as a critical catalyst for dismantling the mercantile ethos and underlying political coalition and for accelerating the process of globalization.

Conclusion

The South Korean case suggests several interesting theoretical and policy implications. First, the Korean crisis is not an outcome of spontaneous globalization *per se*, but of failure to adapt to it and to come up with effective coping strategies. Mismatch of domain between external forces of globalization and internal institutional and structural responses resulted in the disaster. It is not easy to harmonize globalization with domestic realignments. Domestic readjustment and realignments also require a longer period of the learning process. In retrospect, however, the *seggyehwa* (globalization) policy under Kim Young Sam was more rhetoric than substantive. He lacked the will and concrete action plans to implement the globalization strategy. Simply put, South Korea was not prepared to navigate the rough currents of globalization (Haas and Litan, 1998).

Second, South Korea used to serve as a salient empirical site for the statists. Its economic growth was seen as a triumph of statism over market forces and globalism. However, the past glory of statism seems to be waning. The state was rigid, immobile, irrational and even stupid in dealing with the crisis. There are fundamental limits to managerial globalization by the state. International capital movements are so unruly, deep and dynamic that the South Korean state became virtually helpless. But this does not necessarily mean the eclipse of the state by globalizing forces (Evans, 1997). It might also be wrong to dichotomize the state and globalization (Shaw, 1997). Even in the age of globalization and information revolution, the state has its own place. But we cannot deny the fact that globalization has been pushing the state toward a marginal actor, severely constraining its *raison d'être*. Indeed, the South Korean crisis urges us to recast the evolving role of the state in the new age of globalization.

Third, as the panic and contagion effects exemplified in the context of the Korean crisis reveal, globalization of market forces can be accompanied by unintended outcomes and negative feedback mechanisms, which can eventually undermine national as well as global welfare. One country alone cannot cope with these negative externalities of globalization. There must be concerted efforts. New international governance structures should be

institutionalized to tame and harness the hyperbolic nature of market forces. Extended public governance over the ungoverned global economy is essential (Hirst, 1997; Young, 1994; Haas and Litan, 1998; Rodrik, 1998). International governance is not only desirable, but also feasible. Despite the rhetoric of global integration, the Westphalian system still remains the core of contemporary international order. Intergovernmental cooperation and coordination is still valid and powerful.

Fourth, the crisis of globalization is not an end of the globalization *per se*. The South Korean case illustrates that the economic crisis has served as a new momentum for fostering the very process of globalization by dismantling the protectionist coalition as well as forging a sense of urgency in complying with the globalization mandates. An odd alliance of Kim Dae Jung's populist leadership and the neoconservative platforms of international lending institutions exemplifies this.

Finally, the Korean experience appears to lend powerful support to the convergence thesis. Crisis is pushing South Korea closer to the American-style free market. Global standards, which are set by Western ideas, values and norms, have become a new, dominant fad in discourses on crisis management. The triumph of Anglo-American capitalism prevails, putting an epitaph to Asian values and Asian capitalism.

Notes

- 1 Spontaneous globalization is similar to what Prakash and Hart call economic globalization, while managerial globalization refers to strategies to deal with economic globalization (see the introductory chapter).
- 2 The spontaneous globalization is not confined solely to the economic domain. It only serves as a vantage point through which we can understand the nature and scope of globalization. Increasing global interdependence can be easily detected in communication, culture and environment areas too. See Pirages (1989).
- 3 Alice Amsden coined the term in order to make a contrast with the "AngloSaxon" model that emphasizes the primacy of market over the state. See Amsden (1989). Its intellectual origins can be found in List (1966) and Gerschenkron (1962).
- 4 South Korea has been very restrictive on inflow of foreign workers. Although acute labor shortage in the early part of the 1990s facilitated inflow of foreign guest workers, its size has been minimal. And in the wake of recent economic crisis, there has been an exodus of foreign workers from South Korea.
- 5 The Roh government initially undertook a campaign for internationalization. The Kim Young Sam government, however, changed it into the globalization campaign. For the analytical and policy differences between two campaigns, see Moon, 1995:62-79.
- 6 Hong-Koo Lee, former prime minister who initiated the globalization campaign, made an interesting remark in this regard: "Globalization is something like a panacea. Globalization has often been used as the powerful tool for persuasion in dealing with bureaucratic or political oppositions to government policies. Those who opposed globalization policies were branded as parochial, collective egoists. Indeed, it has served as the foundation of social consensus." Private conversation with Dr Lee.
- 7 The number of corporate bankruptcy rose from 9,502 cases in 1993 to 12,000 cases as of October 1997. See *Weekly Chosun*, January 1, 1998, p. 98.

- 8 Proliferation of non-performing loans was a result partly of unruly corporate governance in South Korea. *Chaebols* (big business) in South Korea could borrow loans from banks and financial institutions without any constraints through cross-payment guarantees among their cross-owned affiliates. Thus, the banking and financial crisis in South Korea is closely related to corporate governance structure.
- 9 There has been an extensive literature on the South Korean economic crisis. For a comprehensive and comparative overview, see Corsetti, Pesenti, and Roubini (1998), Radelet and Sachs (1998), and Krause (1998). Roubini's website is particularly useful.
- 10 On the mismatch of macro—and micro-economic indicators, see *Weekly Maekyung* (December 24, 1997), pp. 30–33; *Weekly Hangyerae* 21 (December 18, 1997), pp. 74–76; *Monthly Chosun* (January 1998), all in Korean. 1997), pp. 30–33.
- 11 Devaluation also had political and symbolic implications. Devaluation could compromise the government goal of maintaining and upgrading per capita income of \$10,000. Thus, devaluation was opposed for political reasons too.

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3 Grappling with globalization

The case of Japan's software industry

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Introduction

It has long been the conventional view that Japan must change its developmental institutions and policies to be competitive in an increasingly globalized economy. Clearly, globalization—the integration of input, factor and product markets across the world—is putting tremendous pressure on Japan to make its financial and distribution systems more efficient and to source materials from the best supplier regardless of nationality (Berger and Dore, 1996). How are the Japanese government and firms coping with this challenge? Are they responding by converging with the West in terms of relying primarily on market forces to determine the allocation of resources? How do Japanese government officials, business people and citizens view the challenge? What does their response tell us about the changing role of the state in industrial development, about state-society relations, and about the traditional market versus the state dichotomy that provides the core of much political economy literature?

This chapter explores the response of Japan's state bureaucracy and corporations to the pressures of globalization in the computer software industry. Like the Moon, Ravenhill, Solnick, and Yang chapters in this volume, it explores how institutions, ideas and interests shape how nations cope with international pressures. The software case is important for several reasons. It is a technologically advanced industry, one deemed by Japanese leaders to be key to Japan's future economic success. Software is an industry in which the Japanese bureaucracy and businesses desperately want to succeed globally. Yet they are struggling in both operating system (OS) and applications software because their traditional approach to creating comparative advantage, which worked well in manufacturing industries such as autos, steel and semiconductors, is not effective. In contrast to manufacturing industries, in software, production economies of scale and manufacturing expertise are not keys to success; foreign first-movers control dominant standards; technology cannot be reverse-engineered legally; and learning cannot be done in the traditional way of copying. Looking at Japan's state and corporate responses in an industry

where the traditional approach is not working allows us to evaluate the extent to which history, ideas, and existing institutions and practices sharply constrain the choices available to policy makers.

Software also makes an interesting case because the pressures for convergence are very strong. The success of US firms in the industry is largely due to entrepreneurial efforts in a market-oriented environment sensitive to consumer needs and to their control of dominant standards.² Analyzing how Japanese firms and the state are reacting to US competition in a strategic industry in which they are not internationally competitive provides a window into how they view the strengths and weaknesses of their own system of managed markets and of the US market-based system. And it provides a case in which to explore how “domestic bargains” are renegotiated under severe global competitive pressures.

The study is organized in the following way. This introductory section places the globalization issue in a theoretical framework and lays out two indicators or yardsticks to help measure the response of Japan’s state and corporations to global competitive pressures in the software industry. The second section provides a historical background of the industry’s development up until the 1980s, focusing on the nature of competition in the industry, particularly the state and firms’ roles in shaping price, product and standards competition. It provides a snapshot of the industry in the 1980s against which we can measure responses to global pressures in the 1990s. The third section analyzes changes in the 1990s, focusing on how Japan’s state and corporate policies have changed in response to international competitive forces. The fourth concluding section suggests theoretical implications of the ways in which the Japanese corporations and state have grappled with globalization and discusses the extent to which the software case can be considered representative.

We need yardsticks to measure how Japan’s state and corporations have responded to global pressures in the last decade. In this chapter, I focus on two kinds of indices to measure the degree to which their responses suggest convergence.³ The first, which I call technological convergence, will be measured by the degree to which we see Japanese software companies responding to competitive pressures by offering products based on open, dominant standards, such as the Wintel (Windows and Intel) operating system (OS) standard. The Wintel standard contrasts with systems based on closed standards in which software and hardware are sold as a bundled package and are not compatible with other systems.

The second type of convergence is what I call market convergence, by which I mean the degree to which the state and firms in the software industry have responded to international competitive pressures by relying primarily on the market mechanism to determine their products and prices. Of course, a fully market-based system is only an ideal model; all nations use markets to some extent and intervene in them to attain certain goals such as national security and consumer protection. But Japan’s state and

corporate elite is well known for managing competition in strategic industries. They have actively targeted them with protection policies and subsidies; used cartels, *keiretsu* relations and other cooperative action to accelerate technological progress and gain economies of scale; and manipulated a centralized, bank-centered financial system to allocate low-cost capital to favored sectors (Johnson, 1982; Samuels, 1994; Anchordoguy, 1989). The question in this case is thus whether Japanese software producers and the state are responding to global pressures by moving away from institutional arrangements and practices that manage market competition toward reliance on relatively unfettered market forces to determine the types, quantity and price of products offered. I am not equating an absent state with market convergence. Indeed, a free market requires a state willing to act as a rule-maker and enforcer, an umpire of sorts. If we find the state playing the umpire role necessary to create and maintain a relatively free market and find active competition on prices and products, we will conclude that the Japanese state and firms are responding to pressures for globalization by moving toward a more market-based system.

While the study largely focuses on whether Japan's state and corporate responses to global competition support convergence theory, it also has implications for other theoretical questions in the field of political economy. Assessing how the state and corporations respond to pressures for globalization provides insight into various broader questions. These include: why the Japanese state has been strong in some cases yet weak in others; why targeting policies has worked in some industries but failed in others; and why firms manage competition in some industries but the state in others. It also provides insight into the changing nature of government-business relations, especially whether their give and take is primarily zero or positive sum.⁴

The analysis also highlights weaknesses in the traditional dichotomy of states versus markets. Many political scientists equate state intervention with distorted or unfree markets and private sector decisions with free markets (Samuels, 1987:8–9). This type of view leads to the notion that getting the state out of the marketplace automatically results in unfettered markets. But this obfuscates our understanding of how Japan's form of capitalism works because so-called free markets are rare in Japan. Indeed, Ronald Dore (1986), for example, argues that there generally are no markets in Japan, only networks of established customer relationships. Historically, the Japanese state has not functioned as an umpire and maintainer of markets, a role necessary for free markets. Thus, it is misleading to equate private companies with free and the state with distorted markets. We need to also look at how firms, especially when unconstrained by anti-monopoly policies, distort competition in an industry, sometimes to their own detriment (Chandler, 1977).

This is by no means the only analysis of Japan's software industry.

Michael Cusumano's (1991) study applauds Japanese firms' use of a factory approach to software development. Other studies have focused on identifying the causes of the industry's weakness. They argue that fragmented proprietary standards, deficient venture capital markets, the education system, and an overall lack of creativity have been key factors limiting the success of Japanese software companies (Cottrell, 1996; Baba, Takai and Mizuta, 1996; Fransman, 1995; Anghordoguy, 2000). This study differs from these by analyzing the response of the state and firms to global competition and whether this response supports convergence theory.

The industry's development up through the 1980s

In order to use the computer software industry to explore how and to what degree Japan's political economic system has changed in the 1990s in response to global pressures, we need a clear snapshot of the industry in the 1980s. This section provides reference points for our two indices—technological and market convergence—as well as some historical background on the industry's development. We need to know the degree to which the industry based its past products on open or closed standards and relied on market forces to determine pricing and product strategies.

While all industries' developments are influenced by their pasts, the software industry is particularly path-dependent due to the powerful influence OS standards have on market competition. In particular, standards tend to lock in users because once a user purchases a specific computer system, he is likely to upgrade to that system to minimize costs for new equipment and retraining (Arthur, 1989). It is optimal for consumers to lock into the open standard used by the greatest number of customers because the more popular the standard, the greater its "network externalities"—the benefit a user receives from using a standard compatible with that of their colleagues. Users of machines based on a dominant open standard can share information more widely and enjoy a much better selection of applications software because independent software makers develop products for dominant not closed standards.

To understand Japan's computer software industry in the 1980s, it is necessary to understand issues such as standards and network externalities and to briefly discuss a few key events in the 1960s and 1970s that contributed significantly to where the industry stood in the 1980s. We focus our discussion around our two indices of technological and market convergence.

Technological standards

Up through the 1980s Japan's software industry was dominated by large hardware makers that produced OS and applications software based on closed, proprietary standards and provided the software bundled with, not

priced separately from, their hardware. Using closed standards meant that Fujitsu, Hitachi, NEC and other brands of computers were incompatible. Thus, once a customer bought one of these makers' products, he was essentially locked into buying other related machinery of the same brand and would continue to upgrade to software compatible with the same system. Changing to a competitor's system would be very expensive: it would require purchasing a completely new set of hardware and software, retraining employees on a new standard, and maintaining the old system to read old computer files.

The dominance of various different closed standards and bundling in Japan's software market was in the interest of the producer not the consumer. But all agree it was a necessary strategy until Japanese firms' hardware became competitive. Indeed, without closed standards, it is likely that the firms would have been forced out of both the hardware and software industries.⁵ But even after their hardware became competitive in the late 1970s, Japanese makers clung to their standards, unwilling to unbundle without assurance that all companies would do so. By the 1980s Japanese users were essentially caught in a vicious cycle, investing good money into closed systems with inferior software that denied them the benefits of compatibility.

The fact that Japan's two largest makers, Fujitsu and Hitachi, decided in the early 1970s to make computers based on a modified version of IBM's OS standard would come back to haunt them in the 1980s. IBM's decision to unbundle in 1969, under pressure from the US Department of Justice, meant that IBM agreed to publicize enough information on its hardware to allow firms to make plug-compatible computers, so-called clones. The Justice Department saw this as a way to increase competition in hardware by not allowing IBM to use its operating system software dominance to monopolize both industries. The result was a sharp increase in clone makers. Users of clones purchased IBM OS software to run their machines.

But Hitachi and Fujitsu, unlike US clone makers, were not willing to produce clones and have their customers buy IBM software. Without competitive hardware, they knew they would go out of business if they could no longer lock users into their standards. So they modified their IBM clones enough to make them incompatible. But this left them with a dilemma: they needed software to bundle with their hardware and since their hardware was a clone of IBM's, their software would also have to be similar to IBM's. The US maker, as part of its unbundling, agreed to make its hardware specifications public, but their software information, though open, was only provided to those who paid high licensing fees. The Japanese companies could not make a profit if they paid these fees so instead they illegally copied IBM's OS and applications software and modified it for their own machines.

Fujitsu and Hitachi's strategy of selling computer systems based on closed standards that were modified versions of IBM's standard worked well as

long as they could get away with freely “borrowing” IBM’s software. But it became an expensive headache when in 1982 the FBI caught them stealing IBM software technology in a sting operation. Freed from a major antitrust suit in the early 1980s, IBM set the FBI on the trail of Japanese firms. The firms did not deny illegally acquiring IBM’s intellectual property. Indeed, they had copied IBM’s software, errors and all.⁶ As a result of the IBM Spy Case, Fujitsu and Hitachi had to pay huge licensing fees to IBM for its software.⁷ It was difficult to pass this sharp cost increase on to customers because the firms had been bundling the software for years, acting as if it was their own.

The IBM Spy Case was not just expensive for the computer makers. It was psychologically devastating, sending shudders throughout Japan’s high-tech community. The large fees the firms had to pay IBM put heavy pressure on them to globalize their operations—to unbundle and sell only hardware or find some other OS standard they did not need to pay high licensing fees for. The firms resisted unbundling and went on a desperate search for new standards, either foreign ones that were open and free-of-charge, such as UNIX, or to new ones such as those explored in the private-sector-initiated TRON project or the Ministry of International Trade and Industry’s (MITI) fifth-generation computer project. Despite this flurry of activity in the wake of the FBI sting, Japanese companies remained quite dependent on their modified versions of IBM’s standard at the end of the 1980s. The way in which standards lock in users meant the firms could not convert to a new standard overnight because it would maroon the numerous users of their large installed bases. UNIX became a more popular standard for workstations, though the firms made their own versions of UNIX to lock in customers; the TRON standard, an entirely new open OS standard, made a little headway. But in the late 1980s modified versions of IBM’s standard still dominated the mainframe market and in personal computers NEC’s closed standard had the greatest market share.

MITI responded to the FBI Sting with a desperate move to buy the industry time and money to deal with the crisis. In early 1984 it proposed a software law that would protect copyright on software for only 15 years, not the 50 years provided by international copyright law. This law would have granted MITI the authority to require a firm to license its software to another company when MITI deemed it in the national interest or when a company had substantially modified the original software program and wanted to sell it as a new product. This was an euphemism for borrowing and a bold, internationally unprecedented attempt to legally undermine foreign firms’ intellectual property rights. “We want to prevent firms from having to completely rewrite software that already exists,” explained MITI’s Kawano Hirobumi.⁸ A top computer magazine, *Kompyutopia*, cited an expert acknowledging that MITI’s proposed law aimed to assist domestic firms in cheaply copying foreign software programs.⁹

It was clear by the end of the 1980s that Japan’s software industry was

caught in a vicious cycle due to the proliferation of various closed OS standards. MITI had broached the issue of unbundling a few times over the years, but the firms and users had been reluctant to make a change fearing a loss in business.¹⁰ State and corporate leaders as well as users became increasingly aware that the price/performance ratio of Japanese software was far lower than that of its foreign counterparts. But so much had been invested in closed, custom-made OS and applications software that it was easier to continue to ignore the problem than to make the conversion. The bubble economy of the late 1980s allowed computer users to absorb the costs of inefficient, technologically backward computer systems. Since the “catch-up” system of capitalism (Anchordoguy, 1997), with its strong bias toward large firms and producers in general, continued to work well in other industries, there was little thought of changing it despite a growing concern that Japan was lagging in software and other cutting-edge industries.

Degree of reliance on market forces up through the 1980s

There was little competition in Japan's OS or applications software markets up through the 1980s. Obviously the software makers had to keep their customers satisfied with sufficient upgrades of their computer systems. But the pressure was sharply muted by closed standards that locked users into a particular maker's software and hardware. Indeed, there really was no market for software—no arena where software could be compared, bought and sold. Rather it was provided “free” with hardware. Locked-in and unsophisticated about software, users could not compare their software's functions or price with that of other makers.

Up through the 1980s the large hardware makers that dominated the industry monopolized decisions about software prices, standards and production. That is, the corporations managed competition in the industry with virtually no antitrust constraint by the state. While many political scientists tend to equate the absence of state involvement in a market with a free market, this market was anything but free. Rather it was a tight oligopoly in which the large dominant hardware makers followed their own narrow self-interest by locking in customers with closed standards. There was virtually no competition from new entrants. The lack of a venture capital market inhibited new domestic start-ups. And even if domestic or foreign firms could have entered the market, they would have had difficulty surviving because the three big hardware makers had most users locked into their standards. The labor market, rigid due to the seniority wage and lifetime employment systems that sharply discouraged mid-career job-changes, also made it difficult for potential entrants to hire qualified personnel.

The state bureaucracy was not totally disengaged in the industry's development. But it was neither a strong promoter of the industry nor an

umpire monitoring the creation and maintenance of an open, competitive software market. MITI did sponsor some R&D projects, but their funding was relatively low and the results largely unsuccessful (Anghordoguy, 2000). Busy trying to nurture other industries of greater national priority such as hardware, semiconductors, autos and machine tools, the state allowed the firms to run the industry as they desired. There was no consensus among the various ministries about the importance of software or the technical expertise, even in the private sector, to fully understand the nature of software technology.¹¹ With firms able to “borrow” IBM’s software technology and thereby build up a healthy competitive hardware industry, this was an area where state officials felt they could afford to be relatively uninvolved.

It must be noted that users did not complain much about this oligopolistic behavior. It was difficult to compare products; foreign firms were not yet offering their products in the Japanese language; and the more users invested in their closed systems, the less interested they became in converting to a new system.

The 1990s: grappling with globalization

In the early 1990s, the state and corporations started to view software as a strategic industry, one in which Japan needed to become an international player. Personal computers and computer networks were changing the nature of work in the United States, and the Internet and related businesses emerged seemingly overnight. US firms dominated these new areas. In no major niches did Japanese companies play a global role. At this same time the Japanese economy started its long skid into recession and US companies regained some market share lost to Japanese firms in fields such as semiconductors and autos. America’s comeback, coupled with Japan’s deep recession, raised questions about Japan’s “catch-up” model of economic development.¹² There were, for example, concerns that the bank-centered financial system, which had worked well allocating scarce capital to manufacturing industries in the 1950s, 1960s and 1970s, had the negative side effect of discouraging venture capital and new start-ups. The traditional employment system, which had been credited with contributing to Japan’s rapid economic growth and smooth absorption of foreign technology, was now criticized for hindering invention and entrepreneurship. The education system, long praised for nurturing disciplined, welltrained workers, was now under fire for suppressing creativity and independent thinking. And it was increasingly clear that industrial policies, key to Japan’s success in many manufacturing industries, did not work well in many service industries. Some elite with long experience in the US, such as Yukio Noguchi of the University of Tokyo (1995) and Akio Morita of Sony (1992), called for a complete overhaul of the system in order to effectively respond to international competition. But the broader consensus

in Japan was that they needed to modify the system to make it more inventor-, consumer—and entrepreneur—friendly (Anchordoguy, 1997).

The software industry was at the core of this debate. It was clear that while the traditional “catch-up” system worked well in manufacturing industries, it was not effective in software where technological change was rapid and sometimes discontinuous, and ideas, risk-taking and a pool of venture capital far more important than loyalty, discipline and patient capital. Unlike in the auto, semiconductor, or consumer electronics industries, manufacturing expertise and production economies of scale were not crucial to competitiveness.

Japanese leaders, seeing their technological gap with the US in information-related industries grow starting in the late 1980s, were concerned that Japan's information industries had already become subcontractors of the US and were in danger of becoming so permanently. Software was seen as a clear casualty of the system (MITI, 1996; Japan Electronics Industry Promotion Association [JEIDA], 1994:4, 20). There was much talk as well as books written about the software crisis (Hirata, 1991). Everyone in Japan, MITI and the firms, “has a feeling of crisis about whether we can make the transition to a more creative society,” explained a software manager at a major Japanese electronics firm.¹³ Confidence in their ability to overcome the crisis was shattered. The CEO of one of Japan's few independent software firms, formerly a high-level executive at IBM Japan, said that if he was in charge at MITI, he would advise Japanese software firms that the quickest way to advance would be to go to the US to learn about software.¹⁴ A MITI official lamented: “All of the concept-making is coming from America or Europe. Japanese have been unable to create concepts, which is really a bad situation. Currently there is a mood of giving up, but we at MITI believe we should not do so.”¹⁵

Despite the sense of crisis, the information services and software industry continued to grow steadily over the years, even during the recession. In 1995 it was some 17 percent the size of the world market and equivalent to 35 percent of the US market. It grew from some 2.3 trillion yen in 1987 to some 6.4, 7 and 7.6 trillion yen in 1995, 1996 and 1997 respectively (\$64, \$70 and \$76 billion at 100 yen to the dollar).¹⁶ But growth was not accompanied by increased efficiency.¹⁷ Investment went into closed, custom-made systems; it was like throwing money into a black hole, making the vicious cycle even more costly to break out of. As of 1993, 85 percent of Japan's software market was of custom-made software based on closed, proprietary standards, 15 percent was packaged; in the US, 85 percent of software was packaged and 15 percent custom and proprietary (JEIDA, 1994:27). Japanese users were clearly locked into relatively low performance, high-cost software that denied them major benefits from compatibility.

Corporate and state leaders began to realize they could no longer afford to continue investing in costly, closed, custom-made systems that were

technologically inferior to what foreigners in other advanced nations were using. Continuing down this path would undermine the efficiency of the overall economy as well as endanger Japanese competitiveness in key industries that relied on access to sophisticated software.

The problems were clear but the solution was not. The consensus was to modify the system, to make a two-track or hybrid system that combined traditional practices with some Western practices.¹⁸ In contrast to the conventional view that leaders and citizens of foreign countries aspire to become like the US in terms of being a consumer-welfare-maximizing democratic, capitalist nation, Japanese people do not see the market-based US capitalist model as a desirable option. Rather they view many US problems, such as homelessness, drugs and crime as a result of excessive deregulation—too much reliance on markets.¹⁹ Debate continued over exactly what parts of the traditional system should be changed and how to change them, with a focus primarily on changing the employment, education and financial systems in ways that would nurture creativity, invention and entrepreneurship. In short, an active debate over how to re-negotiate the “domestic bargains” between government and business, management and labor, and producers and consumers was under way.

While this broader debate continued, there were no longer any doubts about the importance of the software industry and the need to move quickly to shore it up. The government, which had long neglected the industry, started to give it the attention and financial assistance that hardware had received since the late 1960s.²⁰ MITI and its related trade associations published reports educating users and firms about the importance of software and explaining how closed standards were hindering the industry’s development. These reports harshly criticized the government’s past policies toward computer software. Only 16 percent of the state’s total funding of computer (hardware and software) projects from the early 1970s up to the Real World Computing System Project in the mid-1990s went to software; excluding the largest project, the Sigma Project, the proportion of state funding going to software was only 6 percent. The reports also criticized other mistakes the state had made, such as treating software as an appendage to hardware, viewing software problems as primarily issues related to small companies and a shortage of programmers, and being blind and inflexible when it became clear that state policies toward the industry were ineffective (JEIDA, 1994:11, 13, 21–2). With the state publicly criticizing itself, one was led to expect serious change.

Technological convergence

The state and the computer firms were acutely aware that the costs of closed standards were mounting and that to become internationally competitive, they needed to unbundle, move toward international standards, and shift their focus from quantity to quality.²¹ The government, which now viewed

software as a “leading industry” with critical positive spillovers onto other industries, favored this path even though it would hurt the hardware makers temporarily. But the firms were afraid to unbundle, especially without assurances that all would do so.

The most expedient and diplomatic way to pressure the industry to unbundle and move toward international standards was to have foreign firms force the conversion. MITI and other agency reports publicized this strategy, most prominently in MITI's December 1992 *Urgent Proposal: The New Age of Software (Kinkyu Teigen: Sofutouea Shinjidai)*. In this report MITI wholeheartedly welcomed foreign software and PC firms into Japan's market. Reflecting the report's concern with software's positive spillovers into the broader economy, Ryoza Hayashi of MITI argued that Japan needs software makers in the domestic market that are able to provide high-value-added, high-quality services cheaply and “it is no longer important whether they are Japanese or foreign firms” (Hayashi, 1993:20; MITI, 1992:7, 9). Because of different languages and cultures, he added, imports alone cannot solve the problem. Soon after MITI's report, a series of articles in Japan's major business daily discussed how Japan's software industry was now open to foreign firms.²²

In unleashing foreign firms, MITI acknowledged that software, due to rapid, unpredictable, and sometimes discontinuous technological change, was significantly different from other industries it had targeted in the past.²³ Hayashi of MITI (1993:24–5) went so far as to say that in such industries, where it is very difficult to envision the technological trajectory, America's “market-leading model” was the best way to promote development. These statements strongly counter MITI's past policies, reflecting their intense desperation over the software crisis and their tacit recognition that Western OS standards had won the standards war. MITI was suggesting that, somehow, deeply embedded institutions, ideas and “domestic bargains” would no longer obstruct change in the computer software industry.

IBM's introduction of a Japanese-language version of DOS—DOS/V—in 1991 paved the way for using foreign firms to pressure Japanese companies to convert to open, internationally accepted standards. With DOS/V, the Japanese language could be used on IBM's PC/AT platform, allowing the US giant to offer the same platform globally. IBM made DOS/V open to everyone, thinking that greater demand for it would have positive externalities on IBM's PC sales. Soon after, Toshiba and Fujitsu responded with DOS/V machines. But it was a foreign firm, Compaq, that jolted the market in October 1992 by offering DOS/V machines priced at about half that of a comparable NEC. This “Kompakku Shokku” (Compaq shock) jolted NEC and its proprietary 98-series PCs, which had some 60 percent of the market, knocking it off its pedestal and pressuring it to move toward global standards. Compaq's aggressive entry has been described as the return of Commodore Perry's Black Ships, which forced Japan to open up to the West in the mid-1800s.²⁴

It is difficult to imagine that the sudden entry of foreign firms around the time MITI welcomed foreign software and PC makers was a mere coincidence. If not intentional, it is hard to understand the dramatic shift in MITI policy at a time when its officials and other bureaucrats were going to great lengths to protect other high-tech industries, such as telecom, supercomputers, medical equipment, pharmaceutical products and cellular phones. The changes in MITI policies—its response to globalization pressures—reflected its acknowledgment of past failures in software and of the need to borrow the strength of US software companies to promote the domestic industry.²⁵ For decades the Japanese government had used *gaiatsu* (foreign pressure) to induce the re-negotiation of “domestic bargains” because it allowed them to blame foreigners for the political fallout; the existence of sympathetic domestic interest groups (*naiatsu* or domestic pressure) in this case made *gaiatsu* all the more effective.²⁶

After the Compaq shock rippled through the market, MITI got what it desired: unbundling and a shift toward open, internationally accepted standards. Today all the Japanese makers offer Windows-based PCs and are gradually converting their larger systems to groups of smaller networked machines based on UNIX, Windows or Windows NT. US hardware makers ultimately gained little market share because Japanese makers responded to price cuts and started offering machines based on international standards. But foreign software makers, especially Microsoft, won big in the packaged software market, where they dominate some 95 percent of the small but growing market. By 1995, Japan was importing some 392.6 billion yen (\$3.92 billion at 100 yen to the dollar) of software while only exporting 3.9 billion yen (\$39 million) worth; even including game software, Japan’s most successful software product, there was a trade deficit in software of 316.3 billion yen (\$3.163 billion).²⁷

Market convergence

To what extent did state and corporate policies in the software industry respond to globalization pressures by shifting to a greater reliance on markets? In the 1990s MITI clearly shifted gears. After long neglecting the industry, it became much more involved in shaping its future. Moreover, it officially welcomed foreign firms, acknowledging that they were needed to rejuvenate the domestic industry. Convergence theory as well as analyses based on neoclassical economic and corporate dominance theories would predict that the firms would shun MITI’s reassertion of capacity to shape the industry, viewing it as a power grab at the expense of big business. But the computer and software companies actually welcomed MITI’s new role and actively looked to MITI for guidance.²⁸ As one corporate software manager put it, companies will not take a leadership role in Japan’s transition to a more creative society. “They [companies] won’t take up a flag and wave it. They do not want to take so much risk, so MITI still has an important role in

coordinating the firms.”²⁹ The CEO of one of Japan's largest independent software companies concurred: “MITI now has a real sense of emergency, a feeling of crisis regarding high tech in general and the software industry in particular. They want to do something for software and MITI has to do something. That is their mission.”³⁰ Thus the emergence of an active state guiding the industry was not viewed by businesses as a zero-sum play that reduced corporate power. Rather, as in other industries in the past, under crisis conditions the firms and the state worked together to promote a competitive industry.

In its new, more active role, MITI officials and those of their related institutions emphasized the benefits of open competition and free markets. MITI appeared to be moving toward full market convergence, toward intervening in the industry primarily as an umpire, a maintainer of markets, rather than its traditional role as a promoter of domestic industry. It argued that the software market needed active competition, that domestic competition had been critical to successfully targeting other industries. It asked hardware makers to establish clear accounting systems for each division and to cease cross-subsidizing software with hardware profits, threatening that such practices might violate anti-monopoly laws. And it called for hardware makers to fully disclose their hardware technical specifications so independent software makers would have enough information to make compatible software (MITI, 1992:7–8, 13–19; MITI, 1993:14–18; Hayashi, 1993:24). MITI underscored its support for unbundling and software packages by purchasing some 7,000 packages from Lotus Software.³¹

But for all its talk of the need for a free, fair market for software, including stronger intellectual property protection, behind the scenes MITI was trying to prevent foreign firms from capturing too much market share (MITI, 1992:16–17; MITI, 1994:68–70; MITI, 1997b:8–9). It used markets much more than in the past, but was not willing to rely on them to determine winners and losers in the domestic industry. One of its first moves, in 1993, was an attempt to revise the copyright law to make reverse engineering of software legal. Its motivation was the same as in its failed effort to create a new copyright law in 1984: to allow domestic companies to legally copy foreign software. After this tactic failed once again, MITI, desperate and determined, tried to establish a voluntary quality assurance program for software, a move US makers argued would require divulging proprietary secrets to get a stamp of approval.³² Because American firms and its government strongly opposed both proposals, the Japanese government backed off.

MITI was fully prepared with several other measures to assist domestic companies in countering foreign inroads. By designating the software industry as seriously affected by the recession, it got the Labor Ministry to provide software firms with employment adjustment subsidies to protect employment.³³ To aid independent software houses in acquiring loans, MITI

and the Information Processing Promotion Agency (IPA), its software arm, set up a system in 1996 whereby major banks would accept software as collateral for loans.³⁴ In mid-1997 it pushed through a revision of the commercial code to allow firms to offer employees stock options; this was aimed at attracting qualified people to industries such as software.³⁵

MITI also dramatically expanded its funding for software-related projects (MITI, 1995:32). Huge chunks of the supplemental budgets used to stimulate the economy in the mid-to-late 1990s went to software-related programs. For example, MITI granted some 60 billion yen (\$600 million) in fiscal 1995 to software-related projects, half of which went to a project to develop an electronic commerce system.³⁶ In fact the 1990s were filled with national R&D projects related to software. These include the Real World Computing Project (1992–2001), the so-called sixth-generation computer project, which focuses on massive parallel processing. Supported by some 70 billion yen (\$700 million) in state funds (MITI, 1997c:66), this project aims to develop a computer with a million or more processors and is clearly a response to the US lead in massive parallel processing. Various other software-related projects received some \$667.61 million (66.761 billion yen) in MITI funding in 1997 (MITI: 1997c:61–8). MITI is also leading commercially-oriented projects in a wide range of fields such as biotechnology, superconductivity, medical equipment, and micromachines. In short, MITI is still heavily involved in projects that have strong commercial relevance for software and other high-tech industries, not just basic R&D projects that all countries support. We do not see the bureaucracy nor the private sector showing any fundamental proclivity toward relying on market forces to allocate resources within and among high-tech industries such as software.

It is impossible to evaluate the effectiveness of the state's various programs in the 1990s. But it is clear that despite its rhetoric about the benefits of free markets and its increased use of market forces to achieve desired outcomes, the Japanese state is not willing to rely on market forces to determine the future of strategic high-tech industries such as software. Rather it is selectively using market forces and only playing an umpire role when it serves national goals. The Japan Fair Trade Commission's (JFTC) raid on Microsoft's Japan headquarters in January 1998, for example, should be interpreted as an attempt to bolster domestic firms, not as a move suggesting that the state is starting to enforce the anti-monopoly law in a consistent, unbiased manner. The primary focus of the JFTC investigation was not the bundling of Microsoft's browser because domestic companies do not offer a competitive browser alternative. Rather it focused on the concern that Microsoft, which arranged to have its Word and Excel programs pre-installed on new computers, was forcing vendors to refrain from pre-installing rival products such as the Ichitaro word processing program, Japan's only really successful packaged software product. Sales of Ichitaro began to drop significantly in 1997.³⁷ While this was a valid antitrust

concern, it selectively focused not on maintaining competition in general, but on investigating foreign firms when their products cut into the market share of specific domestic products. When the investigation was concluded in late 1998, it was not surprising that it found that Microsoft's pre-installation policies violated Japan's anti-monopoly law.

We have also not seen the major changes in labor and venture capital markets that state and corporate leaders called for to nurture a vibrant independent software industry. Despite all the talk of changes in the employment system, as of 1995 only 4.3 percent of companies surveyed in the White Paper on Labor had a merit-based system in place, with 3.5 percent of firms looking into it.³⁸ Data from 1996 on small and medium enterprises suggests that the move toward merit pay is occurring quicker in these companies; but still only 11.5 percent of those surveyed had already instituted the system, though 53.1 percent said they were thinking about it (Chusho Kigyo Cho, 1997:356). And while firms are creating policies to allow top researchers more freedom in what they research, still "people with creative ambition leave Japan," explained a software manager at a major electronics company.³⁹

There has also been little positive change in the financial system in terms of creating a vibrant venture capital market that sufficiently funds start-ups. The long recession in the 1990s has led banks to refuse loans to small and medium-sized enterprises, causing a credit squeeze even for viable companies.⁴⁰ Indeed, bankruptcies of independent software companies have soared in the 1990s (Nihon Joho Shori Kaihatsu Kyokai, 1998:199).

Independent of the current economic downturn, however, Japan's venture capital system is different in ways that make it unlikely to spur start-up high-tech companies as it does in the United States. Most venture capital in Japan comes from banks not investors and thus start-ups are immediately burdened with interest payments. Also, since banks in general are much more sensitive to risk than venture capital companies and since Japanese banks in particular lack analysts with the technical expertise to assess the risk of high-tech projects (Chusho Kigyo Cho, 1997:371-2), much less venture capital goes to high tech in Japan. Some 70 percent of venture capital in the US is invested in high-tech industries compared to less than 20 percent in Japan. And over 70 percent of US venture capital goes to firms in their first ten years of existence, compared to Japan where over 70 percent goes into companies that are at least 10 years old. Moreover, while a firm on average goes public in about 6 years in the US, in Japan the average is 30 years, sharply reducing the incentive for venture capitalists (Nihon Joho Shori Kaihatsu Kyokai, 1996:272-5; Chusho Kigyo Cho, 1997:369-73). Until Japan has a freer flowing, high-volume venture capital market in which funds come directly from investors rather than banks, it is unlikely to nurture a set of healthy independent software houses.

Such change is not likely to occur in the near future due to the financial problems Japan is having in the late 1990s. By late 1998 many of Japan's largest banks could not even meet the BIS requirements without a large injection of public funds; it was clear that over the next few years Japan's banking sector would have to be restructured through mergers and bankruptcies.⁴¹ Even when confronted with the long recession in the 1990s, Japanese leaders only slowly responded to global financial pressures by gradually deregulating their financial system. As the world's second largest economy, they were not forced by the international system to make quick, dramatic changes, as were smaller economies such as South Korea. Indeed, most analysts agree that the "Big Bang" deregulatory measures that started to be implemented in April 1998 were too little, too late (Lincoln, 1998).

Extensive talk of changing the education system to nurture more creative thinkers also has not resulted in much significant change. The biggest modification is a plan to institute a five-day school week (currently school meets five days plus every other Saturday) and cut mandatory classes for an hour or two a week to allow students more general studies classes and more free time to explore their own interests. But even these changes will not go into effect until 2002.⁴² And since university entrance is still based on exams that test rote memory, a shorter school week will likely lead students to spend even more time in after-school cram schools that prepare students for exams. As long as the best predictor of future social status is the university one attends and university entrance is based on exams testing rote memory, Japanese children will continue to spend a major part of their "free" time studying for exams not exploring their own interests.

Without a doubt there has been dramatic change in the computer software industry in the 1990s. Global pressures, especially from the dominant position of the Wintel standard, provided strong incentives to the hardware and software companies to gradually convert to open, internationally accepted standards. There is much more competition in the industry than in the past, as well as increased talk about stimulating the venture capital industry and modifying the education and employment systems in ways that will promote more creativity and entrepreneurship.

But these various ongoing changes in the "domestic bargain" stop short of full convergence to a market-based system. Competition in the computer software industry is still managed, though it is now managed jointly by the state and firms instead of managed primarily by the private sector. The state is still actively trying to tilt the playing field to the advantage of domestic firms. MITI remains fundamentally uninterested in functioning as a maintainer of free markets; rather it uses the market selectively to attain specific goals. Deeply embedded ideas about the value of markets and states, long-standing institutions set up to manage competition, and entrenched vested interests continue to hinder a quick, bold response to global pressures.

Conclusion

What do the events in the software industry over the last few decades tell us about how Japan's state and corporations are grappling with globalization? How representative is the software case and what implications does it have for our broader questions about state-society relations, the traditional dichotomization of states and markets, and state capacity?

Pressures from global technological trends were clearly critical in forcing Japanese makers to unbundle and move away from closed standards. Still, the Japanese government and companies resisted changing their standards strategy as long as they could, giving in only when the costs of not changing overwhelmed them. Japanese companies and the state bureaucracy also appear to be moving reluctantly in the direction of market convergence. There is much more competition in Japan's computer software industry than in the past. With unbundling, it is much easier to compare software prices and to test different machines to determine which brands best meet one's needs. The rush of foreign competition substantially slashed the prices of Japanese personal computers. The policy change in 1996 to allow software as collateral for bank loans has not had much impact yet because of the severe recession. But over the long run it should provide small independents with easier financing than in the past. This should further stimulate competition.

But despite encouraging more market competition than in the past, the evidence suggests that Japanese computer software makers and the state are not moving toward full reliance on relatively unfettered markets to determine winners and losers in the industry. Rather we see the state using market forces to achieve specific outcomes but not depending on them. If state officials are truly committed to globalization, why do they continue to try to undermine foreign companies' advantages in intellectual property rights and comprehensively support many projects that have clear commercial goals? With a move toward full market convergence, we would also expect to see the state playing a much more active and neutral umpire role than it is. And if the companies are globalizing, we would expect corporate leaders to be booting the state out of the industry's business rather than begging MITI to find a solution to the software crisis. It is true that consumer interests carry more weight in the market today than in the past. But the lower prices and open, internationally-accepted standards that came with MITI's unleashing of foreign firms in the marketplace were a positive side effect of its primary goal of strengthening the domestic computer software industry. That is, technological convergence was deemed to be in the national interest and it just so happened to also be in the consumers' interest.

How representative is the software case? While only a detailed comparison of various industries could answer this question definitively, numerous interviews and extensive reading suggest that it is representative

of a category of strategic industries in which Japan is a global player but not a winner. Japan's state and corporate leaders are not enthusiastic about allowing global winds to freely blow through these industries. They believe unmanaged markets would only devastate the firms trying to gain a solid foothold in these areas. Response to global pressures in such industries differs from that in manufacturing sectors where Japanese firms are very competitive, such as autos, semiconductors and consumer electronics products. In manufacturing industries we find much more movement toward convergence with international practices. With solid global market share, firms in these industries could afford to absorb some of the costs of adjusting to globalization pressures and thus change more quickly. And they have also been able to blame the significant domestic social costs of globalizing on foreign firms and governments who have persistently complained about Japan's large trade surpluses.

However, even in these super-competitive industries, Japan's elite has never enthusiastically embraced the market system. Partly this is because they have no historical experience with free markets. But it is also because, fundamentally, Japanese leaders as well as citizens do not see the American way as a desirable option. They are searching for a middle path between markets and oligopolies, a hybrid way combining some traditional practices and policies with some ways of the West. As a result, even where we see movement toward market convergence, it has been long resisted and the move has been managed.

What does the software case tell us about state capacity and effectiveness, the nature of government-business relations and the traditional dichotomy of states versus markets? First, it shows a state that decided not to use its capacity in the first few decades of the industry's development. Other industries were given greater priority. This notion of unused capacity counters work by Japan scholars such as Richard Samuels (1987:259–61) who argue that where the state is not actively involved, it is because of its incapacity to wrestle control. The case thus suggests that the state does not try to intervene in all industries to the same degree and with the same purpose. Rather it has been selective in using its scarce political and financial resources. And its new, more market-oriented breed of policies toward the industry today suggests that the state understands the limitations of its traditional targeting policies in a new globalized technological environment. There is an awareness that these techniques are not effective in industries insensitive to production economies and quality control techniques; nor do they succeed when goals are unclear, dominant standards are controlled by foreign firms, network externalities are critical, technological change is rapid and sometimes discontinuous, and reverse-engineering is illegal.

Second, the move from an industry where firms managed competition to one where the state and the firms are working together to shape competition in positive ways suggests that it is misleading to analyze state

and business activities purely through the lenses of markets (neoclassical economics) and states (bureaucratic dominance). We need to better understand how firms alone as well as firms and the state together manage and mismanage markets. Indeed, in the computer software case we cannot dichotomize the state and the market; rather we find increased market competition and increased involvement of the state as a promoter of the industry. We get state actors and the market, in the market, using the market.

Finally, the case also raises questions about the conventional emphasis on a dichotomy between the state and society. Government-business relations in the software industry have been characterized by persuasion, negotiation and compromise, not direct control by the state or the firms. For example, when MITI floated the idea of unbundling in the late 1970s, firms and users debated the issue but were not willing to comply. In the 1990s, when MITI started to use its capacity more actively, the firms welcomed its guidance. Today the state and firms are working together in what Peter Evans (1995) would call a joint project, in a positive-sum relationship not a zero-sum game. This suggests limitations of a zero-sum state-society paradigm in nations such as Japan where there is a distinct blur between what is public and private and where cooperation is as much the norm as competition.

Notes

- 1 This research was supported by generous grants from the US-Japan Friendship Commission and the Abe Fellowship program, and a travel grant from the Center for International Business Education and Research (GIBER) at the University of Washington.
- 2 Dominant standards or designs have long been discussed in the economics literature, see Teece (1986); recent studies of dominant designs in the computer industry include Borrus and Zysman (1997) and Kim and Hart (1998).
- 3 For discussion of various types of convergence, see Boyer (1996).
- 4 Samuels (1987) posits a zero-sum relationship; Evans (1995) posits blurred lines and often a positive-sum relationship between the public and private sectors.
- 5 Interview with Dr Hiroshi Inose, Director General of the National Center for Science Information Systems, the former Dean of Tokyo University's Faculty of Engineering, and one of Japan's top computer experts, July 14, 1994; Interview with a MITI official, Electronics Policy Division, November 13, 1996.
- 6 'Fukiareta IBM Taifu,' *Kompyutopia*, February 1984, p. 53; 'Fujitsu, Hitachi—19-nen no Rengo no Shushifu,' *Nihon Keizai Shimbun*, September 4, 1990, p. 1.
- 7 Estimates suggest Hitachi and Fujitsu paid IBM some \$25–50 million annually for use of its software, see Shimoda, 1984:60–61; *Nikkei Kompyuta*, August 9, 1993, p. 12.
- 8 Cited in *Business Week*, February 13, 1984, p. 110A.
- 9 'Fukiareta IBM Taifu,' *Kompyutopia*, February 1984, p.53.
- 10 MITI, 1979; series of columns subtitled 'Anbundoringu no Kihon Hoshin,' *Nihon Keizai Sangyo Shimbun*, February 28, March 2, 3, 6, 8, all of 1979, all p. 4; 'Densanki Kakusha no Sofuto Yushoka Jisshi ga Kido no, Yuza no Rikai ga kagi,' *Nikkei Sangyo Shimbun*, July 29, 1978, p. 4. Many interviewees emphasized

that users hindered unbundling, for example, the head of the Japan Users Association of Information Systems, November 13, 1996; a software manager at a major Japanese computer company, November 12, 1996; Deputy Director of Electronics Policy Division of MITI, July 11, 1994; Tojo Akio, the head of MITI's software arm, The Information Processing Promotion Agency (IPA), November 14, 1996. All interviews cited in this article were conducted in Tokyo by the author unless otherwise noted.

