Globalisation Privatisation and Market Economy

Yogesh Kumar Sharma

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PREFACE

Globalisation, privatisation and liberalisation have become dominant forces shaping societies and economies the world over. With the fall of communism and the decline of socialism in most parts of the world. These three processes are interrelated phenomena. Globalised economies are likely to be more privatized and liberalised economies. Globalisation, privatisation and liberalisation are multidimensional phenomena that have implications not only for the economic but also the sociocultural and environmental aspects of countries and societies.

The three phenomena that form the focus of this volume also have differing impacts on different units of analysis. For purposes of understanding and analysing these three forces, the units of analysis can be conceived at regional, country, industry and organizational levels. The chapters in this book deal with all of these, reflecting the multilevel aspects of globalisation, privatisation and liberalisation forces shaping world economies.

One of the major consequences of globalisation, privatisation and liberalisation is the acceleration in foreign direct investment flows. While foreign direct investment has been increasing for some time among the developed triad countries, in recent years it has spread to other parts of the world, especially to the giant emerging economies. The privatisation and liberalization policies pursued by these emerging economies have created new opportunities for foreign direct investment. International investors now face difficult problems such as choosing countries, evaluating risk-return relationships and assessing profitability in private and public sectors.

The Market is about economy. The Market is not what people do and think and how they interact when they buy and sell, give and

take. Instead, it is a conception people have about an idealised form of buying and selling. This conception is important. It is invoked, implicitly or explicitly. It is invoked when the British debate selling state-owned industries or the Common Market or labour legislation. These debates concern many issues and reflect many interests. However, running through them, on one side or another, is a claim and a belief that a certain sort of buying and selling benefits all those involved economically, politically, socially and even morally. And that that is the sort of buying and selling associated with the Free Market. The idea of the Market has many roots, but its most important historical ones are lodged in British soil, in the writings of political economists However, in popular consciousness the idea flourishes best in the United States, with its long traditions of that secular, acquisitive individualism and concern with equality of process rather than of outcome that form part of the Market.

I have consulted various authors and derived much from their thinking and thoughts. I am grateful to them and record my thanks. Also, I thank my family for extending wholehearted support during the compilation of this book. And finally, my thanks are due to Aavishkar Publishers, Distributors for bringing out this book in a pleasing and attractive manner.

Editor

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1

Globalisation, Privatisation and Liberalisation

Introduction

Globalisation, privatisation and liberalisation have become dominant forces shaping societies and economies the world over. With the fall of communism and the decline of socialism in most parts of the world, these processes have accelerated in the 1990s. These three processes are interrelated phenomena. Globalized economies are likely to be more privatized and liberalized economies. On the other hand, privatisation and liberalisation facilitate the process of globalization of a country or a region. Hence, it is essential that these processes be addressed collectively. Globalisation, privatisation and liberalisation are multidimensional phenomena that have implications not only for the economic but also the sociocultural and environmental aspects of countries and societies. The three phenomena that form the focus of this volume also have differing impacts on different units of analysis.

Conceptual Issues

It deals with the concept of globalization taking a broader view of it to include both its economic and political perspectives. It traces

the multidimensionality of the concept and its impacts and explores implications from the perspectives of both the proponents and opponents of globalization. The conceptual exploration addresses the potential socioeconomic problems and conflicts that may result from pursuing globalization policies and practices. The author also identifies the realistic outcomes of globalization in the form of. (1) the end of Western international hegemony; (2) the cultural change; (3) the erosion of national sovereignty; and (4) environmental pollution. In the concluding section it draws attention to the emerging problems of local versus global, globalization and human rights, national identity in a globalized world and, finally, the creation of appropriate new international institutions to facilitate the globalization process.

It explores the privatisation issues based on experiences in Great Britain. Concurrent with globalization of economies and societies, privatisation of public sector enterprises usually follows and intensifies. Privatization is being vigorously pursued in all countries industrialized, newly industrialized, developing and formerly communist countries. However, as Nwanko rightly argues, the traditional categorization of private versus public enterprise has become inadequate. In its place, he introduces the concept of the national enterprise, an emergent organization form that seems to be more relevant in today's global competitive environment.

Countries adopt globalization, privatisation and liberalisation policies and practices so as to accelerate their economic and social development. The environmental and ecological consequences of such unsustainable economic growth could have adverse sociocultural impacts. This chapter discusses various dimensions of globalization, together with its relationship to economic development and its ecological consequences; critically examines the emergence of a new environmental paradigm; and presents the implications of globalization for Third World countries in particular.

Regional Issues

Historically, attempts at regional economic integration have preceded the recent globalization developments. In recent years, at the same time that globalization forces have been shaping the world economies, regional economic integration, both formal and informal,

has intensified. This regional trend raises some troubling questions about the compatibility of regionalism and globalism.

The implications of the emerging regional trading blocs for member and nonmember countries and their enterprises. In particular, they point out that rampant regionalism may be detrimental to those countries that are left out of such regional groupings. They also maintain that closely knit trading blocs may inhibit the emergence of true multilateral free trade on a global scale, which is the ultimate objective of globalization. After presenting the various salient features of NAFTA, he specifically describes the management education and training requirements for outside international managers seeking to enter the regional market. Specifically, the management training issues relating to content, methods of delivery, location of training and type of instructors are discussed.