- 11 Interviews with Tojo Akio, November 14, 1996 and Inose Hiroshi, Director General of the National Center for Science Information Systems, July 14, 1994.
- 12 Interviews with a Keidanren official specializing in science and technology, July 28, 1995 and the president of the Japan Center for Economic Research in Gotemba, August 5, 1995.
- 13 Interview with a manager of the software engineering department of a major firm, Kamakura, July 19, 1994.
- 14 Interview, July 20, 1994.
- 15 Interview with MITI's deputy director of the Information Services Industry Division, July 13, 1994; this pessimism was also expressed in an interview of MITI's Senior Deputy Director, Technology Policy Division, September 21, 1998.
- 16 MITI, 1997a: 1; '7 Nendo wa 7% no Ohaba Seicho,' in *Nikkei Kompyuta*, May 12, 1997, p. 94.
- 17 Hayashi, 1993:22. Interview with Tojo Akio, November 14, 1996.
- 18 Interview with a university professor who was formerly an Economic Planning Agency official, Gotemba, August 2, 1995; a double track system was also mentioned by Yoshitomi Masaru, a high-level Long Term Credit Bank of Japan official in a symposium at the University of Washington, Nov. 27, 1995; interview with deputy director, Information Services Industry Division, MITI, November 21, 1996.
- 19 For example, see the statement by the head of the Economic Planning Agency in *Ekonomisuto*, November 26, 1996, p. 14.
- 20 'Myonichi naki Sofuto Gyokai,' *Nikkei Kompyuta*, August 23, 1993, pp. 56–57; interview with MITI official, International Trade Policy Bureau, July 8, 1994.
- 21 MITI, 1992:1; MITI, 1995:32; Hayashi, 1993:19–20. Tojo, 1995:9; and interview with Tojo Akio, Nov. 14, 1996.
- 22 The first of the *Nihon Keizai Shimbun* articles was on Dec. 16, 1992, p. 11.
- 23 MITI, 1992:4–5; interview with MITI official, Information Services Industries Division, July 13, 1994.
- 24 'Monozukuri Shinwa no Kokai—Kurobune Pasokon no Shogeki,' *Nikkei Bijinesu*, February 8, 1993, p. 11; 'Kompyuta Sangyo no Genjo to Tenbo,' *Denshi Kogyo Geppo*, January 1996, pp. 9–10.
- 25 'Nichibei Sofuto, OS Jigyo de Teikei—Hi no Maru Jirushi Ikusei,' *Nikkei Sangyo Shimbun*, November 17, 1993, p. 1; Interview with MITI official, Electronics Policy Division, November 13, 1996.
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4 Aiming to secure a piece of the action

Interests, ideas, institutions and individuals in Australian integration into the global economy

John Ravenhill

Australia together with its neighbor in the antipodes, New Zealand, maintained the highest levels of tariffs among all OECD countries until the 1980s. Within fifteen years, however, both had reduced their tariff protection to the OECD norm; moreover, both countries had relatively good records on the use of non-tariff barriers and provided little support for their domestic agricultural sectors.¹ For these two countries, efforts to cope with the forces of globalization have involved a dramatic reversal of seven decades of policies aimed at insulating domestic economy and society alike from the vicissitudes of global capitalism. These policies of insulation were sustained by efficient primary product sectors. The declining weight of raw materials in global trade, and consequent deterioration in their economies' terms of trade and current account balances, forced governments in the two countries to seek a new basis for integrating their economies into the global system. This quest has focused in particular on increasing the competitiveness of domestic manufacturing and services sectors.

Responding to the forces of globalization inevitably has brought changes not only in economic policy but also in the institutional arrangements that link state and society.² The process of coming to terms with globalization has been marked by contentious struggles that have pitted competing interests, ideas, institutions and individuals against one another. This paper reviews how Australian governments have attempted to cope with the forces of globalization over the last thirty years. It focuses in particular on policies towards the manufacturing sector. I begin, however, with a discussion of the construction of the origins of "protection all round".

Insulation as a response to vulnerability

Unlike the experience of the small industrialized economies of Western Europe, the historic compromise between capital and labour in Australia rested on efforts to respond to economic vulnerability by insulating domestic groups from international forces.³ The Australian response, mirrored by New Zealand, rested on a particular configuration of ideas, interests and institutions.

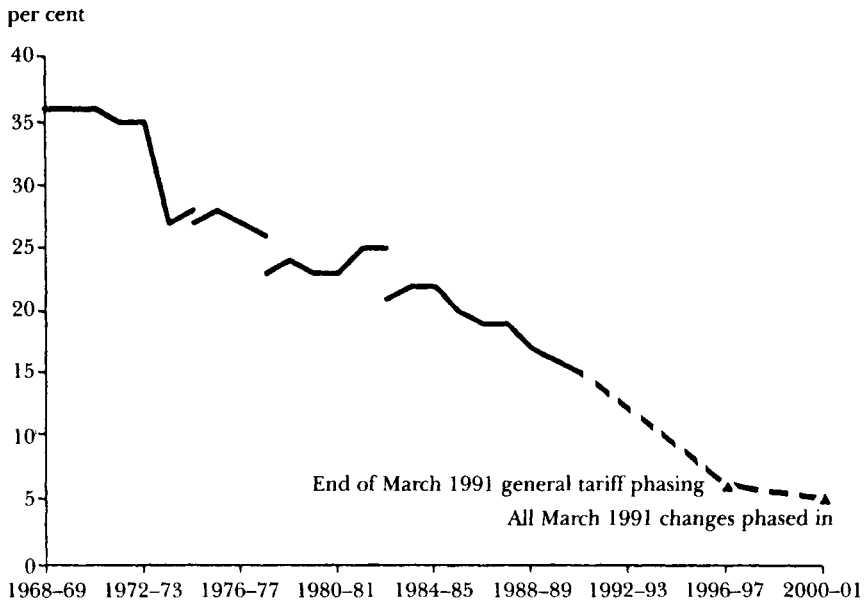


Figure 4.1 Average effective rates of assistance for the manufacturing sector^a; 1968-69 to 2000-01

Source: Industry Commission estimates.

^aThe discontinuities in the series reflect the periodic rebasing of the estimates to account for changes in the structure of the manufacturing sector.

The ideas

Ideas shape identities. They also inform governments' and interest groups' conceptions of the parameters of viable policy options. In Australia both these roles of ideas were important in the construction and dismantling of the insulated state over the last century. The most fundamental idea shaping Australian identity was an extreme consciousness of vulnerability. The underpinnings of conceptions of vulnerability were multi-dimensional. Geographical location was one important element. Australians viewed themselves at the turn of the century as an isolated outpost of European civilization, adrift in "potentially alien seas" to use the phrase of Sir Robert Menzies, the country's longest serving Prime Minister.⁴ Australians had little faith in their capacity to defend themselves against external aggressors, necessitating reliance on, to quote Menzies again, "great and powerful friends".⁵ The "tyranny of distance" complicated governance for a territory still not a sovereign nation at the time of Federation in 1901.⁶

Moreover, the country's distance from its major markets caused Australians to believe that their economy would only be competitive in bulk exports that had benefited from the steamship revolution. Yet a domestic

manufacturing industry would be essential to support a population base of sufficient size to defend the country. Protection of the economy's infant manufacturing industry thus was not merely a matter of economic development but of nation-building. In an argument reminiscent of Alexander Hamilton, Australia's second Prime Minister, Alfred Deakin, asserted that "No nation ever claimed national greatness which relied on primary industry alone".⁷ The depression of the early 1890s had provided a vivid reminder of the vulnerability of a society largely dependent on the export of a handful of primary commodities—albeit a country that at this time enjoyed the highest *per capita* incomes in the world.

Also important in shaping the historic compromise were ideas about the type of society Australia should become. The emphasis was on avoiding the adversarial relations and class conflict that had developed in Britain in the nineteenth century, a task made more urgent by violent conflicts between strikers and troops in Australia in the early 1890s. Even among the leaders on the conservative side of politics, a belief existed that the state could act as an independent arbiter between the forces of capital and labor.⁸

Interests

Ronald Rogowski (1989) in his pioneering study of factor endowments and trade policy preferences believed that a straightforward explanation was available for Australia's adoption of protectionist policies in the first decade of this century. In an economy rich in land but one in which both labor and capital were scarce, the logical political outcome was a protectionist coalition of labor and capital. The reality is rather more complex.

The protectionist coalition constructed in Australia in the early years of Federation owed as much to small farmers, whose rural constituencies in New South Wales and Victoria were over-represented in the state and Commonwealth (federal) parliaments, as it did to manufacturers, who remained divided on the protection issue. Rogowski's (1989, p. 122) assertion that "Australian agriculture had always been free trading" is at best only partially correct. The problem here is a failure to comprehend the differentiated character of the agricultural sector.⁹ One component of the sector—the graziers—was land-intensive and pro free trade. But of greater political significance at the turn of the century was the large number of small-scale farms in dairy, cotton and sugar production. Generally, these small farmers were inclined towards protectionism.

The "historic compromise" in Australia was one of "protection all round" in which each of the factors of production was insulated from world market forces through various mechanisms provided by the state. The protectionist inclinations of small farmers were strengthened by compensation from the state for the higher costs they incurred through protection of the manufacturing sector. The range of supports included subsidized inputs,

government-financed research and development, and the stabilization of prices through commodity boards. The influence of small farmers was sustained through commodity-based farm organizations. In turn, commonwealth and state governments' arrangement of their agricultural departments along commodity lines reinforced these farm organizations. Problems of collective action faced by bodies representing a large number of small producers were alleviated by the geographical concentration of the producers, their sense of identity, and by low subscriptions charged by the farm groups.¹⁰ The representation of producers along commodity lines long kept the agricultural lobby fragmented, preventing large farmers from becoming the dominant political voice of agriculture.

For manufacturing, insulation came through the tariff. The crucial link with protection for labor developed out of the conflicts between capital and labor in the early 1890s, conflicts that capital, backed by the armed force of the state, won decisively. Labor subsequently turned to the state for protection. In this quest it was aided not only by its own representatives in some of the colonies' parliaments but also by the desire of prominent liberal politicians and a large part of the electorate to avoid the class conflict of the early part of the decade (and, more cynically on the part of politicians, to capture the votes of labor). The outcome was a system of arbitration tribunals that were intended to settle disputes and to fix wages and conditions at a "reasonable" level.

This settlement was reinforced at the federal level with the establishment in 1904 of the Commonwealth Court of Conciliation and Arbitration, and the adoption in 1906, of a policy of "New Protection". The Excise Tariff (Agricultural Machinery) Act of that year stipulated that employers would receive tariff protection only if they paid their workers "fair and reasonable" wages. In the following year, the meaning of a "fair and reasonable wage" under the Act was interpreted by the President of the Commonwealth Arbitration Court in the celebrated "Harvester" judgment to be "the normal needs of the average employee, regarded as a human being living in a civilised society", the average employee being defined as a male with a wife and three children.¹¹ Employers were obliged to pay a fair and reasonable wage regardless of the economic circumstances they faced. The author of the judgment, Justice Higgins, asserted that wages should not be "left to the usual but unequal contest, the 'higgling of the market'". The judgment, as Macintyre (1983) argues persuasively, institutionalized a unique (preindustrial) moral economy in Australia that gave priority to workers' welfare and industrial peace over the operations of local and global markets. The adoption of the arbitration and conciliation system reflected the capacity of the new federal state in Australia, influenced by liberal ideas on how to create a just society, to act autonomously in the face of substantial initial resistance from capital.

The state added another crucial component for the protection of labor: the adoption of a discriminatory immigration policy that excluded workers

of non-European background (who were suspected of being willing to work for “sweatshop” wages). In turn, the yardstick for the level of protection was to be costs of manufacturing production in the UK, adjusted for Australia’s higher level of wages.

Institutions

For the system of protection all round to be effective, it had to be insulated from everyday politics. To this end, Australian governments created a unique set of “organs of syndical satisfaction” (Miller, 1959:128). The Conciliation and Arbitration Court, to protect labor, was the first of these. After suffering some reverses in parliament in their quest for higher tariffs, manufacturers in turn sought to remove these issues from the political arena. This objective was achieved in 1912 with the establishment of the Interstate Commission, a quasi-judicial independent body charged *inter alia* with investigating industries that claimed to need tariff protection. The Commission scarcely had an impact before war intervened, a development that reinforced popular impressions about the vulnerability of the country and its economy. Moreover, the isolation of the economy during the war stimulated local manufacturing ventures, many of which faced an uncertain future with the resumption of peacetime commerce. Significantly increased tariffs in 1921 reflected the dominant protectionist sentiment. In the same year, the government created the Tariff Board, a formally independent advisory body with powers to undertake its own investigations into the impact of the tariff on specific industries, as well as a requirement to respond to government referrals.¹² The final branch of the triad of protectionist arrangements were agricultural marketing boards, created at both state and federal level, for specific commodities. These typically sought to stabilize farmers’ incomes by maintaining artificially high prices in the domestic market by closing it off to imports.¹³

The Second World War further reinforced protectionist sentiments in Australia. Again the emphasis in the immediate post-war period was on nation-building, one component of which was the construction of a manufacturing base of sufficient size to support a population capable of defending the country. The post-war commitment to full employment, influenced by Keynesian ideas, further strengthened perceptions that the country needed a significant manufacturing sector. The following twenty years were the apex of the system of protection all round. Until 1960, a system of import quotas and licensing largely supplanted tariffs as the principal instrument of protection. For domestic producers, the system, in the words of the eminent economist, Max Corden (1962), was one of “made-to-measure” protection. “You make it and I’ll protect it” was the injunction of Sir Frank Meere, who held the role of Special Advisory Authority in charge of emergency tariff powers in the 1960s.¹⁴ The phrase epitomized not just popular attitudes towards protection but also those held

by governments in the first two post-war decades.¹⁵ The unconditional granting of industry protection in Australia could not be further removed from the performance-related protection that many authors have seen as a key to the success of industry policy in the export-oriented economies of Northeast Asia.¹⁶ There was no conception that infant industries might grow up or indeed should be encouraged in that direction. Made-to-measure protection skewed assistance towards the least efficient sectors. What were the economic and political foundations for this unusual Australian system?

On the economic side, the system rested on the creation of a dual economy. On the one hand, policies of protection fostered inefficient domestic manufacturing, often in low-skilled, labor intensive industries such as textiles, clothing and footwear where Australia was least well placed to compete. The tendency towards small plant size was further exacerbated by various industry promotion incentives provided by the state governments. The inefficient, insulated part of the economy was underwritten by an efficient and highly productive primary sector, with first agricultural commodities and then minerals providing the vast majority of Australian exports. The “compensation” that these sectors received for the extra costs they faced from having to purchase inputs from the cosseted manufacturing sector came in forms (whether subsidies of diesel fuel, crosssubsidies from artificially high domestic prices, or state-funded research and development) that enhanced these sectors’ competitiveness in international markets. A minerals boom, following the lifting of a ban on iron ore exports to Japan after the signature of a trade treaty in 1957, stimulated economic growth and underwrote domestic inefficiencies but furthered complicated the task faced by manufacturers by generating “Dutch disease” effects.¹⁷

The political bargain that sustained the system of protection all round was built in part on the unusual imbalance in Australia between the contribution of sectors to exports and their contribution to employment. As far back as 1901, the year of Federation, the sectors of the economy responsible for more than 90 percent of exports employed less than one third of the labor force. By 1950, this imbalance was even more striking. Agriculture and mining together contributed 95 percent of Australia’s exports but provided only 16 percent of total employment. By 1980, the share of these sectors in exports had declined to 75 percent, but their share of employment had halved to 8 percent. The vast majority of the labor force owed its employment to sectors (services and manufacturing) that were largely insulated from the global economy. In the political arena, the beneficiaries of protection had the numbers.

Moreover, for the first quarter of a century after the Second World War, manufacturers in “capital-rich” Australia failed to behave in the manner that Rogowski’s (1989) Heckscher-Ohlin model of mobile factors would predict. The Australian experience was more consonant with a Ricardo-Viner model of specific factors: capital and labor within individual industries

combined to lobby for continuing protection for their sectors and, indeed, they were joined by a politically powerful segment of agriculture in this land-rich economy.

The dominance of protectionism was also sustained by the particular configuration of political forces. From December 1949 to December 1972, a coalition of the Liberal and Country parties governed the country. The leadership of the Liberal Party, the larger of the two parties, was generally inclined towards a paternalistic and populist approach to economic policy, despite the party's historical association with large agricultural interests. The junior party in the coalition, the Country Party, was the traditional political home of small farmers, strongly inclined towards protection. Fearful of losing its influence as the farming population declined, the Country Party sought to create a new constituency for itself by championing protection for the manufacturing sector. Some of the industries dependent on protection, most notably textiles, were partly located in country towns, further enhancing the electoral attractiveness for the Country Party of a protectionist stance.

Protectionist policies remained popular with the electorate throughout the post-war period: as late as 1979, an opinion poll found that 60 percent of respondents supported the statement "Australian manufactured products should be protected from low-priced imports." Perhaps demonstrating the political rationality of the Country Party's stance, support for protectionism for manufacturing was higher among rural than urban voters.¹⁸

In this context the role of ideas, individuals and institutions is closely entwined. The influence of the Country Party derived in large part from its longtime leader, Sir John McEwen, occupying the portfolio of Minister for Trade, whose responsibilities included oversight of the Tariff Board. Although the Board itself was nominally independent, the Department of Trade set the terms of reference for its enquiries. It was not unusual for governments to direct the Board to provide sufficient protection to ensure a particular industry's survival. The Department could repeatedly refer an industry back to the Board for further consideration if it was not satisfied with the Board's initial response. And if the Board was not compliant, it could make a reference instead to the Special Advisory Authority.

The international dimension to "protection all round" was that Australia eschewed multilateralism in international trade for more than thirty years. Here, the government's task—domestically and internationally—was facilitated by the failure of the ITO to come into existence and by the subsequent exclusion of agricultural trade from the GATT. Australian governments were able to claim that GATT ignored the vast majority of the country's exports, and that their trade policies therefore should not be bound by multilateral negotiations to reduce tariffs on manufactured goods. The government refused to bind its tariffs. Australia's attempt to renegotiate its commitments in GATT in 1953, with the claim that it was a "mid-way" economy with an export structure similar to that of less developed

economies, met with some success.¹⁹ In this era, and with its stance at least partly legitimated by GATT, Australia was unlikely to attract any retaliation from its trading partners for its recalcitrance on tariffs on manufactures.

The results

At one level, the system of protection all round appeared to work well. From 1900 onwards, manufacturing value added grew at least 50 percent faster than value added in the primary and services sectors. Whereas manufacturing’s share of GDP and employment was substantially below those in other OECD economies at Federation, by the 1950s the gap had been closed (Anderson, 1987). Australia shared fully in the long post-war boom. Gross Domestic Product increased by an average of more than 4.5 percent each year in the two decades after 1947; unemployment seldom exceeded 3 percent even though, thanks to a substantial intake of immigrants, Australia’s population growth was double that of the average of other high-income economies. Manufacturing GDP grew by 6.5 percent annually from 1946 to 1960 and by 5.4 percent annually from 1960 to 1973. Employment in the manufacturing sector grew from 890,000 in 1949 to 1,315,000 in 1967.²⁰ The share of manufactures in total exports grew steadily until the early 1970s (Table 4.1). Protection all round succeeded in moving the Australian economy away from its natural comparative advantage. Critics of protectionist policies would argue of course that the Australia economy would have grown even more rapidly had it not been for protection. Even they acknowledge, however, that protection sustained a larger manufacturing sector (and population base) than would otherwise have eventuated.²¹

Table 4.1 Share of manufactures in Australian merchandise exports (%)

	<i>All Manufactures</i>	<i>Elaborately Transformed</i> [†]
1951	6.6	2.7
1955	11.3	5.4
1960	12.9	5.7
1965	16.4	8.5
1970	25.1	11.0
1974	21.1	11.5
1976	17.4	9.1
1980	19.3	9.3
1985	16.9	8.8
1989	22.9	10.9
1997	30.2	20.5

Source: For 1951–1970, calculated from data in Pinkstone (1992, Table 51, p. 379); for 1974–89 Pinkstone (1992, Table 57) for 1997 Department of Foreign Affairs and Trade (1998). Different data series may not be strictly comparable.

† excludes chemicals, non-ferrous metal manufactures, iron and steel.

Although the share of manufacturing in the Australian economy and in Australian exports had grown in the first quarter of a century after 1945, the sector was not well placed to withstand the new forces of global competition in the 1970s. The share of exports in manufactured output in Australia was far lower than in other industrialized economies, including those such as Canada and New Zealand with substantial commodity exports.²² The rise in Australian manufactured exports had failed to keep pace with their growth in the world economy. Aggregate data posted warning signs: Australia was unique among the smaller industrialized economies in failing to increase the share of exports in its GDP in the postwar period. This ratio, which peaked at the height of the Korean War boom at 31 percent, fell from 21 percent in 1947 (roughly the same share as at the turn of the century) to 16 percent by 1970 (Pinkstone and Meredith, 1992, Table 63, p. 393). As a consequence of specializing in commodities for which world demand was growing relatively slowly, Australia's share of world exports declined from 2.9 percent in 1950 (although again the Korean War had a distorting effect so a more appropriate comparison is the 1954 figure of 2.2 percent) to 1.7 percent in 1970.

Problems arose from Australia's policies not so much from the protection of infant industries but from the way in which the policies were applied, and the perverse movement towards increasing levels of protection at a time when other industrialized economies generally were moving in the opposite direction. Ideas and identity were important in the application of protection. Made-to-measure protection reflected not only beliefs about the country's vulnerability and the obstacles that nature placed in the way of Australian manufactured exports, but also a diffidence, a general lack of confidence in the capacity of Australian companies to compete in more advanced technology sectors. Such diffidence was very evident in the early post-war years and colored attitudes towards direct foreign investment.

The desire of post-war governments to build a manufacturing base quickly, a lack of confidence in the competence of local manufacturers, coupled with a general aversion towards (and constitutional barriers to) directive industry policies led governments to offer a virtually open slather to foreign corporations. Again, the contrast with attitudes towards foreign direct investment in Japan, Korea and Taiwan is striking. A conspicuous instance of the government's failure to bargain effectively with TNCs arose in the context of the establishment of a local automobile industry. Although one of the perceived advantages of a strategy of involving foreign corporations was to exploit their capacity to inject capital into the local economy,²³ the deal that the government eventually struck with General Motors in the immediate post-war years resulted in the government-owned Commonwealth Bank providing the full capital for the project in the form of a £2 million loan.²⁴ Subsidiaries of TNCs were seldom subject, outside

the defense sector, to local content or other performance criteria such as export offsets, and until the 1970s were given a free rein to purchase any Australian competitors. Rather than compelling local subsidiaries of TNCs to engage in exporting in return for access to the domestic market, Australian governments tolerated the imposition of restrictions by parents on the local subsidiaries. A survey at the end of the 1950s found, for instance, that 55 percent of the British subsidiaries surveyed were subject to restrictions on their right to export to Asian markets; the figure for American subsidiaries was 40 percent.²⁵

The share of TNC subsidiaries in Australian manufacturing is exceeded among industrialized economies only by Belgium, Canada and Ireland. In the early 1970s, one third of the value added and one quarter of the employment in manufacturing occurred in foreign controlled companies; these constituted nearly one half of the country's 200 largest manufacturing companies. Subsidiaries of TNCs controlled more than 70 percent of the output in chemicals, autos, petroleum refining, food processing and smelting (Department of Industry, 1998c; Stewart, 1994, pp. 92–3). That these subsidiaries brought technologies and skills to Australia that were not available locally is beyond doubt. The absence of performance criteria, however, did nothing to counteract the tendency of these subsidiaries to focus production predominantly on the protected local market, or the well-established bias of transnational to retain most research and development expenditure and other higher-skilled activities for plants in the home country.²⁶ One consequence of the combination of protection and TNC penetration was that Australia's privately-funded research and development expenditures were among the lowest in the OECD.²⁷

Made-to-measure protection coupled with the incentives provided by state governments for establishment of plants within their boundaries produced an inefficient and fragmented manufacturing sector.²⁸ Very few domestically-controlled companies emerged in the manufacturing sector of a size to be significant exporters.²⁹ Moreover, the government provided little encouragement for firms to move in that direction. The government failed to introduce export incentives until 1961, and even these were only minor tax concessions. Only in 1977 were more substantial export incentives introduced. Until then, almost all manufacturing for export was penalized by negative effective rates of assistance.³⁰ Inefficiencies in the domestic manufacturing sector were compounded by the lack of competition. The concentration of ownership in manufacturing in Australia is among the highest in the world. And even where nominally rival firms operated in the same sector, their positions were buttressed by "all the restrictive practices known to man."³¹ Collusive price-fixing was largely untouched by the law until 1974. Anti-monopoly laws and their enforcement, although tightened in the 1970s, were well behind international best practice until further amended in the 1990s.

Crisis and change

A crisis was required to provide the opening that led to the beginning of the dismantling of the system of protection all round. The oil-price-rise-induced recession after 1973 severely jolted the Australian economy. The breakdown of the Bretton Woods monetary system and changes in the location of international production that occurred in the 1970s can be viewed as two symptoms of globalization to which Australian governments felt compelled to respond. The most obvious signs of crisis occurred in the manufacturing sector. From 1974 to 1975, the share of manufacturing in total exports slumped from 21 to 17 percent. This decline occurred in an era of low commodity prices, and reflected an absolute fall in the value of manufactured exports of 10 percent. The vehicle sector was particularly hard hit. In the early 1970s this sector alone accounted for 5 percent of *total* exports, a larger share than such commodities as wheat, dairy or fruit, for which Australia was traditionally known. In the mid-1970s, however, it lost its major export markets in Southeast Asia and South Africa to Japanese exports—an indication of the new global competition that Australian exporters faced. The crisis gave new impetus to the push begun in the previous decade to force Australian industry to be more competitive in an increasingly global marketplace. Inevitably it required unravelling the policy of protection all round.

Ideas, individuals, institutions and interests in the move to trade liberalization

Protection all round had always had its critics among professional economists. The Tariff Board itself often expressed ambivalent views about the system that it was asked to administer. Until the 1960s, however, the focus of the criticism was primarily on the levels of tariff protection given rather than on attacking the principle that protection would raise real wages. The focus changed with new research conducted during the 1950s and 1960s. It is no coincidence that Australian economists pioneered studies into the costs of protection.³² By the 1960s, professional economists were nearly unanimous in their support for trade liberalization (Anderson and Garnaut, 1987, p. 68).

To have political consequence, ideas need champions among the political elite.³³ In Australia's dismantling of protection all round, the critical marriage of ideas, individuals and institutions began in the Tariff Board with the appointment of a new chairman, G.A.Rattigan, in 1963. Rattigan quickly became a convert to trade liberalization, and used the Board's investigative powers and public hearings to advance the cause. But the political effect was limited so long as the Board was subordinate to the protectionist Department of Trade. Rattigan therefore maneuvered to increase the Board's autonomy, and succeeded in persuading the newly elected Labor Prime

Minister, Gough Whitlam, in 1972 to transfer the responsibility for the Board to the Prime Minister's Department.³⁴ The new government also widened the Board's powers to undertake a systematic review of the entire tariff structure, changed its name to the Industries Assistance Commission (IAC), and increased its staff over a three-year period from less than 200 to more than 520.

That a Labor government should champion the initial dismantling of protection all round might seem incongruous. Again, the role of individuals was important, Whitlam being committed to the construction of a more competitive economy through the reduction of trade protection. Unlike his predecessors, he leaned heavily on professional economists for advice. And while his party was far from unanimous in its support of trade liberalization, the process could be sold to a skeptical audience as one that advanced the cause of economic nationalism, given the resentment that existed towards the cosseted position of TNC subsidiaries in the manufacturing sector.³⁵ The government introduced a 25 percent across the board cut in protection in 1973, a remarkable exercise of state autonomy.³⁶ None of the significant lobbies was even consulted before the government announced its intentions. Unfortunately for the government and for the liberalization cause, the cut in protection coincided with a recession in the economy and came to be blamed by the public, which saw a causal relationship between the two. The Whitlam government was defeated in 1975 and replaced by a conservative Coalition government led by Malcolm Fraser. Fraser was very much a populist on economic issues. During the eight years his government was in office, it actually increased protection for the country's most "sensitive" industries, textiles, clothing and footwear, and autos.

Reaction to the 25 percent tariff cut demonstrated that little support existed among the general public for trade liberalization.³⁷ What of the sectoral interests? The voice of manufacturing capital in Australian politics has always been fragmented, divisions being encouraged by the federal system and by the manner in which the tariff and arbitration systems were administered (Matthews, 1991, pp. 205–7). For the President of the Associated Chambers of Manufacturers, the umbrella group representing smaller firms, the tariff cut spelt disaster for its members. He asserted in 1974 that:

Australia is heading for the dubious distinction of becoming the world's first developed nation to regress into a feudal state of peasant farmers, miners and cottage industry workers.³⁸

Other manufacturing groups threatened to mount a legal challenge to the tariff cut. But the precipitous exercise in liberalization exposed emerging divisions within the manufacturing lobby. By the end of the 1970s, a number of Australian manufacturing companies had emerged that either had

significant exporting interests or depended heavily on imported components. As would be anticipated, these firms were supportive of trade liberalization,³⁹ leaving manufacturing capital increasingly divided on the tariff issue. The longstanding “code of non-opposition” under which no manufacturer objected to requests for protection lodged by other firms, could no longer be sustained.

Meanwhile, “land” had become increasingly disenchanted with the protection all round bargain. By the late 1960s, the Country Party’s support for protection for manufacturing attracted growing criticism in the countryside. Falling prices in the 1970s made the costs added by inputs from protected industries even less tolerable. And the increased powers of the Industries Assistance Commission put in doubt the future of protection for some rural sectors and compensation for others. The formation of a unified rural pressure group, the National Farmers Federation, in 1979 gave the export-oriented sector of Australian agriculture the dominant voice within the agricultural lobby for the first time.

The union movement was the last of the major interests to sign on for trade liberalization. The President of the Australian Council of Trade Unions, Bob Hawke, a Rhodes scholar whose undergraduate majors had been economics and law, had been a member of government enquiries into industry policy, and was sympathetic towards trade liberalization. After Hawke became Prime Minister in 1983, the union movement became increasingly supportive of a more liberal trade policy agenda in conjunction with safeguards for labor in the form of wage indexation and income support guarantees for low wage workers. Liberalization was perceived by leading elements of the union movement as the policy alternative most likely to ensure high income for its members in the future.

Changes in the views of interest groups occurred against a background of a significant increase in knowledge of the costs of protection in the society generally and especially among the political elite. The Tariff Board/Industries Assistance Commission played a critical educative role. The financial press and the financial writers of the broadsheet papers overwhelmingly supported liberalization by the late 1970s. Equally important was the large increase in the number of economists employed in central government agencies. Moreover, as in other industrialized economies, Keynesian approaches fell into disfavor by the 1970s, replaced by an enthusiasm for monetarism and a reduced role for the state in economic life.⁴⁰ The question was no longer one of whether liberalization would occur but how complete a dismantling of the unique political bargain from the turn of the century would be required so as to equip Australian manufacturing to compete more effectively in a globalized economy.

Alternative approaches to industry policy

A general consensus existed on the weaknesses of the Australian

manufacturing sector in the 1970s. Seventy years of protection all round had produced a fragmented, inward-oriented industry that matched up poorly on most international benchmarks such as research and development expenditures, share of output exported, patents issued, etc. Australia ranked close to the bottom of the OECD league ladder on the ratio of exports to imports of high-technology goods. Australian-based companies had failed to integrate themselves into the emerging global production networks. A continuing decline in Australia's terms of trade, a reflection of the worldwide move to less raw materials—and energy-intensive manufacturing, and of global oversupply of many agricultural commodities, made it impossible to sustain an insulated, inefficient manufacturing sector. In 1985, following a slump in commodity prices, then Treasurer Paul Keating warned that the country risked becoming a “banana republic” unless economic performance, particularly within the manufacturing sector, was dramatically improved.

In the last two decades, three approaches to industry policy have been prominent in Australia: corporatism; economic rationalism; and selective intervention.

Corporatism

Protection all round emerged in Australia as an alternative to corporatism in reconciling the interests of capital and labor. It was grounded in a liberal philosophy that envisioned a distinctive role for the state. Rather than being an active player alongside capital and labor, the state would be confined to a juridical role as arbiter between two forces locked in an adversarial structure. Economic well-being was to be generated through high levels of employment and high wages; the welfare state was relatively undeveloped. In industry policy, the state's interventionist role was confined to providing the protection necessary to enable manufacturers to attain the objectives that they set for themselves. Although the Tariff Board accumulated a great deal of information about the costs of production in various industrial sectors, it did not develop the close working relations with industry characteristic of the “embedded autonomy” of the Northeast Asian states.⁴¹ Until the 1970s, the role of the Tariff Board was largely a reactive one, a series of *ad hoc* responses to manufacturers' requests for assistance.

In 1965, a government-appointed committee of economic enquiry (the Vernon Committee) recommended that an Advisory Council on Economic Growth be established to assist the government in indicative economic planning. The recommendation was strongly opposed by the Treasury Department and denounced by the conservative government of the day. Although the IAC in the 1970s was given a more comprehensive mandate to investigate the structure of protection, at no stage did governments envisage that this agency should do more than devise a more rational pattern of industry assistance. And no other government department had

the capacity to play a significant pro-active role in industry policy. The Department of Trade and Industry had traditionally been organized around specific industrial sectors, and had largely been “captured” by its clients.⁴²

With the erosion of the model of protection all round, the Australian trade union movement looked to the corporatism of the small states of Western Europe as a model for future cooperative relations between governments, business and unions, one it believed that would ensure high rates of economic growth, equitable distribution of benefits and continued high rates of union membership. In 1987, the peak labor organization, the Australian Council of Trade Unions, published a report of a study group that had visited Sweden. The report enthusiastically endorsed the Swedish approach as a model for Australia.⁴³ Unfortunately for the study’s proponents, its publication coincided with economic difficulties in Sweden and widespread reports that the Swedes themselves were having second thoughts about their own corporatist model. Heavily criticized by the press, the ACTU report soon disappeared from sight.

The “corporatist” approaches that have been implemented in Australia have been limited in their scope. Elements of “meso”—corporatism were, however, present in the attempts by the Labor government elected in 1983 to develop industry plans for specific sectors that were threatened by a program of tariff reduction—most notably, steel, autos, and textiles, clothing and footwear (Capling and Galligan, 1992). In steel and autos, the Minister for Industry created tripartite councils with responsibilities of advising on future directions of the industry. How significant such tripartite bodies have been is debatable: the industry plans have evolved into forms of selective intervention discussed below.

The other element of “corporatism” introduced by the Labor government was its “Accord” with the trade union movement. The Accord was an agreement between the Hawke government and the ACTU in which the latter would moderate its wage claims in return for a commitment to wage indexation, additional support for low-income workers, and employment growth. Organized labor accepted wage restraint in return for increases in the “social” wage, delivered through means such as compulsory employer contributions to superannuation. The Accord was successful in moderating wage increases; during its operation, the profitability of manufacturing industry increased substantially. And for a while, Australia’s record on employment growth and on unemployment was superior to that of many other OECD economies. The Accord, however, was not a tripartite arrangement but one negotiated between the Labor government and the union movement: in Matthews’ (1991) apt phrase, it was “corporatism without business.” Despite trade union discontent, the Accord survived seven renegotiations with the Labor governments from 1983 to 1996; the incoming conservative Coalition elected in the latter year made no effort to reach a similar agreement with the union movement.⁴⁴

Economic rationalism

Economic rationalism is used in Australia as shorthand for approaches to economic restructuring that favor a total reliance on market mechanisms to promote adjustment. Economic rationalism has its intellectual foundations in neoclassical economic theory with its emphasis on specialization according to comparative advantage. For economic rationalists, the state is the problem rather than the solution. The lesson of protection all round in Australia was that state intervention would inevitably divert the energies of potential beneficiaries into rent-seeking rather than productive activities.

The bureaucratic home of Australian economic rationalism was the renamed Industry Commission and its supervising department, the Treasury. Economic rationalist views were common among senior bureaucrats in most government departments, however. Survey evidence suggested that profession of these views was necessary for recruitment and promotion to senior appointments (Pusey, 1991). By the mid-1980s, economic rationalists had entrenched themselves within the senior levels of the bureaucracy and tolerated little dissent.⁴⁵

For economic rationalists, securing a piece of the global action for Australia rests on “getting the fundamentals right,” that is, in making Australia a low-cost environment in which to conduct business. Getting the state out of the economy involved not just the elimination of tariffs and other forms of protection but comprehensive micro-economic reform. The various components included a freeing up of the labor market (removing the arbitration system and moving wage settlements from a centralized system to one of enterprise bargaining), the corporatization or privatization of state-owned enterprises, the outsourcing of government services, and subjecting as much of the economy as possible to competition. In the words of one commentator, “whatever the question, competition is the answer.”

For economic rationalists, governments should not attempt to “pick winners” by engaging in selective industrial support. Besides the danger of encouraging rent-seeking, governments lacked the information to make competent decisions. Intervention inevitably would generate inferior outcomes than if the market prevailed. The economic rationalist case against selective intervention also rested on partial and general equilibrium approaches:

Selective investment incentives have to be financed by taxpayers and potentially impose costs on other Australian industries, thereby reducing their ability to secure investment. The political attractiveness of high profile projects also can lead governments to pay a high price for new investments.⁴⁶

Even if other governments offered incentives to attract high-technology industries, or if foreign firms attempted to dump their products in Australia,

the appropriate response for the Australian government was to refrain from attempting to match their stupidity.

The economic rationalist agenda was Janus-faced. Alongside the domestic agenda was a new commitment to multilateralism in Australian trade policies. In contrast to Australia's abstention from early GATT negotiating rounds, the government played an active role in promoting a comprehensive outcome in the Uruguay Round, especially the interests of agricultural producers through the establishment of the Cairns Group. Whereas previous Australian efforts to promote liberalization of agricultural trade were vulnerable to accusations of hypocrisy, given high levels of protection for domestic manufacturing industry, the economic rationalist agenda was internally consistent. An activist role in promoting trade policy multilaterally and regionally (through APEC) was used by the government to claim that Australia's unilateral "concessions" in trade liberalization would not be unrequited.

Selective intervention

Selective intervention lacks the cohesiveness of the economic rationalist approach or a similar grounding in a single intellectual approach. Most arguments for selective intervention operate at a different level of analysis to economic rationalism: the focus is on the corporation rather than the economy as a whole, on competitive rather than comparative advantage. The theoretical underpinnings come from research undertaken in business schools, such as that of Michael Porter (1990), and also draw on new growth theories (Romer, 1986; 1987; 1994) and the literatures on technological innovation (Dosi, Pavitt and Soete, 1990) and on market failures.

Rather than arguing that governments should "pick winners", the assertion is that a role for government is essential in *assisting* winners to emerge in a global economy that is not characterized by the economic rationalists' beloved "level playing field." Governments can aid firms through the establishment of appropriate national systems of innovation. These require both macro and micro policies, including the creation of a highly skilled labor force, and appropriate incentives for research and development. For the selective interventionists, a thriving manufacturing sector is essential to the future prosperity of the economy. The externalities generated by manufacturing make it an altogether more significant enterprise than commodity production. Development is path dependent. Again, the contrast with the economic rationalist approach is evident: the Industry Commission, in particular, is frequently accused by the selective interventionists of indifference if not downright hostility towards domestic manufacturing, and of failure to see that a computer chip is of greater economic value than a potato chip.

The selective intervention approach was championed during the course of the Labor governments by the Australian Manufacturing Council, a

tripartite consultative body originally established in 1977 by the Coalition government but revitalized in 1984 by the Labor government (and abolished, over the protests of unions and manufacturers alike, by the new Coalition government in 1996). The AMC financed two major reports from leading business consultants that were critical of the government's failure to devise pro-active industry policies and its over-reliance on reductions in protection as a means of generating a more efficient manufacturing sector.⁴⁷

The bureaucratic home of selective interventionism was the Department of Industry.⁴⁸ In the 1980s, the department developed a range of new policy instruments, discussed below, aimed at securing increased research and development expenditures, more manufactured exports, and an improved performance by foreign subsidiaries located in Australia.

Policies towards manufacturing since 1983

The Hawke Labor government flirted with corporatist approaches in its first three years in office, during which it introduced the “meso corporatist” plans for the steel and auto industries. After 1985, its enthusiasm for the approach waned. A tripartite taxation summit in 1985 failed to deliver the government's preferred outcome for tax reform, and was followed by a currency collapse.

Economic rationalist approaches have generally been in the ascendancy. A combination of factors contributed to their dominant position. One is the central role, noted above, of economists in senior positions in government ministries. A second is the dominant role in economic policy-making of the Treasury (which included under its broad umbrella the IAC). Again, its position rested on multiple factors—including individuals and institutional arrangements. The Treasury has always enjoyed the status in Australia of being the elite department in domestic policy-making. Its role in the Labor era was strengthened by the personality of the Treasurer, Paul Keating, arguably the dominant figure in the Hawke governments. The cohesion of the Treasury's approach, contrasted with disunity within the Department of Industry, its principal rival in domestic economic policy-making. The Industry Department experienced a series of relatively weak ministers and was isolated further when the Department of Trade was merged in 1987 with the Department of Foreign Affairs. Although the merger was primarily designed to strengthen the economic component in Australia's foreign policies, the move also served the rationalist agenda well as the traditionally protectionist Trade Department was subordinated to a ministry pursuing an agenda of international trade liberalization. In 1991 the Industry Department lost responsibility for the country's overseas trade promotion program to the Department of Foreign Affairs and Trade.

The rationalist cause was facilitated by the seriousness of the country's economic crisis in the mid-1980s. The case for a more radical approach, for

fiscal conservatism, and the rejection of traditional approaches to industry assistance appeared more compelling in the circumstances of simultaneous budgetary, current account, and debt crises, and downgrading of the country's status by the major international credit rating agencies. And in calling for a radical move to free markets, the rationalists had the support of almost all the country's financial commentators. Throughout the period, little serious debate occurred in the press over the direction of industry policy. Advocates of selective intervention were caricatured as promoting a return to the old protectionism, of encouraging inefficiency rather than an outward-oriented approach.

At the same time as it pursued the rationalist agenda of lower tariffs and micro-economic reform, however, the Labor government also launched various selective interventions targeted in some instances at industry in general and in others at specific sectors.⁴⁹ Research and development and export assistance policies were significantly extended in 1983. Measures were implemented to encourage the venture capital market. Industry extension and consultancy services were strengthened; so were export promotion services through the establishment of AUSTRADE. In 1986, the government introduced the first comprehensive offsets program for civilian manufacturing. The program was intended to pressure foreign corporations to increase technology transfer to local firms and raise their local research and development expenditures in exchange for access to Australian government contracts.⁵⁰

Other incentives were directed towards incorporating Australian value-added into global production networks. Under the Partnerships for Development program for the information technology sector, introduced in 1987, foreign corporations were exempted from federal and state offsets obligations provided they increased their local research and development expenditures to 5 percent of their total Australian sales, and met a target of exporting from Australia at least half of their value of imports within seven years of the signature of the agreement. In the pharmaceutical industry, under the Factor *f* scheme, companies were eligible for compensation for the low prices for drugs that resulted from the government's monopsony position provided companies attained targets in specified activities (R&D and value-added production), or otherwise demonstrated that they were making a significant contribution to the promotion of internationally competitive production in Australia. In the automobile industry, the Export Facilitation Scheme allowed participants to earn export credits on eligible automotive exports to offset the duty on automotive imports. Credits were based on "Australian automotive value added" in exports multiplied by the tariff rate for passenger motor vehicles.

These incentive schemes, whether of a general nature, such as the research and development allowances, or those confined to a specific sector, have been under constant attack from the economic rationalists, most notably the Industry Commission, for the distortions they allegedly

introduce through the costs they imposed on other areas of the Australian economy.

The results

At one level, attempts to integrate Australian manufacturing industry into the global economy appear to have been successful. The data in Table 4.1 show that the share of manufactures in Australian exports increased substantially after the mid-1980s. By 1997, the share was at its highest level ever. Moreover, manufactures had for the first time become the largest single category of Australian exports, displacing minerals and agricultural products and maintaining a slight lead over services (the most important category of which is tourism). Even more encouragingly, exports of elaborately transformed manufactures (ETMs) grew at a trend rate of 16 percent annually over the last decade, substantially higher than the 7 percent annual growth of simply transformed manufactures and the 6 percent of primary products.

However, while exports of manufactures grew more rapidly than imports of these goods, the latter began from a much larger base. The consequence was that Australia's net deficit in manufactures trade has continued to widen (Figure 4.2). In other words, domestic manufacturers have lost market share in the home market. And this has not been offset by gains elsewhere. Australia's rank in world exports continued to fall in the last decade, down from 14 in 1975 to 20 in 1985 to 22 in 1995. By the latter year, Australia had been surpassed by both Thailand and Malaysia (the latter a country with a population almost equal to that of Australia's but whose economy is far better integrated into regional production networks).

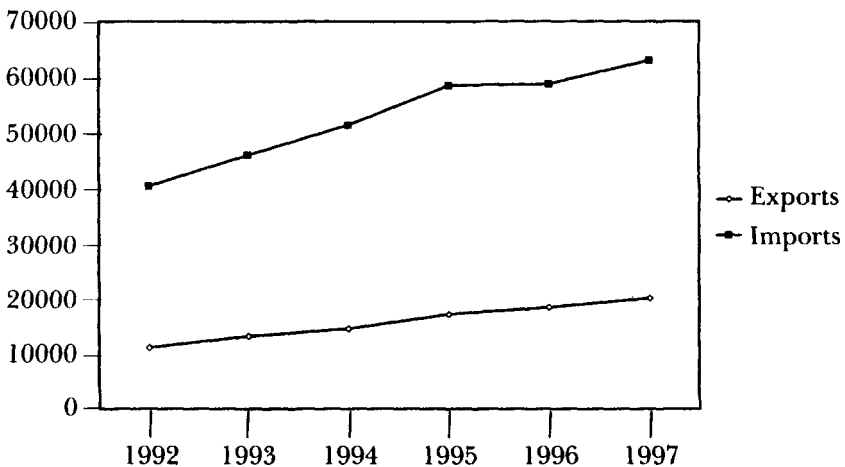


Figure 4.2 Australia's trade in manufactures (A\$m)

From 1973 to 1993, Australia's share of total OECD exports of manufactures declined by nearly 55 percent—from 1.8 percent to 0.8 percent, the largest market share decline of any OECD economy.⁵¹

A more detailed breakdown of Australia's shares in world manufacturing imports (Table 4.2) shows a mixed performance. For the East Asian economies that grew rapidly before 1996, Australia's share of elaborately transformed manufactures imports fell in all except China. Improved performance in that economy, in the European Union, and especially in New Zealand where Australian manufacturers enjoy preferred access through the Closer Economic Relations trade agreement, enabled Australia to maintain its share of overall world imports of ETMs. All data have to be interpreted with caution, however, as the relatively small size of Australia's manufactured exports causes aggregate data to fluctuate markedly with individual transactions. For instance, in 1997, exports of transport equipment doubled from the previous year but this increase was caused almost entirely by the sale of an Australian-manufactured frigate to the New Zealand navy.

New Zealand remains the largest single market for Australian exports of ETMs, accounting for one-fifth of total exports. The second largest market is the US. The geographical distribution of manufactured exports suggests strongly that Australian companies to date have enjoyed little success in penetrating the production networks that were a major factor in East Asia's rapid economic growth.⁵²

As in other OECD economies, the share of manufacturing in GDP in Australia has been in overall decline. The decline in Australia, however, has been more rapid than in other OECD economies (Figure 4.3).

Table 4.2 Australia's share in world imports of elaborately transformed manufactures (%)

	<i>Asean</i>	<i>China</i>	<i>EEC-12</i>	<i>Hong Kong</i>	<i>Japan</i>	<i>Korea Rep.</i>	<i>New Zealand</i>	<i>Taiwan</i>	<i>USA</i>	<i>World</i>
1965	1.37	0.02	—	0.57	0.73	0.16	12.00	—	—	0.20
1970	2.42	—	—	0.94	0.01	0.08	12.85	0.11	0.46	0.27
1975	1.75	—	—	1.02	0.96	0.16	13.42	0.06	0.63	0.30
1980	0.97	0.13	—	0.60	1.86	0.34	14.03	0.17	0.74	0.28
1985	0.94	—	0.05	0.42	—	—	13.09	—	0.44	0.25
1990	0.65	0.85	0.10	0.31	—	—	17.22	—	0.52	0.29
1991	0.73	0.66	0.09	0.34	0.26	—	18.66	0.04	0.54	0.32
1992	0.70	0.32	0.10	0.31	0.36	—	17.50	0.07	0.40	0.30
1993	0.69	0.48	0.10	0.33	0.48	0.10	16.80	—	0.34	0.30
1994	0.67	0.72	0.10	0.33	0.47	0.11	16.81	—	0.30	0.30
1995	0.60	0.57	0.09	0.31	0.40	0.19	16.83	—	0.30	0.29
1996	0.72	0.49	0.11	0.33	0.38	0.21	19.33	—	0.35	0.34

Source: Calculated from UN COMTRADE data, accessed through the International Economic Data Bank, Australian National University. ETMs defined as manufactures less SITC 67 and 68.

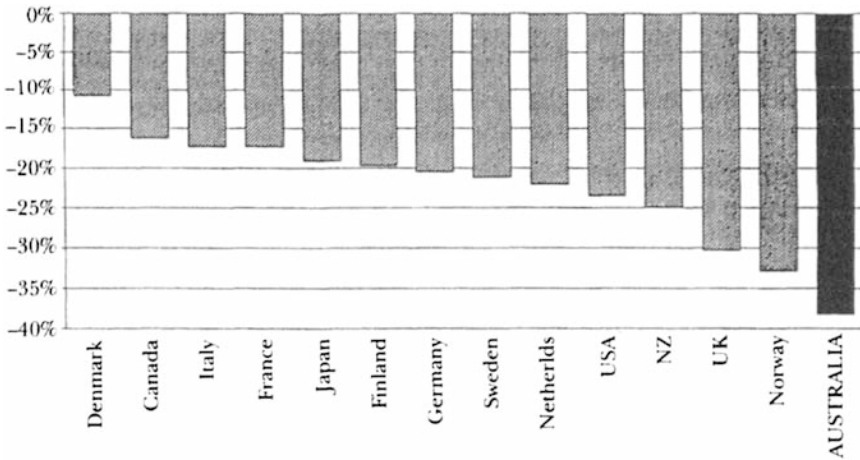


Figure 4.3 Change in manufacturing share of GDP 1970–90

Which policies can take the credit for the success in increasing manufactured exports or the blame for the failure of such exports to keep pace with those of competitors? Here the debate continues to rage. On the one hand the economic rationalist camp claims that lack of success has been caused by the government’s failure to be sufficiently rationalist in its approach (“economic rationalism has not failed: it has not been given a chance”) and by misguided selective government interventions that perpetuate distortions in the economy. For the selective interventionists, however, where success has been achieved, it owes much to the new interventionist policies introduced in the 1980s. That the success has been less than hoped for results from the government being unduly influenced by rationalist opposition to selective intervention.

Any attempt to evaluate the competing claims requires heroic assumptions and runs the risk of committing *post hoc ergo propter hoc* fallacies. Moreover, only a relatively short period of time has expired since the introduction of the significant policy changes—whether lowering of tariffs or selective intervention. Advocates of selective intervention, however, are able to point to exports having increased most rapidly in those sectors benefiting from the new supportive policies the government introduced in the 1980s (Table 4.3). In the information technology sector, exports grew from \$A170 million in 1988 to \$1.8 billion in 1996. Research and development activities by companies involved in the Partnerships for Development program rose from \$60 million in 1988 to \$450 million in 1996.⁵³ In the passenger motor vehicle industry, research and development expenditures in 1996 were double the level in 1989; automotive exports in 1996 had grown more than 450 percent since 1984 to reach a total of \$A2.1 billion.⁵⁴

Against this evidence, the rationalists respond that it is misleading to look only at growth rates, and that in any event more than 80 percent of

Table 4.3 Growth of exports 1986–1996

<i>Product group</i>	<i>Exports 1995–96 (\$m)</i>	<i>Share of total exports 1995–96 (%)</i>	<i>Trend annual growth 1986/7 to 1995/6 (%)</i>	<i>Contribution to growth 1986/7 to 1995/96 (%)</i>
Export Facilitation Schemes ^a	3134	4.6	14.1	5.6
Partnership/targeted programs ^b	2695	3.7	26.0	6.1
'Bounty' programs ^c	2485	3.4	15.4	4.7
No industry specific program	63914	88.5	7.1	83.5
Total merchandise exports	72228		8.0	

Source: Industry Commission, *Annual Report 1996–97*, p. 32.

^a Passenger Motor Vehicle Export Facilitation Scheme and Textile, Clothing and Footwear Import Credit Scheme.

^b Includes telecommunications equipment and parts, pharmaceutical products, aircraft and associated products, office machines and automatic data processing equipment.

^c Includes ships, metal-working machinery, machine tools and parts and accessories, photographic goods, and dairy products.

the contribution to the growth of Australian exports in the last decade derived from companies that received no sectorally-specific support (Table 4.3). Moreover, they claim that the Commonwealth business support program (which the Industry Commission estimates to cost \$3.4 billion annually) frequently favors large over small firms, and comes at the expense of other sectors of the economy and of taxpayers. The jury is still out on these issues.

Conclusion

Efforts to unravel the intricate antipodean systems of social protection began before the full onslaught of the forces of globalization in the 1980s. The increasing economic problems manifested in fiscal and current account deficits in the first half of that decade, however, finally convinced governments and sectoral interests alike that the old social bargain could no longer be sustained on the back of declining resource rents.

To increase the competitiveness of the economy, especially the manufacturing sector, necessitated not only a reduction of the protection that it had previously enjoyed but also an attack on the whole apparatus of social protection, and its ideational and institutional underpinnings.⁵⁵ The uncertainties created for the population have been compounded by reductions in welfare expenditure, driven in part by governments' preoccupation with the responses of financial markets to their budgetary balance sheets.

That governments had little option but to unravel the social protection bargain is beyond doubt. More questionable is the economic success of the various policy instruments that governments have chosen. What is certain, however, is that economic rationalism is deeply unpopular with the electorate. The Labor government lost office in a landslide in 1996 in part because of its perceived unwillingness to heed complaints about the pace and direction of economic reform. Its Coalition successor in response has flirted with a return to populism, announcing a five-year freeze on tariffs in the auto and textiles, clothing and footwear sectors. Furthermore, it has indicated that its commitment to APEC's goal of complete elimination of tariff barriers will depend on equivalent movement by its trading partners: reciprocity has crept back into the trade policy vocabulary at the expense of the rationalists' preference for unilateralism. Nonetheless, the government persisted with policies that cut back on social expenditures and on industry assistance. Public resistance to these policies was widely perceived as contributing to a substantial reduction in the government's representation in parliament following the federal election in October 1998. The mood of the electorate remains volatile, with populist approaches gaining increasing support.

Unravelling the social protection bargain in Australia threatens also to unravel the social fabric. No substitute has yet been found for protection all round as a formula and philosophy for social cohesion.

Notes

- 1 In 1996, the trade-weighted average applied tariff for Australia was 5.0 percent; for New Zealand it was 5.7 percent (Figure 4.1). In 1988, Australia's average was 15.6 percent; the figure for New Zealand was 14.9 percent (APEC, 1996). In 1970, the figure for both Australia and New Zealand was 23 percent, 50 percent higher than that for Canada and three times the rate in Western Europe (Anderson and Garnaut, 1987, p. 7). The economic and social transformation in New Zealand, now seen as a model liberal economy by *The Economist*, arguably has been even more dramatic than in Australia. For discussion of the New Zealand experience see Boston *et al.* (1991) and the memoirs of the New Zealand Treasurer, Roger Douglas (1993). For comparison of the Australian and New Zealand experiences under reforming Labo(u)r governments in the 1980s, see Castles, Gerritsen and Vowles (1996).
- 2 Space considerations preclude a detailed discussion of the enormous literature on globalization. For the purposes of this chapter, I am assuming that the forces of globalization place new constraints on governments. The effects of the globalized financial market are particularly obvious, with most governments having to tailor their fiscal policies to produce a budgetary outcome 'acceptable' to the market. However, I share Cox's view that the defining characteristic of contemporary globalization is change in the organization of production—specifically, the growth of transnational production networks that "link groups of producers and plants in different territorial jurisdictions in order to supply markets in many countries" (Cox, 1993, pp. 142–3). The advent of these networks poses new challenges for firms and governments alike: how to secure a piece of the action in an increasingly transnationalized marketplace.

- 3 Frank Castles (1988) contrasts this approach of “domestic defence” with the politics of “domestic compensation” that Peter Katzenstein (1985) suggested characterized attempts by the small economies of Western Europe to cope with their vulnerability.
- 4 Menzies (1970) p. 44.
- 5 First Britain and then, following the British defeat in Singapore, the United States. A study of Australian foreign policy by a former senior diplomat (Renouf, 1979) is appropriately titled *The Frightened Country*.
- 6 The phrase, one of the most quoted in studies of Australia, comes from Blainey (1968). When Australia actually achieved full sovereignty is a matter of debate. Most would date Australia’s “independence” to the Balfour Report accepted by the Imperial Conference of 1926, although the Australian government did not bother to ratify the ensuing 1931 Statute of Westminster until 1942. Although Australia was a member of the League of Nations, it failed to play a significant independent role in foreign affairs until the 1940s. Some place the date of independence in the mid-1980s when the practice of allowing appeals from the Australian High Court to the Privy Council was discontinued. Some republicans suggest Australia will not attain complete sovereignty until it removes the English monarch as its head of state.
- 7 Quoted by Glezer (1982, p. 6).
- 8 Hugh Collins (1985) suggests that the dominant political philosophy of Australia’s founders was a form of Benthamite utilitarianism. Even if this argument is correct, utilitarianism was not the only popular philosophy of the time—see Stokes (1994).
- 9 Rogowski (1989, p. 19) acknowledges the danger of reifying categories such as “land” and “labor” but fails to avoid this problem.
- 10 For further discussion, see Matthews (1991, pp. 197–201).
- 11 Justice Higgins outlined the following as essential for a decent standard of living: civilized habits; frugal comforts; decent shelter; decent partitioned rooms; fresh air; water to wash in; enough wholesome food; and provision for rainy days. The judgment discriminated against female employees. It also established a fixed differential between skilled and unskilled labor.
- 12 The Tariff Board has persisted to the present day through various administrative mutations. Its name has been changed consecutively—reflecting a movement away from its protectionist origins—to the Industries Assistance Commission, the Industry Commission, and the Productivity Commission.
- 13 Space precludes any detailed consideration of the role of specific individuals in the construction of the system of domestic protection. Of particular import were the “founding fathers” of the Federation such as Deakin and Barton, and the Melbourne publisher and proselytizer of protectionist ideas, David Syme.
- 14 Quoted in Glezer, 1982: p. 71.
- 15 As Glezer (1982, p. 26) argues eloquently, protection served multiple purposes:

Depending on the orientation, a tariff was seen to do many things. It developed skills in industries, created employment, produced a faster rate of population growth, developed national pride, produced a more balanced economy, reduced Australia’s reliance on foreign suppliers but attracted foreign investors, increased defence capability, allowed for higher wages and a higher standard of living, redistributed income to urban areas, reduced balance-of-payments problems and created a more varied and interesting society.

- 16 Amsden (1989); Matthews and Ravenhill (1994); Wade (1990); World Bank (1993).

- 17 For discussion in the Australian context, see Gregory (1976).
- 18 *The Age* poll cited in Anderson and Garnaut (1987, pp. 66–8). Support for protection of agriculture was even stronger, both among urban and rural voters. Little change has occurred in public attitudes towards protectionism: the most recent *Australian Electoral Survey* conducted at the time of the March 1996 Commonwealth election, found that almost 60 percent of respondents believed that Australia should continue to use tariffs to protect its industries; only 12 percent disagreed or strongly disagreed with this proposition (McAllister and Ravenhill, 1998).
- 19 Arndt (1965).
- 20 Data from Maddock (1987, pp. 79, 90); Anderson (1987, pp. 170, 190); Bell (1993, p. 24).
- 21 The Australian case for protection attracted considerable interest among economists. Stolper and Samuelson (1941) in their pioneering model of protection focused in part on the Australian case and concluded that protection of the labor-intensive manufacturing sector would raise real wages and reduce the real returns to land. Their argument confirmed the proposition first put forward by Brigden (1925) that protection would either raise real wages or allow a larger population to be employed at any given real wage. This argument later served as a foundation for his official report on Australian tariffs (J.B. Brigden *et al.*, 1929). Brigden concluded that “the maximum income per head for Australia would probably be obtained by reducing it to one large sheep station.” Other contributors to the debate included Jacob Viner (1929) and W.B. Reddaway (1937).
- 22 In 1984, exports accounted for only 14 percent of total manufacturing output in Australia compared with 27 percent in Canada and 29 percent in New Zealand. Report of the National Export Marketing Strategy panel quoted in Capling (1994, p. 4).
- 23 Although Australia may be “capital rich” for the purposes of international comparisons of factor intensities, economic growth has always depended heavily on imported capital.
- 24 Two of the country’s most distinguished economic historians concluded that “the crucial decisions lacked professionalism. The dominant consideration was the creation of employment.” Butlin and Schedvin (1977) quoted in Bell (1993, p. 21).
- 25 Arndt and Sherk (1959).
- 26 For a summary of the evidence, see Porter (1990) and Dunning (1993).
- 27 Government-funded research and development expenditures were similar to the OECD average but were directed overwhelmingly towards the rural sector.
- 28 On the incentives provided by state governments, see Warhurst (1986) and Warhurst, Stewart and Head (1988). The industrialist John Uhrig in 1978 summed up the impact of government policies on local firms:

Originality of design was unimportant and licensing designs from other countries was the quick and easy way... Sales growth was seen to be achieved by widening the product range on the home market rather than by attempting to sell existing products outside Australia. This resulted in a proliferation of relatively small scale operations for each product. There was no incentive to invest in modern high volume equipment, and the idea was to add product lines which would allow extended use of the general purpose machinery already in use. This has left us with factories in which equipment is old and obsolete.

Quoted in Bell (1993, p. 33).

- 29 The relationship between size and export proclivity in Australia and elsewhere is well established. See Yetton, Davis and Swan, (1992, p. 14).
- 30 Anderson and Garnaut (1987, p. 62) citing Industries Assistance Commission data.
- 31 The title of chapter five of Butlin, Barnard and Pincus (1982).
- 32 Most notable here, is the work of Max Corden on the effective rate of protection (Corden, 1966), (1971).
- 33 Goldstein (1993); Hall (1989).
- 34 It was later transferred to the Treasury, the most 'rationalist' of the ministries. On the transformation of the Board in the 1960s and 1970s, see Rattigan (1986) and Glezer (1982).
- 35 The late 1960s and early 1970s were the high point of economic nationalism in Australia. The conservative Coalition government introduced measures in the late 1960s to place restrictions on foreign ownership.
- 36 Glezer (1982).
- 37 The initial public reaction to the cut, marketed by the government as a measure to control inflation, was positive, however.
- 38 C.R. Nichols, President of the Associated Chambers of Manufacturers of Australia, 1974 quoted in Bell (1989, p. 32).
- 39 Milner (1988).
- 40 Whitwell (1986; 1993); Pusey (1991).
- 41 On embedded autonomy, see Evans (1995).
- 42 On the weaknesses of those parts of the state apparatus responsible for industry policy, see Stewart (1994) especially chapter six.
- 43 Department of Trade (1987).
- 44 Trade union discontent by 1996 was such that, had a Labor government been re-elected, a continuation of the Accord seemed unlikely. Unions were discontent not only with the government's pursuit of an economic rationalist agenda and the declining share of wages in GDP but also the government's failure to involve the union movement in decision-making. It is somewhat ironic, therefore, akin to the late 1980s enthusiasm of the Australian trade union movement for the Swedish model, that in the mid-1990s a commentator would see the approach of the Australian Labor governments from 1983 onwards as a model for European countries. See Schwartz (1998).
- 45 Coleman and Skogstad (1995), for instance, argued that the presence of a neoliberal (economic rationalist) epistemic community in agricultural policymaking was the principal explanation for different policy outcomes in Australia and Canada. For a discussion of the Australian experience in comparative perspective, see Schwartz (1994).
- 46 Industry Commission (1997, p. 28). The annual reports of the Industry Commission provide a full statement of the economic rationalist philosophy. Another excellent source is Garnaut (1989). One element of the economic rationalist approach was to deny that the state had played any significant role in the rapid economic growth of Northeast Asian economies. The only lessons that the Northeast Asian experience held for Australia was the conformance of policy to the imperatives of the marketplace. For further discussion, see Matthews and Ravenhill (1996).
- 47 Australian Manufacturing Council (1990); Yetton, Davis and Swan (1992). The most recent major study from a selective interventionist perspective is Marceau (1997).
- 48 The Department has had various incarnations in the last fifteen years. It started the period as the Department of Industry, Technology and Commerce; it is currently the Department of Industry, Science and Tourism.

- 49 The best sources on industry policy in the 1980s are Bell (1994); Capling and Galligan (1992); Stewart (1994).
- 50 For a detailed discussion, see Capling (1994).
- 51 Marceau (1997) p. 10.11.
- 52 For discussion of the role of these production networks, see Bernard and Ravenhill (1995).
- 53 Department of Industry (1998a, s.1.5).
- 54 Department of Industry, (1998b, Tables 7.1 & 14).
- 55 Space limitations have precluded discussion of many of the dimensions of this social re-engineering, such as the move away from centralized wage fixing to enterprise bargaining.

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Part II

Actors, whether firms or governments, may respond to globalization processes at multiple levels of aggregation such as subnational, national, regional and global. This part examines regional responses to globalization. Michele Fratianni describes how the euro is a European response to multiple facets of globalization, examines conditions under which the euro may challenge the US dollar as the principal international money, and analyzes how the creation of the EMU and the euro may alter the architecture of the international monetary system. Fernando Robles examines how Latin American firms are adopting regional corporate strategies to confront multinational enterprises (MNEs) seeking to expand in the region.

The European integration project predates the current discussions on globalization. Key landmarks include the European Iron and Steel Community (1952), the Treaty of Rome (1957), the Single European Act (1987), and the Maastricht Treaty (1991). The euro was launched on January 1, 1999. Though the euro has economic rationale, it has a critical political dimension in that it binds firmly countries that have fought two major wars in this century.

Fratianni believes that the formation of European Monetary Union (EMU) will give the euro a big push in competing against the dollar for the position of dominant currency and to cope with shocks originated in the dollar area. The euro architecture, however, has a downside as well: it will be issued by a new central bank representing a group of countries that have yet not achieved political unification. Nevertheless, The EMU and the euro will alter fundamentally the international monetary system, pushing it away from the existing structure where one international money, the dollar, is dominant to an oligarchical structure where the role of international money will be shared by a few currencies, the dollar, the euro, and possibly the yen. Each of these currencies will form a gravitational center to which clusters of “domestic” monies will be attracted.

Fratianni suggests that the EMU has three alternative courses of actions in relation to the international monetary system: cooperate on exchange rate variability with the other major currency bloc and with Japan; assume

benign neglect; or adopt a plan of stabilizing prices and not exchange rates. He points out that even if the dollar and euro blocs had an incentive to cooperate, a major obstacle to this strategy will be posed by the implied institutional design. There are three possible solutions to this issue: the US sets the growth rate of money growth and EMU fixes the exchange rate; the EMU fixes money growth and the US pegs the value of the dollar to that of the euro; or the Federal Reserve and the European Central Bank decide jointly the value of the target exchange rate and cooperate on monetary policies. Fratianni believes that given the economic and political weight of the two blocs, the first two solutions appear far fetched: neither bloc would be willing to relinquish the role of setting monetary policy and passively adjust to the other bloc's monetary policy. He suggests that the current philosophical climate in central banking appears to favor the implementation of the Keynes' proposal of leaving exchange rates flexible and the central banks targeting the price level or the inflation rate.

Regional integration is accelerating in other parts of the world as well. Robles focuses on regional corporate strategies of Latin American firms and views them as firm-level responses to globalization. The formation of a number of new regional trade blocs indicates that regionalism is emerging as a strategic response to the globalization process. He defines regionalism as having two components. The first is economic regionalism, which is based on the desire of economic agents and nation-states to enhance the welfare of their members. The second component is a regional "mind-set" that results from sharing common values and beliefs, which shape a vision of what regional members want to become.

Latin America is in the midst of a transition from an import-substitution protectionist model to a liberal and open one. As a result, MNEs are vying to invest in this region. In response, a new breed of Latin American corporations is making its mark and challenging the MNEs. Shedding the protectionist mode, these firms are adopting the latest technology and are becoming low cost producers. However, their competitive advantage over MNEs lies in their understanding of the region's intricate cultural fabric. Hence, they seek to become regional players in niches neglected by MNEs. Most importantly, the Latin American managers are adopting a regiocentric mind-set, whereby they view the whole of Latin America as the relevant economic landscape for their firms. Robles is cautiously optimistic about their success and discusses many real world examples in this context.

5 The international monetary system after the euro

Michele Fratianni

Introduction and summary of conclusions

The creation of the Economic and Monetary Union (EMU) and of its currency, the euro, is a historic decision, not only for the European Union (EU) but also for the world at large. The sheer size and economic importance of the countries involved is bound to alter the character of the international monetary system. Historically, there is a positive correlation between relative size and dominant-currency status. On this score the formation of EMU will give the euro a big push in competing against the dollar for the position of dominant currency. On the other hand, the euro will be issued by a new central bank representing a group of countries that have yet not achieved political unification. Historically, political unification tends to occur before monetary unification; there is no precedent for a monetary union of the size and economic importance of EMU. Thus, the benefits from a large economic and financial area will be partly offset by relatively untested institutions.

EMU and the euro will fundamentally alter the international monetary system, pushing it away from the existing structure where one international money, the dollar, is dominant to an oligarchical structure where the role of international money will be shared by a few currencies, the dollar, the euro, and possibly the yen. Each of these currencies will form a gravitational center to which clusters of “domestic” monies will be attracted. The dollar sphere of influence today stretches to Latin America, South and East Asia, Iraq, Bahrain, Qatar, Saudi Arabia, and United Arab Emirates. That of the euro will most likely encompass Central and Eastern Europe, the CFA zone, and parts of the Middle East and North Africa. These maps will have uncertain boundaries. A deepening and widening of NAFTA and the EU will enlarge the sphere of influence of both currencies; trade wars will restrict them. The prediction on the yen area is more problematic. The deep and still unresolved financial crisis in Japan works against the enlargement of the yen; deregulation of its financial markets, with the attendant decline in transaction costs, goes in the opposite direction. Asian countries have preferred the dollar to the yen as anchor

currency, but the recent currency crisis in the region may call for a re-thinking of this strategy. Clearly, predictions on the size of the yen are more difficult than for the dollar and the euro.

The creation of EMU will improve the ability of the European countries participating in the new monetary union to cope with shocks originated in the dollar area. This for two essential reasons. First, the EMU will be less open to the rest of the world than each of the constituting economies. A given change in the dollar-euro exchange rate will have less of an impact on EMU than, say, in France before EMU. Second, the domestic component of financial portfolios in EMU will be larger than the domestic component of financial portfolios in France, Germany and Italy before EMU. This, in turn, will insulate portfolios from shocks originated in the dollar-euro exchange market.

As is true for Latin America (see Robles' paper in this volume), the EU has pursued a regional rather than a global strategy to better insulate its economy from world shocks. However, unlike Latin America, the European monetary union is bound to create large spill-overs onto the rest of the international monetary system. Europe will have acquired a currency of its own with the potential to challenge the US dollar in international money and financial markets. Like the United States, EMU may be in the desirable position to borrow abroad by issuing debt in its own domestic currency and, consequently, relax the borrowing external constraint. This clearly was not possible for each of the member countries of the EMU before the introduction of the euro. In the process, the EU will have acquired a symbol of financial power. To the extent that identity counts (see Ravenhill's paper in this volume), the euro will have given the EU a monetary flag which flies higher than the sum of the old national currencies the euro replaces. Seen from a different perspective, the international role of the euro will be larger than the sum of the pre-EMU currencies. There may be costs as well from the internationalization of the currency in the form of constraints on EMU monetary policy that were not present in pre-EMU countries.

The hierarchical structure that was successful in the gold standard, Bretton Woods, and the EMS cannot be duplicated in a multi-polar world: the United States and EMU, for example, are so large that neither is likely to subordinate monetary policy to the other. What are the chances that the two or three currency areas may coordinate monetary policies? On a first look, the case for coordination appears ambiguous, resulting from two conflicting forces, the openness of the economy and the reduction of relevant players in desiring a cooperative solution. A large EMU works in favor of coordination because fewer players imply lower decision-making costs in reaching a cooperative solution. The openness of the economy, on the other hand, works against cooperation and in favor of benign neglect because the EMU will be as closed as the US economy. Using the experience of the Federal Reserve System, which takes monetary policy decisions more on domestic than international considerations, one arrives at the prediction

that also the decisions of the ECB will be heavily influenced by domestic (i.e. inside the EMU) considerations. This line of argumentation, however, ignores the fact that it is large countries that initiate cooperation; the reason is that large countries reap a large share of the benefits and do not suffer from free riding problems. Collective action theory would predict that the incentives for an exchange-rate agreement would be higher in a multi-polar world than under current conditions.

The paper overlooks, by design, several important topics; let me mention a few. What will be the impact of the euro on the competitiveness of the various financial centers in Europe? Will Britain be induced to join EMU soon to preserve London’s financial superiority in the EU? Will European governments facilitate the creation of cross-national financial networks? How will banking and financial regulators respond to the challenge of integrated money and financial markets? Will regulation remain primarily national until the first financial crisis or will there be a Maastricht of regulation that tries to effectively integrate national regulation with EU-wide regulation?

The paper is structured as follows. First, I briefly examine those few national currencies that act as international money and the “entry” point of the euro into this market. Then, I consider the conditions under which the euro may challenge the US dollar as the principal international money. Finally, I analyze how the creation of the EMU and the euro may alter the architecture of the international monetary system.

The euro and international monies

Since money has several functions and is used by both the private and the public sector, it is useful to organize the discussion around the well-known 3×2 classification scheme proposed by Kenen (1983):

Functions	Private Sector	Public Sector
Means of payments	Vehicle	Interventions
Unit of account	Denomination	Anchor
Store of value	Portfolio allocation	Official reserves

Figure 5.1 Kenen’s classification of money

When country A carries out transactions with country B, both currencies can be used. If A’s currency is used in preference to B’s currency, A’s currency is an international currency for country B. Country A and B may use country C’s currency, a third currency. In this case currency C is an international currency or a vehicle currency for both countries.

In the last two decades the US dollar has lost some market share, yet it remains the dominant currency in the world (Fратиanni *et al.*, 1998). The

German mark, more, and the Japanese yen, less, have gained market share at the expense of the dollar. The increased role of the mark and the yen in private portfolios stands in contrast with their decline as official reserves in the last five years. This is especially astonishing for the mark, given its leadership in the European Monetary System (EMS) and the fact that it acts as the nominal anchor for East European countries (e.g. Poland, the Czech Republic and Hungary). The growth of trade brought about by the opening of the Asian economies (e.g. China) explains the ascendancy of the American currency in the compartment of official reserves. These economies tend to peg to or shadow the dollar. The increasing debt invoicing in yen as well as the transition of Asian countries from a pure dollar peg to a basket peg, consisting of dollar, mark and yen suggests further diversification away from the dollar in the future.

The euro, the new currency of EMU, will benefit initially from the inflation record and reputation of the eleven member countries' currencies, and possibly of the entire group of EU countries.¹ What will be the initial market share of the euro? The United States and the European Union are comparable in economic size, accounting for approximately 20 to 21 percent each of the world GDP and 15 percent of the world's exports; yet, the dollar is much more important than the sum of the EU currencies in the international money and capital markets. Approximately 47 percent of world trade is invoiced in dollars against 32 percent in EU currencies (Fratianni *et al.*, 1998, Table 1); 42 percent of foreign exchange transactions involves dollars against 34 percent involving EU currencies (Fratianni *et al.*, Table 2); over 60 percent of official foreign reserves is constituted by dollar assets (Fratianni *et al.*, Tables 3 and 4); 59 percent of international money market instruments is priced in dollars; 40 percent of Eurobonds is denominated in dollars against 41 percent in EU currencies (Fratianni *et al.*, Table 6); 33 percent of foreign bonds is denominated in dollars against 17 percent in EU currencies; 80 percent of syndicated loans are priced in dollars; and 44 percent of developing countries' long-term debt is expressed in dollars against 13 percent in EU currencies (Fratianni *et al.*, 1998, Table 9). In sum, the dollar is over-represented in the international money and capital markets in relation to the US share of world output and world exports. On the contrary, the sum of the EU currencies are under-represented, again in relation to the same criteria. The biggest differences occur in the categories of official reserves and developing countries' debt.

On the basis of these statistics, should the euro get a share of the international money and capital markets that reflects the economic weight of EMU in the world, private and public portfolios will have to be re-weighted in favor of the euro and against the dollar; the impact on the yen is more uncertain (Fratianni *et al.*, 1998, Tables 12 and 13). Ultimately, the euro must compete with the dollar in terms of cost savings and/or purchasing-power reliability.

The euro and transaction costs

The hypothesis that lower transaction costs will be the engine driving the euro towards the destination of a dominant currency goes as follows (Portes and Rey, 1998). The creation of EMU will consolidate the process of financial markets integration in the EU. With a larger domain, liquidity in these markets would rise and transaction costs would fall, a process that would endow the euro with the micro characteristics for competing with the dollar and possibly replacing it as the dominant currency in the world.

Data on the relative size of financial markets in EMU, the United States and Japan are shown in Table 5.1. The size of the financial markets is defined as the sum of the broad money aggregate, M2, debt securities, and stock market capitalization. The US has larger financial markets than the sum of the financial markets of the eleven countries constituting EMU and of the entire EU. Furthermore, the composition underlying the total figure confirms the well-known fact that the United States relies more heavily on security markets than on bank credit, whereas the opposite is true for the EU (with the exception of the UK) and Japan.² The latter two have developed bank-intermediated financial markets.

For our purposes, integration is more important than size. Unlike the highly integrated US financial markets, markets in the EU, in particular those of EU-11, are more segmented than integrated. How will EMU affect financial market integration? To answer this question we will consider, first, the market for government securities and, then, the market for private debt. Recent data show that yields on long-term government securities of EMU “ins” have purged the exchange rate risk relative to one another; what remains are differences in credit risk. The countries with the highest credit rating—France, Germany and the Netherlands—trade with virtually same yields. Italian and Portuguese governments bonds have the lowest credit ratings and trade within 20 basis points of the highest-credit-rating-group yields. Will EMU push integration to the point that the eleven national securities markets will behave like the market for US

Table 5.1 Size of financial markets in EMU, US and Japan (billions of US dollars, 1995)

<i>Areas</i>	<i>M2</i>	<i>Debt securities</i>	<i>Stock mkt. capitaliz.</i>	<i>Total</i>	<i>Population (millions)</i>	<i>Assets/pop. (\$)</i>
EU-15	5,738	8,673	3,779	18,190	369	49,295
EMU	4,343	6,993	2,119	13,455	286	47,045
USA	4,246	11,007	6,858	22,111	263	84,072
Japan	5,339	5,326	3,667	14,332	125	11,656

Sources: M2 from IMF, International Financial Statistics; the rest from Prati and Schinasi (1997, Table 1). Notes: M2=money (line 34 in IFS) plus quasi-money (line 35); the member countries of EMU are Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

treasury securities? On this point, McCauley (1997, p. 37) expresses a widely held view:

Market participants want, and thoroughgoing integration would require, European treasuries to cooperate in establishing common market practices and conventions... Joint auctions would not be necessary to build large benchmark issues; instead, European treasuries could simply match each other's terms, in effect "reopening" each other's issues.

Complete market integration must need more than harmonizing auction practices. So long as investors perceive that creditworthiness differs among the "ins," yield differentials will persist. The EMU-11 government bond market cannot be as integrated as the US treasury market, unless either of two conditions is satisfied. The first is that investors will have deemed the "Excessive Deficit Procedure," codified in the Maastricht Treaty (Article 104c) and reinforced by the "Stability and Growth Pact" to have real bite.³ In that case, the yields on Italian and Portuguese government securities will converge to the level of the most credit-worthy member countries. The alternative condition is that investors will have reached the belief that neither the "Excessive Deficit Procedure" nor the "Stability and Growth Pact" are enforceable and that solidarity, instead, will prevail. In this case, uniformity of government yields will be achieved at levels above those of the most credit-worthy countries. The long-run repercussions of the second scenario will depend on the degree of opportunistic behavior: the stronger this behavior and the stronger the feeling of solidarity among the "ins," the higher will the uniform yield on securities paid by member governments.

Moving from public to private debt, the creation of EMU is bound to encourage more placements; liquidity will improve and transaction costs will decline. The important question is whether EMU corporations will switch significantly from bank to market financing. Current consensus indicates that corporate financing in the EMU will converge to the size and mix prevailing in the United States. Yet, some caution is in order because the "ins" still retain national regulations and tax laws that act as borders in the financial markets. This point is emphasized by Prati and Schinasi (1997, pp. 287, 289):

Although outstanding debt securities issued by EU private entities totaled about \$4 trillion (about 87 percent of the size of the US corporate debt market), about 25 percent of this total was issued in international markets... Excessive regulatory burdens have simply prevented these markets from developing in some countries. For example, tax policy and issuance requirements prevented the development of commercial paper and bond markets in Germany until very recently. More generally, regulators in virtually all EU countries have stifled corporate debt

securities markets by discouraging issuance of lower-grade corporate debt securities.

Undoubtedly, there will be pressure on the high regulation and tax member countries to align with the competition, but this process will be slow and contentious. Similar considerations hold for the equity markets. There, however, the leadership of London—the capital of an “out” country—augurs well for a euro equity market.

The euro’s challenge to the US dollar

The prospective growth in the euro share of the international currency market, beyond the initial conditions, will be determined by the relative purchasing power of the key currencies and the reputation of their respective central banks. The received wisdom is that the ECB will be as averse to inflation as the German Bundesbank. Kenen (1998, p. 372) goes even further and ventures the hypothesis that the preferences of the national governors have become homogeneous:

The policies and statements of Antonio Fazio at the Banca d’Italia and Angel Rojo at the Banco de Espana are virtually indistinguishable from those of Jean-Claude Trichet at the Banque de France or Hans Tietmeyer at the Bundesbank.

A word of caution is in order. The ECB is an untested institution and will operate in a different political environment than the Bundesbank in Germany or the Federal Reserve System in the United States. The critical distinction is that both the Bundesbank and the Federal Reserve System are central banks within a well-defined political union, whereas the ECB is the monetary authority of eleven (and eventually more) sovereign states linked together economically and financially, but not politically. This difference implies that country interests will weigh heavily in the decisions of the ECB. Furthermore, the fear of financial crises spilling over from one country to another will reduce the credibility of the no-bail-out clause. More on this below.

EMU architecture

The EMU architecture emerged as part of a grand bargain in Maastricht, where government preferences were constrained by the bargaining power of other members and the politics of ratification at home. In the bargaining process member countries were roughly divided in two camps, a division that was reminiscent of the controversy of the 1970s between “economists” and “monetarists” (Swann, 1988, pp. 180–2). Germany—with Belgium, Luxembourg, the Netherlands and Denmark—was the leading exponent of

the “economic” view of EMU, namely that economic convergence must precede monetary unification. France and Italy were the leading exponents of the “monetarist” view, namely that monetary union facilitates economic convergence. Germany favored a long transition period and formal convergence criteria before the final stage of EMU; France and Italy, on the other hand, wanted EMU quickly and without strong preconditions. The German position was consistent with a multi-speed approach to monetary unification; the French and Italian position with a one-speed approach.

The initial reaction to the treaty was that Germany had won the day at Maastricht (*The Economist*, 2 November 1991, p. 77). A more careful reading of the treaty revealed that the German position had been considerably watered down by the group led by France and Italy (Fratianni *et al.*, 1992; Garrett, 1993). One clear victory for the “monetarist” camp was the defeat of the Dutch proposal (Kenen, 1995, pp. 24–6), according to which the European Council would have decided when to fix the date for Stage III and which countries would have qualified. In his memoirs, Guido Carli, who was at the time the Italian Treasury Minister, gives special emphasis to the ECOFIN meeting at Kolding where the Dutch proposal was discussed. In his rejection of the proposal, Carli objects primarily to the divisive procedure of six countries creating a monetary union and labels it a “legitimization of the hegemonic principle” (Carli, 1993, p. 408). The other objection to the Dutch proposal was that it would have postponed to an unspecified time in the future the realization of Stage III for the entire Community. Another victory for the “monetarist” camp was the introduction of a “dynamic” interpretation for the two fiscal convergence criteria. This was a point of great importance to the Italian delegation which had argued that a country with a high but declining debt ratio and primary surpluses should be considered eligible for Stage III, even though the “static” entry conditions were not met. Indeed, Article 104c of the treaty does not speak of outright ceilings for the fiscal criteria but rather that the ratio of budget deficits to GDP “has declined substantially and continuously and reached a level that comes to the reference value” and that the ratio of government debt to GDP is “sufficiently diminishing and approaching the reference with a satisfactory pace.” The use of reference values and the dynamic interpretation of the fiscal criteria reflect the Italian point of view (Carli, pp. 406–7). In sum, the German design of the treaty had been softened considerably by France and Italy.

Garrett provides a cogent analysis of the “two-level game” at Maastricht and comes to the conclusion that the German government, which had the most to lose by replacing the status quo with an EMU that differed materially from the German monetary model, accepted significant compromises to have “more Europe.” Not only was Germany eager to have Community acceptance of German unification, but was also eager to consolidate and enhance its export position in the Community. “The other member governments understood this, and thus were able to gain significant

concessions from Kohl in the wording of the Maastricht treaty, notwithstanding Germany's monetary hegemony and the bargaining power over EMU..." (Garrett, p. 117).

Voting behavior

On the voting behavior of the ECB, the potential for conflicts in the Governing Council has less to do with personal preferences of the governors than with structural differences in the national economies they represent. EMU monetary policy will have a differentiated impact on the participating countries, depending on differences in price and wage rigidities, openness, and industrial and financial structures (Dornbusch *et al.*, 1998). Asymmetric shocks and asynchronous cyclical conditions will further add to the inclination of Council members to vote as French, Germans and Italians rather than as Europeans. The upshot is that such differences will imply that the Council, on most monetary policy issues, will be divided in at least two groups, one representing the inflation hawks and the other representing the inflation doves. Where each national representative will gravitate depends very much on how a monetary policy action affects his or her country. The history of the Federal Reserve System illustrates well the extent to which regional effects influence voting (Woolley, 1988; Dornbusch *et al.*, 1998, pp. 25–7). In predicting that the ECB will be as averse to inflation as the Bundesbank, one must assume that all Council members have Bundesbank-like preferences and that the common monetary policy has undifferentiated effects across euro land. Since neither of these assumptions, but especially the second, is likely to hold, the safer prediction is that the ECB will have a hard time in matching the long-run inflation performance of the Bundesbank.

The second implication of being a central bank of many sovereign states is that the institution cannot be completely insulated from opportunistically behaving governments. It is true, as we have already mentioned, that the treaty explicitly exonerates a member state from the debts of another member state and constrains national fiscal finances to the straightjacket of the excessive-deficit procedure. It is also true that the Stability and Growth Pact was signed to accentuate the preoccupation against fiscal profligacy. But how practical are these provisions in handling a financial crisis that is sparked by an unsustainable debt in a member country and can quickly spill over to the rest of the EMU? The markets may come to the conclusion that the no-bail-out clause is not operational in a world of integrated finance. Despite what the Treaty says, solidarity may be the *modus operandi*; and the ECB may have to swallow some credibility losses.

Summary

Financial markets in the EU member countries will be "pulled in" by EMU

centripetal force and, as a result, these markets will acquire depth, breath and liquidity close to those in the United States. On this conclusion there is wide agreement. But, according to the transaction-cost hypothesis, the euro needs deeper and more liquid domestic financial markets than their US counterparts to challenge the supremacy of the dollar as a vehicle currency. This condition is much harder to be satisfied. In the market for government securities, the absence of a federal government in the EU puts a ceiling on the integration process. Transaction costs may remain lower in the US financial markets than in the EMU financial markets for quite some time. The euro will rise in importance but it is not likely to displace the dollar as *primus inter pares*, at least not for a few years. This conclusion is reinforced by the fact that the ECB is a new and untested central bank, serving eleven sovereign states. The “Excessive Deficit Procedure” and the “Stability and Growth Pact” are a poor substitute for the missing political integration. The latter places a second ceiling on the anti-inflation credibility of the new ECB. National interests will weigh in heavily in monetary policy decisions. The differentiated effects of monetary policy across euro land and the likelihood of asymmetric shocks and asynchronous cyclical movements raise the potential for conflicts in the Governing Council of the ECB; they also raise the odds that the long-run inflation performance of the ECB will not match the Bundesbank’s. So, we are left with a middle-of-the-road prediction that the euro will be a big international currency, but not big enough to dislodge the dollar from pole position.

A multi-polar international monetary system

The creation of EMU is a big innovation in the international monetary system: established currencies from eleven industrialized countries will be replaced by a brand new one. Such a change is destined to alter the configuration of the international monetary system. Will the resulting structure be hegemonic or hierarchical? Will coordination of exchange rate movements be facilitated by the creation of large blocs? These are the key issues raised in this section.

Hegemony vs. hierarchy

While there are many possible exchange rate regimes, these can be derived as combinations of two pure regimes, the fixed and the flexible exchange rate. For the latter, the rule set reduces to one: the monetary authorities do not intervene in the foreign exchange market. A fixed exchange rate regime, instead, commits participants to a specific type of policy coordination. The reason is well known in the literature as the *N-degrees of freedom paradigm*. When N countries form an exchange rate union only N-1 central parities can be fixed; the regime as a whole is left with one degree of freedom. This

degree of freedom determines the union's common monetary policy. More specifically, it gives the union the ability to respond to fluctuations in the union's aggregate demand and aggregate supply and to common external shocks, e.g. changes in world interest rates. Over the long run, the one degree of freedom sets the union's inflation trend and its rate of depreciation against other non-union currencies.

The most important consequence of the *N-degrees of freedom paradigm* is that there can be at most one monetary authority in the union that sets its policy independently of other members. Thus, it is important in the design of an exchange rate union to determine which member is assigned the authority over the remaining degree of freedom and, consequently, how the burden of adjustment to external shocks is distributed. To a large extent, this is a result of how the institutions of the union are framed: the rules for foreign exchange market interventions and their sterilization, which stipulate whose monetary base is affected by the efforts to maintain the central parities; the tolerance for barriers to international capital flows, which shield monetary conditions in one country from the rest of the system and allow the country to retain some monetary independence even within the union; and the rules for changing central parities (Fратиanni and von Hagen, 1992, pp. 43–4).

The resulting range of possibilities is delimited by combinations of two extreme organizational structures, the hegemonic and the cooperative. In the hegemonic structure, one country, typically the largest member, unilaterally determines the union's common monetary policy and the other members adjust passively though the fixity of the exchange rate. In the cooperative organizational structure, monetary policy is the outcome of a collective process of decision-making. This process, in turn, can vary from the strictly democratic—one member, one vote—to weighted voting, with weights reflecting the relative economic and/or political power of each member, as for example in the International Monetary Fund.

Much of the debate about the creation and performance of exchange rate unions boils down to the question of how the *N*th degree of freedom is distributed among the participating countries. Hegemonic explanations have dominated the literature, not only in political science but also in economics. Typically, Britain is identified as the hegemonic country and the pound as the hegemonic currency in the classical gold standard (1880–1914); the United States as the hegemonic country and the dollar as the hegemonic currency in the Bretton Woods system (1945–1971); and Germany as the hegemonic country and the mark as the dominant currency in the EMS (1978–1998).⁴ Kindleberger (1973) argues that all stable international monetary arrangements require a hegemon that provides stability as a public good. Eichengreen (1989, p. 287), on the other hand, finds that “collaboration is equally apparent in the design of the international monetary system, its operation under normal circumstances, and the management of crises.”

A careful review of the evidence reveals that the organization of exchange rate unions tends to be more hierarchical than hegemonic (Fratianni and Hauskrecht, 1998). The requirements for hegemony are extremely demanding on the data. The hegemon not only imparts large effects on the rest of the system, but is insulated from it. In a hierarchical structure, instead, asymmetries exist but the country at the top of the pyramid is not insulated from the actions taken by countries located at lower levels of the pyramid. Furthermore, cooperation is more consistent with a hierarchical structure than with a hegemonic one. In the gold standard, Britain was at the top of the pyramid, followed by the junior core countries France and Germany and finally by passive countries in the periphery. In Bretton Woods, the United States replaced the United Kingdom and the dollar replaced the pound sterling. In the EMS, Germany replaced the United States and the mark replaced the dollar.

A key currency is related not only to the economic size and inflation record of the issuing country, but also to the size and depth of the financial markets and the external credit position of the country (see above). In the gold standard, Britain, at least initially, enjoyed relative economic preeminence, the deepest financial markets, and the largest creditor position. In Bretton Woods, the United States was the undisputed economic and financial leader and had accumulated large foreign credit. In the EMS, Germany was the largest economic unit and had the most stable currency.

Finally, the reserve country has a large weight in determining the system's inflation rate (in the hegemonic organizational structure the weight goes to unity). This was true for Britain in the gold standard and even more so for the United States in Bretton Woods. This practice was challenged by some countries, especially France, meaning that some members reject the hierarchical structure or are unwilling to cooperate. More importantly, it revealed the difficulty of the reserve country of both managing internal balance and providing the system with an international currency. It was this conflict that delayed the United States in playing a leading role in the inter-war period and Germany in the 1970s. Although designed to be symmetric, Bretton Woods and the EMS performed asymmetrically. Here, too, objections to policy dominance were raised by members located at lower levels of the hierarchy.

Multi-polarity

The formation of EMU will transform the international monetary landscape in the fundamental sense that the hierarchical structure that was successful in the gold standard, Bretton Woods, and the EMS will no longer be applicable in the twenty-first century. The United States and the EU are, at the moment, comparable in economic size and international trade. Furthermore, the dollar area is much larger than the United States and the euro area will also be larger than the EU. The dollar sphere of

influence extends to Latin America, South and East Asia, Iraq, Bahrain, Qatar, Saudi Arabia, and United Arab Emirates. The euro will be an anchor currency for Central and Eastern Europe and for the CFA zone. The expected enlargement of the EU, not only to the East, but also to the South, raises the odds that Middle Eastern and North African currencies will link with the euro (McCauley, 1997, p. 8). These maps have uncertain boundaries, the redesign of which depends on whatever moves the EU and the United States will be making next. A deepening and widening of NAFTA and the EU will enlarge the sphere of influence of both currencies. The yen is a big question mark. On paper, some Asian currencies would do no worse by anchoring to the yen; yet, the dollar remains the anchor of choice, possibly because of the “network” effect (Ibid., p. 30). The deep and still unresolved financial crisis in Japan works against the enlargement of the yen; deregulation of its financial markets, with the attendant decline in transaction costs, goes in the opposite direction. From today’s vantage point, the best bet is that the yen area will be much smaller than the dollar area and the euro area.

The incompleteness of the euro bloc

I have already mentioned one potential weakness of the euro bloc: the ECB—despite the overt effort of making it a “harder” copy of the Bundesbank—is an untested institution and will operate in a different political environment than the Federal Reserve System in the United States. The differences in political environments between the two blocs are bound to make the difference. The dollar is backed by a complete bloc, the euro by an incomplete one. To wit, the United States is a political and fiscal union, the EMU is not. Political and fiscal union is an important ingredient for the success of a monetary union. Capie (1998) reviews the evidence of the nineteenth-century monetary unions and concludes that “they were principally driven by a desire for political union [and] were essentially currency unions in countries using the same metallic standard.” Since EMU is not a political union, the more relevant question is whether currency unions formed by sovereign states are stable. Cohen (1993), after examining the experience of six such currency unions, identifies two factors for success: the existence of a local hegemon (e.g. Belgium in the Belgium-Luxembourg Economic Union) or the development of a strong sense of solidarity (e.g. the East Caribbean Currency Area). The Maastricht Treaty rules out the hegemonic solution and goes to great length to rule out solidarity in fiscal matters. The treaty not only exonerates member governments from the debt obligations of other member governments, but also imposes fiscal discipline: budget deficits must be contained within 3 percent of GDP, government debt within 60 percent of GDP, and governments cannot resort to monetary financing. Should transgression occur, offending sovereign states will be subject to punishment ranging

from branding the debt prospectuses with warning statements all the way to the imposition of fines. Are these treaty clauses credible and enforceable? Consider the following scenario (Fratianni, 1998). Country X, with an initially high ratio of debt to GDP, becomes more fiscally profligate. The ECB pursues a high interest rate policy because most of the EMU, but not Country X, is in the expansion phase of the business cycle. Country X's debt, denominated in euro, carries a default premium. This premium discounts the possibility of Country X's government either consolidating its debt—lengthening of maturities—or raising tax rates on interest payments. There is a premium beyond which investors prefer not to hold government debt. At this point the Treasury of Country X could not renew its debt at maturity and would fail to meet financial obligations. Prices of government securities would fall and trading in these securities would be drastically curtailed. Debt holders would incur a wealth loss. Banks would face a liquidity crisis, in addition to a wealth loss. This is because government debt is an asset that credit institutions trade to adjust their liquidity. The financial crisis would embrace the banking system if the total amount of bank reserves were to fall short of the liquidity requirements of the industry. These events would inevitably shake the confidence of bank deposit holders and instigate bank runs.

The crisis could not be contained within the border of Country X, for two reasons. To begin with, holders of other government debt—debt issued by prudent governments—may wonder whether such a crisis may not occur in their markets as well. The higher degree of uncertainty would spill onto other debt markets and force interest rates to rise.⁵ The second reason has to do with the banking crisis. No government can tolerate large bank defaults because of their large negative effect on the rest of the economy. A government debt crisis, inevitably, would force the hand of the ECB to provide the necessary liquidity and thus restore confidence in the banking system of Country X. This liquidity injection may not necessarily imperil the quality of monetary policy in the EMU, so long as the liquidity expansion in Country X's money market were compensated by liquidity absorption in the rest of the EMU, or if the injection were temporary. However, it is very likely that a liquidity crisis in Country X would also affect liquidity in the rest of the EMU area. Banks are in the market of the means of payments and settle with one another debits and credits. Liquidity crises in a national banking system would endanger the safety of the euro payment mechanism. In sum, a liquidity crisis started by fiscal imprudence in Country X is likely to spread to the entire EMU money market. The ECB would have no choice but to inject liquidity, possibly for a long period of time.

The absence of political and fiscal union in EMU may have another negative consequence on the quality of monetary policy. Regional shocks or regional economic disparities cannot be compensated by the center with appropriate fiscal instruments (e.g. the federal income tax in the United States). The affected regions will express dissatisfaction with the EMU and

will blame the ECB for their predicament. This problem is acknowledged in the Delors Report (1989, p. 89):

In all federations the different combinations of federal budgetary mechanisms have powerful ‘shock-absorber’ effects, dampening the amplitude either of economic difficulties or of surges in prosperity of individual states. This is both the product of, and the source of the sense of solidarity which all relevant economic and monetary unions share.

The third and final factor working against the EMU is accountability or lack thereof. The Federal Reserve System is an independent branch of government but is accountable to the US Congress which created it. The ECB, in contrast, is accountable to no one and can act in total vacuum. For Capie (1998, p. 15) “this looks like a deeply flawed institution.” The total insulation enjoyed by the ECB may actually work against the very principles that inspired its establishment. Should the people find that the EMU central bank is not representing them, legitimacy will be lost and with it the quality of monetary policy.

There is a factor that works in favor of the euro area and against the dollar area: EMU is a net creditor vis-a-vis the rest of the world, the United States is a large debtor nation. Historically, center country and key currency status was associated with the nation being an external creditor. This was true for Britain during the gold standard and the United States during Bretton Woods. As a result of the current-account deficits of the 1980s and the 1990s the United States has moved from being the largest creditor to the largest debtor nation in the world. Other things being the same—i.e. holding constant fundamentals and cyclical variables—a large debtor nation faces a prospective devaluation of its currency in relation to the creditor nation’s currency.

Possible scenarios

EMU has several alternative courses of actions. It can decide to cooperate on exchange rate variability with the other major currency bloc and with Japan; it can assume benign neglect; or can adopt Keynes’ preferred plan of stabilizing prices and not exchange rates.

Even if the dollar and euro blocs had an incentive to cooperate, a major obstacle to this strategy will be posed by the implied institutional design. There are three possible solutions: the US sets the growth rate of money growth and EMU fixes the exchange rate; the EMU fixes money growth and the US pegs the value of the dollar to that of the euro; or the Fed and the ECB decide jointly the value of the target exchange rate and cooperate on monetary policies. Given the economic and political weight of the two blocs, the first two solutions appear far fetched: neither bloc would be willing to

relinquish the role of setting monetary policy and passively adjust to the other bloc's monetary policy. Again, we stress the point that the hierarchical structure of the gold standard, Bretton Woods, and the EMS cannot be reproduced in a multi-polar world. The cooperative strategy is the only feasible one. Kenen (1995, pp. 122–3) looks at the incentives for cooperation and arrives at an ambiguous answer. EMU will be approximately as open—measured by the ratio of the sum of exports and imports to GDP—as the United States. Assuming that degree of openness and desire for exchange rate stability are positively correlated, the construction of EMU, *ceteris paribus*, implies more exchange rate variability. The ECB is bound to follow the path of the Fed, which is known to be more concerned by domestic than international factors. On the other hand, coordination costs fall when club membership shrinks. Hence, the answer to the question of whether exchange rate would be less volatile is ambiguous.

Note, however, that leading countries tend to initiate cooperation. The hierarchical structure of the gold standard and Bretton Woods could not have succeeded without cooperation. The center countries assumed the role of the international lender of last resort (e.g. the United States and the Marshall Plan) and the periphery accepted the rules of the game. The issue of interest is whether a multi-polar system has more incentives to cooperate than the hierarchical structures of the past. The United States and EMU will capture a larger proportion of the benefits from cooperation. Should a regime of exchange rate stability be welfare improving for the world, the United States and the EMU would reap a large share of these benefits. Hence, their incentives for cooperation rise, not fall, as predicted by the theory of collective action (Olson, 1965; Fratianni and Pattison, 1982). This prediction is opposite from the prediction obtained from the degree of openness. Some evidence in favor of the collection action theory comes from currency crises. The United States has been the principal actor in resolving the Mexican crisis of 1994–95 and has been leading the charge in the more recent Asian currency crisis. One would expect EMU to internalize a larger share of the benefits from exchange rate stability than the participating countries. Thus, our conclusion is that a multi-polar world may actually deliver more cooperation than the present system, not less.

Exchange rate stability is not an objective pursued for its own sake, but serves to facilitate trade and capital flows. Inter-country inflation rate differences and exchange rate stability imply real exchange rate movements and consequent shifts in competitiveness that have distributional and political consequences. Better to let real exchange rates be determined by real factors for which monetary policy cannot be blamed. If two blocs had identical economic structures, inflation rates, productivity improvements and shocks, nominal as well as real exchange rates would be stable. The desirability of an exchange rate movement occurs either when shocks are asymmetric or when inflation rates between the blocs differ. What are the prospects that inflation rates are the same in the United States and EMU?

Assume a common negative supply shock. Will the two central banks respond in a similar fashion? Much will depend on the short-run tradeoff between inflation and unemployment. Since US labor markets are more flexible than EMU labor markets, the ECB would have a larger incentive to inflate than the Fed (Fratianni, 1998). These differences in incentives would undermine exchange rate stability. Given the impossibility to impose either a dollar or a euro standard and the inherent instability of a fixed exchange rate between two large economic blocs that enjoy different degrees of labor mobility, the best chance for cooperation is that the Fed and the ECB target the same long-term rate of inflation. This is what Keynes advocated in *A Tract on Monetary Reform* (1923). Keynes (p. 117) posed the central question:

Is it more important that the value of a national currency should be stable in terms of purchasing power, or stable in terms of the currency of certain foreign countries?

His answer was unequivocally in favor of stabilizing the purchasing power of the currency because the gold standard, especially in the post-World War I experience, had produced undesirable deflation (pp. 117–25). In addition to avoiding unwanted inflation fluctuations, inflation targets if properly coordinated would reduce exchange rate fluctuations. Again quoting from Keynes (pp. 158–159):

If Great Britain and the United States were both embarked on this policy [i.e. pursuing stability of the commodity value of the national currency] and if both were successful, our secondary desideratum, namely the stability of the dollar-exchange standard, would follow as a consequence. I agree with Mr. Hawtrey that the ideal state of affairs is an intimate co-operation between the Federal Reserve System and the Bank of England, as a result of which stability of prices and of exchange would be achieved at the same time. But I suggest that it is wiser and more practical that this should be allowed to develop out of the experience and mutual advantage, without either side binding itself to the other... A collaboration which is not free on both sides is likely to lead to decisions, especially if the business of keeping dollars steady involves a heavy expenditure in burying unwanted gold.

...we have not yet reached the point when the management can be entrusted to a single authority. The best we can do, therefore, is to have *two* managed currencies, sterling and dollars, with as close a collaboration as possible between the aims and methods of the management.

Keynes' first-best solution was a world monetary union. Recognizing the implausibility of his proposal, he chose the next-best solution, one where countries set not only coordinated inflation targets, but also a procedure to

ensure that these targets would be achieved. That leads us directly into today's literature on inflation targeting, with its emphasis on transparency and flexibility (Mishkin and Posen, 1997; Laubach and Posen, 1997). Transparency translates in the monetary authorities communicating clearly with the public about goals and strategy. The public outreach policy enhances central bank's legitimacy. Furthermore, it allows the use of discretion (i.e. flexibility) when it is most needed, in time of shocks, without compromising the belief in the validity of the central bank's goals.

Common long-run inflation targets—say at approximately 2 percent—do not mean automatically that nominal exchange rates will be stable. Changes in real exchange rates, portfolio shift, and the inevitable noise, so typical of auction markets, would cause movements and jolts to the nominal exchange rate. What consistent inflation target can deliver is long-run predictability of the most important exchange rate in the international monetary system.

Summary

In sum, the emergence of a large currency area like EMU creates problems and opportunities for the existing structure of the international monetary system. The dollar and the euro areas are too large to expect one area to subordinate its monetary policy to the other. These two blocs are relatively closed economic systems and thus have reduced incentives to worry about the domestic effects of fluctuations in the foreign exchange markets. On the other hand, both areas are large enough that if they wanted to stabilize exchange rates they could do so. The central question, thus, has more to do with willingness than ability. It is hard to predict which of the three scenarios discussed in this chapter is most likely to be adopted. The current philosophical climate in central banking appears to favor the implementation of the Keynes' proposal of leaving exchange rates flexible and the central banks targeting the price level or the inflation rate.

Notes

- 1 It is very likely that EMU will encompass the entire EU by 2002 and grow further by the end of the first decade of the twenty-first century.
- 2 M2 is a proxy for bank credit, since bank deposits equal bank reserves plus bank credit minus other bank liabilities minus bank net worth.
- 3 The reference values set by the "Excessive Deficit Procedure" are the same as the fiscal convergence criteria: 3 percent for the ratio of government deficit to GDP and 60 percent for the ratio of government debt to GDP. The "Stability and Growth Pact" was agreed by the European Council at its Dublin meeting of December, 1996, and further expanded by the European Council at its Amsterdam meeting of June, 1997.
- 4 In an immense literature I refer only to Kindleberger (1973) and Keohane (1984), representing respectively the economics and political science literature, for the hegemonic hypothesis. For the application of the hegemonic hypothesis to the

European Monetary System the standard reference is Giavazzi and Giovannini (1989). The reader may want to consult Eichengreen (1989) for a long list of references.

- 5 The experience of the Mexican crisis of 1994–95 is illustrative in this context. Several Latin American countries felt the negative effects of the peso devaluation. Equity prices fell indiscriminately without regard to the underlying fundamentals. Only after some time did investors begin to discriminate between fundamentally healthy economies—e.g. Chile—and unhealthy ones. This blind reaction of the public is reminiscent of bank panics, where the public is incapable of differentiating liquid from illiquid banks.

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6 Latin American corporate strategy under the new regionalism

Fernando Robles

The formation of a number of new regional trade blocs indicates that regionalism is emerging with force as a strategic response to the pervasive and relentless globalization process. After taking a back seat to multilateral efforts to increase trade and investment, regional trade integration has emerged once again as a viable way to shape and protect the economic interests of nation-states from the competitive pressures of globalization.

A new breed of Latin American corporations is making its mark in response to this new reality of more open economies, globalization and regional integration. These corporations are rapidly exploiting technology, low costs, and their in-depth understanding of the region's intricate cultural fabric to compete with global firms and become regional players in niches neglected by these powerful rivals.

Although a few Latin American corporations are moving quickly to seize opportunities in an integrated Americas market, the large majority of companies operating in Latin America have not yet embraced a regional vision. Those local companies using corporate strategies which proved effective under protectionism and weak regional collaboration are being challenged by more regionally integrated firms and the attack of powerful global corporations. It is too early to distinguish the winners and losers of this struggle, but it is more likely that those Latin American corporations which fail to adjust to this new environment will become casualties of this process.

This chapter analyzes the response of Latin American corporations to increased regionalism and intense globalization. The essay is organized in five sections. The first section reviews economic regionalism in the Americas. The second section presents a framework for international corporate strategy and regional corporate strategy. The third section adapts the framework to analyze the interplay between globalization and regionalization and its impact on the corporate strategy of Latin American corporations. The fourth section identifies the key elements of Latin American regional corporate strategy. The last section explores future challenges for the evolution of regional corporate strategy in Latin America.

Regional integration in the Americas

The new regionalism

Regionalism can be defined in terms of two components. The first component is economic regionalism, which is based on the desire of economic agents and nation-states to enhance the welfare of their members. The second component is a regional “mind-set” that results from sharing common values and beliefs, which shape a vision of what regional members want to become. This section discusses the first component. The second component will be presented within the context of international corporate strategy orientation in the next section.

Hine (1992) defines economic regionalism as the promotion by governments of international economic linkages with other countries. This is accomplished by the removal of barriers to trade and by enhancing the free movement of capital and labor among member states leading to regional economic integration. This process of economic integration is designed to abolish discrimination between the economic units of member states. The creation of an economic region lowers the transaction costs among economic agents of member countries and increases the transaction costs with non-members. Transaction costs among members are lower because membership entails reduced uncertainty, information asymmetry and opportunism.¹ When regionalism is mostly based on trade, Schott (1991) argues that the success of the group depends on the similarity in per capita incomes, geographic proximity, similar or compatible trade regimes and commitment to regional organization.

Regionalism is not new. Early regionalism took shape in the form of regional trading agreements. During the period after the Second World War, regionalism in the form of preferential trade agreements, free trade areas, customs unions and common markets proliferated across the world. With the exception of the European Union, past efforts at integration have not achieved any significant impact for their members. In many cases, trade integration negotiations left out important non-tariff barriers outside the scope of agreements. This is particularly true of the many regional integration efforts of developing countries. The lack of real benefits of regional integration among developing economies stems principally from economies that were more competitive than complementary. Governments discouraged intra-regional competition and policymakers were driven more by negotiating the equal distribution of meager benefits rather than allocative efficiency. Other limiting factors included the poor dynamic demand effect within the regional trade group due to the low income of its members, the vulnerability of the region to external financial shocks, and the lack of a strong lead economy among its members which could stimulate a regional economy.

A new round of regionalism however, is emerging, stemming from the complexity and slow progress of multilateral free trade liberalization under

WTO, the proliferation of non-tariff barriers, and the perception by the rest of the world of a fortress mentality in Europe. Furthermore, the recent attention given to capital flows and direct investment in particular has relegated trade to a secondary level. The logic of trade creation or diversion has been replaced by the investment creation logic that dominates the current thinking of most policymakers today. As a result, regionalism in many cases became the only way through which newly formed and reformed states could participate in multilateral negotiations. Also, under more fluid financial markets and more receptive investment climates, capital moves freely worldwide, and states intensify their competition to share the benefits of global production, employment and technology developments. Regional membership provides an additional advantage in attracting capital. This was especially true for regional groups that deepened their integration effort to include investors' considerations such as labor conditions and intellectual property laws. In sum, a new regionalism largely motivated by the fear of exclusion from the world economic order has emerged. This new regionalism consists of the deep integration of reform-minded small countries and large countries that confer minor trade advantages.²

Regional integration, participation in multilateral trade negotiations, and attracting foreign investment are priorities for reforming countries. In addition, reforming countries are concerned with the sustainability of their reforms. An agreement with a large country economy provides greater guarantees of sustainability by binding these reforms and providing an enforcement mechanism and penalties in the case of reversals. For example, Mexico's long path toward trade and economic reform is forever bound to the NAFTA agreement.

In contrast to the conditions of successful integration posited by Schott (1991), this deep integration of large economies and small reforming countries is a characteristic of the new regionalism. The asymmetric participation of small economies and large ones was not part of the list of success factors under the old regionalism. Another characteristic of the new regionalism is that most integration concessions are made by the small and reforming countries wishing to have access to the large economy. Deep integration with the large and other economies binds reforms through agreements that guarantee worker's rights, environmental protection and human rights among others. Given that the large economy is more likely to have a low tariff to begin with, the trade creation impacts are modest at best, but they are compensated for by the investment creation effects that generate employment, tax revenues and technology transfer.³

New regionalism in the Americas

During the 1980s and 1990s, Latin America undertook significant political as well as economic reform. In a period of about fifteen years, Latin American

nations have restored democratic elected governments and legislatures. With different levels of progress, these nations are building democratic institutions and practices. Although much remains to be done to alleviate poverty, arrest violence and deter corruption, civil societies in the region have made strong gains.

With respect to trade liberalization, most Latin American nations reformed their export, import and exchange rate policies. Trade policy reforms involved, among others, reducing import tariffs and eliminating non-tariff barriers, official references to prices, export taxes, and financial subsidies. Exchange rate policy reforms led to the elimination of multiple exchange rate systems and a trend towards floating exchange rates (Alam and Rajapatirana, 1993).

The most significant manifestation of new economic regionalism is the creation of two formidable subregional blocs: NAFTA, the free trade agreement of the US, Canada and Mexico and Mercosur, the customs union made up of Argentina, Brazil, Paraguay and Uruguay. NAFTA's intra-regional trade expanded significantly before and after its creation. Since 1990, intra-NAFTA trade has increased at the rate of 11 percent per year, much faster than the trade of this group with the rest of world, which was 7 percent. As an example of the new regionalism, Mexico has reduced its trade barriers to the US more significantly than the US with respect to Mexico. For instance, the average Mexican tariff of imports from the US went down to about 3 percent in 1997 from 10 percent in 1993. On the other hand, although admittedly starting from a lower base, the average US tariff on imports from Mexico went from 2 percent to 0.6 percent in the same period (Inter-American Development Bank, 1997).

Although NAFTA has contributed to a modest increase in US exports and has had a positive if minor impact on the US economy, the market integration of its members has permitted integrated regional production in automobiles, chemicals and electronics (US Trade Representative Office, 1998). Without strong US support to negotiate NAFTA's extension to other Latin American countries, Canada and Mexico have pursued free-trade NAFTA-like agreements with other countries in the Americas. Canada signed a bilateral agreement with Chile. Mexico, in turn, has signed agreements with Bolivia, Chile, Colombia, Costa Rica and Venezuela.

In contrast to NAFTA, Mercosur has become one of the most dynamic trade expansion groups in the 1990s. The intra-regional trade as a percent of total trade of the trade bloc rose from 4 percent in 1990 to 22 percent in 1997. The rate of intra-Mercosur exports expanded at double the rate of the group's exports to the rest of the world. Mercosur imports have been increasing at even faster rate than its exports. Imports have growing at a rate that is almost three times greater than that of total exports.⁴

As part of its expansion strategy, the Mercosur group negotiated and extended associate membership to Chile and Bolivia, developed a framework for cooperation with the European Union, and initiated talks with the

Andean Group. The aim of all of these initiatives is to bring about a South American Free Trade Area (SAFTA). Mercosur is evolving according to the agreed upon schedule and has become the Third World's largest market group after the European Union and NAFTA. Whereas Mercosur has served to create trade among its members, there is no evidence of trade diversion resulting from discrimination to non-members.⁵ In a review of the progress of regional integration in the Americas, similar to NAFTA, a significant part of intra-Mercosur trade in manufactured goods is attributed to infra-firm trade among the subsidiaries of major multinational companies. Also, significant levels of rationalization and specialization took place in industries such as automobiles, chemicals and transportation.

According to Hufbauer and Schott (1994), the process of integration in the Americas in the 1990s can be best described as the formation of multiple mini-hubs and the expansion of the two large hub-spokes of NAFTA and Mercosur.⁶ Mini-hubs are represented by many of the old integration models such as the Central American Common Market (CACM), the Caribbean Common Market (CARICOM), and the Andean Common Market (ANCOM). Chile and Cuba are the only two nations in the Americas that are not members of these hubs.

At present, mini-hubs serve as a means of gaining access to the two major-hubs of NAFTA and Mercosur. According to Hufbauer and Schott (1994), further integration of the mini-hubs and hubs are "way-stations" along the road to negotiation with other world hubs (EU), or the creation of a larger hemispheric market in the Americas. In fact, the second option seems to be more likely to occur.

In 1994, the presidents of all the countries of the Americas with the exception of Cuba, agreed to the creation of a single Hemispheric Free Trade Area by year 2005 (FTAA).⁷ The goal of hemispheric trade integration has been largely supported by all Latin American nations. Deliberations of a potential hemispheric trade zone have mobilized a diversity of interests in the region; human rights to labor interest groups have been present in most of the annual meetings. The business sector in the Americas has been one of the most active players in this process. Latin American business representatives joined forces with their counterparts in the US and Canada to make sure that their interests were heard.

The real progress towards the creation of the FTAA will depend on the position of the principal leaders of two major hubs (NAFTA and Mercosur): the US and Brazil. Brazil advocates a go-slow approach which will permit the consolidation and expansion of Mercosur. This incremental approach suits Brazil's gradual approach to undertake further economic reforms first and then negotiate trade agreements with other regional blocs. The US's ability to lead a fast approach has been undermined by the lack of "fast track" authority to negotiate future trade agreements. Hufbauer and Schott (1994) characterize this situation as a "way-station," along the path toward hemispheric-wide integration.

International corporate strategy and regionalism

The notion of “go global or die” has been the battle cry of many firms. As defined by Prakash and Hart in the introduction to this volume, globalization is the increasing integration of input, factor and final product markets along with the increasing salience of cross-national value-chain networks in the global economy. In an integrated global business strategy, a company fully globalizes all of its functions, processes, products and strategies. In practice, most global strategies involve partial globalization where some elements of the strategy are localized to the diverse business environments in which global firms operate, while certain core elements are maintained. On the other hand, if the firm goes too far, market effectiveness may be compromised. Increasingly, managers are realizing that world markets are more diverse than they are homogenous. If a firm does not go far enough, however, potential synergies and economies of scale are not realized. This is the dilemma of international corporate strategy.⁸

International corporate strategy

The multinational corporation pursues a corporate vision of exploiting business opportunities worldwide. Multinational corporations have built formidable and complex systems by which they link, transfer and tap local and global resources to produce and market superior products and services for worldwide markets. Faced with intense competition worldwide, multinational corporations strive for efficiency by attempting to coordinate and integrate their diverse operations. Also, their global reach must meet the challenges of a variety of market, competitive, and political situations.

Ghoshal (1987) posits that the mission of the multinational corporation is to achieve efficiency, manage risks, and develop capabilities to sustain future competitiveness. Barlett and Ghoshal (1988) argue that although multinational firms recognize the need to achieve these goals, they realize the difficulty of formulating a strategy that achieves these goals simultaneously. Consequently, most firms will emphasize one more than others.

Prahalad and Doz (1987) provide a framework to reconcile this dilemma. In formulating a corporate strategy, the authors argue that multinational companies formulate their strategies based on their perception of needs for integration and local responsiveness. These pressures exert competing forces. The need for local responsiveness stems from the differences and diversity of national environments in which multinational firms operate. A countervailing need for integration results from pressures to achieve efficiency and greater coordination of competitive response in global industries. According to Prahalad and Doz (1987), firms that perceive a high level of pressure for integration use a corporate strategy of global integration. Firms that perceive a high level of

pressure to respond to local needs use a nationally responsive strategy. Finally, firms that perceive the need to respond simultaneously to both integration and national responsiveness pursue a strategy of administrative coordination (multifocal).

The main objective of global integration is to reduce unit costs and capture large sales volume. Under this strategy, firms strive to integrate and rationalize their activities among several countries. By consolidating volume in a few production centers, firms can achieve economies of scale and afford plant specialization. Spar and Yoffie (2000) argue that this strategy has been the centerpiece of globalization in recent years. This strategy is appropriate when there are few restrictions in trade and investment to facilitate the extensive transshipments of components and finished goods among subsidiaries. With increasing trade liberalization, multinational firms are able to pick and choose among competing locations, situating their commercial activities wherever regulations and enforcement are less onerous. One of the major benefits of this strategy is that it provides a unifying focus for the firm.

Under a nationally responsive strategy, each subsidiary of the firm pursues autonomous strategies that respond to a given country situation. Firms using this strategy perceive high levels of domestic competition, and many constraints from host governments; as a result, they prefer to manufacture for the local market. Lacking the advantages of scale economies and low costs, these firms stress differentiation and high customization to the local market.

Prahalad and Doz (1987) argue that a firm which adopts the multifocal strategy has actually chosen not to have a strategy. Here, the firm responds to each situation and contingency of responsiveness/integration. Under this approach, the aim of the firm is to address both integration and national responsiveness. Finding ways to solve this dilemma introduces a lot of ambiguity, as the response is not consistent all the time or for every case.

Based on their study of corporate structures of major multinationals with global presence, Barlett and Ghoshal (1988) developed a typology of four types of corporations: international, multinational, global, and transnational corporations. International corporations build strong global presence by exploiting the parent corporation's resources and competencies worldwide. This approach is appropriate when the pressures for integration and local responsiveness are low. A multinational corporation builds strong presence through adjustment and sensitivity to diverse national requirements. This approach seems to be present when the pressures for integration are low and high responsiveness is needed to address diverse national conditions. A global corporation builds global competitive advantage through global efficiency, global scale, and a highly centralized operations strategy. A transnational corporation attempts to benefit from the efficiency of integration and customization to a variety of multi-country situations. The latter is appropriate when pressures for integration and

responsiveness are both high. Barlett and Ghoshal argue that in global markets, the transnational solution is the most effective and efficient. A transnational strategy, however, is very complex and difficult to manage.

Several studies have validated the integration/responsiveness framework. Roth and Morrison (1990) analyzed the corporate orientation of a sample of multinational firms in twelve industries and identified the three strategic responses originally proposed by Prahalad and Doz (1987). In an analysis of 131 companies competing in global markets, Leong and Tan (1993) found evidence of global and multinational corporate structures. According to expectations, Leong and Tan (1993) found that the transnational solution was the least frequently reported. Johnson (1995) analyzed a sample of US construction firms competing in global markets and found the three distinctive strategic responses as proposed by Prahalad and Doz (1987). Thompson (1995) also used the integration-responsiveness framework to study the corporate strategies of information technology providers in Latin America. Her study identified the use of global integration, multinational, and locally responsive corporate strategies by these companies.

Regional corporate strategy

Although a global orientation has dominated corporate thinking and scholarly research, the sheer complexity of implementing fully global strategies has forced many companies to rethink their global strategies. Others have argued that regional strategies are utilized as learning mechanisms to fine-tune global strategies and can be viewed as stepping-stones to more effective global strategies (Morrison, Ricks and Roth, 1991). Furthermore, Rugman (1998) posits that truly transnational corporations come from countries with small home markets and economies which are forced to adopt global strategies to succeed. Using an index of transnationality for the 500 largest world multinationals, Rugman found that most remain firmly rooted in their native regions. The author concludes that despite the success of MNCs producing and marketing products for global consumption, there is little evidence of a global monoculture in their corporate strategic approach.

Despite the increasing interest in regionalism, the amount of literature on regional corporate strategy pales in comparison to that on globalization. A literature review revealed a scant number of publications in this area.⁹ However, an early concept of “regiocentrism” appears in the literature of international corporate orientation. As part of the Ethnocentric, Polycentric, Regiocentric and Geocentric (EPRG) typology to describe the strategic predisposition of the multinational firm, Heenan and Perlmutter (1979) define regiocentrism as a predisposition that attempts to blend the interest of the parent with that of the subsidiaries on a limited regional basis.¹⁰

Building on the EPRG framework, Chakravarty and Perlmutter (1985) defined the mission of a regiocentric strategy as the achievement of viability (profitability) and legitimacy within the region. In multinational companies the governance of the regional organization is mutually negotiated between the parent and its subsidiaries in the region. The communications are both vertical and lateral, the products are standardized within the region but not across, profits are redistributed within the region and human resources are developed for key positions anywhere in the region.

Other contributors to the literature on regional corporate strategy argue that a regional corporate strategy intentionally links national markets, gives managers of diverse national subsidiaries opportunities to solve regional challenges, scales production regionally, coordinates markets, and redistributes profits within the region (Morrison *et al.*, 1991). The authors argue that having a strong regional presence gives multinationals an insider advantage and regional political clout. The latter is especially important if the region is the home base of the corporation. Regional organizations have the opportunity to develop sustainable regional advantage by building regional resources and competencies more attuned to their competitive environment. This regional competence can be complemented with transfers of the parent's resources or from other regional organizations in the corporate system. The authors argue that regional production is more scale-efficient and responsive to local needs than global strategies, and that regional organizations are more easily managed than global ones. Also, by focusing on a region for configuration of production, the firm is perceived as an insider and can respond quickly to regional market variations.

Few studies have used empirical analysis to study the response of firms to regional integration. In an analysis of the corporate strategies of US and European multinationals adjusting to the EU, Xardel (1997) found that the successful firms relied on a careful balance of unity and diversity. Successful firms realized cost savings by centralizing operations and scaling their logistics operations to continental Europe. These firms remained sensitive to the national differences in Europe and adjusted their marketing operations accordingly. Knight (1997) studied the corporate strategic responses of 152 Canadian companies to NAFTA. The author found that firms emphasizing an entrepreneurial orientation, product differentiation, and focus on specific market segments of the region tended to enjoy superior returns. According to Knight, these firms were more likely to have made adjustments to their corporate strategy in response to NAFTA. Black and Haar (1998) studied the corporate response of 52 US large multinational firms to NAFTA. They found that these firms were creating corporate strategies and structures specific to North America. These strategies emerged from a careful analysis of production efficiency, geographic differences, technology, characteristics of national markets, and the locational advantages of NAFTA economies. This strategic response

reflected not only the NAFTA considerations but also the intensity of global competition and technological changes. Most important, the authors found that the leaders of these corporations view NAFTA as a single regional, economic and competitive space.

The dynamics of regionalism and globalization in Latin America

The fundamental imperatives of global integration and regional responsiveness appear to be the most relevant factors driving corporate strategy.¹¹ As Prakash and Hart explain in the introduction to this volume, globalization is a process of market integration where multinational enterprises and institutions disperse value-chains across countries and regions of the world. As the authors point out, resource allocation and other important economic decisions are increasingly made by firms and institutions. As Moon points out in Chapter 2, globalization has intensified with the spread of economic neoliberalism and technology. Moon refers to this process as spontaneous (exogenous) globalization, which results in growing interdependence and unruly impacts (vulnerabilities) to all actors (governments, firms, individuals).

Globalization narrows a state's policy options. Furthermore, increasing globalization exerts pressure on states to restructure their economies to be attuned to the global system (Phillips, 1998). This is the case in Latin America, where governments throughout the region made fundamental transformations to their economies in the late 1980s and early 1990s. As was argued before, governments and firms in Latin America promoted a new regionalism, which further aligned their economies with globalization as governments introduced policies to enhance competition and investment. Thus, one can conclude that the new regionalism (NAFTA, Mercosur) and globalization were complementary (building blocs). Higgott and Reich (1999) argue that regionalization is an intermediary and mitigating stage in the relationship between states and the globalizing economy. They further argue that regionalism enhances the overall credibility of members of the region vis-à-vis external actors, especially sources of foreign direct investment, and the same time attempts to preserve some degree of autonomy (Higgott and Reich, 1999).

In Chapter 2, Moon refers to this response to globalization as managerial globalization. He contends that countries must be outward looking and open to universal ideas to adapt and accommodate spontaneous globalization. Key to this response, Moon argues, are ideational changes. According to Moon, countries should be open, outward-looking and form new interests and underlying coalitions to support liberalization. In Latin America, such support came from the congruence in economic management policies between policymakers and leaders in the private sector, first at the national level, and then at the regional level. Coincidentally, as Higgott and Phillips (1999) observe, Latin

American neoliberalism has conformed closely with the Anglo-American model of global capitalism. The authors argue that this convergence in policies stems from the homogeneity in the training and styles of policy elites, technocrats and business leaders (mostly in the US).

The dynamics of globalization and regionalization processes have a striking correspondence with Prahalad and Doz's integration-responsiveness framework. The globalization pressure is the exogenous variable driven by ideas, policymakers and interest groups worldwide (see Figure 0.1 in the introductory chapter). Regionalism is the response strategy by states, policymakers, and institutions within a given region. Regionalism is a compromise between full opening to globalization and national autarky. In this compromise, the actors within the region have to sacrifice some level of local responsiveness. Figure 6.1 shows the interplay of globalization and regionalism in terms of orientation (ideas), economic policies and corporate strategies under globalization and regionalism, on the one hand, and protectionism and nationalism, on the other. As shown in Figure 6.1, globalization and regionalization strategies emerge when the intensity of globalization and regionalization is high, and there is widespread acceptance of market based efficiency and neoliberal ideas. National responsive strategies are aligned with protectionism, isolationism, and local responsiveness. As explained before, globalization pressure is exogenous to all Latin American economies and its impact made no distinction.¹² The degree of integration has been more intense in some subregions (NAFTA) than in others (Mercosur, Andean Countries) but most nations are gradually moving from right (National Responsiveness) to left (Regional Responsiveness). As economies move to the left, firms must realign their corporate strategies to this new environment.

At the firm level, globalization puts pressure on firms to become efficient, competitive and to participate in the global value-chain architecture in their industries. As Prahalad and Doz argued, multinational firms respond with strategies that stress greater efficiency and global integration. At the regional level, one could argue that firms with a home base within the region would follow the same strategy. In Latin America, where the regional integration process is not complete, firms are more likely to establish subregional strategies, at least in the two major hubs of NAFTA and Mercosur. These subregional strategies may lead to increasing convergence of national corporate styles and strategies. The development of regional standards and the harmonization of business laws and regulations would tend to homogenize the business environments within the regional bloc. Kedia (1997) argues that a regional focus may enable the firm to reduce complexity as the diversity within the region diminishes.¹³ On the other hand, the asymmetric membership of large and small economies in new regional blocs, such as NAFTA, may demand greater responsiveness of firms to address differences in income, infrastructure, and demand of regional partners. In the case of NAFTA, substantial

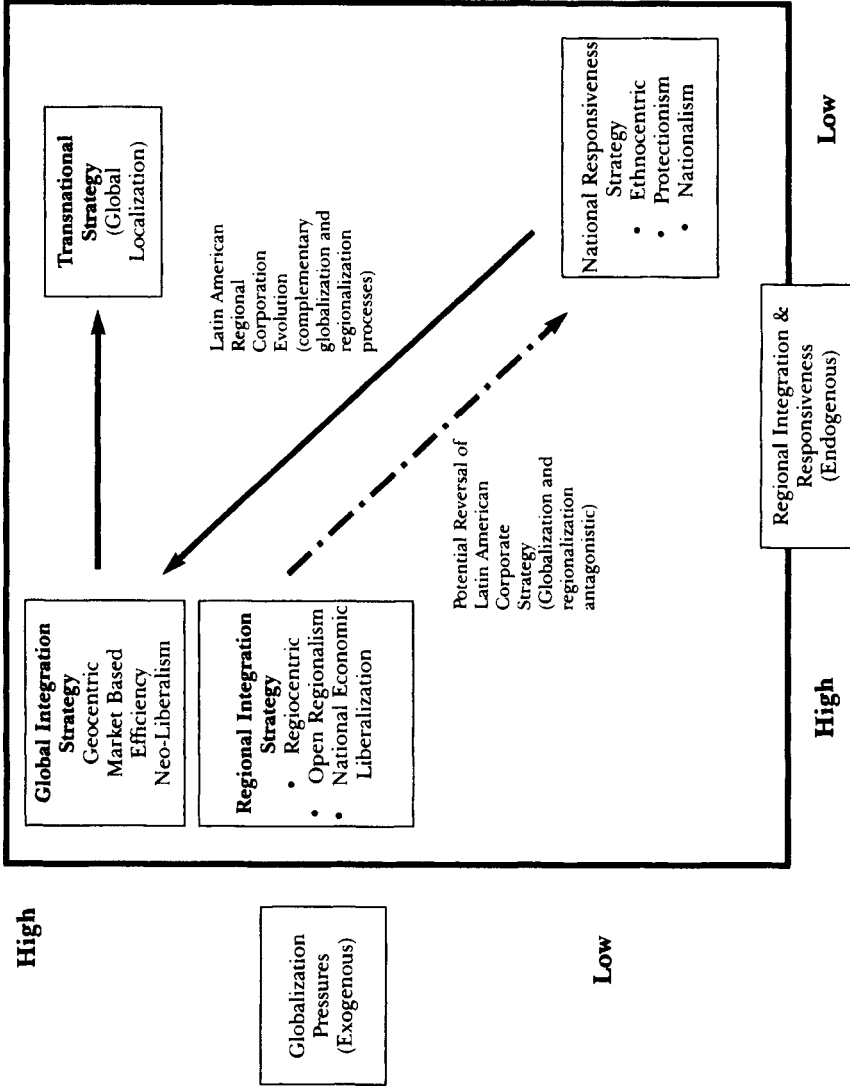


Figure 6.1 Global and regional integration-responsiveness framework

differences in buying power, market infrastructure and local regulations between Mexico and its NAFTA partners present a challenge to develop a common approach to the region. Nevertheless, evidence suggests that Mexican companies have deepened the integration of their strategies with US and Canadian firms after the passage of the NAFTA free trade agreement (Black and Haar, 1998).¹⁴ As a result, many Mexican companies' systems, and business processes are increasingly more aligned with those of their North American partners.

Regional efficiency is difficult to achieve because competing trade integration initiatives such as NAFTA and Mercosur impose different business conditions. Local responsiveness is also a challenge because of the idiosyncratic differences among Latin American markets, despite a common culture and language. Slight differences in income distribution, ethnic backgrounds and climatic conditions are sometimes enough to reduce the effectiveness of proven business strategies even among neighbor countries.

In recent years, many Latin American corporations have indeed reformulated their strategies in response to the two pressures of globalization and regionalization explained here. As these pressures have intensified and been complementary in recent years, government policymakers and business leaders have lobbied for the deepening of liberalization and further integration. The impact of the recent international financial crises, however, has called such an approach into question. Using the framework in Figure 6.1, one possible scenario is the reversability of further regionalization (a shift to the right on the X-axis), assuming a slowdown on globalization. Under this scenario, national government policies may be seen as an attempt to insulate national economies from negative globalization impacts, even if these policies may run contrary to regional integration agreements. How would firms react to these scenarios? Are these reversals short-term? How do these non-reinforcing pressures impact corporate business strategies?

In the next section, I use the framework described in Figure 6.1 to examine the impact of globalization and regionalization pressures on the corporate strategy of Latin American firms. First, I examine the impact of these two forces in the early 1990s when the two processes were complementary. In my analysis I use a sample of Latin American firms which I have followed systematically in recent years (see Table 6.1). Since the debate on the benefits of further opening to globalization and regionalization are too recent, I speculate on the possible response strategies of these firms to a situation when these two processes may be antagonistic.

Responding to integration pressures

Globalization and regionalism have exerted pressure upon Latin American firms to improve operational efficiency. Lower tariffs, overvalued currencies,

Table 6.1 Selected Latin American regional corporate strategies

Company/ Country/ Industry	Strategy	International Presence	Latin American Presence (HQ = home base and headquarters)		Sales (US \$million)/ Sales Growth	Profit/ Profit Growth	Employees
			Argentina Brazil Chile (HQ)	Argentina (HQ) Brazil Chile Paraguay Peru Uruguay			
Andina Chile Beverages	Provide low-cost bottling and distribution services in Latin America's Southern Cone		Argentina Brazil Chile (HQ)	Argentina (HQ) Brazil Chile Paraguay Peru Uruguay	\$780 +3%	\$91.8 -20%	10,000
Arcor Argentina Candy and food packaging	Use low-costs and distribution strategy to compete regionally and globally; reinvest profits in technology and integrate vertically				\$914 +3%	\$40 -20%	10,000
Brahma/Brazil Beverages	Position Brahma as the premier Brazilian beer alternative in national markets and locate production close to market		Argentina Brazil (HQ) Venezuela	Argentina Brazil (HQ) Venezuela	4,738	312.6	4,710
Bimbo Mexico Baked Goods	Use homegrown distribution expertise to expand throughout Latin America	US	Argentina Costa Rica Colombia El Salvador Honduras Mexico (HQ) Nicaragua Uruguay Venezuela	Argentina Costa Rica Colombia El Salvador Honduras Mexico (HQ) Nicaragua Uruguay Venezuela	\$1,920 16%	\$108 165%	45,000

Bunge Argentina Food Processing	To become a global player in the basic agricultural and fertilizer businesses	US Australia Bermuda (HQ)	Argentina (HQ) Brazil Venezuela	\$8,000		
Venevision Venezuela Telecommunications/ Media	Create a single regional TV network and offer regional and global content	US Trinidad	Chile Venezuela	\$1,454 431%	\$436 293%	19,290
Cemex Mexico Cement	Develop world-class technology to compete in global markets	US Philippines Spain	Colombia Dominican Republic Mexico (HQ) Panama	\$3,390 5%	\$981 3%	20,500
Cruz Blanca Chile Pension Funds	Capitalize in regional economic reforms and become market leader in pension funds; create a regional holding company to control acquisitions of national pension funds firms		Argentina Bolivia Chile Peru	\$52		
Enerjis Chile Energy distribution	Turn around neglected energy infrastructure and gain 20% of Latin American energy market		Argentina Brazil Chile (HQ) Colombia Peru	\$2,731 61%	\$249 11%	10,000 (e)

Table 6.1 Selected Latin American regional corporate strategies—continued

Company/ Country/ Industry	Strategy	International Presence	Latin American Presence (HQ=home base and headquarters)		Sales (US \$million)/ Sales Growth		Profit/ Profit Growth		Employees
			Argentina Chile (HQ) Peru	Argentina Mexico (HQ)	\$896.4	\$108.9	\$203 477%	\$127.5 -27%	
Falabella Chile Retail	Use corporate brand name and replicate successful retail and consumer credit format in other countries with substantial adaptation of merchandising to local markets		Argentina Chile (HQ) Peru	Argentina Mexico (HQ)	\$896.4	\$108.9	\$203 477%	\$127.5 -27%	9,300
Femsa Mexico Bottling	Become a leading bottling and convenience retailer in the region		Argentina Chile Costa Rica Mexico (HQ)	Argentina Mexico (HQ)	\$2,559 3%	\$203 477%	\$127.5 -27%	\$127.5 -27%	35,937
IMSA/ Mexico/ Steel			Argentina Chile Costa Rica Mexico (HQ)	Argentina Mexico (HQ)	\$1,494 20%	\$203 477%	\$127.5 -27%	\$127.5 -27%	12,299
Madeco Metallurgy Chile			Argentina Brazil Chile (HQ) Peru	Argentina Mexico (HQ)	\$569	\$21.5	\$21.5	\$21.5	905
Maseca (GRUMA) Food Mexico	World's leading producer of corn tortillas; capitalize on cultural and historical country-markets where corn is the base of consumer food diet; exploit GRUMA's technology based on cost efficiency and economies of scale	US	Costa Rica Honduras Guatemala Mexico (HQ)	Argentina Mexico (HQ)	\$1,494 20%	\$21.5	\$21.5	\$21.5	12,299

<i>Company/ Country/ Industry</i>	<i>Strategy</i>	<i>International Presence</i>	<i>Latin American Presence (HQ = home base and headquarters)</i>		<i>Profit/ Profit Growth</i>	<i>Employees</i>
			<i>Sales (US \$million)/ Sales Growth</i>	<i>Sales (US \$million)/ Sales Growth</i>		
Falabella Chile Retail	Use corporate brand name and replicate successful retail and consumer credit format in other countries with substantial adaptation of merchandising to local markets		\$896.4	\$108.9	9,300	
Femsa Mexico Bottling	Become a leading bottling and convenience retailer in the region		\$2,559 3%	\$203 477%	35,937	
IMSA/ Mexico/ Steel			\$1,494 20%	\$127.5 -27%	12,299	
Madeco Metallurgy Chile			\$569	\$21.5	905	
Maseca (GRUMA) Food Mexico	World's leading producer of corn tortillas; capitalize on cultural and historical country-markets where corn is the base of consumer food diet; exploit GRUMA's technology based on cost efficiency and economies of scale	US	\$1,494 20%	\$127.5 -27%	12,299	

Table 6.1 Selected Latin American regional corporate strategies—continued

Company/ Country/ Industry	Strategy	International Presence	Latin American Presence		Profit/ Profit Growth	Employees
			(HQ = home base and headquarters)	Sales (US \$ million)/ Sales Growth		
Panamco Mexico Bottling	Lead the consolidation process of the Latin American bottling sector by providing superior bottling, distribution, and point-of-sale support at the lowest cost possible		Brazil Colombia Costa Rica Mexico (HQ) Nicaragua Venezuela	\$1,993 24%	\$117.6 66%	
Perez Companc Argentina Energy	Integrate energy business across the region		Argentina (HQ) Bolivia Ecuador Peru	\$1,410 7%	\$328 32%	2,570
Quilmes Argentina Beverages	Regionalize the Quilmes brand and marketing through investments in fully controlled brewing operations		Argentina Bolivia Paraguay Uruguay	\$797		
Provida Chile Private pension fund	Launch funds in other Latin countries and earn 35% profits from regional sales			\$5,400 13%	\$23.8 5%	5,100
Tintas Renner Brazil			Argentina Brazil Chile Paraguay Venezuela	\$149		

Siderca Argentina Seamless pipe	Exploit synergies within parent company (Techint Group)	Italy	Argentina Mexico	\$729 8%	\$175 440%	3,900
Sonda Chile Customized software	Follow expansion of regional pension fund, banks and other industry clients		Argentina Chile (HQ) Ecuador Paraguay Venezuela	\$213 40%	\$15 to 20 NA	2,150
VASP Brazil Airlines	Develop a southern cone regional hub through controlled equity investments in regional airlines		Argentina Bolivia Brazil (HQ) Ecuador	\$1,188	\$151.5	5,582

Sources: *America Economía*, 500 Largest Latin American Companies, November 1997; *America Economía*, The Largest Multinationals, Annual Edition 1997-1998; *Apertura*, Made in Chile, September 1996; *Business Week*, The Top 200 Emerging-Market Companies; *Latin Trade*, The Latin Multinationals, October 1996; *Latin Trade*, Top 100 Publicly Traded Companies, September 1997; *Mexico Business*, Mexico's 100 Largest Companies.

and aggressive import competition, especially from Asia, have upped the competitive ante for many Latin American corporations. Many of these companies have responded by making large investments to upgrade capital equipment, rationalize production (reduced product line and concentrated in volume markets), invest in informational technologies, develop productivity and quality program initiatives, train human resources, and begin aggressive outsourcing of non-core operations.

Although efforts to improve quality and efficiency in Latin American firms might have always been components of corporate strategy, globalization and regionalism have forced them to establish global and regional benchmarks. In the past, Latin American firms viewed US and European multinational companies as their immediate challenge. Under the new regionalism, Latin American firms have found that the greatest challenge can come from other Latin American companies entering their home markets as a result of trade agreements or regional integration. For example, Mexico's Cemex, the world's third-largest cement manufacturer, has shaken the relative stability of cement markets in several Latin American countries. After improving efficiency in its home market, this company saw the potential in acquiring and modernizing inefficient Latin American plants. Since 1992, Cemex has acquired cement manufacturers in Spain, the Dominican Republic, Panama, Trinidad, Venezuela, the United States and Colombia. Having turned around inefficient national operators, Cemex has lowered prices to a level that national producers have struggled to meet. In brief, in a very short time, Cemex has dominated every market where it penetrates, and has become a regional benchmark.¹⁵

The pressure for integration intensified with the entry of competitors from member countries in regional blocs. Mexican firms were first challenged by their country's participation in NAFTA. Competing successfully against US and Canadian firms became the key to their survival. Many Mexican firms opted to collaborate with other North-American corporations and viewed themselves as platforms for a Latin American expansion. Large Mexican retailers such as Cifra and Gigante formed strategic alliances with US Wal-Mart and K-Mart with the expectation that these alliances could be easily expanded south. The Mexican crisis of 1995 stalled this vision, and many of the US firms expanded alone or took over the alliances. The Mexican crisis left many Mexican retailers too weak to pursue any international expansion. Such was the case of Wal-Mart's acquisition of a controlling interest in Mexico's Cifra in 1997 with plans to make a massive conversion of Cifra stores to Wal-Mart Supercenters.¹⁶ Other Mexican corporations focused on the potential opportunities in neighboring countries and expanded quickly to Central America. Based on these early successes, these companies realized that further expansion south was key to long-term development.

In addition, new global players from other regions entered Latin American in response to the round of privatization and deregulation

programs triggered by economic reform. For instance, in the span of seven years, Spain's Telefonica took control of the telephone networks of Argentina, Chile and Peru. Since its first acquisition in 1990, this company has amassed a telecommunications empire that includes 7.5 million fixed lines, 600,000 cellular subscribers, and some 300,000 cable TV subscribers. Latin America represents 15 percent of total Telefonica's revenues, the ambition for the future is to achieve 50 percent (Ferro, 1997). Other global competitors have not ignored Telefonica's move. In the cellular market, for example, since its first entry into Argentina in 1989, Bell South has moved at a fast clip. In less than three years, Bell South has gained presence in eight Latin American countries by buying equity positions or winning the right to operate in key metropolitan areas in Latin America including the big prize of Sao Paulo, Brazil. The only large Latin American market where Bell South does not operate is Mexico, which the company exited in the early 1990s (Mears, 1997).

In the quest for improved efficiency, some Latin American companies carefully assessed the vulnerability of their businesses to a new competitive reality and adopted a more focused strategy. A good understanding of the value-chain and the vulnerability of their present business positions locally and internationally forced many companies to identify a strategic thrust where they could build local competitive advantage. This redefinition of business invariably questioned the role and future of many businesses in the portfolio. In many cases, a more narrow business focus led to the divestiture of unrelated operations. A more streamlined portfolio of businesses was a stronger defense against major global and multinational companies. Other groups looked for better synergies and resource sharing among their businesses.

An example of this transformation is the Argentinean firm Bunge & Born. This venerable Argentinean conglomerate has been going through a radical restructuring initiated in 1991 when Bunge & Born decided to concentrate on the food packaging business. Since that time, the company has sold its cement, chemical, computer and textiles operations in Brazil and Argentina. A holding company, Bunge International, used to control a large network of national companies in Argentina, Brazil, Venezuela, the US, and Australia. Faced with a formidable challenge from multinationals such as Nestle, Nabisco, Unilever, Parmalat and Danone and powerful national champions such as Mavesa in Venezuela, and Sadia in Brazil, Bunge explored several options. One option was to expand to other Latin American markets such as Chile, Colombia or Mexico. Under this option, Bunge faced strong regional competitors such as Mexico's Bimbo or Chile's Luksic group (Hudson, 1997). Another option was to strengthen its position in Mercosur by acquiring companies in Brazil or Argentina with good brands in the consumer food sector. A third option for Bunge was to enter into joint ventures with food multinationals with relatively less presence in Latin America such as Kraft, Danone or Barilla. In the end,

Bunge surprised everyone by selling its consumer packaging business and retaining its basic agricultural products and fertilizers processing business. Bunge moved back to its roots, divesting its processing plants in Brazil, Australia and Venezuela and retaining the Argentinean, Brazilian and US agricultural concerns.

The Bunge case illustrates the dramatic changes in the corporate strategies of Latin American corporations in recent times. The case illustrates how globalization has increased competition for consumer food products in Latin America. It also illustrates how another global trend, the shift of power from producers to distributors and retailers, is reducing the attractiveness of food processing, and forcing regional companies to shift their strategies. The Bunge company did not have too many options to consider, given the global power of regional and global players in this industry. Despite the divestment decisions, Bunge remains vulnerable to competition from global giants; so far, global food processors such as Cargill and Archer Daniels Midland have not moved to challenge Bunge in NAFTA or Mercosur (Adriano, 1998).

Having a regional presence has been imperative for firms in local markets which did not provide a large enough base to sustain business in the long term. For instance, Chilean firms which benefited from Chile's earlier economic reforms relative to other Latin American countries, and a longer period of macroeconomic stability and growth, gained experience in privatized, deregulated industries such as utilities and financial markets. Enersis, a Chilean energy group, gained a dominant position in its home market. Cramped with a small domestic market, the company quickly realized that future expansion would be derived from the incipient privatization and modernization processes in the region. Enersis's vision was translated into a positional advantage based on its superior efficiency over power plants in other countries. The confluence of the region's rising per capita consumption, deregulation and the potential for improved efficiencies of acquired utilities explains the quick regional expansion of Enersis. The firms' potential expansion in the region is limited by its management resources as well as its ability to transfer its energy technology experience to other Latin American countries (Bradley, 1997).

As Latin American corporations reformulated their strategic focus, as in the case of Bunge, the proceeds of divestment of non-core assets provided these firms with resources to finance international expansion. Access to international capital markets also provided additional resources to support regional integration. For instance, Panamco, the world's second-largest Coca-Cola bottler, was able to consolidate its equity positions in a number of local operations in Mexico, Brazil, Costa Rica and Venezuela by raising equity in the international markets (*America Economia*, 1998b). Similarly, Chile's Enersis used internal capital and access to international funds to acquire majority equity in power and distribution plants in Argentina, Brazil, Colombia and Peru (*Latin Trade*, 1996).

Coping with regional responsiveness

Without any significant integration before the 1990s, most Latin American markets were strictly national markets. Local customers did not have much product choice. If there was choice, it was dominated by two or three brands. In some cases, the dominant brands were a mix of long-established multinational brands and those of powerful local competitors. In spite of high price elasticity in many markets, all players avoided price competition at any cost. Market regulations included high-tariff protection, and many non-tariff regulations that effectively protected the existing players.

Tolerance to monopolies and oligopolies did not provide the environment to create strong market regulatory bodies. Lack of competition resulted in low product innovation. A commodity orientation with no strong product differentiation favored economies of scale and concentration on controlling the value-chain in a given country from one end to the other.

With tariff protection and lack of strong competition in small domestic markets, many firms saturated their traditional local markets. In order to grow, Latin American firms sought entry to international markets, typically neighboring markets due to transportation costs and the advantage of national export promotion programs and incentives. Latin American firms typically exploited cost advantages and subsidized local costs with little attempt to differentiate or adapt their products to export markets, in other words they utilized a product commodity approach. Very few Latin American brands had any significant market penetration and recognition in other regional markets.

As mentioned before, Kedia *et al.* (1997) assert that the pressure for local responsiveness should diminish with regional integration. In the case of Latin America, several cases suggest that the process of integration may lead to more homogeneity of environments. For instance, Venevision, a Venezuelan TV producer of popular soap operas for continental viewing, took great care so that every word and image would have regional appeal. Another example is Mexico's Bimbo corporation, which centered its international expansion strategy on its corporate brand. The corporate brand (Bimbo), identified by a smiling teddy bear, is the umbrella for a portfolio of bread and confectionery products which the firm produces and markets throughout Latin America. The company has replicated its efficient distribution system in every country in which it operates. Bimbo uses a strategic positioning based on the freshness of its product, which is guaranteed by its distribution system and its policy of frequent replacement at all points of sale.

The next section analyzes the characteristics of the regional strategy that appears to be emerging among Latin American firms. Using the

integration/responsiveness framework, I explore the resemblance of this corporate strategy to the strategic responses identified by Prahalad and Doz.

Latin American corporate strategy under new regionalism

Some Latin American corporations seem to have developed a corporate strategy that is sustainable under the pressures of globalization, regional integration and responsiveness reviewed above (see Table 6.1). These companies have a clear business focus. Some exhibit impressive sales and profit performance whereas others have had low performance. A number of companies have built a regional presence, as indicated by the number of countries in which they have subsidiaries. In attempting to become regional players in their industries, these companies have developed a regional corporate strategy. Key elements of this regional corporate strategy include a regiocentric orientation, a selection of positional advantage, scope of action, the form and pace of establishing regional market presence, participation in particular subregional trade blocs,¹⁷ and the development of corporate systems to sustain regional operations.

Another component of regional corporate strategy of Latin American companies is to have presence in major trading blocs. NAFTA and Mercosur are clearly the most important new regional blocs. For the Latin American firms listed in Table 6.1, a key decision was whether to establish a presence in one or both of these trading blocs. For firms whose home base is one of these bases, the strategic thrust was to gain presence in the other trade bloc, a formidable challenge for even the most powerful group.¹⁸ For example, despite being the third-largest cement producer in the world, Cemex does not have any significant presence in Brazil. On the other hand, leaders at Colombia's publishing company Editorial Norma realized very early on that Mexico and Argentina were a must in their ambition to become the leading publisher in Spanish-speaking Latin America. As part of this vision, Norma acquired Argentina's Kapeluz and beefed-up its Mexican presence. Norma's presence in the twin hubs of trade in the Americas may compensate for the deteriorating conditions of its Colombian home base and prove vital to its future. As the market for publishing globalizes, Norma is a small competitor against Spain's publishing houses which are re-entering Latin America in force to regain the market share lost by their decision to withdraw during the depressed decade of the 1980s.

The Latin American companies in Table 6.1 also used collaboration and strategic alliances in their regional expansion. Brazil's Localiza, a car-rental company, has quickly obtained regional presence in Bolivia, Chile, Ecuador, Paraguay and Peru through franchising agreements (Karam, 1996). A quick build-up of regional presence puts a strain on local managerial talent. To prevent managerial labor shortages, many of these companies relied on management development programs to groom a local

and regional talent pool to support this rapid expansion. Important investments in corporate information systems and new technologies are also key at this stage. Argentinean's Arcor reinvests 90 percent of its profits in all of its thirty-three plants in the region (Mandell-Campbell, 1998). Collaboration seems to be particularly effective with a twin-hub strategy. Argentinean firms joined forces with Mexican firms to cover the two trade blocs adequately and to present a coordinated front against Asian imports and other global threats. An example of such a strategy is the agreement of Argentinean Siderca and Mexican TAMSA to exchange equity and collaborate in technology exchanges (Toulan, 1997).

Other companies chose to use acquisitions as a form of regional expansion. Latin American companies transformed acquired companies and put them to work under new management such as the case of Chile's Enersis conversion of privatized Latin American utilities. Another case is Brazil's Banco Itau which has set up six branches in Argentina with the latest electronic banking system in the region. Banco Itau's clients can access bank services throughout Mercosur, an advantage over other national banks (Carvalho, 1995). With their acquisition of Argentina's bank Banco del Buen Ayre, Itau has the largest network of ATMs in the sub-region. Itau is clearly aiming at being one of the largest banks in Mercosur (*America Economia*, 1998a).

Another component of Latin American strategy focuses on consolidation and quick regional expansion. In some cases, Latin American companies quickly substituted their import agents for controlled sales offices. The implementation of this stage of a regional marketing strategy required keen expertise in managing expansion, acquisitions, and raising external funding. For instance, Mexico's Bimbo has acquired sixteen companies in eleven countries since 1990. As the company moved south, the risks and challenges increased. In recent ventures, Bimbo entered into joint ventures with local firms. In Colombia, Bimbo joined forces with Industrias Alimenticias Noel, a national leader in biscuits and crackers (*Latin Trade*, 1997b). In Peru, Bimbo took a majority position in a joint venture with local company Alicorp (*Market Latin America*, 1998). In every country, Bimbo achieved quick market entry, leveraged its competencies in marketing and distribution, and created a national distribution network.

Another dimension of regional strategic thrust is consolidation of the product portfolio. In the past, market protection afforded national companies the luxury of managing complex product portfolios. In many cases the product portfolio consisted of their own brands as well as representations and products manufactured under licensing agreements from multinationals. The competitive pressures unleashed by economic reform and globalization have forced many companies to focus their business strategies, divest from many businesses, and trim weak brands. Many companies retained only brands with regional potential. As licensed brands

are regionalized, an obstacle has emerged in that licensors usually gave rights for one or two countries but not for the region. As a result, to increase their bargaining power with the licensor, Latin American firms have adopted a strategy to acquire companies in countries which are holders of similar licensing rights.¹⁹

A final component of the Latin American corporate strategy is to build a pan-Latin American corporate culture. In the past, Latin American corporations relied heavily on expatriates from their home bases. The major assumption made by many Latin American companies was that countries within the region shared the same corporate culture. As long as the strategy relied on exports from the home base, cultural differences did not matter much. A strategy of regional expansion with controlled subsidiaries, however, required managing cultural differences. For instance, Chilean companies in Argentina realized quickly how different the internal managerial culture was in this neighboring country. Building a pan-Latin managerial mind-set became important. In many cases, local managerial talent had experience with US and European multinationals, but few had much experience working for other Latin American firms. An increase in the number of young Latin American graduates from US, European and Latin American business programs in recent years, however, has enlarged the pool of Latin American managerial talent available to these firms. Latin American companies have intensified their recruitment of managerial talent everywhere and recruited Latin Americans from US and European multinationals. Hiring on a regional basis has allowed Latin American companies to tap this talent pool to obtain a deeper understanding of other Latin American markets. In addition, having managerial talent with experience of multinational companies has helped firms to understand the corporate strategy of these potential rivals. The creation of a regional mind-set is still a process in gestation in many Latin American companies but the need has been clearly recognized. In short, the Latin Americanization of the managerial pool in Latin American corporations has become an important element of regional corporate strategy.

As the information technology revolution spreads around the world, Latin American corporations have invested in information and control systems for their regional operations. As they expand rapidly to other Latin American countries their challenge is to integrate these remote operations and provide their managers with a unified corporate information environment. As many multinational companies have learned, national differences in accounting practices, tax systems, and reporting systems are very difficult to integrate with internal corporate systems. Many Latin American corporations have allocated human and capital resources to achieve this integration. Effective regional information systems is helping these corporations to enhance regional corporate culture as managers become aware of all of the business challenges of their counterparts in every Latin American country connected to the system.

Summary and conclusions

In a relatively short time, Latin America has undertaken substantial economic and political reforms. A set of democratic, economic and trade liberalization reforms has created a favorable environment for the emergence of new regionalism. For many, the formation of NAFTA and Mercosur has locked in the economic reforms and set the region onto an irreversible path towards further integration. As reviewed in this essay, the pace and path of the goal to form a single hemispheric free trade zone depends on the resolve of the leaders of these two main models of integration and particularly the positions of Brazil and the US.

Both the process of globalization and regional integration are exerting pressures on Latin American corporations. Although the process of globalization is exogenous to these corporations, the process of regional integration is not. These corporations participate actively in the different rounds of negotiations and discussions in NAFTA, Mercosur and FTAA, and lobby their governments to resolve issues of importance to their operations.

The deliberations on a single hemispheric free trade zone seem to be shaping or contributing to the development of a new collective vision of the state and society in the Americas. At economic summits, broader discussions beyond topics of economic integration have opened up to include the participation of new actors: educators, corporate leaders, labor representatives, and others who want to exercise their rights, present their views and have access to information. Latin American states are changing their traditional roles and appear more open to sharing the stage with a broader spectrum of their societies. This greater openness among nation-states which are at the same time reducing their participation in their national economies and strengthening their role as regional brokers supports the view expressed by Evans (1997) that more capable and modern states may develop more innovative forms of state-society synergies.

As a result of the open debate and dissemination of information, a new regiocentrism seems to be emerging in the Americas. This new regiocentrism is a response to increased regionalism in the world at large, and a way to cushion the impact of globalization. Eurocentrism has crafted a vision of a European society unified politically, economically and on the basis of monetary unity. Before the Asian crisis, Asianism emerged as an explanation of economic success based on Asian values and discipline. In fact, many writers predicted that the next century would be the century of Asian hegemony (Frank, 1998). It is then understandable that the nations of the Americas would attempt to forge an American vision of regionalism to complete and provide balance of what has been described as a triad of economic globalism. Regiocentrism in the Americas also helps the nations of the hemisphere to better insulate their economies against the vulnerabilities of spontaneous globalization as described by Moon (Chapter 2) in his analysis of South Korea's response in this volume.

I have argued in this chapter that the integration-responsiveness framework is a valid tool to analyze a firm's strategic response to the ongoing pressures of globalization and regionalization. Twenty years after it was first articulated by Prahalad and Doz (1987), the framework offers a compelling logic to analyze multinational corporate strategy under regionalism. Using this framework, I have argued that globalization and regionalism exert pressures of integration on the Latin American corporation. These pressures are based on an intense race for increased efficiency, as global corporations chase lower costs around the world. I have also argued that regional integration reduces national responsiveness as business conditions tend to homogenize and national markets tend to converge under regionalism.

My analysis of a sample of Latin American corporations suggests that their strategic response corresponds to the global strategy characteristics in the Prahalad and Doz's typology. This strategy referred to as a regiocentric strategy. As part of this regiocentric strategy, these companies participate actively in regional trading blocs, with a view to creating regional brand equity positions that challenge the entrenched positions of powerful national brands. These corporations are building a network of regional subsidiaries, affiliated companies, suppliers and distributors that could rival global corporations. In some cases, corporations team up with other regional or global players to build formidable barriers to entry for other firms. To coordinate their operations throughout the region, Latin American regional players have developed advanced information technologies that facilitate integration, communication and coordination. Finally, they are creating a regional corporate culture that articulates their vision and strategic thrust at all levels.

Latin American corporations that have adopted a regional vision execute their strategies quickly and with determination. A first-mover advantage against other global competitors compels them to move quickly from country to country. Northern cone-based corporations move north to south whereas southern cone firms move in the opposite direction. An eventual clash of these regional giants may be disputed in the middle markets of the Andean or Central American regions. Collaboration among these regional organizations cannot be ruled out. In the process of achieving regional coverage, all markets, small or large, are important. A critical mass of markets and products is key to recoup the large capital and technology investments of the early phase of regionalization.

In most cases, no single Latin American firm has a presence in all the key large markets (Argentina, Brazil and Mexico). Language (in the case of Brazil) and cultural differences are still high market entry barriers. Another obstacle is lack of resources. An assault on a major market requires a careful assessment of all options, as any critical setback could be devastating for even the best financially endowed firm. In this transition, participation in a subregional bloc provides a launching pad for a hemispheric approach.

Thus, for instance, Brazilian companies seem to be using Mercosur as a training ground for regional expansion into Spanish-speaking Latin America.

As explained in Figure 6.1, Latin American corporations started with modest international regional expansion using a commodity approach (no local adaptation or differentiation) leading to a fast regional expansion. The Latin American corporations analyzed in this essay can be characterized by a regiocentric integration strategy.²⁰ When regional integration and globalization pressures aligned themselves and reinforced each other, Latin American corporations moved quickly from an international strategy mode to a highly integrated strategy of regional efficiency as Mexico's Cemex case illustrates.

But globalization pressures can also exert forces that may reverse this process. As the recent global financial crisis has demonstrated, national interests may prevail over the regional ones. The pressure on the Brazilian currency demonstrates that some members of a regional bloc are more vulnerable than others and will react unilaterally to defend their economy. Thus global pressures on single economies may challenge governments to consider to reverse economic policies and return to the more nationalistic stand of the past (a move from left to right in regional responsiveness in Figure 6.1). Venezuela's reversal of economic policies is perhaps the most dramatic example in recent years. Distracted by national crisis, Latin American governments may stall deeper trade integration. This last reversal would slow the pressures for further integration.

A reversal of pressures toward less regional integration could force Latin American corporations to reformulate their strategies. One possible consequence is to revert to a strong national entity by divesting from regional operations. Another possibility is that corporations may follow the multinational approach and make their regional subsidiaries more autonomous, operating like national companies.

It is hard to predict the future impact of globalization on the integration and responsiveness pressures that drive regional corporate strategy in Latin America. Brazilian corporations may reconsider further investments in Mercosur until austerity plans to deal with the international financial crisis in that country are fully implemented. Strong Latin American corporations, such as those listed in Table 6.1, are the first line of defense against the erosion of economic autonomy by rampant globalization. Strong Latin American corporations can play a role in revitalizing Latin American economies. They have supported modernization of the legislative framework that governs economic activity, and furthered the stabilization process that has been underway since the beginning of the decade. These companies are nurturing indigenous managerial talent and leadership. They are developing a Latin American regional vision and contributing to the economic development of the region.

It is still too early to judge the effectiveness of these regional visions and

ambitions. Building regional presence and critical mass takes time and can deplete corporate resources. Access to financial markets willing to bet with these companies that their strategy will prevail is a must. Most important, the determination and support of corporate leaders is a critical factor.

Notes

- 1 In the case of the Americas, regional integration and negotiations for the creation of a single hemispheric trade zone has made the business and economic environment more transparent. Convergence is greater within the subregional groups of NAFTA and Mercosur. For instance, as part of the NAFTA process, Mexico has strengthened intellectual property laws and investment guarantees. As a result, one can argue that opportunism and costs to protect investors' intangible assets have decreased substantially.
- 2 See Ethier (1998).
- 3 See De Melo and Panagariya (1993).
- 4 See Inter-American Development Bank, *op. cit.*
- 5 It should be noted, however, that increasing imports from the rest of the world can be explained by the unilateral trade liberalization, exchange rate and economic reforms undertaken by the member countries in the same period. As a result of these reforms, Mercosur members experienced exchange rate appreciation, which may have stimulated imports from the region and the world. They also received substantial inflows of capital that helped them to sustain increasing trade deficits. The Inter-American Development Bank (1997) asserts that Mercosur has benefited not only its members but also the rest of the world.
- 6 Hufbauer and Schott (1994) argue that there are several paths to economic integration: (a) the bang-bang model, the hub-and-spoke; the multiple-hub; and the membership-by-invitation. They posit that integration hubs evolve from the expansion of hub-spoke trade agreements into a fully-fledged FTA or custom union. For instance, NAFTA evolved from a system where the US was at the center of two smaller countries (spokes). With NAFTA, the two spokes (Canada and Mexico) are integrated.
- 7 Since the Presidential summit in 1994, the trade ministers of the Americas have met annually to deliberate the architecture of the FTAA. Several working groups have provided recommendations on issues ranging from market access, investment policies, intellectual property rights, competition policy, and dispute resolution mechanisms. A second Presidential summit in 1998 ratified the commitment to the FTAA and set up a concrete agenda of meetings up to the year 2004 to ensure progress toward this goal.
- 8 For an extended discussion on international strategy see Jeannot and Hennessey (1998).
- 9 Regional corporate strategy literature include the following: Eden, L. (1994) *Multinationals in North America*, Calgary: University of Calgary Press; Chandra, Mareesh (1997). The regionalization of global strategy, paper presented at the 1997 Meeting of the Academy of International Business, Monterrey, Mexico; Kedia, Ben L., Harveston, Paula D. and Dibrell, C. Clay (1997). 'Firm competitiveness and regionalization: a theoretical perspective', paper presented at the 1997 Academy of International Business Meeting, Monterrey, Mexico; Knight, Gary (1997) 'Firm orientation and strategy under regional market integration: a study of Canadian firms,' *The International Executive* 39, 3:351-74; Karloff, Bengt (1994) 'Strategies of the emerging European market,' *Long Range Planning* 27, 2:36-44; Laserre, Philippe and

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- 10 See Heenan, D.A. and Perlmutter, H.V. (1979) for a complete discussion on international managerial orientations. In an earlier work, Perlmutter (1969) argued that strategic predisposition is shaped by the place of origin of the firm, the leadership style of its CEO, its administrative practices, and the myths and folklore that have endured in the organization.
 - 11 Under regionalism, the pressure to integrate originates from the opportunity to achieve economies of scale in expanded regional markets. For an elaboration on this subject see MacCormack, Newman and Rosenfeld (1994). According to the authors, recent developments in flexible manufacturing, just-in-time processes, and information technologies have made it possible to operate efficiently with reduced scale. The authors further suggest that global companies can now establish a manufacturing presence in each region where there is significant demand.
 - 12 The fact that global financial crises impact reformed and non-reformed economies has been one of the sharpest criticisms among Latin American economic policy makers.
 - 13 Kedia, op. cit.
 - 14 Black and Haar, op. cit.
 - 15 As reported in Crawford (1997).
 - 16 See *Business Latin America*, February 1998:2.
 - 17 A good summary on corporate strategy can be found in Collis and Montgomery (1997). The authors indicate that a carefully designed corporate strategy determines the goals and objectives, tasks, structure, systems and processes, and resource deployment to pursue the vision that the firm sets for itself. A vision is the conceptualization of what the corporation strives to become. An effective vision incorporates the values, ethics and definition of the corporate domain. The structure, systems and procedures define the way corporations control their activities in multiple businesses. Thus, the role of corporate leaders is to build a system of interdependent parts in which all the elements are aligned to each other.
 - 18 Firms with a home base in countries which are not members of NAFTA or Mercosur face a greater challenge as they have to defend their home market as well as keep their options in these trade blocs.
 - 19 Based on author's field interviews with selected Latin American firms in the Summer of 1998.
 - 20 Malnight (1995) documents a similar process of evolution of ethnocentric firms into globalized strategies, in Malnight, Thomas W. 'Globalization of an ethnocentric firm: an evolutionary perspective,' *Strategic Management Journal* 16 (2):119-41.

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Part III

Responding to globalization is challenging for countries that are engaged in the tasks of nation-building and establishing a market-based economy. This part examines responses to globalization in three such countries: Russia, Bulgaria and Yugoslavia. Steven Solnick examines Russia while Beverley Crawford discusses Bulgaria and Yugoslavia. All three countries are former Communist countries composed of multiple nationalities and ethnicities. As a consequence, the end of the Cold War and the challenges of nation-building have significantly constrained their efforts to respond to globalization.

Solnick discusses how globalization poses special challenges to states attempting to redefine the boundaries of their public and private spheres. In post-Communist countries, the collapse of the centrally planned economy created a crisis in which the role of the Westphalian state was unclear and transnational entities often enjoyed greater legitimacy than domestic governments. In Russia, this crisis has been deepened by the internal divisions of the federal polity. Thus, the central state must redefine itself on the world stage while simultaneously renegotiating the division of powers with subnational governments. The processes of globalization make it harder for central state actors to consolidate control over economic and political resources and the central government's failure to secure a sustainable tax base has ushered in a chronic fiscal crisis.

Solnick identifies five elements of the "Russia syndrome" that significantly impact the abilities of the Russian economy to coherently respond to globalization: (1) a fragmented economic space due to disruption of the vertically integrated production chains that were created by central planners; (2) a high need for capital to modernize and restructure the economic base; (3) a weak legal culture and a lack of institutions for enforcing contracts, which create a high-risk environment for foreign capital; (4) the slow evolution of Russian identity in a post-imperial world; and (5) the unwieldy federal structure that consists of twenty-one ethnically defined republics and sixty-eight other subnational governments.

Beverly Crawford examines how globalization, in its impact on the state's withdrawal from an allocative role in society, the introduction of markets

and the disproportionate economic hardships that result, has given rise to identity politics and exacerbated ethnic conflict in Bulgaria and former Yugoslavia. Globalization processes can have a dual negative impact on state and society; they can weaken those state institutions that guarantee the “domestic bargains” and can cause distinct cultural groups in multiethnic societies to suffer disproportionate economic hardships. Under the disintegrating power of these two forces, “ethnic entrepreneurs” can emerge to articulate grievances and create a parallel political authority among distinct cultural groups. Culture, therefore, becomes the primary political cleavage, and that cleavage, combined with the weak legitimacy of established authority can lead to violent social conflict.

Crawford compares the responses of Yugoslavia and Bulgaria to these two disintegrating forces. She shows how Bulgaria’s institutions “coped” with the forces of globalization to avoid social disintegration, while Yugoslavia’s “coping mechanisms” exacerbated the problem of social fragmentation and led to violent cultural conflict. The two countries are strikingly similar in terms of historical legacies, social composition, and economic structure. In both countries, ethnicity and religion were highly politicized and the economic hardships associated with the fall of Communism and an opening to the international economy fell disproportionately on politicized cultural groups. Yet Yugoslavia erupted in violent conflict, while Bulgaria did not. Her conclusion is that the institutions of political participation and resource allocation are the crucial factors affecting social integration, and these key institutions differed in Yugoslavia and Bulgaria.

7 Russia between states and markets

Transnational and subnational pressures in the transition

*Steven Solnick*¹

It has become common to assert that “globalization” poses a challenge to the post-Westphalian state.² Transnational capital mobility, multinational production of goods, and international competition in goods and services in open markets have combined to restrict the domain of policies susceptible to control by national governments.³ As more regulatory authority is ceded to international regimes (the WTO, the euro) and as borders become increasingly transparent to capital, labor and information, the role of the state requires—at the very least—rethinking.

Much of this rethinking about the nature of states in a globalized world has focused on the experience of countries already integrated into the global liberal trading system. Both the established industrial countries of the OECD and the more recently industrialized states of Asia and Latin America bring to the “globalizing” 1990s long histories of established political and economic power exercised by the national government. Whether we consider the regulatory state, the welfare state, or the developmental state, we can see the particular challenges of adapting to an environment in which the levers of state control no longer produce the expected result.

At first glance, those countries which formerly practised centralized economic planning by the state might be expected to confront similar challenges—i.e. managing a shift from a strong central state to a weaker state that shares or competes for power with transnational actors. In post-Communist countries, however, the collapse of the centrally planned economy created a crisis in which the role of the state was unclear.⁴ In many of these post-Communist countries, transnational entities often enjoyed greater legitimacy than domestic governments. The challenge for these states, therefore, has not been to manage a “retreat” of the state but rather to *create* a legitimate national government even as powerful forces of globalization made redundant many traditional state roles.

This chapter examines the special challenges facing the post-Communist government of Russia as it attempts to redefine the Russian state in a global economic environment. Section 1 considers why the challenges facing Russia are particularly complex and distinctive, even among the post-Communist

states. Section 2 then discusses how the pervasiveness of transnational economic actors and global financial flows acts as a double-edged sword in Russia's federal polity—offering regions and non-state actors opportunities to defy or evade the authority of the center, but also providing the center with critical leverage over recalcitrant regions. This section examines a variety of “coping mechanisms” employed by three key groups of actors: federal officials, regional officials and non-state actors. In Section 3, I consider the August 1998 collapse of the Russian economy and its implications for the relationships among national, subnational and transnational actors.

Russia in a global post-Communist world

All of the post-Communist states of East Europe and the former Soviet Union were forced to confront the twin challenge of simultaneous political and economic transformation. Processes of globalization played an important role in these transformations across the post-Communist world. Four particular areas of intersection of globalization and post-Communist institution-building merit particular mention.

First, as noted above, the power of transnational actors complicated the post-Communist project of state-building. It is important here to distinguish among the different types of transnational actors, however.⁵ Private transnational actors—such as multinational corporations or banks—are driven primarily by individual profit motives. On the other hand, public sector or non-profit transnational actors—such as international organizations, multilateral financial institutions, or transnational coalitions of environmental or human rights activists—are motivated chiefly by policy objectives or principled ideas. As I note below, the interests of these different transnational actors may be congruent for periods of time and still diverge sharply in times of crisis.

Functions traditionally associated with a central government—including regulation of the domestic market, control of international trade, and even guarantees of national security—have not been smoothly transferred from the Communist to the post-Communist governments. Interest rates are set in response to demands of international lenders—private transnational actors such as banks, currency traders and hedge funds. The desire of post-Communist countries to join multilateral trade and currency communities (particularly the EU for the states of central Europe) gives these public transnational actors extensive leverage over dictating regulatory policies. Similarly, multilateral security regimes like NATO are being called upon to provide security guarantees for pivotal states in central Europe.⁶

Second, international competition was able to serve as a proxy for competitive domestic markets, offering policymakers a means of liberalizing domestic markets even in the presence of pervasive monopolization.

Employing a strategy first used in Poland in 1990, neoliberal policyplanners attempted to postpone any urgent steps toward demonopolization by making the currency convertible and demonopolizing tightly controlled foreign trade operations.⁷

Third, international investment offered a quick and effective means of injecting both capital and managerial-technical know-how into economies sorely lacking in both. These infusions came at a high price, however, as equity stakes in many state sectors were surrendered at bargain-basement prices, a process that ignited a nationalist backlash.

Finally, the international consensus of “embedded liberalism” incorporated a high reliance on state provision of minimum levels of social provision (i.e. the welfare state) to shelter domestic interests from the vicissitudes of international market swings (Katzenstein, 1985; Ruggie, 1982). The post-Communist project, however, involved the large-scale *dismantling* of a comprehensive welfare state. While neo-liberal policymakers in these countries extolled the importance of maintaining an adequate “social safety net,” the implementation of such a safety net was complex in practice. The Communist social welfare system was administered at the workplace, with social assets like housing, schools and medical facilities generally owned and financed by local enterprises. While divestiture of these social assets became a high priority of the privatization and restructuring process, cash-strapped local governments across the post-Communist world have been reluctant to accept full responsibility for their operation. As a consequence, many of the post-Communist states have been thrust into the global marketplace without many of the shock absorbers developed by other open economies.

While Russia has confronted all of these issues, it faces a series of even greater challenges deriving in large part from its unique role as the center of the former Communist world. While not all of these conditions are unique to Russia, they combine to make the sudden impact of global economic forces particularly disruptive and threatening. There are five distinct elements to this “Russia syndrome”:

A fragmented economic space

The economic organization of the Soviet Union was designed to exploit economies of scale and regional comparative advantage, at least as interpreted from the perspective of Moscow. One corollary of this approach was that the centrally planned economies discouraged diversification of regional economies, and instead fostered regional concentration. As a consequence, planners relied on “gigantism”—massive vertically integrated productive enterprises that employed tens of thousands of workers, dominated entire cities, and produced thousands of separate goods.⁸

Since prices in the centrally planned economy were artificial constructs, production networks in various industries were constructed with limited

attention to energy or transport tradeoffs of different siting decisions. Thus, it was not uncommon for raw materials to be shipped across six or seven time zones for processing, and then shipped back over several thousand miles for manufacture and assembly. Conversely, manufacturing plants were frequently constructed close to resource extraction sites, especially in Siberia, without regard to the adverse consequences of such a decision for power consumption.

The breakup of the Soviet Union disrupted vertical production chains for all successor states, but Russia faced particularly acute problems for two reasons. First, while individual enterprises in non-Russian successor states could be adapted to utilize different inputs available more cheaply on world markets, or integrated into alternative, global chains of production, Russia found itself with inefficiently exploited raw materials and incomplete chains of production.⁹ Thus, while globalization may have created opportunities for accelerating the economic transformation of other former Soviet states (with the possible exception of Ukraine), Russian producers were forced to turn to international markets to restore the inefficient status quo ante. To be more precise, a large factory producing cigarette paper in, say, Azerbaijan might market its output to a variety of international cigarette manufacturers, but the Russian cigarette industry would be paralyzed without its paper.

Second, by virtue of its size, Russia stood most vulnerable to the dysfunctional consequences of the Soviet disregard for transport and energy costs. While these costs mattered little in the Soviet environment of pervasive monopoly and artificial prices, they have severely adverse consequences for the global competitiveness of Russian goods. The irrationality of these prices also accelerated the shift toward reliance on barter: much of the non-cash paper (known as *veksels*) circulating in Russia derives from IOUs issued by the fuel and power companies and the railroads, which only receive a small fraction of payments from customers in cash (Hendley, Ickes and Ryterman, 1999; Woodruff, 1999).

Taken together, the sudden exposure to the global economy dictated by neo-liberal reform plans had radically different consequences for Russia and its former satellites. While the smaller non-Russian states were able to utilize transnational economic forces as a means of diminishing their integration into the dysfunctional Russian economic system, Russian actors themselves were grossly unprepared for international economic competition. Exposure to the global economy stripped them of formerly captive suppliers across the USSR and CMEA, and exposed the crippling consequences of Russia's decades-long disregard for economic geography.

High capital needs for investment and for stabilization

All post-Communist economies face steep bills for modernization and restructuring of their industrial and agricultural bases. Once again, the scale

of the challenge is greater in Russia, as are the capital needs in the resource extraction sector. While Russia enjoys substantial deposits of oil, natural gas, gold, diamonds and other precious metals, Soviet planners sacrificed efficiency for expediency in their extractive technologies.¹⁰ As a consequence, the most accessible deposits are now depleted, and high levels of investment are needed to reach new fields located in desolate arctic conditions.

These steep requirements for international lending must be considered alongside the consequences of the Soviet Union's reckless debt binge of the late 1980s. In an ill-fated effort to keep the partially reformed Soviet economy afloat, Soviet governments of the late 1980s incurred over \$60 billion in foreign debt, almost all of which was inherited by Russia (European Bank for Reconstruction and Development, 1997). In addition, Russian governments of the early 1990s paid high costs sustaining the ruble zone across the former Soviet space, and depleted most of its inherited foreign reserves. By the spring of 1998, Russia's foreign debt burden exceeded \$130 billion, and service on that debt alone represented 1.3 percent of GDP.¹¹ More than half of that financing in 1998 was due to come from Eurobonds and other open market debt instruments—and the IMF's short-lived July 1998 bailout plan sought to replace even more domestic debt with foreign debt. Thus, even among post-Communist states, Russia is particularly dependent upon international markets, and thus particularly vulnerable to the transnational capital flight.¹²

Weak legal culture

Unlike many countries attempting to attract international capital, Russia and the other post-Soviet states are plagued by a weak legal culture and dubious institutions of contract enforcement. In addition, several crossnational studies of corruption rank the former Soviet states as the most corrupt places on the planet to do business (European Bank for Reconstruction and Development 1997, pp. 37–9). One study of entrepreneurs in Russia and Poland finds the Russian businessman far more constrained by corrupt state bureaucrats and the need to manage criminal protection rackets than by considerations of market risk (Frye and Shleifer, 1997).

For international investors, the problematic state of contract enforcement and weak tradition of “rule by law” is exacerbated by the state's lack of credibility as a guarantor of property rights. Russia is not a party to any established multilateral trade regimes beyond the moribund Commonwealth of Independent States.¹³ Potential investors cannot therefore count on an international regime to adjudicate conflicts. Furthermore, Russia's ongoing and turbulent experiment with democracy has created a patchwork of competing institutions (President, Cabinet, two houses of parliament, Supreme Court) and jurisdictions (federal, regional, local). While I consider the implications of federalism in more detail below,

Table 7.1 Net foreign direct investment as percentage of GDP

	1993	1995	1996 (est)
Azerbaijan	1%	10%	19%
Turkmenistan	2%	11%	6%
Russia	0.22%	0.55%	0.45%

Source: European Bank for Reconstruction and Development (1997). GDP and FDI both dollar-denominated.

the simple practice of electoral competition for office introduces great uncertainty into an already murky investment climate.

A perverse consequence of Russia's progress toward electoral democracy has been the weakening of investors' confidence in the enforceability of their rights. A new tax code has been stalled in the Russian parliament for several years, leaving in place a confusing layer cake of federal and local taxes that can push marginal tax rates over 100 percent. When lawmakers do act, they sometimes erode investor confidence even further: in April 1998, the parliament triggered a stock selloff by passing a law over a presidential veto limiting foreign ownership of United Energy Systems (the national power monopoly) to 25 percent, despite a present level of 30 percent foreign ownership (*Kommersant Daily*, 23 April 1998). The law gave no guidance for reducing the level of foreign ownership to prescribed bounds, confronting the government with a choice between ignoring the law (and further undermining any claims to a "law-based" state) and renationalizing shares.

Beyond such blatant attacks on investor rights, Russian officials have proven less than ardent in their enforcement of legal rights of minority shareholders. Replacing management at large enterprises has proven exceptionally difficult, and minority shareholders have repeatedly encountered obstacles even to gaining representation on boards of directors.¹⁴ Consequently, many foreign investors have abandoned projects in Russia, often in favor of similar projects in other post-Soviet states with more authoritarian regimes. Especially in the energy sector, multinational actors like Mobil and British Petroleum have walked away from large oil and gas projects in Russia to concentrate their efforts on Caspian Sea projects in Turkmenistan or Azerbaijan. The consequences can be seen in Table 7.1.

Thus, in a world of highly mobile capital, investors can respond quickly to uncertainty and rent-seeking by moving their capital elsewhere. The margin for error for transitional states like Russia becomes razor-thin.

Weak state identity

Russia faces a distinctive set of problems flowing from the collapse of its empire. As noted above, Soviet planners used the non-Russian satellite states

as economic buffers to insulate Russia from the global economies; consequently, the collapse of the Soviet empire left the Russian economy particularly vulnerable to global forces. Beyond this, however, Russian leaders and the Russian people have faced the challenge of reconceiving the Russian state as a post-Imperial power.¹⁵

This has proven more difficult than expected for Russians. Not only must they adjust to the loss of empire, they must also come to grips with the realization that the sacrifices made by several generations in the name of building Communism were in vain. The crisis of *Zeitgeist* grew so acute—the new Russian national anthem still has no lyrics—that Boris Yeltsin actually appointed a presidential commission of scholars in 1996 to devise a new “Russian national idea.”¹⁶ This challenge of national reinvention is certainly complicated by the emergent “global culture” of recent decades. Just as the West proved a magnet to young Russians during the late Soviet period, Western culture continues to exert a powerful influence over Russian tastes and ideas.

This influence has extended as well to political and economic models, as Russian leaders have adopted Western templates of parliamentary democracy and market economics almost by default. The influence of international advisers during the first decade of the Russian transition has been enormous; though many Western blueprints for institutional design yielded unrecognizable (and barely functioning) constructs when actually implemented. One potential consequence of this phenomenon may be the growth of a reactionary Russophile populism in the next decade. Unlike the non-Russian Soviet republics, many of which identified key nationalist themes in the course of their struggle against the Soviet center, the Russian Federation may need to find *its* nationalist tropes in opposition to Western symbols like the IMF, World Bank, and “rapacious” Western speculators.

Federalism

In Russia, the central government must redefine itself on the world stage while simultaneously renegotiating the division of powers with subnational governments. Alone among the Soviet successor states, Russia is a federal polity, with a complex, asymmetrical structure developed haphazardly over decades by Soviet nationality planners. In the process of extricating the Russian Federation from the Soviet Union, Yeltsin was forced to grant extensive degrees of autonomy to the twenty-one small ethnically-defined constituent “republics” of the federation.

Beyond the special concessions granted to these autonomous republics, the Russian government has been forced to devolve similar powers to the regional governments of the remaining sixty-eight subnational governments of Russia—oblasts, krais, okrugs and federal cities. The tensions between regional demands for greater autonomy *across* the federation, republics’ demand for special status *within* the federation, and the federal government’s

efforts to consolidate its powers *atop* the federation have become a defining feature of the first nine years of the Russian transition.

These federal dynamics have important consequences for Russia's capacity to cope with the forces of globalization discussed above. In Russia, where the central government's failure to secure a sustainable tax base has ushered in a chronic fiscal crisis, processes of globalization make it harder for central state actors to consolidate control over economic and political resources being claimed by subnational administrations. If officials at the center fear that transnational forces will relegate them to the margins, they may be tempted to launch a pre-emptive strike against liberalization. On the other hand, if transnational actors provide adequate assurances that the central government remains an essential participant in any significant cross-border transfers of capital, labor, or goods, then globalization may serve to retard any restoration of economic or political tyranny.

As a consequence, the Russian government's strategies for coping for globalization must be evaluated in tandem with its strategies for state-building, and particularly for managing the centrifugal forces of Russia's asymmetric federal system. Far from diminishing it, forces of globalization offer the federal government an opportunity to increase its leverage over constituent units by exercising its power as a gatekeeper to international capital and markets. Since this interaction between transnational and subnational forces is so central to evaluating Russia's future trajectory, it is considered separately in the next section.

Federal and transnational forces in Russia—games on multiple levels

As Putnam (1988), Gourevitch (1978) and others have noted, international activities of nations may have a direct impact on their domestic politics, and may also be manipulated by national leaders to further particular domestic agendas. In Russia, international markets and capital flows have played a critical role in shaping the struggle over the shape of the future Russian federal state. Regional leaders have looked to transnational actors to provide many of the public goods poorly supplied by Russia's central government. Just as autonomy movements in northern Italy, Belgium, Scotland, and Quebec have grown in tandem with international economic integration, ambitious regional leaders hope to increase their power by diminishing the indispensability of the federal center. The federal government, for its part, seeks to ensure that it alone controls access of regional governments to international markets.

It is difficult to overestimate the volatility of Russia's compound federal republic. Like Spain after Franco, Russia must reconcile a recent history of authoritarian centralization with a longer tradition of distinctive regionalism—but it must do so without the stabilizing influences of European Community membership or the EC-associated burst of economic

growth. Like the Indian federation—especially in the early post-colonial period—Russia must integrate a mosaic of ethnic enclaves striving for varying degrees of national self-determination and international recognition. As in Nigeria, banking and financial conglomerates (national and transnational) in the distant capital ruthlessly exploit the vast riches of its impoverished oil and gas regions—resulting in regional, economic and ethnic cleavages that are mutually reinforcing.¹⁷ As the economic collapse of 1998 extinguished any hopes for economic recovery in the short term, Russia seemed poised between turbulent democracy sustained by India, and the intermittent dictatorships suffered by Nigeria. Which path it follows will depend in large part on how national, subnational and transnational actors structure their ongoing interactions.

Before considering the various strategies employed by these actors, some background on Russia's federal structure is necessary.

Federal dynamics in Russia: 1990–98

The Soviet Union was a multi-ethnic federation in which major ethnic groups were associated with particular national “homelands.” This linkage of ethnic groups with territorial divisions defined the structure as “ethnofederal,” and the present Russian constitution retains this distinction. In reality, however, Russians constituted the majority in many of these autonomous “ethnic” territories.

The federal structure of the Soviet state was based upon a detailed hierarchy of federal sub-units. At the top of this hierarchy were the fifteen Union Republics, like Ukraine, Kazakhstan or the Russian Federation (RSFSR). Each of these fifteen republics became independent after 1991. The Union Republics were themselves composed of some twenty autonomous republics and 120 territorial-administrative oblasts or krais. Each autonomous republic was the designated homeland of one ethnic group (or occasionally a cluster of nationalities).

In June 1990, the Russian Federation's newly elected legislature followed the lead of the Caucasian and Baltic republics and declared Russia to be “sovereign.” This action was quickly mimicked by the sixteen autonomous republics within the borders of the Russian Federation, eager to seize the opportunity to gain greater control over their own affairs. Yeltsin encouraged them, reluctant to provide Gorbachev with any precedent for recentralization; in August 1990, he famously told the leaders of the republics to “take as much autonomy as you can swallow.”¹⁸ By October of 1990, all sixteen republics had passed their own sovereignty declarations. However, we should not interpret subsequent conflict between regions and the center as threatening the territorial integrity of Russia.¹⁹ Instead, the struggle was over the distribution of powers between the federal and regional governments, and especially the distribution of resources. Since these resources included Russia's oil, gas, diamond and

metal deposits, it was inevitable that transnational actors would be drawn into the battle.

In the waning months of the Soviet Union, the autonomous republics were able to goad the Russian and Soviet governments into a high stakes bidding war. In 1990, for instance, Yeltsin promised the government of Sakha/Yakutia, home to most of the Soviet Union's diamonds, that it could keep a share of its diamonds for independent sale. Sakha subsequently accepted Russian sovereignty and ceased diamond shipments through Soviet channels. Critically, however, this diamond concession would have required the consent of DeBeers, through which the Soviet Union had marketed its diamonds for decades.

In addition, eleven regions sought and received "free enterprise zone" status, offering tax and regulatory concessions, including limited rights to waive certain tariffs in international trade (Filippov and Shvetsova, 1998). Tatarstan, for its part, began negotiating a bilateral treaty with the Russian Federation, as dictated by the April 1990 law.

The abortive coup of August 1991 put an abrupt end to the bidding free-for-all. While Gorbachev continued to pursue the Union Treaty after August 1991, the December 1991 agreements establishing the Commonwealth of Independent States effectively ended any hope for a confederation retaining a Soviet center. Autonomous republics could no longer play the Russian and Soviet governments off each other, but rather faced a choice between accepting subordination to Russia and seeking direct independence.

With just two exceptions, republics moved quickly to cut deals with Moscow. Yeltsin signed three similar treaties at the end of March 1992: one with the autonomous republics, one with the lesser autonomous okrugs, and one with the non-ethnic oblasts and krais (and the "federal cities" of Moscow and St Petersburg). These Federation Treaties recognized two different classes of "subjects of the Federation": twenty-one ethnic republics and sixty-eight administrative-territorial regions.²⁰ Territories in the former group were recognized by the Federation Treaty as "sovereign states" and were promised expanded rights over their natural resources, external trade and internal budgets. Two republics, Tatarstan and Chechnya, insisted on a fuller statement of their independence from Moscow and refused to sign the treaties. Some republics received special inducements to sign: Sakha's special 1990 diamond marketing agreement was honored, and Bashkortostan demanded a special appendix granting it addition control over its foreign trade (Slider, 1994, p. 247). The nonrepublic territories—oblasts, krais and the "federal cities" of Moscow and St Petersburg—received few enhanced rights beyond their designation as "subjects of the Federation," the same term used to describe the republics.

With few exceptions, the Federation Treaties quelled any secessionist movements within the ethnic republics. In Tatarstan, however, the broader movement for national independence was stronger, and was skillfully

manipulated by the republic's leader, Mintimir Shaimiev (McAuley, 1997). Moscow's tactics toward Tatarstan were conciliatory from the outset, and undoubtedly helped defuse the tensions during this standoff. The Kremlin also exploited its ability to neutralize Tatarstan's natural advantages by blocking its access to international markets. While Tatarstan was an oil-exporting region, it was wholly dependent upon Russian pipelines. While Russia could have imposed an economic blockade (as it had with Lithuania in 1990), it chose instead to continue full economic relations with the republic as *if* it had signed the Federation Treaties. In addition, by 1993, the Russian government had agreed to transfer ownership over major industrial assets, including the massive KamAZ truck factory, to the republic, and had unfrozen its hard currency accounts for oil exports.

In the wake of the October 1993 destruction of the Russian parliament, Yeltsin imposed a new Constitution (ratified by national referendum) that treated republics and regions essentially as equals, dropping earlier references to republican sovereignty. As 1994 began, only two regions—Chechnya and Tatarstan—refused to acknowledge the legitimacy of the new constitution.

After the ratification of his constitution, Yeltsin resumed negotiations with the Tatar leadership, and on 15 February 1994 Yeltsin signed a bilateral treaty with Tatarstan defining the respective roles of federal and republican authorities. There were, in addition, a number of important concessions were contained in the treaty and the twelve inter-ministerial “agreements” that accompanied it: the republic received the right to establish its own “state bank,” for instance, signed a special agreement on “foreign economic relations” and confirmed the transfer of federal assets to the regional level as negotiated in 1992–93.

The Tatarstan treaty ushered in a new round of bilateral negotiations between regions and the center.²¹ Through 1995, treaties were signed exclusively with republics, but beginning in 1996 oblasts and kraia also became signatories. By mid-1998, more than half of the eighty-nine subjects of the Russian Federation had signed bilateral treaties with the Kremlin, several of these accompanied by special agreements devolving limited powers to regulate international trade and even sign international agreements.

Federal strategies

Though the federal government has been forced to cede control over certain key levers of power, it continues to regulate access to international capital and markets by most federation subjects. One of the most striking examples of its continuing leverage is its negotiation with the Republic of Sakha over the independent marketing of diamonds. As noted above, the Russian government agreed as early as 1990 to permit the government of Sakha—home to almost all of Russia's diamond mines—to independently

market a portion of its diamonds.²² According to the terms of the original deal, Sakha had the right to keep 20 percent of diamonds mined in the republic, and market them through the diamond mining firm “AlmazRossii-Sakha” (ARS). Though ARS—the former state diamond monopoly—was ostensibly “privatized,” the vice-president of the republic continues to head the company. According to published reports, ARS generated over \$250 million in profits in 1995, accounting for over 80 percent of Sakha’s budget. Flush with the proceeds of these diamond sales, Sakha’s president was able to negotiate an agreement with Yeltsin in 1993 exempting Sakha from federal taxes as well as all federal financing; given the profits generated by the diamond industry, the deal was a windfall for Sakha that greatly augmented its independence from the Kremlin. This advantageous position was formalized in 1995 when the republic signed a bilateral treaty with the federal government.

By 1996, however, Yeltsin and other regional leaders were beginning to chafe at the privileges being enjoyed by Sakha. In February 1996, Russia signed a preliminary agreement with DeBeers, the international diamond cartel, to extend their previous marketing arrangement by three years. DeBeers had marketed the vast majority of Russian diamonds, and Russian diamonds, in turn, accounted for about a quarter of deBeers’s global sales (*OMRI Daily Digest*, 3 January 1997). At this point, however, federal officials began pressuring Sakha to abandon its lucrative diamond set-aside. Though Russia’s contract with DeBeers lapsed at the end of 1995, the Russian government refused during 1996 to sign a new final agreement unless Sakha’s share of diamonds was reduced well below 20 percent. At the end of 1996, DeBeers suspended diamond trade with Russia.

The freeze on diamond exports by DeBeers provided the federal government with a very large stick with which to beat on its once-privileged republic. Since ARS provided the lion’s share of the republic’s budget, the stalemate created much more concentrated hardship for the Sakha government than for the federal government. Critically, DeBeers enabled this power play by federal authorities by refusing to sign any deal that was not tripartite—i.e. including the federal government and Sakha officials. From DeBeers’s perspective, the federal tactic offered it an opportunity to crack down on Sakha, which it accused of marketing its own share of diamonds outside the DeBeers cartel. Thus, for its own purposes, the international diamond cartel provided vital leverage to the federal government as it sought to gain greater control over one of its most autonomous territories.

Other regional leaders supported the federal hard line against Sakha over diamonds. In May 1997, Deputy Prime Minister Chubais visited the Siberian center of Krasnoyarsk and was lectured by that region’s governor against offering extensive privileges to a limited number of republics. The Krasnoyarsk governor, Valerii Zubov, claimed that continued special treatment of Sakha would provoke the wrath of all the remaining governors

of Siberia, who felt they were effectively subsidizing their eastern neighbor's sweetheart deal (*Kommersant Daily*, 14 May 1997). Two months later, a Presidential decree terminated the 20 percent set-aside of diamonds for Sakha (*Kommersant Daily*, 22 July 1997).

Finally, in October, ARS and DeBeers signed a new diamond marketing deal under the watchful eye of the Russian Finance Ministry (*Financial Times*, 22 October 1997). According to some reports, Yeltsin overruled some provisions of his July decree and allowed Sakha to continue marketing a limited amount of diamonds in return for Sakha's reintegration into the federal unitary tax system.²³ The consummation of the long-awaited contract not only restarted the diamond industry in Sakha, but also revived negotiations with international lenders for over \$500 million in financing for modernizing the republic's mines.

In addition to regulating subnational contacts with transnational actors, the federal government is also able to reward compliant or supportive regions with access to international capital flows. Beginning in 1997, several regions began planning to issue Eurobonds to finance regional programs. The federal government moved quickly to regulate the practice, making it clear that federal approval would be required for any Eurobond offerings. In the event, only three regions managed Eurobond offerings before the global financial crisis darkened the outlook for such a speculative debt offering.²⁴ Nevertheless, Yeltsin continued to issue decrees authorizing additional regions to float bonds, in part as a reminder that approval of all offerings was a federal prerogative (*Kommersant Daily*, 22 October 1997).

As it did with its control over Sakha's access to global diamond markets, the federal government can use access to international capital markets as an instrument to gain additional leverage over regions. The federal government has stalled approval of Yamalo-Nents okrug's request of issue Eurobonds while it works to resolve a jurisdictional dispute between the okrug and Tyumen' oblast. Since the Siberian okrug is home to most of Russia's vast natural gas resources, which were to serve as collateral on the loan, the federal tactic effectively neutralizes the region's resource advantage. Similarly, the federal government has blocked the attempt by Moscow oblast to secure \$800 million in loans at high interest rates (23 percent) from a consortium of Western banks (*Russkii Telegraf*, 9 June 1998). While federal officials raised legitimate concerns about the adverse terms of the loan and the consequences of any default on other regions' creditworthiness, they were also worried about losing their control over subnational governments' access to international capital markets. Even the World Bank has allowed regions' access to a newly established "regional development fund" to become contingent on compliance with *federal* conditions.²⁵

While transnational capital and markets offer the federal government some leverage over the regions, they also impose severe constraints on federal

discretion. Russia's dismal record with tax collection has left it heavily dependent on short-term borrowing from banks, international financial institutions, and foreign (European and Japanese) governments. While this leaves Russia vulnerable to sudden capital flight—the consequences of which I discuss in the next section—it also introduces an important secondary role for international financial organizations like the International Monetary Fund (IMF). In Russia, the IMF's influence has extended far beyond its statutory role of extending short-term structural adjustment loans. The IMF's decisions about whether and when to extend additional financing to Russia became greatly magnified in importance, because they sent signals to the broader international financial community about the riskiness of lending to Russia. For this reason, reports of IMF sessions with Finance Ministry officials in the summer of 1998 had the same dramatic effect on Russian interest rates as Alan Greenspan's cryptic comments before Congress can have on American stock markets. Peripatetic global capital has created a new class of oracular financial bureaucrats, whose direct control over relatively modest capital is a misleadingly small indicator of their true global influence.

Regional strategies

Just as transnational actors and international markets offer the federal government some leverage over the regions, they also offer the regions tools for circumventing federal authority. This dynamic has been particularly apparent in the second stage of Russian privatization, begun after the completion of voucher privatization in 1994. During this second stage, federal and regional authorities have been selling their remaining stakes in major enterprises, attempting to raise capital without relinquishing effective control.

This second stage of privatization has brought regional administrations into conflict with international investors and the federal government. In most regions, a few huge enterprises are the largest employers and the chief contributors to the regional treasury.²⁶ Governors have evolved cozy arrangements with many managers of these enterprises in which regional administrations extend financial support to enterprises, and enterprises give priority to local debts (often through the use of barter and tradeable IOUs that have the added benefit of denying the federal taxman his cut). These incestuous relationships have drawn the wrath of both federal officials (who are frustrated when attempting to collect taxes) and outside investors (who find themselves blocked in efforts to shuffle management). Once again, the forces of globalization change the playing field of domestic political conflict.

The case of KamAZ provides a useful illustration. KamAZ, located in Tatarstan, is the largest truck manufacturer in Russia. Under the terms of Tatarstan's bilateral treaty with Moscow, the republic gained control of

KamAZ and managed its privatization at the republican, rather than federal, level. A fire at the company's main engine plant left it in dire need of a capital infusion, and the collapse of the domestic truck market left it unable to pay its bills.

In 1994, KamAZ began working with the New York investment firm Kohlberg, Kravis Roberts (KKR) to line up international financing. KKR took a significant equity stake in KamAZ, as well as options on future shares in return for a promise to raise over \$3 billion in financing from international markets.²⁷ While KKR did help arrange a \$100 million loan from the EBRD, it found few other willing lenders.

In October 1996, the federal government launched bankruptcy proceedings against KamAZ in an effort to collect back taxes owed to the federal treasury. The conflict forced KamAZ to idle its production lines for over a month. The Tatar government stepped in to pay the firm's debt, but claimed a 30 percent equity share in the company in return (*Segodnya*, 3 February 1997). The shares for the transfer presumably came out of the pool over which KKR had options, and the transaction served to partially renationalize KamAZ. In May 1998, the KKR stake in the company was diminished further under an equity restructuring plan approved by shareholders. Under this new plan, the federal and republican governments acquired additional 25 percent stakes in the company, with the KKR stake reduced to just 11 percent. A new board of twenty-three directors elected at the meeting included seven Tatarstan government representatives, and the republics first deputy prime minister was elected chairman of the board (ITAR-TASS, 12 May 1998).

The KamAZ story illustrates how subnational governments can take advantage of weak shareholder rights to transform federal-regional conflicts into opportunities to consolidate control over regional assets. Transnational actors often come out the losers in such episodes. In April 1998, the Sayansk Aluminum Factory (SAZ) in the Siberian republic of Khakassia issued a large block of stock that was ultimately purchased at favorable prices by associates of the plant's director. The stock offering reduced the ownership stake of the British Trans World Group from 38 to 15 percent. In this case, however, the international investors may be able to join forces with the federal government, which saw its share reduced from 15 to 6.5 percent (*Finansovaya izvestiya*, 18 June 1998).

Another example of how transnational actors can become caught in the middle of struggles over federal power comes from Rostov. There, shareholders approved a shakeup of the board of directors in July that effectively returned control of the agricultural machinery giant Rostselmash to the regional administration. Previous plant management had resisted Rostov oblast's efforts to gain control over the plant, but the oblast emerged from the June reorganization with six of the twelve seats on the board. Once the dust had settled, however, the new management of the plant announced its plans to break the enterprise up into a series of smaller entities, several of

which would act as assembly points for products manufactured abroad. Thus, one subdivision would begin assembling automobiles for Daewoo, while another would produce harvesters for John Deere. While it was not apparent at the time, it became clear with hindsight that the oblast administration's agreements with transnational actors like Deere and Daewoo had provided it with the leverage to effectively renationalize (though at the regional not federal level) one of the region's largest employers (*Kommersant Daily*, 19 June 1998).

While foreign investment and joint ventures place important resources in the hands of regional leaders, they do not affect all regions equally. Foreign investment tends to concentrate in a small number of regions, and generally serves to make rich regions richer. Though foreign direct investment (FDI) is low for Russia overall, its concentration in certain regions produces a highly selective impact. More than 60 percent of the cumulative FDI in Russia through 1996 was concentrated in just seven regions (Moscow, Arkhangelsk, Krasnoyarsk, St Petersburg, Tyumen, Moscow Oblast, and Tatarstan).²⁸ The same seven regions accounted for over 60 percent of joint venture exports (dollar value) in 1996 and almost 80 percent of joint venture imports.²⁹

This asymmetric distribution of foreign trade and investment activity contributes to the growing gap between Russia's dozen rich regions and the rest (Smirniagin, 1997). The widening gap in regional income deepens the political rift among regions. Regions that stand to gain the most from foreign trade and investment favor less federal intervention, and looser controls over subnational administrations. Regions that are left out of the globalization bonanza, on the other hand, are more supportive of an interventionist and redistributive federal government. This disagreement over the desirable level of federal intervention serves to block any effective collective action among regions to constrain the federal government. It can also make any federal effort to coordinate economic reform nationally more difficult.³⁰

By keeping regions in competition with one another, therefore, the race to attract limited foreign attention makes it less likely that regions will unite against the center.³¹ Thus, indirectly, globalization may be empowering individual regions at the expense of regional power more generally.

Other actors

While this chapter has concentrated on the impact of globalization on the evolution of state institutions, particularly the delicate balance of jurisdictional balance in federal government, the process outlined here have important implications for a wide range of other actors as well.

For Russian banks, easy access to international capital has left them dangerously vulnerable to capital flight. During the stock market boom of 1996–97, Russian banks borrowed heavily in the Eurobond and syndicated

credit markets. By March 1998, foreign liabilities of commercial banks exceeded foreign assets by over \$6 billion (*Russian Economic Trends*, June 1998). By early 1998, however, the global currency crisis had choked off the flow of foreign capital, leaving Russian banks scrambling to find the foreign exchange needed to service these loans. In May, the Central Bank placed Tokobank, one of the top twenty banks in Russia, under receivership as a consequence of its foreign loan exposure. The Central Bank's move did little to curb speculative excesses, however; as I detail in the next section, the financial crisis of August 1998 left most of Russia's banks insolvent.

For Russian citizens, the power of transnational actors and markets may guarantee that the separation of the economic and political spheres that began after 1991 remains in effect. Pressure on the ruble in early 1994 forced Viktor Chernomyrdin to publicly commit to a policy of monetary austerity, despite the presumption that the January 1994 resignation of Economics Minister Yegor Gaidar and Finance Minister Boris Federov opened the door for a return to freer monetary policy. The 11 October 1994 "Black Tuesday" crash of the ruble drove the government and opposition parliament to agree to a crisis program that slashed Russia's budget deficit. In August 1998, the persistent assault on Russia's equity and financial markets brought the president and parliament together in agreement on some elements of a radical anti-crisis program. In September 1998, Yevgenii Primakov was able to assemble a cabinet with representatives of a broad spectrum of political parties, from reformist Yabloko to conservative Communist. Under Primakov's government, fear of derailing debt rescheduling negotiations apparently led to the elimination (or at least deferral) of the most radically interventionist elements of an economic recovery program.³²

The consequences for average citizens of Russia's responsiveness to transnational actors have been far from rosy. The austerity plan adopted in the wake of "Black Tuesday" triggered the escalation of wage non-payments, which in turn permitted the Communists to sweep to parliamentary control in December 1995. The devaluation and debt moratorium of August 1998 paralyzed the banking system, temporarily choked off the flow of goods on wholesale and retail markets, and reintroduced inflationary pressures into the economy. The resulting economic downturn unleashed an ugly wave of chauvinistic nationalism and anti-Semitism. While crises may force policymakers to set aside partisan divisions, even if momentarily, the same crises may be helping cement partisan leaning in the electorate.

Finally, since international capital plays such an important role in Russian politics, it is probably inevitable that foreign leaders are playing an ever-growing role as protectors of their "home" transnationals. British Petroleum's purchase of part of the Russian oil firm Sidanko was announced by Tony Blair himself. Similarly, an important part of the agenda for meetings of the Gore-Chernomyrdin (subsequently Gore-Kiriyenko, Gore-Primakov, and Gore-Stepashin) commission was clearing

roadblocks to American firms' business activities in Russia, and addressing complaints from Russian firms that their access to American markets was blocked. Thus, despite the persistent trend toward the globalization of major firms, these same firms will fly the flag high when diplomatic intervention is called for.

The August 1998 crisis and prospects for the future

The interplay of national, subnational and transnational actors outlined above grew even more complex during meltdown of the Russian economy in the summer and fall of 1998.³³ In part, the objectives and strategies of public and private transnational actors diverged sharply. In the wake of the August 1998 devaluation of the ruble and moratorium on debt service, it may no longer be possible for these two categories of transnational actors and the two levels of Russian state actors to find any accommodation that can pull Russia out of its crisis.

The collapse

As I note above, Russia's chronic problems with tax collection forced the government to seek other sources of funding after the Black Tuesday ruble crisis convinced it that printing money was a doomed strategy. Beginning in 1995, the government began issuing short-term treasury notes, known by their Russian acronym GKO, offering 30 to 40 percent interest for periods up to a year. At the same time, Russian households and companies shunned these instruments, preferring instead to invest their savings in foreign cash, especially dollars. In the fourth quarter of 1997, for instance, the Russian Central Bank spent \$5.9 billion of its reserves repurchasing ruble securities to support the ruble, while households spent an identical amount purchasing foreign cash (*Russian Economic Trends*, June 1998). The depletion of Central Bank reserves, therefore, was a direct consequence of Russians' relatively unfettered access to dollars and deutschmarks.

Given the weakness in domestic demand for ruble debt, the Russian government grew increasingly dependent upon foreign borrowers to make up the difference.³⁴ Foreign investors held nearly a third of Russia's \$70 billion in short-term ruble-denominated debt by mid-1998, and the threat of rapid capital flight (especially given the short duration of many of the notes) forced the Russian Central Bank to keep interest rates high. In 1998, GKO's were offered at astronomical interest rates—topping 150 percent in the summer—for extremely short durations, reflecting the increasing currency risk perceived by purchasers.³⁵ While this strategy was temporarily effective—even during the global financial selloff of the last quarter of 1997 there was a net inflow of \$200 million into domestic Russian government debt (*Russian Economic Trends*, June 1998)—it also dashed hopes of restoring growth to the Russian economy in 1998. While international capital enabled the Russian government

to finance its budget deficit without radically expanding the money supply, the costs and constraints of this Faustian bargain cannot be underestimated.

Ultimately, many of the same contagion effects of the global financial crisis of 1998 that toppled the Korean economy began to erode the foundations of Russia's debt pyramid.³⁶ The relentless decline of the Russian stock market (down 90 percent by July 1998 from its record highs of 1997) triggered margin calls by Western creditors on their loans to Russian banks. The banks, in turn, were forced to liquidate their GKO holdings, forcing the Central Bank to repurchase many of the obligations itself. Speculators bet on a ruble devaluation, as Central Bank currency reserves (not counting gold) fell below \$10 billion. By July, the Russian Central Bank was spending as much as \$1 billion of its foreign reserves each week to defend the ruble.

In July, Russia urgently appealed to the IMF for assistance. In the face of stiff American government pressure not to allow Russia to collapse, IMF officials agreed on July 10 to offer Russia \$11.2 in loans as part of a \$22.6 bailout package from a wide range of international lenders (Gordon and Sanger, 1998).³⁷ The international rescue package proved to be too little, too late. As the Russian Duma balked at implementing tax and budget reforms promised by Kiriyenko, many foreign investors continued to withdraw their money. Interest rates remained prohibitively high, tax receipts remained weak, and the Russian stock market, after a brief rally, resumed its slide to historic lows. Russia's commitment to preserving the value of the ruble seemed increasingly unrealistic. Even Anatolii Chubais, who negotiated with the IMF, later admitted that Russia "swindled the international community out of \$22 billion" (*Kommersant Daily*, 8 September 1998).

The ill-fated IMF bailout marked an important watershed for transnational actors in the Russian transition. Up to July 1998, international investors—private transnational actors—had looked to the IMF for important signals about the credibility of Russian government policy. The July 1998 bailout package, however, was linked to policy commitments (such as radical reduction of government debt) that were both unrealistic and highly improbable. By extending credit on purely political criteria, the IMF greatly diminished its ability to influence international capital flows. At this critical juncture in the Russian crisis, the policy objectives of *public* transnational actors (averting a collapse in Russia) clashed dramatically with the profit motives of *private* transnational actors. This divergence had momentous consequences for both Russian and the international financial system.

On August 13, Russian banks began defaulting on inter-bank loans, signaling the impending collapse of the entire banking system. Many Russian banks were using all their funds to pay foreign creditors, and they were therefore unable to meet the demands of their own depositors. The Russian Central Bank began making loans to prevent the collapse of the banking system, but even with the IMF's money it could not defend both the ruble

and the banking system. On Monday, August 17, Prime Minister Kiriyenko announced that the Russian government would no longer defend the exchange rate of the ruble, and would suspend payments on its GKO pending a restructuring plan. While the move slashed the government's GKO debt, it also left many Russian banks unable to service their debt to foreign lenders. The Russian government therefore simultaneously announced a 90-day moratorium on all foreign interest payments by banks and regional governments. In effect, on the same day Russia had simultaneously devalued its currency and defaulted on its debt.

Russia's move triggered turmoil on global stock and bond markets, as investors began to assess their losses (Siconolfi *et al.*, 1998). The Russian ruble fell from under 6 rubles per dollar to over 15 in less than two weeks (it would pass 20 before the end of the year). The Russian banking system froze, unable to pay depositors or make simple transfers, as over half the operating banks in Russia found themselves bankrupt. Prices jumped over 40 percent in just one month. Kiriyenko's government fell, and the struggle over his successor incapacitated Russia's political and economic systems for over a month.

Root causes of the crisis

Just as transnational actors played a greater and more problematic role in Russia's transition than in most other post-Communist states, so too was the impact of the global financial crisis magnified on Russian soil. As in the Asian cases, the Russian political and economic system lacked the requisite institutions to permit credible and enforceable regulation of financial markets.³⁸ Two factors distinguish the Russian crisis from those in Asia: the role of the Russian government in distorting financial market incentives, and the expanded role of international financial institutions.

Unlike the Korean or other Asian governments, the Russian government was guilty of far more than lax regulation of financial markets. Indeed, the engine driving the Russian economy over the cliff in the fall of 1998 was not the impending collapse of its banking system, but the exploding and unmanageable market for Russian government securities. By directly soaking up all available liquidity at any rate demanded by the market, the Russian government virtually ensured that investment elsewhere in the economy would grind to a halt. That it was able to do so is a powerful demonstration of the dangers of moral hazard: lenders accepted unrealistically high interest rates allowing the government debt pyramid to grow through the entire summer because they believed that at some point the international financial community would bail Russia out. This belief undermined the central assumption of market liberalization that was promoted by the IMF and other international financial advisors—i.e. that the discipline imposed by financial markets themselves is more effective than any external regulation or intervention.³⁹

Furthermore, the IMF's role in Russia was much more long-term than in many other crisis-ridden countries. The IMF was not arriving in Russia to rectify a short-term imbalance in currency reserves, but rather became enmeshed in guiding Russia through a protracted and deepening economic contraction and depression. Ultimately—and especially in 1998—the IMF had ceased to be a “lender of last resort” in Russia, but had instead begun to assume a role much closer to that of representative for a creditors' syndicate, producing quarterly judgments on Russia's economic program that could trigger capital flight in the tens of billions of dollars.

Put another way, public transnational actors promoted liberalization because they believed that private markets would more efficiently reward growth-stimulating economic policy. This belief, and the subsequent influx of international capital from 1994 to 1997, allowed them to promote their policy objectives by exploiting the profit motives of private transnational actors. In many cases, however, these private transnational actors—investors, commercial banks, hedge funds—believed that the prominent role being played by public transnational actors would, by itself, represent some degree of insurance against the risk of market failure; if this was the case, the returns offered by Russian government securities far outstripped the minimal risk of calamity.⁴⁰

In August of 1998, however, the perception that public transnational actors—the IMF, the G-7—would indemnify investors against a Russian collapse was finally shattered. As a consequence, the capital flight was sudden and dramatic, not because conditions in Russia had deteriorated suddenly, but because private transnational actors had shifted their assumptions about public transnational actors. Russia, supported by transnational capital flows since the 1980s, ultimately found itself at the mercy of this game of chicken being played between transnational actors. It had failed to channel the great capital flows of 1996–97 into productive investment and restructuring to build a sustainable tax base; by 1998 it had lost control of its fate.

Resolving the financial crisis

In the wake of the collapse of 1998, the Russian federal government must now contend with the conflicting demands of subnational governments and *two* different sets of transnational actors. With the rift between policy-driven and profit-driven transnational actors now laid bare, it is difficult to conceive of any economic plan that could satisfy the conflicting requirements of contending stakeholders. Ultimately, the federal government may be forced to choose between satisfying demands of transnational actors and its own regional governments.

Any effective economic recovery program that preserves Russia as a federal state will need to reestablish a fiscal base for the federal budget; by October 1998, the federal government was spending two rubles for every

cash ruble collected in taxes. If the Russian government follows the prescriptions of public transnational actors like the IMF, it will give priority to rationalizing and recentralizing its tax system. However, any overhaul of the tax system must come at the expense of regional governments, which have gained control of tax and treasury agencies at the regional level, and currently compete with the federal government for dwindling tax revenues.

Tax reform must also entail breaking the vicious cycle of barter and nonpayments, which in 1998 accounted for up to 70 percent of Russia's commercial transactions (Gaddy and Ickes, 1998; Hendley, Ickes and Ryterman, 1999). However, any remonetarization of the economy requires bankrupting value-destroying firms, which include some of Russia's largest industrial enterprises. Bankruptcies on such a large scale would be politically difficult, but the political backlash would be concentrated in those regions most directly affected. Regional governors, again, would likely oppose any economic plan that closed down their primary sources of regional financing and votes.

The demands of private transnational actors are different, however. International equity investors care primarily about the enforceability of their property rights—especially their shareholder rights—and about production sharing agreements that provide for profit to be taken out as shares of outputs rather than in cash. These provisions, however, also assault the interests of regional governments, which would see their control over economic activity at the regional level sharply curtailed. This incompatibility of incentives between regional and federal levels makes any commitments to property rights non-credible for the foreseeable future. This problem will remain endemic unless the federal government moves to recentralize the entire federal system—removing the dependence of regional governors on electoral constituencies in the regions.⁴¹

Commercial banks, for their part, care far more about the terms of any GKO restructuring plan than the long-term viability of any economic recovery package. Even if Russia were to reach an acceptable deal with its creditors, however, resumption of international lending to Russia on any significant scale is unlikely now that the illusion of moral hazard has been shattered. It is worth noting that certain regions within Russia—notably the City of Moscow—continued to service their foreign debt through 1998, ignoring the protection of the federal government's 90-day moratorium. With the collapse of the ruble, certain regions may begin to see themselves as more viable economic entities outside the Russian federation than as part of it.

Conclusion

The Russian case makes clear that even in a world of transnational finance, production, and marketing, *national* actors play a complex and nuanced role in states in transition. In Russia, national, subnational and private actors

have all tried to gain leverage for their domestic struggles from their ties to the global marketplace. The great challenge facing Russian in 1999 and beyond consists of reconciling the conflicting demands of public and private transnational actors with the conflicting objectives of Russia's national and subnational governments. As suggested above, the best case may be a benign blend of economic stagnation and political stalemate, as India endured for much of its first four decades. At worst, Russia may slide into a Nigerian morass of economic corruption and political violence.

Notes

- 1 The author is grateful to the National Council for Eurasian and East European Research for support, to Leslie Powell for research assistance, and to James Millar, Peter Katzenstein and the editors of this volume for valuable comments on an earlier draft.
- 2 For some overviews of the literature on globalization and states, see Evans (1997); Garrett (1997); Prakash and Hart (1999); and Strange (1996).
- 3 This focus on the economic aspects of globalization—i.e. the “increasing integration of input, factor and final product markets”—is an element of the theoretical framework outlined in the introductory chapter to this volume. As discussed in that chapter, and consistent with the approach taken by other authors in this volume, I essentially treat these trends toward cross-border economic integration as “exogenous variables that impact firms and governments.”
- 4 An important exception, of course, is China (which can still be classified as a Communist country). In the Chinese case, of course, the national government was able to maintain control over domestic political forces and exert considerable influence over international flows of capital. See the chapter by Yang and Su in this volume for more details on the Chinese case.
- 5 The distinction I draw here borrows in part from the editor's introductory chapter in Risse-Kappen (1995 p. 8). I am grateful to Peter Katzenstein for drawing my attention to this analysis.
- 6 Less obviously, the extensive consultation between NATO and Russia over NATO expansion may provide important security guarantees for Russia given the parlous state of its army. Even without Russian membership in NATO and even taking into account strains created by NATO's intervention against Serbia, Russia's consultative role in NATO affairs may ultimately play a greater role in securing its borders than any offensive or deterrent value of its own armed forces.
- 7 In Russia, however, the policy failed to introduce the expected competitive discipline because many firms continued to face soft budget constraints at least into 1993.
- 8 These industrial behemoths were especially prevalent in the military-industrial sector. For profiles of two such plants in the Volga region of Saratov, see Gaddy (1996, pp. 131–47) and Hendley (1998).
- 9 In other words, Russia's economic activity depended more heavily than its neighbors' on transactions that were highly asset-specific. The resulting high transaction costs were ameliorated in the Soviet system by pervasive vertical integration and an artificial price structure for inputs and labor. During the transition to a market, however, these transaction cost obstacles become more intractable. On transaction costs and asset-specificity, see Williamson (1985).

- 10 For details on the short-sighted exploitation of the energy sector, see Gustafson (1989).
- 11 Russia's external debt was refinanced by special arrangements with the Paris and London Clubs, reducing debt service on these obligations by roughly 50 percent. Internal debt service (i.e. ruble obligations) represented an additional 3.1 percent of GDP, of which roughly a quarter is owed to foreigner bond holders. For details see *Russian Economic Trends*, March 1998.
- 12 While Russia's exposure to international debt markets—and hence its vulnerability to market panic—may have been high among post-Communist states, it is not uncommon among developing countries that have financed industrial expansion through international borrowing. See the chapter on Korea by Moon in this volume for a strikingly similar example.
- 13 Russia has applied for membership in the World Trade Organization, as have all of the other Soviet successor states.
- 14 For details of obstacles to effective minority (especially foreign) participation in corporate governance, see Blasi, Kroumova and Kruse (1997, pp. 86–166) and Frydman, Gray and Rapaczynski (1996). For a recent, graphic, example, see description of the struggle between the Primorskii Krai administration and foreign shareholders for control over the Far East Shipping Company, described in *The Moscow Times*, 7 July 1999, p. 10.
- 15 For an account of the centrality of imperialism to the definition of the Russian state, see Hosking (1997).
- 16 The commission, headed by Yeltsin aide Georgi Satarov, was established after the 1996 presidential elections. It wrapped up its work the following year, inconclusively, after publishing a sprawling collection of articles titled *Russia in Search of an Idea*. (*Nezavisimaya gazeta*, 9 August 1997).
- 17 The case study of Yugoslavia by Crawford in this volume provides another example of the perils of aligning institutional (federal), ethnic and economic cleavages during the uncertain periods of regime transition.
- 18 TASS, 7 August 1990, cited in Teague (1994, p. 30). Yeltsin initially directed the comment to oil-rich Tatarstan, whose sovereignty declaration did not acknowledge its membership in the Russian Federation. Yeltsin's remark was repeated, and more widely cited, in an interview with *Komsomol'skaia pravda*, 14 March 1991.
- 19 Indeed, in the context of the disintegration of the Soviet Union, the sovereignty declarations are more accurately viewed as attempts by these regions, to upgrade their status *within* a recast Soviet federation. (Filippov and Shvetsova, 1998).
- 20 Actually, only twenty republics were recognized in the March treaties, but Chechen-Ingushetia later split into two separate republics.
- 21 Sergei Shakhrai, who handled treaty negotiations for Yeltsin, had initially described the Tatarstan document as an exceptional case, but soon began to talk about signing treaties with all eighty-nine federation "subjects." A presidential commission, headed by Shakhrai, was established to orchestrate the myriad intergovernmental negotiations that were soon underway linked to the treaty signing process (see Shakhrai, 1997).
- 22 For accounts of Sakha's diamond deals with Moscow prior to 1997, see Balzer (1998), McAuley (1997), and Robert Ortung's account of the Sakha presidential election in the *IEWS Russian Regional Report*, 18 December 1996. See also *Kommersant Daily*, 15 December 1996.
- 23 For details see the *IEWS Russian Regional Report*, 21 August 1997, *RFE/RL Newslime*, 5 August 1997, and *Rossiiskaya gazeta* 15 August 1997. To be more precise, under the old agreement, Sakha had the right to buy up to 20 percent of ARS's diamonds at production cost, and then market them independently—a practice DeBeers argued was undercutting the cartel. Under the final terms of the

- new deals, while the details are murky, the Sakha government can now purchase a limited amount of diamonds at a discounted price, but both the quantity and price are at the discretion of the federal government and hence presumably the subject of annual negotiation.
- 24 Moscow, St Petersburg and Nizhnii Novgorod completed bond placements in 1997.
 - 25 According to the 18 June 1998 *IEWIS Russian Regional Report*, the Russian government signed a series of agreements with the governor of Chelyabinsk to bring the oblast into compliance with federal wage, tax, housing, and fiscal guidelines. In return, the oblast can apply for preferential credit from the World Bank's "Developing Regional Finances" fund, as well as supplemental federal funding.
 - 26 On the relationship between leading industrial elites and regional administrations in the early stage of the transition, see Stoner-Weiss (1997).
 - 27 For details of the KamAZ restructuring, see V. Frumkin's report on the Russian auto sector for Paribas Capital (5 December 1997).
 - 28 Figures for the geographic distribution of FDI and joint ventures are taken from unpublished work by Michael J. Bradshaw, University of Birmingham, and are based on Goskomstat figures. For a discussion of earlier trends, see Bradshaw (1998).
 - 29 The vast majority of joint venture import-export activity is accounted for from three regions: Moscow, the surrounding Moscow Oblast, and St Petersburg.
 - 30 To provide just one example, the policy of permitting certain regions (like Ingushetia in the Caucasus) to attempt to attract investment by declaring themselves "free enterprise zones" threatened to trigger a "race to the bottom" among regions, as they sought to outbid each other to attract capital. Ultimately, the federal government discontinued the practice of establishing free enterprise zones, despite their success in other transitional countries like China.
 - 31 For a discussion of the federal government's "divide and rule" strategy with the regions, see Solnick (1998).
 - 32 Unfortunately for Russia's economic future, one consequence of this sensitivity about ongoing negotiations with transnational actors was the virtual paralysis of economic policy-making in the final quarter of 1998. During this period, Russia's Finance Ministry and Central Bank engaged in ad hoc efforts to support the ruble and the banking system, while the cabinet remained stalemated over alternative recovery strategies.
 - 33 For useful accounts and analysis of the August 1998 crisis, see *Russian Economic Trends* for August and September 1998, as well as the excellent accounts provided by Western journalists (Hoffman, 1998b; Liesman and Higgins, 1998; Thornhill, 1998).
 - 34 As Gaddy and Ickes argue, this continued external financing of the budget deficit enabled the Russian government to continue propping up "value-subtracting" sectors of the economy, thus forestalling the wave bankruptcies needed for real financial and industrial restructuring (Gaddy and Ickes, 1998:65-7).
 - 35 Devaluation fears were ignited by the collapse of world commodity prices—slashing Russia's earnings from oil and mineral exports—and by the growing pyramid of ruble debt itself. Investors perceived (accurately, it turned out) that the government would eventually have to devalue in order to reduce this debt burden, as the lack of progress on improving tax collection seemed to doom any hopes that Russia would find a fiscal solution to the growing debt crisis. Interest rates for dollar-denominated debt remained stable over this same period, at around 10 percent, even as interest rates for ruble debt skyrocketed. This fact suggests

- the chief risk perceived by purchasers concerned currency and not default. (*Russian Economic Trends*, June 1998).
- 36 For an account of the Korean collapse, see Moon's contribution to this volume.
- 37 According to the bailout package, the Russian government sought to replace much of its short-term ruble debt with long-term foreign debt. In the event, however, the IMF's credit infusion merely served to provide some foreign investors (and many domestic investors operating offshore) with an opportunity to exit the GKO market. It did not, however, restore investor confidence in Russia, and hence did not relieve the relentless pressure on Russia to rollover six to ten billion rubles (1–1.7 billion dollars) of debt *each week* from June through December for ruble obligations alone.
- 38 There are several dimensions to this institutional deficit, and I lack the space to discuss them here at length. They include the lack of political party development (making it difficult to coordinate economic policy between the executive and legislative branches, and almost impossible to hold politicians to account for their policies), Yeltsin's progressively worsening illness (leaving the superpresidential system with a vacuum at the top), a federal structure with ambiguous and overlapping spheres of competence, and pervasive corruption in all branches of the government. For a discussion of how inefficient political institutions distort the economic behavior of agents in Russia, see Shleifer (1996) and Frye and Shleifer (1997).
- 39 The hedge fund crisis of 1998, headlined by the near-collapse of Long-Term Capital Management, created similar misgivings about unregulated financial markets.
- 40 For examples of the illusions harbored by many sophisticated investors who entered the Russian market, see Hoffman (1998a) and Kahn and O'Brien (1998).
- 41 Indeed, one element of a constitutional reform package promoted by a broad spectrum of scholars and politicians in November 1998 was a return to presidential appointment of governors (*Nezavisimaia gazeta*, 6 November 1998). The constitutional amendments would not be likely to pass the upper house of the Russian parliament, however, in which all eighty-nine governors sit.

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8 Mediating globalization and social integration in post-Communist societies

A comparison of Yugoslavia and Bulgaria¹

Beverly K. Crawford

Question and argument

What is the impact of globalization on the national political community? Does “globalization” hasten social disintegration and exacerbate social conflict? And if it does, what are the potential coping mechanisms that might mitigate its role in social disintegration? The global imperatives of “state shrinking,” economic liberalization and fiscal reform have clearly affected social integration throughout the world, from hate crimes in Germany associated with rising unemployment, to rising violence in Egypt with the end of Fordism, to war in the former Yugoslavia as Communism collapsed (Leslie, 1998; Lubeck, 1998; Crawford, 1993). Particularly throughout the post-Communist world, the transition to the market and the pressures of liberalization have weakened the state’s capability to allocate resources and threatened social conflict. In those places where ethnicity and religion had been previously politicized, struggles over declining resources often resulted in communal violence as old institutions were dismantled and old social contracts broken. Yugoslavia, Abkhazia, and Georgia are prominent examples.

By globalization I mean two things: (1) as defined in the introductory chapter, the cross-border financial and commercial integration resulting from the opening of new markets for goods, services, capital, and people, and (2) the implementation and convergence of “state shrinking” ideologies constructed in response to these global forces that have triggered a reallocation of resources throughout society (Reich, 1991; Ohmae, 1990; Meyer *et al.*, 1997; Barber, 1995). The forces of globalization can have a dual negative impact on state and society: They can weaken those state institutions that ensure social peace and can cause distinct cultural groups in multi-ethnic societies to suffer disproportionate economic hardships. Under the disintegrating power of these two forces, “ethnic entrepreneurs” (Roeder, 1998) can emerge to articulate grievances and create a parallel political authority among distinct cultural groups. This can mean that culture becomes the primary political cleavage, and that cleavage, combined with the weak legitimacy of established authority, can lead to violent social conflict.²

In this chapter I compare the responses of Yugoslavia and Bulgaria to these two disintegrating forces of globalization. I show how Bulgaria's institutions responded to the forces of globalization to avoid social disintegration, while Yugoslavia's "response mechanisms" exacerbated the problem of social fragmentation and led to violent cultural conflict. The two countries are strikingly similar in terms of historical legacies, social composition and economic structure: both suffered from the legacies of Ottoman rule that left Muslim enclaves within largely Christian populations; both suffered the economic and political distortions of Communism's "command" economy layered over ethnically segmented markets. In both countries, ethnicity and religion were highly politicized. Participation in the global economy left their economies with high debts and highly uncompetitive industries. In both countries, the economic hardships associated with the fall of Communism and an opening to the international economy fell disproportionately on politicized cultural groups. Both experienced struggles over the allocation of declining resources in the wake of Communism's collapse; both emerged from the Communist period with politically charged ethnic competition, and both saw the rise of "ethnic entrepreneurs" who attempted to usurp political authority in the face of weakened political institutions. Indeed, Muslim minorities in Bulgaria had been systematically oppressed during the Communist period, while in Yugoslavia, they had been given increasing autonomy. Yet Yugoslavia erupted in violent conflict, while Bulgaria did not. Why?

I hasten to note that I do not wish to argue that the forces of globalization caused the war in the former Yugoslavia or that it was only Bulgaria's success in coping with those forces that prevented conflict there. Nor do I argue that the forces of globalization will always have a negative impact on social integration; indeed in places like Punjab and Malaysia, integration into the global economy has brought growth that has helped to attenuate cultural conflict (Singh, 1998; Lubeck, 1998) My argument is a much more modest one. I wish to explore the role of globalization in cultural conflict by looking at both its differential impact on diverse cultural groups in multicultural societies and its impact on the state's ability to support institutions that provide social order or repress dissent. I argue that the institutions of political participation and resource allocation are the crucial factors affecting social integration, and these key institutions differed in Yugoslavia and Bulgaria. Globalization is a "trigger" for cultural conflict, but not an underlying cause. Responding to globalization can attenuate social conflict but not erase it.

In the remainder of this chapter I elaborate on these claims and attempt to muster support for them. I begin with a conceptual elaboration of the argument. I then turn to an examination of the two regions. I begin by looking at the institutions, the impact of growing international integration, and the state of social integration of each country during the Communist period. I then examine each of these factors under the effect of globalization

in the post-Communist period. The Yugoslav case illustrates how federalism before the fall of Communism and the failure to institute a competitive political system after 1989 exacerbated ethnic tensions in the face of growing international pressures. The Bulgarian case shows how global pressures worked to exacerbate ethnic tensions, already heightened by minority oppression, but how political institutions that fostered compromise and an independent judiciary mediated those pressures to reduce “identity politics” and attenuate ethnic conflict.

Theoretical considerations

While many analysts suspect that there is a link between economic globalization and the current round of cultural conflict (e.g. Kapstein, 1996; Woodward, 1995; Lapidus *et al.*, 1992), few have investigated potential causal forces that might explain that relationship. I suggest here that the causes operate at two levels, the level of *society* and the level of the *state*. If a state is uncompetitive in the global economy, and economic hardship falls disproportionately on distinct cultural groups, those groups are ripe for the mobilization efforts of *political entrepreneurs*.³ Economic hardship provides a concrete justification for political grievances that can be transformed into a resource for political mobilization. States that are weakened by the forces of globalization have fewer means to cope with social disintegration. And violence may be the only alternative course for political entrepreneurs making non-negotiable resource demands. I expand on this two-pronged impact of globalization briefly below.

Globalization and the disproportionate distribution of hardship

Economic change that results from integration into the global economy can cause social disruption and radical dislocation of communities. When secular economic trends lead to low growth, debt crises, rising unemployment, and rising rates of immigration, and when the resulting hardships and benefits are disproportionately allocated among various cultural groups, existing political cleavages based on cultural difference are exacerbated and new ones are created. In Bulgaria, for example, the introduction of markets and the restitution of land created disproportionate unemployment among the Muslim population. In England, as industry declined in the early 1980s, the resulting unemployment was disproportionately allocated to minority populations. In Yugoslavia, Croatia fared better in global economic competition than the less developed republics and yet was forced to transfer resources to them, fostering deeper and deeper resentments against federal Yugoslavia that took the form of ethnic discrimination and privilege.

Economic hardships that lead cultural groups to distrust the state can make these groups available for reassignment to new political identities. The

losers in economic transformation will attempt to use their political resources and position themselves to resist changes that disadvantage them. Economic difficulties that fall disproportionately on culturally defined social groups thus create the demand for the goods that political entrepreneurs promise to deliver, particularly when those same factors that fuel cultural grievances also reduce government resources to uphold the “social contract.” It is to the importance of this notion of the social contract in the face of the imperatives of globalization that I now turn.

Globalization and state strength

All stable countries are characterized by political and social arrangements that have some form of historical legitimacy. Sometimes these arrangements or “social contracts” are written in constitutions; sometimes they are found instead in a country’s political and social institutions. In either case, such social contracts structure the terms of citizenship and inclusion in a country’s political community, the rules of political participation, the political relationship between the central state and its various regions, and the distribution of material resources within a country. When political institutions make ascription—that is, cultural distinctions—a criterion for membership, participation and resource allocation, “identity politics” is played out in the political arena. When the institutions of central authority are strong, and perceived as legitimate, and when resource allocation is considered “fair,” political conflicts are less likely to become violent. Indeed, perceptions of fair resource allocation are a key pillar of institutional legitimacy. Strong and legitimate institutions provide broadly accepted channels of political competition within which political actors operate in “normal” times. They allow central authorities to make credible commitments to distribute benefits and structure bargaining among various groups in ways that will be perceived as mutually advantageous. Institutional legitimacy enhances institutional capacity, reducing the threat of communal conflict by increasing the benefits of peaceful dispute resolution and reducing the benefits of violence. Although these institutions may privilege some groups over others, they can counter the threat of backlash with offers of side payments and compensation to those who see themselves as harmed by the preferential practices.

It would be wrong to assert that perfect social harmony is the result. These institutions often foster resentment because of these practices of privilege and compensation, but where they are considered essentially legitimate, their behavioral rules are echoed in other organizations and in the society at large. Thus these institutions can create “sticky” norms that shape social practice even in periods of institutional disruption. These norms, reflected in dominant public attitudes, act as a firebreak against ethnic and sectarian violence in that they provide the basis for a legitimate contract between state and society that ensures a degree of domestic order.

The opposite is true when state institutions are considered unfair, illegitimate and oppressive. Often, privilege is granted to one group, and others are excluded from the privileged resource allocation. Resentment is likely to build but will be repressed as long as the state is strong enough to exert coercive power to maintain social order. For example, both Punjabi Sikhs and Georgian peasants in Abkhazia were excluded from privileged resource allocation. Thus both sought to secede from the governing state that they perceived as oppressive. As long as that state remained strong enough to repress dissent and as long as these two groups continued to be deprived of resources for mobilization, their grievances festered, but they did not resort to violence until the institutions of the central state weakened.

There are many reasons why a central state would weaken; corruption, inefficiency, and over-extension come readily to mind. In addition, however, upholding these social contracts becomes more difficult when globalization weakens the state through its imperatives for budget reform and “state shrinking.” To increase economic efficiency and survive in global competition, states pursue domestic policies that will make them attractive to capital and foreign investment, often drastically shrinking their budgets and privatizing their industries. This, in turn, should allow further generation of wealth, creation of economic opportunities for individual and country, and should generate improved living standards. But these policies usually require drastic changes in domestic social contracts, and such changes threaten those who have possessed power and wealth under the old arrangements.⁴

State withdrawal from its allocative role in society through fiscal reform, the introduction of markets, and disproportionate economic hardships are grist for the mill of eager political entrepreneurs. Again, this is exemplified in the case of Bulgaria. There, the former Communist regime provided the Turkish minority with economic security: ethnic Turks were concentrated in the tobacco industry; the state purchased tobacco, ensuring full lifetime employment. With the fall of Communism, however, the inefficient and uncompetitive tobacco industry was privatized, and its failure in global markets left the majority of Turks unemployed and destitute. Turkish political entrepreneurs in Bulgaria began to label unemployment ethnic “genocide” in their effort to mobilize the Turkish population against the liberalizing policies of the new regime.

In short, long-term globalization trends and short-term policy responses to those trends—i.e. forces that reduce the state’s role in the economy and reduce its sovereignty over political membership and exacerbate social cleavages along cultural lines—are important causes of broken social contracts and failed coercive policies. National economic growth and decline and the level of external debt affect the level of resources that the state can allocate, and short-term policies of economic liberalization yield up the state’s distributive powers to the market. Indeed, when states make the

decision to allow the market to pick economic winners and losers, they can break the social contract that once permitted them to soften some of the disadvantages suffered by particular cultural groups. Under Communist rule in both Yugoslavia and Bulgaria, the state's ability to soften those disadvantages permitted the partial integration of those groups into the political community.

The myth of liberalization

The argument I make here challenges the claim that the rapid and simultaneous construction of liberal economic and democratic political institutions, a process for which "globalization" is sometimes a code word, can mitigate ethnic and sectarian conflict.⁵ Free markets create wealth for all, the argument runs, erasing the need for violent struggle over resources. And democracy permits political aggregation and representation of all social interests, elevating conflicts of interest that can be adjudicated in the political arena over conflicts of identity that are more difficult to negotiate. The logic of liberal democracy suggests that the construction of democratic institutions makes the *individual* rather than collectivities the subject of legal protection and political participation. Democratic theory claims that if ethnic and religious conflicts do exist, they can be peacefully resolved if the organizing principles of the political system elevate tolerance and national unity above ethnic and religious domination and privilege.

Furthermore, this logic claims that federalism, confederalism and other forms of territorial decentralization that devolve political power to the local level create local and responsive government that will maximize individual freedom and satisfy the claims of some groups for autonomy and self-determination (Lake and Rothchild, 1997:36–7). In short, the classical liberal argument claims that the construction of markets and democracy and the decentralization of political and economic power ensures that individuals receive equal protection under the law and that economic and political competition need no longer be violent.

Despite widespread acceptance of these claims, however, the evidence suggests that perceived economic inequities, particularly those that arise from current policies of economic liberalization and the longer-term effects of globalization can undermine liberal political practices and lead to the illiberal politics that characterize ethnic and sectarian conflict.⁶ Where communal differences had become politically relevant in the past, the ethnic or religious card may be the easiest one to play in the effort to mobilize political support in the face of the uncertainties of economic decline, in the shift from welfare to market economies, and in the move from centralized to decentralized polities. This is particularly evident where both political and economic decentralization threaten to break down established community and the liberal focus on individual self-reliance threatens historical bonds and leads to deep insecurities. Secular economic decline

and policies of economic liberalization require the “dismantling” of institutions of state resource allocation; weakened states are unable to provide equal protection for all who live within their territory. Solnick’s chapter in this volume illustrates this point with the Russian example: the asymmetric distribution of foreign trade and investment activity contributes to the growing gap between Russia’s dozen richest regions and the rest. This widening gap in regional income deepens the political rift among regions. Regions that stand to gain the most from foreign trade and investment favor less federal intervention, and looser controls over subnational administrations. Regions that are left out of the globalization bonanza, on the other hand, are more supportive of an interventionist and redistributive federal government. This disagreement over the desirable level of federal intervention serves to block any effective collective action among regions to constrain the federal government. It can also make any federal effort to coordinate economic reform nationally more difficult.

Finally, the global spread of democracy is not a panacea for cultural conflict. Liberal democracies can indeed mute cultural conflict with institutions of inclusiveness, universal representation, and electoral systems designed to encourage elite compromise. Indeed, a robust liberal democracy may be one of the strongest defenses against cultural conflict. But “democracies” are not all liberal; *illiberal* democracies may possess many of the attributes of polyarchy, like free elections, freedom of speech, freedom of movement, freedom of association and freedom of religion. But they pay only lip service to the rule of law, minority and citizen rights, and independent judicial review (O’Donnell and Schmitter, 1986; Karl, 1986; Przeworski, 1991; O’Donnell, 1993; Collier and Levitsky, 1995; Brown, 1993). Such systems can actually exacerbate cultural conflict. In periods of economic uncertainty and political transition, when states that once provided entitlements pull back or are dismantled, when illiberal democracies are so constructed that they fail to protect rights, and when the introduction of markets leads to deep insecurities, the rich symbolic resources of ethnicity and religion offer hope in their promise of collective power to those populations who feel powerless under these conditions.

Coping with ethnic conflict by responding to globalization

A perception of unjust political and economic resource distribution among distinct cultural groups lies at the heart of many of today’s cultural conflicts. Therefore, political leaders in multicultural societies must take care to maintain strong, legitimate institutions in the face of state-shrinking imperatives of globalization. Institutions should be fashioned so that economic hardships and benefits are allocated in ways that integrate rather than fragment the political community. Federal systems in multi-ethnic states must create a strong center if they are to survive.⁷ They must be strong enough to protect and maintain the rule of law and civil and

political rights, and governments must be committed to those rights. An independent judiciary, not captured by political forces is essential. Institutions of the presidency and parliament must be constructed so that stalemates do not repeatedly occur and in which only negative majorities—able to veto decisions but unable to take positive action—do not dominate. A system of political competition that fosters compromise will buffer against perceptions of further unfair resource distribution as state budgets shrink. The consequences of globalization in the form of introducing market rationality can actually be a coping mechanism for ethnic conflict: markets can reduce the influence of patronage networks, including ethnic ones. In sum, coping with globalization in post-Communist multi-ethnic societies must mean more than reducing fiscal deficits, privatization, currency stabilization and creating economic efficiencies; coping with globalization must also mean the refashioning of institutions that both depoliticize and respect cultural identity.

I now turn to an illustration of these claims through a comparison of the Yugoslav and Bulgarian cases. In both cases I begin with a description of institutions relevant to social integration and how they were affected by the processes of globalization. I also describe how the forces of globalization exacerbated ethnic tensions by creating disproportionate hardships for distinct cultural groups. I then turn to the post-Communist period of institutional collapse and show how social tensions grew in an institutional vacuum. Finally, I show how institutional incentives and constraints exacerbated tensions in the former Yugoslavia and mitigated them in Bulgaria.

Evidence

Pre-1989: impact of institutions on social integration in the face of international pressures

The roots of Communism's collapse can, in part, be traced to the forces of globalization and the position of Communist countries in the international economy. Both Tito and Stalin refused to become part of the new post-war international economic order, and attempted to steer their countries—and the Eastern bloc in general—in the direction of economic autarky (Davis, 1991:113–20). But growth rates *fell—not* only because of the distortions of central planning but also because of the inefficiencies of autarky. Communist countries found themselves on the sidelines in the race for economic prosperity as its technical expertise in commercial industry began to lag far behind the industrial capitalist nations. Throughout the Cold War, technology gaps between them and the West widened and multiplied (Crawford, 1993).

While both Bulgaria and Yugoslavia pursued autarky and central planning that brought economic hardship to all social groups, they were

marked by differences in the structures of their political institutions. Despite the central grip of the Communist party over both countries, Bulgaria was a centralized state while post-war Yugoslavia was constructed as a federal system. These different structures made a crucial difference in filtering the forces of globalization when they began change economic and political calculations within each country.

Yugoslavia

Tito believed that national integration was not possible in a unitary Yugoslav state. He thus established a federal system of ethnic republics after the war that would provide guarantees of national equality. Like any federation, authority was distributed between the central government and the governments of the constituent units, and the distribution of authority could not be changed without mutual consent. The constituent units participated in the making of decisions at the federal level. And finally, important federal decisions required equal representation of all of the constituent units, regardless of their size and population.

Yugoslavia, however, was not a centralized federal system, like that of the United States, the Federal Republic of Germany, or, in its most centralized form, the Soviet Union. Indeed, it did not resemble most other federations, in which the central government could make many decisions without consulting the member governments of the federal units. Instead, because Yugoslavia was so divided as a result of the events of World War II, Tito created a “non-centralized federalism”, in which the constituent units exercised a large degree of control and authority. Although the 1946 constitution placed all mineral wealth, power resources, means of communication, and all foreign trade under state control, it also stipulated that the central government could make decisions in only a few narrowly restricted issue areas without obtaining the approval of the governments of the constituent units (Kostunica, 1988:78–79; Riker, 1975). In effect, the economic policy decentralization and weakening of the federal center in pre-1989 Yugoslavia resembled post-1992 Russia as described in Solnick’s chapter in this volume.

Further, like the Soviet Union and Czechoslovakia, Yugoslavia was now governed by the institutions of “ethnofederalism” which were intended to transform ethnically-based political identities into cultural/administrative identities, and thereby prevent the re-emergence of extreme “identity politics” as a dominant political force. As Vesna Pesic (1996) argues, two kinds of national groupings were organized *hierarchically* in the constitution. Five culturally defined groups—Serbs, Slovenes, Croats, Macedonians, and Montenegrins—were territorially organized in constituent republics in which, as the titular nationality, they held the status of “constitutive nation.” The 1971 census recognized Muslims as a separate nation, and in 1971 Bosnia-Herzegovina was recognized under the national principle as a

republic, consisting of three constitutive peoples: Serbs, Croats, and Muslims.⁸

This federal structure—which we can call “ethnofederalism”—was intended to balance the interests of all of the peoples of Yugoslavia. The importance of equality of the “constituent nations” in representative institutions cannot be overstated: indeed a territorially-based federation was not considered fully adequate to provide an equal representation of Yugoslavia’s constituent “peoples,” since most territorial units, even those with titular nationalities, had mixed populations. Therefore, territorial ethnofederalism was reinforced by a system of ethnic quotas or “keys” as a central principle for the allocation of political resources. All appointments to public office (including the military) were decided by a formula for the proportional representation or, in some cases equal representation, of individuals by constituent nation or nationality. And the effort to maintain balance in public institutions went far beyond the intent of the quota system. For example, in an attempt to maintain balance even in the prosecution of politically motivated nationalist activities, central government authorities often went out of their way to balance a particular prosecution with charges against people from other ethnic groups (Woodward, 1995:37).

Economically, ethnofederalism took the form of distinct ethnic republics; investment funds were provided to these republics by the central state partly according to political and ascriptive criteria rather than economic “rationality.” Ascriptive allocation fostered both resentment and perceptions of intrinsic “rights” to further resources from the center. This system fostered mutual resentments and suspicions of other republics; resentments, suspicions, and belief in one’s own collective “intrinsic rights to resources” strengthened ethnic identity, weakened loyalty to the central government, and reinforced the dominant logic of identity politics at the federal level. A pattern of downward spirals that do not resemble the Chinese experience of regional decentralization as shown in Yang and Su’s analysis in Chapter 1 of this volume.

Tito established these institutions of ethnofederalism because he believed that if the resolution of disputes between national groups appeared to favor one group over the others, the federation’s internal balance would be upset and Yugoslavia would be destabilized. His goal was to preserve the central Yugoslav state. Given Serbia’s disproportionately large population and history as an independent state, and given Croatian elites’ historic distrust of Serbs, this was not an easy task. Indeed, some analysts argue that the constitution implied an unwritten agreement between Tito and Serbian political elites in which it would espouse Yugoslav unity and equality of representation in order to mitigate Croatian fears of Serb dominance in the state apparatus and thus cement Croatia’s loyalty to the center. One often heard the slogan, “Weak Serbia, Strong Yugoslavia” (Pescic, 1996; Banac, 1992:145).

This structure had an important impact on social integration as Yugoslavia became increasingly linked to the global economy. Unlike the Warsaw Pact nations who were dependent on the Soviet Union, Yugoslavia did not have a patron to which it could turn for economic assistance or cheap resources. In the 1949 break with the Soviet Union, Yugoslavia found itself increasingly isolated and dependent on the West for aid and investment that was never adequate for its needs. When growth rates fell as a result of inefficiencies of central planning in the early 1960s, Tito requested an IMF loan; the condition was economic decentralization. Although the “national economy” remained in the hands of the federal government, republics were given their own budgets over which they exercised independent control. In the search for a more impersonal allocative mechanism that would deflect criticism from the central government but fall short of the introduction of a “market,” central authorities introduced administrative market socialism (Burg, 1983:26; Bridge, 1977:350–51; Mencinger, 1991:73; Bicanic, 1957:63–74; Rusinow, 1977:71)

But economic conditions continued to worsen. Wage earners pouring into the cities from the countryside in the industrialization drive exerted pressure on demand for consumer goods that were all in short supply. Expanding demand forced accelerated imports, and the balance of payments deficit dramatically increased. But as exporters, Croatia and Slovenia were both suffering from the 1961 recession in Western Europe, and their exports sagged dangerously. IMF loans boosted imports of consumer goods but industry did not restructure for industrial competitiveness.

Once the regionalization of the economic policy was in place, the incentives for regional economic autarky increased (Bicanic, 1957:120–41). The regionalization of the banking sector witnessed the creation of as many banks as republics and regions. Bank authorities controlled allocation to individual firms, and regional regulatory authorities controlled banking practices. This regionalization of the banking structure made a nation-wide monetary policy unattainable and blocked the possibility of inter-regional economic activity.⁹ Invisible but thick economic walls between the republics were gradually being constructed.

Furthermore, as the various regional political elites gained increasing autonomy from the federal government, they began to follow self-protective import substitution policies, leading to important losses in economies of scale. Furthermore, the regional culturally-defined governments did not coordinate foreign exchange stockpiles. The absence of coordination led to fragmentation of economic activity and the reduction of the stock of available capital for new investment. The resulting losses of revenue to the central government helped to undermine its ability to resist further regional encroachments on its effort to coordinate economic activity.

Growing fragmentation under growing international pressure

After 1973, the four-fold increase in the price of oil combined with a decline in the economic growth rate to trigger expanded borrowing on international markets. Western banks and their governments were only too eager to provide balance of payments financing and additional export credits. The accumulation of petrodollars in Western banks, combined with the 1974 recession, freed loan capital, and like most other borrowers, Yugoslavia had little difficulty in arranging loans on excellent terms, in a financial environment marked by excessive liquidity and “overcompetition” among lenders. Borrowing created an artificial sense of economic wellbeing. Consumers became increasingly dependent on imports, and exports became increasingly uncompetitive. As imports grew faster than exports, repaying the debt in convertible currency became increasingly difficult. New loans were needed to service old ones.

Although there was a sense of well-being on the surface because consumption was financed by debt, overall economic growth ground to a halt. In 1982, real gross fixed investment fell by 37 percent. Labor productivity in the public sector fell by 20 percent, and public sector earnings fell by 25 percent. The average annual growth rate fell to 0.9 percent, a drop from an annual rate of 6.3 percent (Lydall, 1989:24–5). As the economy worsened, regional fragmentation increased; the conduct of economic policy now depended on the wishes of the regional party organizations. Regional enterprises were subsidized as part of patronage systems; patronage investments could only be financed by increased borrowing; increased borrowing deepened Yugoslavia’s external debt and both worsened the economic system and weakened the central state even further.

As a result of uncoordinated investments, foreign reserve imbalances, and overborrowing in the 1970s, the 1980s witnessed permanent economic crisis in Yugoslavia. By mid-decade, inflation had reached 100 percent annually, while wages were frozen. The federal government faced a mounting debt obligation without any return on moneys spent. Unemployment rose from 600,000 in 1982 to 912,000 in 1983, not including the 700,000 who had been forced to emigrate abroad in order to find work. In 1981–85, unemployment in Serbia proper was 17–18 percent, and in Kosovo it was over 50 percent. By 1985, one million people were unemployed, and in all republics except Slovenia and Croatia, the unemployment rate was above 20 percent (Woodward, 1995:64, 73).

As the external debt exploded and as the global recession closed export markets, conflicts among the republics over the distribution of rapidly declining economic resources contributed to economic decline. The regionally-based allocation of resources increased local power and the political strength of local ethnically-motivated political entrepreneurs at the expense of the central state. Ethnically-defined republics legitimated the political relevance of cultural identity. Although ultimately accountable to the central government

in Belgrade, political elites found that they could use funds distributed from the center to the republics to build a political power base at the local (republic) level in order to mobilize and gain the political loyalty of their culturally-defined populations, unlike China, where the federal center maintained control over the larger projects (Yang and Su, this volume). The disintegration of federal control over resources created opportunities for regional officials in ethnic republics to seize assets, gain political support, and to eventually threaten with violent conflict. With its economy in free fall, Yugoslavia was unable to meet international payment obligations. The price for long-term and extensive debt rescheduling was a set of stiff IMF conditionality requirements, but, lacking the capability to create a coherent stabilization program, the federal government was turned down.

As a result, in 1982, Yugoslavia was forced to accept a far more draconian policy of debt rescheduling than had been offered earlier. The IMF imposed a strict emergency package on the country's economy, greatly reducing the state's scope for policy discretion. By 1983, devaluations of the currency and an orchestrated drop in domestic demand, both of which were IMF requirements, as well as the Reagan recession in the West, led to another precipitous fall in growth rates for the country and the further cannibalization of the economy by the regional governments.

In sum, the seeds of ethnic conflict in Yugoslavia were planted in Yugoslavia's federal institutions. Yugoslavia's participation in the global economy, constrained by its non-market economic institutions led to a series of economic crises that were mediated by those institutions, fanning the flames of ethnic resentments and putting resources in the hands of ethnic entrepreneurs. The divergent effects of the international market on the regional economies placed competing stresses on the federal government. The more developed republics of Slovenia and Croatia wanted more integration into the international economy, whereas the less developed republics of Serbia and Montenegro wanted protection from international economic competition. These conflicting demands further reduced the federal government's ability to deal effectively with pressing economic problems and issues of economic restructuring.

What the republics and regions did not drain from the central state, the international economy did. By the early 1980s, in an era dedicated to neoclassical economic reform, Yugoslavia found itself with an incoherent and ad hoc system of state interventionist policies in the economy, mainly to meet the loudest and best organized demands of various political entrepreneurs. It faced mounting debt payments without any return on monies spent. With its powers and resources drastically reduced, the federal state became paralyzed: centrifugal elements served to divert development funds to those regions with the most political clout while federalists looked on helplessly. As a state that was both weak and decentralized, Yugoslavia was not capable of withstanding the forces of fragmentation, unlike the Chinese state.

Bulgaria

In contrast to Yugoslavia, Bulgaria was a unitary state. Despite attempts at decentralization, the 1971 constitution concentrated power in the center (Curtis, 1992), and created a new body, the State Council, to replace the Presidium as supreme organ of state power, with the power to initiate as well as approve of legislation. At the same time the Bulgarian Communist Party (BCP) program specified an orthodox hierarchical party structure of democratic centralism, each level responsible to the level above. The lowest-level party organizations were to be based in workplaces: all other levels would be determined by territorial divisions, which were weaker than the workplace organizations (Bell, 1986). Allocative institutions privileged party members and functionaries rather than particular ascriptive groups.

This centralization was reflected in the forced inclusion of Muslim minorities into the central state.¹⁰ From the outset, the Communist regime sought to “overcome the backwardness” of the Turkish population through policies of forced inclusion, e.g. the destruction of autonomous local organizations and decrees of mass public de-veilings of Turkish women (Neuberger, 1997:5). In 1971, the constitution dropped any mention of national minorities or the word minority itself, and supported the creation of a nation-state with a single language and a homogeneous culture as explicit government policy (Eminov, 1997:7). In fact, after 1971 references to “national minorities” or “ethnic groups” were purged from official discourse. Instead, there were only “Bulgarian citizens,” normal ones, on the one hand, and those of “non-Bulgarian” ancestry on other. Indeed, after the approval of the 1971 constitution, the creation of a nation-state with a single language and a homogeneous culture became an explicit government policy. Party ideologues began to declare that Bulgaria was well along the way to becoming a unified single-nation state (Eminov 1997:7).

In 1984–85, the regime tightened the screws of “inclusion.” It declared that Bulgarian Turks were not really Turkish, but rather they were Bulgarians who had been forcibly Islamicized and Turkified under Ottoman rule. It forced all Turks to change their names from Turkish names to Slavo-Christian ones, and prohibited most religious rites, closing down of mosques, and destroying public signs of an existing Turkish culture (Neuberger, 1997:6; Curtis, 1993:82). The name-changing operation was carried out through the surrounding of the Turkish villages by Bulgarian army units and the issuance of new identity cards with new Slavic names. Failure to present such a card meant forfeiture of salary, health benefits, pension payments and bank withdrawals (Curtis, 1993:82). As Eminov shows, soon after the conclusion of the campaign the Turks were forbidden to speak Turkish in public conveyances and public places. Those who disobeyed were subject to harassment and fines. Signs saying “it is forbidden to speak in a non-Bulgarian language in this shop” and “communication between Bulgarian citizens will be carried out in Bulgarian” were prominently

displayed in shops and restaurants where Turks lived (Eminov, 1997:91). This process started in the Eastern Rhodope mountainous regions of Southern Bulgaria in December 1984 and was carried in the rest of the country by March 1985. As Zhivkov stated in 1985, regarding the perennial Turkish question, "there are no Turks in Bulgaria" (Quoted in Eminov, 1989 and cited in Neuberger, 1997:6).

The Bulgarian Muslims, or the "Pomaks," suffered much less repression. Because, historically, there had only been a weak and ultimately failed effort to construct a Pomak political identity, there was no need for the Communist regime to single them out, either for special repression or privilege. (Todorova, 1998) If anything, the Pomaks were coincidentally privileged because they enjoyed "border benefits," that is, development funds that were granted to the border regions of the Rhodopes in which they lived. They thus attained a higher than average standard of living for the region. Nonetheless, because Bulgaria was a small and unitary state, these "border benefits" were doled out directly from the central government to the border populations; unlike the case in Yugoslavia, there were no intermediary political entrepreneurs who could control the distribution of those benefits in order to enhance their own power base.

Despite these policies, the Bulgarian economy was characterized by an "ethnic" division of labor. The majority of Turks and Pomaks worked in agriculture, particularly in the tobacco industry, agriculture, and in light manufacturing, sectors that were not privileged by the regime in its industrialization drive. These sectors were completely tied to domestic demand and to exports to other CMEA countries. As long as that trade remained strong, as long as the domestic market was sheltered from international competition, and as long as they were granted equal welfare benefits, these minorities did not suffer disproportionate economic hardships. But as Bulgaria became increasingly integrated into the international economy during the 1980s, those hardships manifested themselves. It is to this story of integration and its effects that the discussion now turns.

Growing fragmentation under growing international pressure

Unlike Yugoslavia, the Warsaw Pact nations staved off an opening to the West until the 1980s. Only when Gorbachev came to power did the Soviet bloc open the floodgates to the international economy and begin the process of creating internal markets. These moves were initially widely supported by Soviet economic elites, who (it would now appear rightly) believed that the USSR would not remain a great military power unless it could raise the technological level of its industry to meet the standards of global competition. Opening to the West was one of the many strategies of renewal constructed to meet this goal.

Domestic reforms and growing market ties with the West, however, obviously failed to shore up declining economies. Because internal economic

rigidities still persisted, Western technology was purchased as a substitute for economic restructuring; Soviet and East European planners knew that if they tried to compete in the international economy with sales of oil, timber, furs and other commodities, they would never be as competitive as those states who produced computers, advanced components and new materials. If their industries were to compete in the world market, innovative technology would have to be imported. But not enough value-added goods could be sold on the world market to pay for those imports and technology had to be purchased with Western credit.

Growing internal economic weakness meant that the Warsaw Pact was eventually plunged into debt to purchase technology and consumer goods and raise wages to stave off domestic unrest. East European and later Soviet debt to the West reached dangerously high levels in the 1980s, only to be reduced by drastic cuts in Western imports and massive rescheduling. Subsequent decreases in economic growth rates and decline in living standards squeezed populations who could no longer be mobilized by ideological appeals.

Bulgaria was especially hard hit by the global recession of the 1970s and early 1980s and by the debt crisis of the 1980s. The recession which began in 1974 closed Western markets, and increasing EC agricultural protectionism exacerbated the problem for all the East bloc countries but especially for Hungary, Bulgaria, and Romania, countries whose chief exports were farm products. By 1990, Bulgaria had suspended both principal and interest payments of principal on its foreign debt. It requested debt reduction rather than long-term payment deferral, but creditors united to reject the request.

Meanwhile, in 1989, as a result of the forced assimilationist policies and the growing economic crisis, 300,000 ethnic Turks left Bulgaria for Turkey, in what some observers called the largest post-war civilian population movement in Balkan history (*Economist Intelligence Unit* Quarter 3, 1989:20). The exodus resulted in an acute loss of agricultural personnel during the harvest. And the two-thirds of the Turks who eventually returned found that the authorities had given their homes to Bulgarians (Tzvetkov, 1992:40).

In short, with Communism's collapse, Bulgaria was ripe for "ethnic conflict." A highly centralized state engaged in extremely repressive policies against its ethnic minority. Economic crisis had fallen disproportionately on Bulgaria's Muslim population, creating conditions for a politicized, ethnically-constructed opposition, able to call on shared memories of oppression, and ready to mobilize politically. Ironically the Yugoslav response to ethnic disputes had been to further decentralize and grant autonomy, rather than to force assimilation into the Yugoslav state. Resources were distributed among various ethnically-defined regions in order to achieve balance and fairness. Yet it was Yugoslavia that collapsed in the wake of Communism's demise, while Bulgaria's Muslim minority was integrated into the new democratic system of peaceful political competition.

After Communism's collapse: ethnic conflict in post-Yugoslavia and democratic competition in Bulgaria

In Yugoslavia, as long as the central state was relatively strong, ethnofederalism functioned as a channel for effective, if not efficient, resource distribution, despite the resentments and fears that it nourished. There are also many indicators that central institutions were partially successful in moving Yugoslavia toward integration: a rising Yugoslav national identity, especially among young people, the strong preference among Serbs for the preservation of the federal state, and the widespread political popularity of Ante Markovic, Prime Minister and head of the only all-Yugoslav party in 1990. Polls taken in July 1990 showed him to be the most popular politician in all of the republics, with a 93 percent rating in Bosnia, an 81 percent rating in Serbia, and an 83 percent rating in Croatia (Hayden, 1992:7). In Bosnia, by the late 1980s, 30 percent of marriages in urban areas were mixed marriages. (Malcolm, 1994:222) Perhaps the most significant indicator of Yugoslav integration is the outcome of the first multiparty elections. When elections were held throughout the Yugoslav republics in 1990, no ethnic nationalist party received an electoral majority in Slovenia, Croatia, or Macedonia; in Montenegro, former Communists received the bulk of the vote. Most important, no party calling for an independent ethnically exclusive state received a majority vote in any of the Yugoslav republics. Indeed, election results suggested a broad preference for Yugoslav integration; this preference was stronger than many analysts believed.

It was when the central state weakened and finally collapsed that those resentments and fears became resources for mobilization in the hands of political entrepreneurs espousing violent secession and capture of territory. The demise of central power wiped out federal protection for national and minority rights and led to domination and discrimination of minority groups wherever one ethnic group enjoyed a majority. Domination and discrimination in one area prompted countermeasures in another, encouraging the escalation of open ethnic discrimination and violence. This, in turn, provided incentives for local politicians to exploit ethnic resentments for their own political advantage. Where the legacy of ethnofederalism was strongest, nationalist parties won the first "free" elections in federal Yugoslavia, held in 1990. Where they dominated republican governments, they created exclusive institutions and prevented losing ethnic groups from obtaining citizenship rights in their state, thus encouraging more secessionist violence.

The legacy of ethnofederalism also prevented the formation of political coalitions *across ideological lines* that could reverse this trend. It thus prevented the "pacted" and peaceful transition to democracy that had taken place in Latin America and Southern Europe (Schmitter and Karl, 1994:173–85; Przeworski, 1991; Remmer, 1990).¹¹ And by preventing political

coalitions *across regional lines*, the legacy of ethnofederalism blocked liberal politicians from obtaining positions of political power. To counter nationalist political forces, liberals needed pan-Yugoslav coalitions that regional fragmentation prevented, but those coalitions did not exist.

When Communism collapsed, this fragmentation that permitted resources to fall into the hands of ethnic entrepreneurs paved the way for them to play the “ethnic card” in the first democratic elections in Yugoslavia. Slovenia and Croatia had long been the strongest advocates of decentralization and republican autonomy. By the 1990 elections, political and economic resources were in the hands of their regional and exclusive nationalist politicians. Serbia had long been a supporter of centralization, but was pressured by new accountability rules in the 1974 constitution to relinquish political control over its territory. This intensified ethnofederalism induced Serb politicians to drop their support of the federal government and take control of territories populated by majority nationalities. Where other titular nationalities were making exclusive claims to territory, Bosnian Muslims, identified as a “nation,” also began to make territories claims. The bandwagoning effect of exclusive national claims to territory reduced incentives for pan-Yugoslav coalitions and increased incentives for an escalation to violence.

Sadly, the Dayton Accord did not correct for these institutional failures that fanned the flames of cultural conflict. Indeed, they produced political institutions in Bosnia that replicated those features of the Yugoslav constitution that encouraged ethnic rivalry and weakened the central government. Like Yugoslavia, Bosnia is constructed as a “non-centralized federation,” composed of two separate entities, the Republika Srpska, and the Federation of Bosnia and Herzegovina, a federation of Bosnians and Muslims within the larger Federation of Bosnia. The constitution of the Republika Srpska allows it to enter into an “association” with Serbia, and the Muslim-Croat Federation can enter into an association with Croatia. Bosnia is thus partitioned into ethnic regions, and the Croats and Serbs each have powerful patrons.

The central government is constructed to be weak and ineffective. It takes many of its institutional features from Tito’s Yugoslavia and the 1974 constitution. The constitution provides for a Parliamentary Assembly constructed of two houses, a House of Representatives and a House of Peoples, similar to the Chamber of Nationalities.¹² All decisions in each chamber are made by a majority of those present and voting; Robert Hayden argues that constitutional provisions make it possible for Croat and Muslim members of the House of Representatives to assemble without the Serb members, declare themselves a quorum, and pass valid legislation.

The constitution further specifies, however, that in the House of Peoples a quorum consists of nine members and must include three Serbs, three Muslims and three Croats. No legislation can be passed if one group boycotts the House of Peoples. This means that legislation can be blocked

by absenteeism. Like the federal presidency created in the 1974 constitution, the Bosnian presidency consists of three members, a Serb, a Croat, and a Muslim, with a rotating chair. With the economic crisis in the aftermath of war, these institutions spell a recipe for disaster. Bulgaria, on the other hand, constructed institutions that guarded against ethnic conflict, despite increasing economic crisis after Communism's collapse.

Throughout the 1990s, Bulgaria was brought to the brink of economic disaster several times; CMEA trade all but disappeared, leaving Bulgaria with a huge debt and no export markets. The unemployment rate skyrocketed from 1.7 percent in 1990 to over 11 percent in 1991 and 16 percent in 1993. Growth rates plummeted to—10.9 percent in 1997, and industrial output all but ceased (NSI, 1996:10–11). And as a UNDP report states, “The changes...greatly affected the sectors and manufacturing lines employing labor from the Gypsy and Turkish ethnic groups.... The canning and the tobacco industry, where workers of Turkish and Gypsy origin predominated, were also affected by the dwindling of the external markets due to the disintegration of the CMEA” (UNDP, 1996:6–11). Some figures illustrate this: in the predominantly Muslim districts of Blagoevgrad and Smolyan, unemployment rates hit 90 percent; in Borino, unemployment was 96 percent; in all other Muslim districts—Girmen, Bregovo, Strumyani, Khadzhidimovo, Razlog, Yakoruda, Sandanski, Gotse Delchev, Kirkovo, Devin, Kresna, and Nedelino—the unemployment rate was over 90 percent (Todorova, 1998:493); while in Bulgaria as a whole, the registered unemployment rate fluctuated between 1.7 percent in 1990, 11.1 percent in 1991, 15.3 percent in 1992, 16.4 percent in 1993, 12.4 percent in 1994, 11.1 percent in 1995 and 12.5 percent in 1996 (ILO, 1997:447).

While the market brought disproportional hardship to the Muslim populations, democracy brought political freedom and the right to organize in the political arena. In December 1989, the Bulgarization campaign ended and ethnic Turks were permitted to take back their Turkish names. The BCP voted to condemn the policy of forced assimilation and restated the constitutional rights of ethnic Turks to choose their own names, practice Islam, observe their religious customs, and speak Turkish.

These moves toward political liberalization were countered by Bulgarian nationalists. On December 31, 1989, there were demonstrations against political liberalization measures in Kurzhali, and in early January 1990, there was a series of demonstrations in Razgrad and Kurdzhali and a nationalist march on Sofia, protesting the “Turkification” of Bulgaria. There is some evidence to suggest that these nationalists were supported by BSP (Bulgarian Socialist Party) resources. (Economist Intelligence Unit Quarter 1, 1990:27; Troxel, 1992:414; Neuberger, 1997:8).¹³

The regime's response to this explosive situation was to both affirm the constitutional rights of minority groups and ban ethnic political parties. Nonetheless, the Movement for Rights and Freedom (MRF) was formed,

which, while not officially a Turkish party, did represent the Turkish minority in Bulgaria. And nationalist opposition rapidly increased both at the level of social protest and in a complaint to the Supreme Court. On July 11, 1990, the National Assembly held its first meeting. Ahmed Dogan, the MRF leader was prevented from addressing the floor because of the gathering of nationalist groups outside the old Bulgarian Parliament in Veliko Turnovo (Q3, 1990:25). Mosques and MRF offices in the Turkish towns of Haskovo, Shumen and Prodvina Bulgaria were attacked. On November 22, 1990, the National Committee for the Defense of National Interests (a right-wing nationalist group whose members included many former Communists who had participated in the implementation of the various Bulgarization campaigns) proclaimed the “Bulgarian Republic of Razgrad” (a city with a large Turkish population) as a response to the “treacherous pro-Turkish policy” of the National Assembly (Curtis, 1993:215). Indeed, in 1991, the BSP actively courted the nationalistic right wing, and its political rhetoric claimed that its UDF rival and its alliance with the MRF would reawaken Turkification that would increase the chances for secession and threaten the territorial integrity of the Bulgarian state (Perry, 1992:81; Nikolaev, 1992:15; Dainov 1992:10; Troxel, 1993:422). Further nationalist protests followed.

The BSP also tried to outlaw the MRF. Once the 1991 constitution was ratified by the National Assembly in the July of 1991 it presented the MRF with an obvious problem because Article 6 prohibited the creation of parties along ethnic lines. Despite the MRF’s leadership’s comments to the contrary, it had become increasingly apparent to all relevant observers that the MRF was the Turkish party in Bulgaria. The BSP sought to exploit this for strategic benefits and sued to prevent the registration of the MRF for the 1991 parliamentary elections

In this period of heightened ethnic tensions, the MRF began a campaign to politicize the Turkish minority, calling on past grievances to mobilize collective support. It announced the party’s plan to introduce the Turkish language in the school curriculum in Turkish-dominated cities and villages. Dogan pointed to disproportionate unemployment among Turks, calling it “genocide.”

The politicization of Pomaks was also underway (Todorova, 1998). At the end of 1992, the Democratic Labor Party was formed to represent the Pomak minority. Its leader was Kamen Burov, a Bulgarian of Muslim descent and the mayor of the village Zhiltusha in the Eastern Rhodopes. He was sent to the United States to attend a seminar on ethnic diversity and was apparently converted to the notion that Pomaks could compete for political resources on the basis of a distinct cultural identity. American and United Nations’ administrators encouraged him to work for the recognition of a Pomak ethnic minority as an important element of Bulgaria’s democratic transition. Upon his return to Bulgaria, Burov founded his party and immediately sought American backing.

But unlike “ethnic” political parties in the former Yugoslavia, Burov’s party made little impact and received little political support. And the MRF did not possess an existing regional party machine that it could use to mobilize for an alternative political authority in opposition to the central government. Indeed, both parties lacked the organizational and material resources of the regional party elites of Yugoslavia. Further, the Bulgarian Supreme Court decided, with the smallest of possible margins, to allow the MRF to register and thus to compete and represent the Turks in the Parliament. It then decided that under Article 11 the MRF was legitimate (Ganev, 1997). The MRF was left without resources to organize opposition outside the political arena, and the Supreme Court effectively maintained and legitimated the MRF in the political arena, allowing it to participate in democratic competition rather than be excluded or marginalized, and permitting minorities to be politically represented.

It is in this context of potential ethnic conflict that one should note the role that Bulgarian political institutions played. The absence of a federalized political structure along ethnic lines, like in the case of Yugoslavia, meant that the MRF lacked any substantial means of resource allocation which would enable it to resist participating in the mainstream of Bulgarian politics. Unlike Tudjman and Milosevic, Dogan did not have the “luxury” of inheriting an organized and well-funded political base. Thus he was forced to participate in the “normal” bargaining processes of post-Communist Bulgaria, structurally induced to temper his demands. Put more succinctly, the Communist experience of political centralization meant that the MRF did not have an “exit” option that was available to the regionally—and ethnically-based parties of Yugoslavia. Similarly, the existence of a politically independent Supreme Court served as an effective veto point that preserved the democratic politics of post-Communist Bulgaria. By recognizing the MRF as a legitimate party, even though it was against the *de jure* constitutional definition of a party since it shadowed party membership along ethnic lines, the Bulgarian Supreme Court allowed for the institutionalization of a representation mechanism for the sizable and economically hurt Turkish minority. In essence, the Supreme Court served as the institutional veto point that prohibited the emergence of exclusionary politics as was the case in many of post-Yugoslav republics. It did so by resisting the political pressures of the BSP to outlaw the MRF, thus signaling its intentions that the exclusionary and discriminatory policies that the BSP would not be allowed to institutionalized in the post-Communist context.

Under these conditions, the MRF managed to become a power broker in the Bulgarian government. Despite the fact that the UDF won the parliamentary elections in 1991, it did not gain a clear majority and thus was able to govern only with the acquiescence of the MRF, which had become the third largest party in Bulgaria. In 1993, the MRF led strikes for higher tobacco prices in order to pressure the caretaker government to

increase revenues that would cushion the transition to the market, and Dogan opportunistically supported a deal together with the UDF and BSP to construct a gas pipeline from Russia to Greece through Bulgaria under the assumption that Russia could be paid partly through sales of Bulgarian tobacco (EIU, 1993).

At first there was very little pressure on the party elite from the Turkish constituency to reduce poverty rates and the declining economic prospects of the Turkish minority. But in the 1997 election, the party split over party elite power struggles. (EIU Q21, 1997; EIU Q3, 1997). Now the MRF is behaving like a normal, interest-based party in democratic competition, and cultural conflict in Bulgaria is attenuated.

A role for the European Union in attenuating ethnic tension in the Balkans?

Political institutions that mitigate ethnic conflict may not only be domestic; they can also be regional and international. The Greek example illustrates the economic role of the EU in attenuating ethnic strife. Community Development and the Regional Development Funds have played a key role in generating much needed investment resources for the implementation of infrastructural projects that have attenuated ethnic tensions in Thrace. These EU resources have increased the Greek government's ability to provide domestic entrepreneurs and foreign firms with attractive and generous tax incentive packages that have increased the attractiveness, and consequently have contributed to the renewed economic growth of the region with increased employment and development opportunities for the Turkish minority. Further, this EU participation in the economic development of the region has taken the form of concrete and direct measures for the occupational and sectoral transformation of the region. Given the large minority representation within the agricultural sector, the EU has long and actively supported the introduction and implementation of projects that will reduce the region's dependence upon tobacco farming. As in Bulgaria, tobacco is grown primarily by the Turkish minority. An experimental project, funded by the EU, has supported peppermint cultivation because of the better fit to the local climatological conditions, higher prices than tobacco or cotton, more harvest cycles within a given year and the option for mechanized cultivation (*Financial Times*, 17 January 1995). The comparison with the Bulgarian situation is particularly apt because of the common agricultural profile (a large dependence upon the declining tobacco crop and a large minority segmentation within that sector) as well as the need for economic adjustment to the international market. Hence, it becomes increasingly clear that membership of the European Union, with its vast array of development and adjustment funds, has provided Greece with viable mechanisms for dealing with moribund and inefficient sectors, which face increased negative effects from participating in the

international market, in a remarkably effective and smooth fashion, despite the obvious ethnic tensions. In other words, Greece has been able to deal with the Turkish tobacco farmers without the rise of an MRF within the county.

EU membership has also meant the increased institutionalization of minority rights legislation and protection with the domestic institutions of Greece. This increased institutionalization of the protection of minority rights has taken the form of increased respect for private property rights, the unbiased allocation of credit and the elimination of restrictions upon the commercial practices of the Turkish ethnic minority which have increased the chances that this minority will avoid a process of occupational segmentation and socioeconomic marginalization. More specifically, under pressure from the EU, all of the restrictions that had been placed on the Turkish ownership of land and property, once argued as the only viable policy given the uneasy relations between Greece and Turkey, have been removed. Similarly, access to state-owned bank loans has become non-discriminatory, and tractor ownership has been deregulated as well. Indicative of the changes in the regional legal restrictions is the following: "The bureaucracy has grown much more responsive to the minority in the past year. You put in your application for whatever it may be and get an answer in days, instead of the endless delays and prevarication there used to be," says Mr Abdulhalim Dede, secretary of the mufti's office in Komotini (*Financial Times*, 4 November 1992). Although all these institutional changes cannot be entirely attributed to the existence of EU-level pressures for the protection of minority rights, as the local Turkish political leaders have claimed, the role of EU membership has served to increase the incentives for the Greek state to adhere to international treaties about minority rights protection by increasing the institutional fora in which Greek citizens of Turkish origin can protest. A similar case can be made about the minority protection and non-discrimination clauses that exist within any kind of accession agreements with Eastern European countries vying for EU membership.

Conclusion

Why did Yugoslavia and Bulgaria, which had similar societies and suffered similar pressures of globalization, take such different paths in terms of ethnic conflict and social integration? The answer lies in the role of political institutions. In contrast to Yugoslavia, Bulgaria did not develop a system of ascriptive resource allocation. Therefore, the collapse of central control in the face of economic crisis did not leave ethnic or sectarian political entrepreneurs with internal resources to exchange for political support (the BSP may be an exception here). Nonetheless, in Bulgaria, given the "cultural division of labor" under which Pomaks and Turks were largely employed in uncompetitive and inefficient tobacco industries and farming, a transition to

a market economy left a disproportionate number of Muslims unemployed. Economic hardship made them available for reassignment to a new political identity, and sectarian political entrepreneurs attempted to cash-in on the discontent in an effort to gain political support. With only a Turkish or Pomak “identity” and no material resources to offer, however, his efforts were less than successful.

Yugoslavia experienced the opposite outcome. The system of regional resource allocation had provided ethnic entrepreneurs with tangible resources to exchange for political support. Economic factors thus explain the decision to exploit cultural grievances for political advantage, but institutional incentives and constraints explain whether support is forthcoming. Without those resources, political entrepreneurs cannot establish an alternative political authority and must establish themselves with other political elites in political competition.

The lesson of these two tales is that political institutions of participation and resource allocation must mediate the domestic impact of the forces of globalization in multi-ethnic societies in order to maintain social harmony. Institutional channels can be constructed to ensure that social cleavages will be cross-cutting and not reinforcing. Markets can sever patronage networks. Institutions can be created that both depoliticize and respect cultural identity. These kinds of institutions must form the basis of post-Communist states as they integrate into the global system if the incentives for intercultural cooperation are to outweigh the incentives for cultural conflict.

Notes

- 1 I would like to thank Matthew Krain and Peter Katzenstein for helpful comments on an earlier draft of this chapter. I gratefully acknowledge the assistance of Nick Bizouras in the research and writing of this study.
- 2 A similar point is made by Solnick in Chapter 7 in his analysis of the strategies that the regional leaders have pursued in their attempts to increase their power vis-à-vis the federal center in post-Communist Russia.
- 3 Political entrepreneurs resemble their economic counterparts in that they seek to maximize their individual interests and in doing so, have an effect on aggregate interests. The political entrepreneur seeks to maximize political power, while the economic entrepreneur seeks to maximize wealth. But like their economic counterparts, political entrepreneurs engage in risk-taking behavior to maximize their returns. See La it in (1985), Brass (1976) and Solnick (Chapter 7 of this volume).
- 4 The ability of the federal center to drastically change the social contract is vividly illustrated in Yang and Su’s analysis of the mechanisms that the Chinese federal center used to change regional patterns of foreign direct investment and to enter into the process of partial marketization (see Chapter 1 of this volume).
- 5 For elaborations on this argument see Bhalla, 1994; Whitehead, 1995; Geddes, 1994.
- 6 Benjamin Barber (1995) makes similar connections, although his logic of explanation diverges from the logic presented here. He argues that economic

- globalization also globalizes politics by creating new sources of dominance, surveillance and manipulation, thereby weakening the nation-state.
- 7 This argument is forcefully presented in Solnick's analysis of the travails of the federal center in post-Communist Russia to create some kind of exit option from its chronic fiscal crisis.
 - 8 Susan Bridge (1977:345–47) argues that the structure of formal political representation throughout the post-war period discouraged minority participation and representation through the single-member district in both party and government. But the single member district worked to the advantage of minorities in two defined regions where the “nationality” was a majority of the population. After the constitutional changes of 1974, Kosovo, with a majority Albanian population, and Vojvodina, with a majority Hungarian population, gained increasing autonomy throughout the post-war period and enjoyed equal participation at the federal level with the same representative status as the constituent nations. Kosovo would become a trigger for the wider conflict that ensued.
 - 9 In the period 1970–76, inter-republican trade in goods dropped from 27.7 percent to 23.1 percent of the national social product, while in 1981, 66 percent of all trade was intra-regional and only 22 percent was inter-regional, with only 4 percent of all investment crossing republican and regional borders. See Dyker (1993:74–5) and Tomc (1985:58–77).
 - 10 The Turkish minority has always been part of the modern Bulgarian state. The latest census (1992) calculated 86 percent Bulgarians, 9.5 percent Turks, 3.5 percent Gypsies and 1 percent other.
 - 11 The literature on these transitions is vast. Examples include: Schmitter and Karl (1994); Przeworski (1991); Remmer (1990) and Karl and Schmitter (1992).
 - 12 The material in this section is taken from Hayden, 1995:65–8. The House of Representatives has forty-two members, two-thirds of which must come from the Muslim-Croat federation, and one-third from the Serb Republic of Bosnia. The House of Peoples consists of fifteen members, five Serbs, five Croats, and five Muslims.
 - 13 The BSP is the former Communist Party, formerly named the Bulgarian Communist Party.

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Responding to globalization

A conclusion¹

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Economic globalization—the increasing integration of factor, input and final product markets across countries, coupled with the increasing salience of the international value-chains created by multinational enterprises (MNEs) in international economic flows—is reshaping policy landscapes. Because of globalization, societal actors everywhere are faced with new opportunities and challenges. There are both “winners” and “losers.” Everyone is trying to maximize the gains and minimize the losses associated with globalization. This volume examined the strategies of governments and firms undergoing four types of institutional transitions:

- From centrally planned to market-based economies (in China, Russia, Bulgaria, and Yugoslavia)
- From import-substituting to export-promoting development policies (in Latin America and Australia)
- From developmental to regulatory states (in Japan and South Korea)
- From country-level strategies to regional-level responses (in Latin America and Western Europe)

In the process of examining these four types of institutional transitions, the volume focuses on the role of ideas and interests, as articulated within given institutional and historical contexts. This chapter summarizes what we learned from preceding chapters and identifies questions for future research.

Globalization continues to unfold in a variety of ways. Though there has been a decided tendency towards greater MNE-led economic integration of the world economy in recent decades, the jury is still out regarding the reversibility of this trend. Further, since globalization accelerated after the end of the Cold War, with the sudden opening of the formerly Communist countries to world trade and investment flows, it is not yet clear whether it was globalization that accelerated the collapse of central planning or vice versa.² The collapse of the Soviet empire led to the emergence of new democratic political systems in Central Europe, whose economies were still in the process of making the transition from central planning to markets,

while also permitting suppressed inter-ethnic tensions in these formerly Communist countries to come to the fore. As Solnick (Chapter 7) and Crawford (Chapter 8) pointed out, the need to deal with the problems of nation-building has significantly constrained national governments of former Communist countries from responding effectively to globalization.

The Anglo-Saxon model of capitalism—the “regulatory state”—favors resource allocation through markets rather than central planning and frowns upon the making of industrial policies by state bureaucracies in alliance with *keiretsu-like* industrial groupings, which is referred to as the “developmental state” (Johnson, 1982). The regulatory state requires that contracts be negotiated and enforced at low costs. Common accounting standards and a well-established contract law that enables clear definition and enforcement of property rights are essential. At the macro-economic level, it also requires that governments minimize their intervention in the economic activity, deregulate, privatize, and reduce budgetary deficits.

In contrast with the regulatory state, the developmental state attempts to intervene in the market to improve the competitiveness of individual firms or industries that state bureaucrats think are vital to national security and the economic competitiveness of the nation. The developmental state, like the regulatory state, requires the rule of law and the protection of private property rights in business matters and works to reduce the costs of negotiating and enforcing contracts. But at the same time, the developmental state is much less likely than the regulatory state to require consistency and transparency in accounting methods. Because of the promanufacturing bias, it is considerably more prone to collusive and potentially predatory business practices, and to the use of bribery and other corrupt practices on the part of businesses to secure the cooperation of powerful state bureaucrats.

One of the most important lessons of the post-war era was that it was possible for the economies of industrialized countries with both regulatory and developmental states to grow at respectable rates while maintaining or enhancing their democratic political institutions. It was not clear, however, whether this would be possible in either the formerly Communist world or the developing countries. Based on the experience of the East Asian newly industrializing countries (NICs), authoritarian developmental states seemed more likely to achieve acceptable rates of economic growth in the rest of the Third World than democratic regulatory states (Haggard, 1990).³ With this thought in mind, the leaders of the Chinese Communist Party agreed to abandon central planning (gradually) without dismantling China’s authoritarian political structures, hoping thereby to benefit from the enormous dynamism of the East Asian regional economy.

Substantial progress was made toward political liberalization in East Asian countries like South Korea, Taiwan and Singapore by the mid-1990s; progress that was not likely to end with the crisis of 1997–98. But faith in the developmental state has declined as a result of the recent crisis, even in

bastions of developmentalism like South Korea. Now countries in every region of the world are trying to decide whether to adopt the regulatory or the developmental model of capitalism in the face of increasing globalization. Most of the former centrally planned economies (China being a notable exception) have emulated the Anglo-Saxon model. However, the implementation of necessary institutional changes has been spotty and its success is by no means guaranteed. Foreign Direct Investment (FDI) has flowed freely into the new China, but not into Russia and Eastern Europe, suggesting that foreign investors are more interested in political stability and the potential for growth than in political liberalization *per se*.

State shrinking, social bargains and domestic peace

Economic growth requires domestic peace. Governments often serve as guarantors of domestic social bargains that bring about such peace. Such bargains could be between agriculture and manufacturing (the policy of “protection all around” in Australia), among different ethnic groups (as in the former Yugoslavia and Bulgaria), or between labor and capital (as in South Korea and Japan). “Soft” and “hard” states have different strategies available to them to ensure domestic stability.⁴ One way to ensure peace is to use coercion. The suppression or cooptation of dissident groups is always an option, but either may sometimes be too expensive. Social bargains that do not require either coercion or cooptation of large disaffected populations are generally preferred. Governments, therefore, have incentives to broker, construct and enforce compacts among competing groups.

These bargains are of many kinds: corporatist bargains in pluralistic institutional frameworks (Shonfield, 1965; Katzenstein, 1985); paternalistic bargains in quasi-pluralistic systems such as Korea and Japan; partyimposed bargains in authoritarian systems. Many bargains involve sidepayments or resource transfers by the government to groups disenfranchised in the political or economic processes. As Crawford described in Chapter 8, governments in Bulgaria and the former Yugoslavia were quite successful in imposing social bargains among different ethnic groups, thereby securing domestic peace. The Bulgarian government provided price supports for tobacco, a major cash crop cultivated by the Turkish minority. Due to the pressures of globalization, and the consequent cutting of government budgets, such programs were withdrawn. As the domestic bargain unraveled, the economic hardships of the ethnic Turks were exploited by “ethnic entrepreneurs” who began to call their situation “ethnic genocide.” Thus, the shrinking of the state as a policy response to globalization can create domestic unrest by enfeebling the main guarantor—the government—of domestic bargains. Why are some bargains more vulnerable to governmental downsizing than others? How do domestic politics and international pressures affect which bargains will be abandoned and which will survive? These are questions for further research.

Crawford suggests that international aid agencies could protect some social bargains by displaying more sensitivity towards human rights and other societal issues. External powers, superpowers or international organizations, could also help to guarantee domestic social bargains. For example, the United States served as the guarantor of the Dayton Accord on Bosnia. The role and obligations of the guarantor and the credibility of its commitments could vary. If an international organization like the United Nations is the guarantor, there are additional issues of organizing collective action and overcoming bureaucratic dysfunctionalities for forceful and prompt enforcement.

Solnick argued in Chapter 7 that although international actors may become more important in enforcing social bargains, they cannot provide all the necessary public goods that governments provide to citizens. Key public services in Russia were provided at the workplace. With the statemanaged enterprises in dire straits and privatization largely unsuccessful, many Russian citizens do not have access to such basic services as healthcare. Undermining the political authority of the government in one sphere often spills over into other spheres. State shrinking as a response to globalization therefore calls out for careful scrutiny, especially when it undermines the basic structures ensuring social peace and stability.⁵

Attracting MNEs

Globalization differs from previous phases of economic integration in terms of key role of MNEs in allocating resources across their cross-border value-chains. In this context, the challenges for governments are both generic and idiosyncratic. Maintaining social peace and making the country more attractive as an investment destination are obvious generic challenges.⁶ Ignoring MNEs implies losing opportunities for acquiring capital and technology, exporting goods, and expanding the tax base. Governments try to attract MNEs in various ways. In portraying their country as an ideal location for global businesses, they try to emphasize resources that are cheap and plentiful. It is not unusual to see advertisements for countries in business newspapers and magazines that stress abundant natural resources, new infrastructure, vibrant capital markets, and inexpensive but high quality workers. Much of this is hype, but each country has to find out for itself what attracts the attention of potential foreign investors and what claims are credible to them.

It is incorrectly believed that governments always dilute their labor, environmental, and health and safety laws to attract foreign investors, which result in so-called “races to the bottom” (Spar and Yoffie, 2000). Such considerations were perhaps important when MNEs invested primarily in extractive or labor-intensive industries. Now, MNEs increasingly focus on high-technology sectors because this is where their “ownership-based”

(Dunning, 1993) advantages lie. Not surprisingly, more than 60 percent of FDI now flows between industrialized countries with comparable levels of labor and environmental laws (UNCTAD, 1997). Since the “traditional” advantages of countries (cheap labor, poorly enforced environmental laws, etc.) are not always highly valued by MNEs, a generic challenge for governments is to devise effective policies to attract this new form of knowledge—and technology-intensive FDI.

The ability of governments to attract new FDI flows will vary across countries and across industries. For example, although both China and Russia have huge untapped markets that MNEs covet, the former is the favored destination for FDI. An explanation offered by the United Nations Commission on Trade and Development (UNCTAD) is that MNEs are attracted to countries with well-functioning market systems, transparent policy-making, and policy stability (UNCTAD, 1996). Since Russia has none of these attributes, it remains unattractive for MNEs. Though China has had stable policies, as Yang and Su described in Chapter 1, its policy-making processes are certainly not transparent, but MNEs are still attracted. There are also other reasons to believe that firms may actually desire direct government interventions—the literature on business “capture” of regulators is well established (Bernstein, 1955; Kolko, 1963; Stigler, 1971). The recent antitrust cases in the United States, especially the case against Microsoft, also suggest that firms (e.g. competitors of Microsoft) eagerly embrace governmental intervention when it benefits them directly.

A more glaring example of opaque decision-making that benefitted MNEs is Indonesia prior to the 1997 meltdown. Indonesia was the second-most popular FDI destination among developing countries during this period. In 1996, it attracted almost \$8 billion of FDI (UNCTAD, 1997). MNEs greatly profited from the privileged access to policy makers in Indonesia. Crony capitalism, now a favorite whipping boy of reformers, constituted an institutional device for reducing the transaction costs associated with managing host-MNE relationships.⁷ Thus, one of the important lessons we learned from Chapter 1 is that MNEs may not always desire transparent policy-making.

However, Russia also seems to be experiencing crony capitalism but has not attracted significant FDI. As Solnick described in Chapter 7, Russia tried to impose a market economy on a non-market society in a fractured political space. Two salient features of Russia’s transition were the overly rapid selling off of state enterprises to MNEs and reckless levels of external borrowing. The “reformers” portrayed privatizing state enterprises and acquiring foreign debt as a quick and effective means of injecting new capital and managerial and technical know-how into the Russian economy. Because many state enterprises were sold to private investors at bargainbasement prices, there was a nationalist backlash. This contrasts directly with the Chinese government’s cautious supervision of the privatization process and its

reluctance to sell off state enterprises in sectors such as telecommunications and energy to foreign investors.

Clearly, domestic political constraints in Russia, coupled with the inept leadership of Boris Yeltsin, led to ineffective policy responses. To gain the support of the subnational constituencies, Yeltsin rapidly dismantled the economic and political power of the federal government. The state shrank just at the time when Russia needed the state to create confidence in newly adopted market institutions. Some observers refer to what happened as “spontaneous privatization” (Boycko, Shleifer and Vishny, 1995). By rapidly shrinking the state, Yeltsin made it impossible for his government to sustain the original coalition that supported domestic economic reforms and the leaders that followed Yeltsin were likely to abandon some of the earlier reforms. It is not surprising, therefore, that foreign investors preferred China to Russia as a site for new investments. Both systems lacked transparency, but the Chinese market and political environment appeared to be more stable and predictable. Thus, additional lessons learned from this volume are that: (1) governments should not let themselves be used as pawns in global interfirm warfare; (2) policymakers need to carefully scrutinize claims that everyone wins or loses when foreign investment flows into a country (a case-by-case approach is preferable); and (3) governments need to retain policy autonomy to maximize the benefits of FDI flows and to safeguard the interests of non-business societal actors even in the thinnest of regulatory states.

The end of the developmental state?

In the early stages of development, economic growth depends on resource mobilization—the intensive use of resources (Krugman, 1995). China is still at this stage. Different challenges emerge as countries enter the next phase of development in which growth in total factor productivity (TFP) is required. Korea, Japan and Australia, are at this stage. TFP growth requires structural changes in the domestic economy. Achieving internationally competitive high-volume production of industrial goods and consumer durables requires a new set of supportive practices and institutions. It is possible to catch up with the industrialized countries if the resources of the state are combined with those of large private enterprises to reduce the risk of introducing new technologies, transfer the necessary knowledge and skills to the workforce, and maintain social peace during the difficult transition from earlier institutional arrangements.

The South Korean and Japanese developmental states were successful in fostering the growth of internationally competitive businesses in many important industries, including high-tech electronics, until the beginning of the 1990s. Then they began to stumble. In the last two years, domestic political actors in the two countries began to seriously propose reforming the system to deal with the following developments: (1) the weakness of

domestic financial institutions in the face of a sharp increase in non-performing loans; (2) overcapacity in mainstay industries like shipbuilding, textiles, steel, autos, and semiconductors (especially DRAMs), (3) the relative uncompetitiveness of the larger firms in new markets for software and Internet-related products and services, and (4) the tendency of large US and European MNEs to establish international alliances with smaller Asian countries to compete with Japan and South Korea in manufacturing industries.

Chung-In Moon suggested in Chapter 2 that Korea was unable to undergo a transformation toward a regulatory state quickly enough to effectively respond to globalization. Marie Anghodoguy reached a similar conclusion in her examination of the Japanese software industry in Chapter 3. Though Australia scaled back “protection all around” and liberalized, fiscal and current account deficits grew rapidly. As John Ravenhill noted in Chapter 4, the electorate was unwilling to live with further liberalization that led to structural changes. With the social bargain weakening due to the dilution in “protection all around,” there was a growing support for extremist, anti-immigrant, and anti-trade liberalization sentiment. Domestic interest groups favoring changes in markets and corporate governance were not sufficiently mobilized, organized, or powerful in those countries. International pressures can empower such groups only up to a point. As the continuing stalemate in the three countries suggests, domestic politics becomes a key variable in shaping the nature, pace and sequencing of responses to globalization.

The recent reforms in South Korea indicate that governments can still force significant changes in their domestic economies. The Korean economy is dominated by *chaebols* whose close alliance with politicians and bureaucrats brought them easy access to cheap bank credit and a protected home market. The recent crises generated demands that the Korean government restructure the *chaebols*, and it is doing so through forced divestitures, mergers and asset swaps, and even closures of firms. The objectives are to reduce excess capacity and to force the *chaebols* to focus on core activities where they can be competitive internationally. Further, President Kim Dae Jung—who represents the political interests of small and medium industries, the mid and western region of the country, and the workers—took over in 1998. The previous ruling coalition represented the *chaebols*, the eastern region, and conservative forces. President Kim Dae Jung would obviously like to reduce the power of the constituencies that oppose him.

Many *chaebols* oppose President Kim Dae Jung’s policies. The government has threatened that banks, several of them now nationalized, will cut off funding to *chaebols* unless the restructuring goes through. The threat is credible because historically the government has employed its control over credit to channel investment into critical areas. The restructured automobile industry now has two players (previously five);

Hyundai alone holding 64 percent of the market. Daewoo, the other remaining player, has swapped its electronic business with Samsung's automobile business. Consequently, Samsung now holds 60 percent of the domestic consumer electronic market and internationally it controls the production of 30 percent of microwave ovens, 18 percent of videocassette recorders and 10 percent of televisions (*Wall Street Journal*, 1998a).⁸ It is therefore clear that the Korean government retains the abilities, and has the political incentives, to reconfigure market and corporate governance at the macro level and business strategy at the micro level. Though it does not directly manage firms, it does play the role of an "orchestrator of resources" (Stopford, 1997).

Domestic politics remains important

Globalization processes by themselves cannot solve domestic problems, structural or institutional. They can create "demands" for policy changes but cannot fully supply them. Domestic institutions can also block the signals from the international system, thereby moderating the perceived demands for change (Evangelista, 1996). The "supply" is critically dependent on domestic politics, the incentives for governments to act, and their abilities to do so. The latter is influenced by the character of the state-societal relationships, and their abilities to rally a winning coalition.

In the early 1990s, South Korea partially deregulated the domestic economy ostensibly for responding to globalization. In reality, the commitment to domestic reforms was superficial: the globalization platform merely replaced the previously popular democratization platform. Haphazard and incomplete globalization sowed the seeds of the current crisis. Due to easier access to foreign funds, Korean banks and manufacturing firms accumulated short-term debt, unhedged. The government failed to supervise the debt binge; when the crisis struck, it could not even quantify the level of country's indebtedness. The use of globalization as a political slogan, and embracing market processes without an institutional framework to govern them, proved disastrous.

Why did the Korean political economy not permit such changes? Perhaps Korea was entrenched in protectionism. It was difficult to discard the *chaebol-based* system that propelled it to impressive prosperity. Success was its own enemy. It required enormous foresight and political will to abandon the developmental state in favor of untried institutions. Future research could examine why the Schumpeterian gales succeed in creatively destroying only in some cases. How can "creative destruction" be differentiated from destructive destruction, *ex ante*? Or, should this be left to be determined by the market, *ex post*? Do markets differentiate creative destruction from destructive destruction? If market processes succeed best in democracies, how can democracies resist populist pressures to avoid creative destruction? Governments, therefore, need to carefully select aspects of globalization

processes that they wish to adopt for the domestic economy. Changes should be ushered only when institutional structures are in place.⁹

From country-level to regional-level responses to globalization

Globalization processes are undoubtedly redefining the essence and the purpose of national boundaries and the roles of governments. This volume suggests that governments continue to play a major role in shaping countries' responses to globalization but differ in their abilities to choose policy instruments, their sequencing, and the pace of implementation. Governmental responses show significant variations: partially or completely withdrawing from direct (privatizing government-owned firms) or indirect (downsizing welfare) participation in economic activity; outsourcing the production of public services (for example, privatizing prisons); deregulating or liberalizing but retaining regulatory and rule-making powers; transferring decision-making and regulatory powers to supranational or subnational authorities where national governments only indirectly play a role (creation of regional blocs such as the NAFTA).

Fratianni (Chapter 5) argued that the euro signifies a transfer of sovereignty: eleven countries of the European Monetary Union (EMU) have voluntarily ceded control over an important arena of state sovereignty—the power to issue currency. The euro is predicted to enable them to better face the challenges of globalization by catalyzing structural changes in the systems of industrial organization. With only one currency, European companies will not be able to hide their substandard performance behind national currencies. Since cross-border acquisitions within the euro zone will no longer be subjected to currency risk, such firms may be more vulnerable to being taken over and, as a result, managers will focus on maximizing shareholder value. This could redefine the relationship between labor, capital and other stakeholders of firms. The European system of industrial organization may then adopt some aspects of Anglo-Saxon capitalism.

Of course, the euro project has political dimensions as well. Externally, an economically integrated Europe (the euro being one dimension of it) is a stronger political actor in world affairs, and internally it binds Germany closer to its European neighbors. Both of these serve political and security objectives of national governments: giving up sovereignty in one issue area could have payoffs in others. The euro project clearly illustrates that governments matter, even when they are strategically retreating from some areas.

International system and policy responses

The 1990s are different from the previous decades since the end of World War II, not just in witnessing the end of central planning but also in

experiencing a major increase in flows of short-term capital. Increased flows of short-term capital to the Third World and the formerly Communist countries are a mixed blessing. On the one hand, these capital flows can add to the overall level of investment and thus can contribute positively to economic growth. On the other hand, nervous investors holding short-term assets are prone to extract their funds when anything appears to be going wrong. Long-term investors, in contrast, will liquidate their investments only when economic crises are deep and prolonged.

The fluctuations in the international economy in the 1990s connected with the growing importance of short-term capital flows have created some ironic situations. The Peso Crisis in Mexico in 1994 posed major problems for the international system and particularly for the United States. The devaluation of the peso caused short-term investors to extract a great deal of capital from Mexico and from several other countries in Latin America. The United States had to assemble a very expensive bailout package to prevent political and economic chaos in Mexico. The Asian Crisis of 1997 left South Korea and several other East Asian countries nearly bankrupt, while promoting China (a much poorer country) to the role of regional stabilizer.

There remains a high degree of interdependence among the major industrialized economies even though the fragility and volatility of the global economic system is increasing. In this unstable environment, international organizations, especially the IMF, have become more important than ever before in shaping country-level policies.¹⁰ In his testimony to the US House of Representatives on the world financial crisis, Alan Greenspan noted:

This burgeoning global system has been demonstrated to be a highly efficient structure that has significantly facilitated cross-border trade in goods and services and, accordingly has made substantial contributions to standards of living worldwide. Its efficiency exposes and punishes underlying economic weaknesses swiftly and decisively. Regrettably, it also appears to have facilitated the transmission of financial disturbances far more effectively than ever before.

As I testified before this committee three years ago, the then emerging *Mexican crisis was the first such episode* associated with our new high-tech international financial system. *The current Asian crisis is the second....* Once the web of confidence which supports the financial system is breached, *it is difficult to restore quickly....* Moreover, investor concerns that weaknesses revealed in one economy may be present in others that are similarly situated means that the *loss of confidence can quickly spread to other countries....* At one point the economic system appears stable, the next it behaves as though a dam has reached a breaking point and water (read confidence) evacuates its reservoir.... *The abrupt onset of such implosions suggests the possibility that there is a marked dividing line for confidence.* When crossed, prices slip into

free fall—perhaps overshooting the long-term equilibrium—before markets will stabilize.

(1998:1–4; emphasis added)

How does the international system empower or enfeeble government in responding to globalization? Korea makes an interesting study. The waning of the Cold War in the 1980s and the burgeoning trade deficit led the United States to pressure Korea for trade and FDI liberalization. Not surprisingly, the *chaebols*, the beneficiaries of the protectionist system, opposed it. However, South Korea wanted OECD membership and liberalization was required for it. Due to the pressures from the *chaebols*, financial and trade liberalization preceded FDI liberalization—FDI liberalization threatened them on their home turf while financial liberalization gave them resources to build manufacturing capacities. Easy access to foreign funds created highly leveraged (high ratio of debt to equity) banks and manufacturing firms.

The recession in Japan and the lackluster economic growth in Europe made international fund-managers keen to invest. But debt eventually has to be paid back. The short-term debt, unhedged, was either diverted to real estate (that does not earn foreign exchange) or to industries with global excess capacities (hence low potential for generating export earnings). Thus, some fundamentals of the Korean system were weak. Thailand was first to crumble in July 1997. The baht's depreciation threatened the competitiveness of its neighbors, especially Korea and Indonesia. The speculators reasoned that neighboring countries with similar fundamentals would soon be forced to depreciate. The run on various currencies began, forcing their depreciation.

Why did the international system not force the yen's depreciation or a free fall of the Japanese economy? For one, Japan has had a consistent trade surplus since the 1980s. Second, Japan does not compete with most Asian countries (Korea and Taiwan being exceptions) because it has moved up in the value-chain. The wave of currency depreciation in East Asia did not make its imports uncompetitive. They did impact Japan, however, by shrinking the market for its exports to East Asia. Further, since Japanese banks were major lenders to these countries, the crisis further undermined the financial health of the Japanese financial sector.

Japan was more successful than Korea in resisting US pressures to open up the domestic economy for trade and investment for many reasons. Unlike Korea, its economy is more at par with the US economy. It was a major investor in US treasury bills that financed the budgetary deficits of preClinton days. It is relatively less dependent than Korea on the US for its national security. It was also the major engine of growth in East Asia, an import economic and military region for the US. The US could, therefore, not dictate the pace of liberalization to Japan to the extent it could do for Korea.

China did not competitively devalue its currency, the *renminbi*, although its exports competed with those of its Asian neighbors. How did the international system empower China to achieve this glory? China has many advantages over Korea in determining the pace of economic liberalization. It is a large market coveted by US firms. Due to significant FDI inflows of US MNEs such as Boeing and Motorola, it influences US domestic political processes (see the debates on the renewal of the Most Favored Nation status). Militarily, it significantly impacts US interests in East Asia (especially North Korea and Taiwan), Iran (missile sales), and the Middle East. Thus, the US is not able to force its vision of globalization onto China. Also, China does not have full convertibility on its capital account. This, coupled with its substantial foreign exchange reserve, empowered it to assume the role of a stabilizer.

Australia also retains a degree of autonomy in shaping its policy responses since it is already an OECD country and not dependent on the US for exporting its products. Further, though it has a military alliance with the United States, and is protected by its nuclear umbrella, it faces no imminent military threats that would require US intervention on its behalf.

International organizations such as the IMF are increasingly establishing parameters (sometimes dictating specific policies as well) within which governments decide on policy responses. The role of international credit agencies, for-profit firms providing evaluations on the financial health of firms and countries, has also come under scrutiny, especially their role as the “eyes and ears of financial capital.” Moon, for example, blames them on two counts: first, for failing to give warnings about the precarious financial health of the Korean banks and firms, and then for aggressively downgrading credit ratings after the start of the crisis. The market overreaction and panic that resulted was out of proportion to the fundamentals. Moon attributes at least some of this overreaction to the raters’ precipitous actions.¹¹

A country’s vulnerability to credit ratings is a function of many variables including the level and character of its external debt, especially the shortterm debt. An important area of future research, therefore, would be to examine how such rating agencies can be made more accountable and to whom. International rating business is not perfectly competitive where the bad raters are punished by “consumers.” If raters incorrectly rate financial instruments of a country or firm causing them significant financial losses, the “victims” cannot sue and recover damages. The new architecture of international financial governance must have mechanisms to ensure the accountability of credit rating firms. This means, for example, that international financial institutions may have to provide their own independent ratings services as a check on the arbitrariness of the private raters.

Ideas and norms

Market-based economies succeed only if transaction costs of securing property rights are low. Transaction costs are the costs of negotiating, monitoring, and enforcing contracts (Eggertsson, 1990; North, 1990). Transparent, simple and clearly laid out laws, however, cannot provide guidance for every contingency. Contracts therefore need to specify rights to residual control, that is control over contingencies that have not been written into contracts. Williamson (1985) argues that market failures due to unforeseen contingencies, coupled with “asset-specificity” and opportunism, can be dealt with by vesting residual control with hierarchical superiors.¹² However, as Williamson’s critics point out, this only replaces market failures with hierarchical failure (Miller, 1992). Dealing with uncertain contingencies requires that managers be vested with the residual power, but giving them such power could lead to hierarchical abuse. Thus, norms create a climate of trust that ensures that creating mechanisms that bestow authority and at the same time check its abuse, do not make transactions unviable.

This discussion suggests that markets are not impersonal arenas where anonymous actors transact. Markets are social institutions and the role of widely shared and legitimate norms is crucial in the evolution of rules of governance. Market economies, therefore, require sets of norms to reinforce and supplement formal rules.¹³ Since norms cannot arise and gather legitimacy overnight, policymakers should not assume that wellfunctioning markets can be created merely by the decree of the IMF or any other international institution.

Ideas and norms impact how policymakers respond to globalization in three ways (Goldstein and Keohane, 1993). As “world views,” they suggest economic and political models to policymakers for understanding the etiologies and implications of globalization and for thinking about generic responses to them. Many think the Anglo-Saxon model of capitalism (or the regulatory state) is the way to go, while others defend import substitution or the developmental state as models. Second, as “principled beliefs,” ideas provide normative underpinnings to response strategies. For example, are the societal objectives of efficiency and economic growth that are prioritized in the Anglo-Saxon model of capitalism desirable? Or, are the societal objectives of developmentalism—a bias towards international competitiveness in manufacturing, cooperation between government and industry, and the subordination of consumer interests to the interests of “catching up”—superior to those of the regulatory state? Finally, as “causal beliefs,” ideas explain why specific features of globalization are posing challenges, and the expected outcomes if certain policies were to be adopted to deal with them. For example, the Anglo-Saxon model requires flexible labor markets. Thus, ideas about labor market flexibility must inform policymakers how and why it will impact economic growth and wage rates, thereby influencing strategies to respond to globalization.

Often there are multiple ideas about the efficacy of a given response strategy and about the desirability of its societal goals. How do policymakers choose from competing ideas? Do ideas impact policy only if they are championed by influential actors? If so, are ideas epiphenomenal? This volume suggests that neither ideas nor interests are epiphenomenal. Ideas about responding to globalization influence preferences of actors on policy alternatives, and vice versa. Thus, ideas and interests together shape responses to globalization (Goldstein and Keohane, 1993).

Though the acceleration of MNE-led market integration—globalization—predates the ending of the Cold War, globalization processes began receiving serious scrutiny only in the 1990s. Predictions about the arrival of the so-called “new world order,” where economic issues take precedence over security issues, focused attention on the causes and the implications of economic integration. It should not be forgotten that in the 1980s, many scholars were writing epitaphs for Anglo-Saxon capitalism and proclaiming the virtues of Japanese “alliance-capitalism” (developmental state). Thus, popularity of various “world views” fluctuates. We are not suggesting that there is a “flavor of the decade” and we can expect a new version of capitalism to be on the ascendancy in the next decade. We only advise caution about jumping to conclusions quickly about the “end of history” (Fukuyama, 1992) regarding competing “world views” on market and corporate governance, even in a world devoid of central planning. It is much more likely that the debates on how to organize capitalist systems will continue and will shape the next generation of international economic institutions (Berger and Dore, 1996).

Like products, ideas have a life-cycle. New ideas, or repackaged old ideas, focus attention on pressing problems and force policymakers to confront them. New ideas may also arise to solve both existing problems or new problems. As we approach the end of the 1990s, with the buoyant US economy, the crisis in East Asia and Japan, and the discrediting of centralized planning, the Anglo-Saxon version of capitalism and the regulatory state that is consistent with it are more popular today than they were prior to 1989. Not surprisingly, as the various chapters suggest, policymakers are attempting to create the correct conditions for the effective functioning of this type of capitalism. However, as the Australian experience demonstrates, the regulatory state cannot solve many of the economic problems created by the jettisoning of import substitution and is being discredited in that country (and possibly elsewhere). The Russian experience suggests that it is difficult to dismantle a system based on central planning and replace it with a regulatory state in societies that are accustomed to highly centralized forms of economic and political organization.

Identity and policy responses

Perceptions about and responses to globalization are also significantly

impacted by shared notions about identities. Though identities shape responses, they are in turn also influenced by them. Moon suggested that the South Korean identity reflects xenophobia and paranoia, both of which can be attributed to its proximity to two big powers—China and Japan. In part, Korea’s protectionist developmental state model was predicated on the national desire to be self-reliant. The jettisoning of this model is, therefore, meeting with internal resistance. Crawford discussed the role of “identity politics” in shaping the Bulgarian and Yugoslav perceptions about globalization and responses to it.

The euro exemplifies the impact of identity politics on policies.¹⁴ As Fratianni argued, it is a regional Western European response to currency globalization. The euro project has been made possible by a number of steps taken since World War II to foster a European identity by integrating Western European economies. The euro is a political project as well:

Finland is a clear example of what the euro is really about: politics. Germans will rhapsodize about the benefits of economic harmonization, but former Chancellor Helmut Kohl pushed for the euro in the sincere belief that it was the way to avoid another war with France. In France, the euro is seen as a way to get a bigger voice on the world stage. For Ireland, the new currency gets it out from Britain’s shadow. When Italy was threatened with exclusion from the initial wave of countries participating in the euro, it used a political argument to get in: “Europe without Italy is not Europe,” Italian Prime minister Romano Prodi said.

(Wall Street Journal, 1998a: A1)

The euro experiment is noteworthy because it tests the efficacy of regional response where national governments willingly surrender an important aspect of state sovereignty: control over currency. Since a common currency without a political union has not been successfully tried before, the EMU members have taken a significant risk. These risks stem from the insufficient economic integration of euro countries among themselves. Due to different structural compositions of the national economies, at any point in time they could experience different phases of the economic cycle and asymmetric external shocks (that is a function of the level and nature of their integration with the non-euro economies).¹⁵ With monetary policymakers located in Frankfurt, national governments will not be able to employ monetary policy to pursue domestic objectives. For example, for Finland, the euro-zone accounts for only one-third of its exports. Unlike France and Germany, where manufacturing and high-technology industries dominate the economy, Finland relies on the primary sector, forestry alone accounting for 40 percent of its exports. Thus Finland’s structural constraints differ from the euro partners’. Yet, it enthusiastically embraces the euro due to political reasons and its need to identify with Europe, and not Russia which has traditionally

dominated it. The euro is a fascinating institutional innovation to collectively respond to globalization. An important area of research is to what extent the euro contributes to the evolution of a European identity, and whether such an identity impacts the competitiveness of European companies in the world markets. As Robles argued in Chapter 6, an evolution of a “regiocentric” mind-set among the managers of Latin America firms could give them competitive advantage versus the MNEs that cannot fully appreciate the idiosyncratic demands of the market. It remains to be seen if such an argument holds in the European context as well.

To conclude, this volume suggests that globalization processes are recasting opportunities and threats faced by governments and firms. How policymakers comprehend the challenges and respond to them, cannot be understood by reductionist explanations. It can be understood only by engaging in the kind of research that typifies the chapters in this volume: careful examination by experts in specific countries and regions who are informed by a sophisticated conceptualization of globalization. Such research requires a careful examination of the interests and ideas of key actors, and how they are articulated within given institutional and historical contexts. We hope that this volume represents a start in the right direction.

Notes

- 1 We thank the anonymous reviewers for their input. Research and editorial assistance of Jun-ho Kim and Jennifer Baka is gratefully acknowledged.
- 2 Some argue that the Soviet system collapsed primarily because it could not cope with the pressures of globalization (Kort, 1992; Castells and Kiselyova, 1995; for a review see, Reuveny and Prakash, 1999). This chapter does not examine the merits of this argument.
- 3 The issue of the impact of political systems on economic growth is complex. For a review see, Diamond (1992) and Przeworski and Limongi (1993).
- 4 Mastanduno, Lake and Ikenberry (1989) classify states as “soft” and “hard” based on their relationship with domestic societal actors, and as “weak” and “powerful” in terms of their relationship with the international system. They criticize Wallerstein (1974) for the notion of “weak” and “strong” states since it does not distinguish between domestic and international dimensions of state strength.
- 5 On the relative advantage for governments to provide redistributive services that contribute to domestic peace, see McGinnis (1999).
- 6 FDI is often viewed to ease balance of payment (BOP) deficits. Anchordoguy (Chapter 3) and Moon (Chapter 2) have pointed out that Korea and Japan have resisted FDI inflows. Japan does not require FDI inflows because it has had a BOP surplus since the mid-1980s. Though Korea has had a BOP deficit since 1990, it relied on short-term capital inflows to meet the deficit.
- 7 For example, US energy firms succeeded in securing huge contracts in Indonesia due to their alliance with the “crony capitalists” (*Wall Street Journal*, 1998b).
- 8 The restructuring program hit the first major roadblock when the LG Group refused to submit to the government-favored merger of LG Semicon Company with Hyundai Electronics Industries. However, with the banks threatening to

- recall loans from the company, the LG Group relented and submitted to the government-sponsored restructuring plan. The merger will form the world's second-largest manufacturer of DRAM (dynamic random access memory) chips (*Wall Street Journal*, 1998c; *New York Times*, 1999).
- 9 There is a huge literature on the causes of the East Asian crisis and the responses to it. The IMF has been criticized for forcing governments to raise interest rates for stemming currency depreciation and to undertake budgetary cuts. However, all agree that high-leverage of banks and firms was a key structural weakness of these economies. For a review of the key issues, see Sachs (1997), Fisher (1998), IMF (1998), Greenspan (1998) and Prakash (1999).
 - 10 Key IMF policies require support from 85 percent of its shareholders. Since the United States holds 18 percent of IMF's shares, it can veto such policies. Hence, the IMF is correctly viewed to toe the US line.
 - 11 Sachs (1997) views the IMF as the other culprit since it coerced countries to sharply increase interest rates.
 - 12 Williamson's argument has been extensively debated. For a critique, see Ghoshal and Moran (1996); Perrow (1981).
 - 13 The literature on this subject is rather vast. Key works include Commons (1934); Coleman (1988); North (1990); Ostrom (1990); Putnam (1993); Taylor (1993).
 - 14 Effective January 1, 1999, the euro replaced the European Currency Unit (ECU), a basket of currencies used for a long time in foreign exchange markets, as the unit of account. Though the currencies of the eleven European Monetary Union (EMU) members will continue to remain in use until end 2002, only the euro will be quoted in relation to non-EMU currencies.
 - 15 In this context, see the literature on whether the EU qualifies as an optimum currency area (McKinnon, 1963; Cohen, 1998; Jacquet, 1998).

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