Global Investment Issues

One of the major consequences of globalization, privatisation and liberalisation is the acceleration in foreign direct investment flows. While foreign direct investment has been increasing for some time among the developed triad countries, in recent years it has spread to other parts of the world, especially to the giant emerging economies such as China and India. The privatisation and liberalisation policies pursued by these emerging economies have created new opportunities for foreign direct investment. As a result, international investors now face difficult problems such as choosing countries, evaluating risk-return relationships and assessing profitability in private and public sectors. These global investment issues are addressed in this section, particularly in the context of two burgeoning economies India and China.

Japanese investments in China are considered to be larger and broader in scope than those in India and are often reflected in the overall global strategies of Japanese firms. In contrast Japanese investments in India are market exploring investments spurred by incentives by the host government and typically reflect a multidomestic strategy. The authors conclude that not only is Japan's direct investment in China larger than that in India, but also that

accruing benefits of technology and management expertise transfer are more substantial in the case of China than in India.

It is an empirical study reflecting the U.S. investors' perception of the risk-return relationship to their investments in India since 1991, the year when liberalisation of the Indian economy began. The major finding of this chapter is that U.S. stockholders do not perceive investment opportunities in India to be positive net present value projects. Duggal and Cudd believe that the higher perceived risk of the Indian investments may slow down the pace of future of U.S. investments in that country.

The relative profitability of private versus public sector enterprises in India and assess the effects of competitive intensity in making such comparisons. Not surprisingly, private sector firms have clearly outperformed the public sector counterparts. However, these differences in profitability seem to be accentuated when competitive intensity is high and minimized when it is low. This relationship suggests that competitive intensity has moderated the relationship between ownership status and commercial profitability. Consequently, industry's competitive market structure must be considered when evaluating the effects of ownership form on performance. Ramaswamy and Renforth raise some interesting questions that have implications for privatisation policies and public sector programs.

Managerial Issues

The macrolevel developments associated with globalization, privatisation and liberalisation have created many managerial challenges at the microlevel. First, all managerial functions have become global in scope and complexity, and competitiveness has intensified. Technology and its management has become the bedrock of managerial efficiency. Manufacturing, sourcing, marketing, financing, human resource management and management information systems have all become global in scope. Organizational survival and growth have come to depend on how successfully organizations manage these managerial functions both individually and collectively in an integrated manner.

Subbarao addresses the issue of managing diverse human resources for globalization. He discusses the diversity of human

resources in two developed countries, the United States, and Canada, as well as in three developing countries, India, Malaysia and Sri Lanka. The public policies of these nations that are influencing the management of a diverse workforce are analyzed separately as equality, equity, job preference and job reservation models. Subbarao introduces a representation model for managing human resources in workplaces that compete in global markets. He also examines the problems related to the multicultural workforce in both developed and developing countries.

Country-specific Experiences

The experiences of individual countries vary widely with regard to adopting globalization, privatisation and liberalisation policies and practices. Some countries, such as the Southeast and East Asian countries, have been more successful in integrating their economies into the global economy than other countries. Given the greater diversity of developing countries, it would be instructive to focus on the specific experiences of these countries. To support his argument, he points to the success of the Southeastern and East Asian countries in globalizing their economies through their ability to blend their cultural Confucian ethic with Western technology. As a parallel, he contends that in order to successfully globalize its economy India must blend the Hindu ethic with technology. In this regard, Gulati assigns the core cultural values of a society a central role in the process of globalization. In other words, cultural adaptability to the demands of technology and market values assimilation is a prerequisite for successful globalization.

It examines globalization, privatisation and liberalisation in the context of Bangladesh. According to this author, blind emulation of other successful country approaches (in this case the Asia-Pacific neighbors of Bangladesh) is not always appropriate or even feasible. Countryspecific factors such as image problems, overly ambitious policies, the rise of religious fundamentalism, inadequate infrastructure, wide-scale corruption and poor selling due to bureaucratic wrangling and lack of support and information are formidable impediments to transforming Bangladesh into a globalized economy.

Secioral and Industry-specific Issues

The different industrial sectors and industries in any economy are affected by globalization, privatisation and liberalisation forces in quite different ways. Some industries, such as the automobile, electronics and steel are more readily globalized than other industries, which are purely local. The same is true with regard to privatisation affecting different industries to different degrees. Even the government that is most committed to privatisation will hesitate to privatize either defense or social service-related industries. For some industries such as pharmaceuticals and other knowledge-based industries, intellectual property protection becomes critical in the global spread of such enterprises.

It deals with domestic and global environmental changes and their impact on the international marketing strategies of the textile industry in Zimbabwe. They trace the forces that caused the poor performance of Zimbabwe's textile and clothing sector, including the government's long-standing protectionist policies, economic structural changes in the domestic market, limited vision of opportunities in different international markets and inability to adapt strategy to quick changes in both the domestic and global markets. The textile firms' lack of experience and knowledge of the wider external markets has become a great obstacle to their ability to in internationalize their operations.

2

Privatisation and Organisational Behaviour

Introduction

The most common approach to the classification of enterprise organizations is to distinguish between the public and the private. Although the public-private dichotomy may provide a useful guide, it is nevertheless inadequate for constructing a general taxonomy. It no longer provides a comprehensive description of the subtleties and varieties of a broad range of modern enterprise organizations.

This chapter accordingly advances the concept of the national enterprise, which is intended to overcome some of the obvious weaknesses of the public private model. It does this by (1) specifying the domain of the national enterprise identifying its major attributes and the configurations different national enterprises create at particular points in their development, and (2) highlighting the implications of the national enterprise concept as an aid to the successful management of public-to-private transitions. The need to signify the existence of national enterprises and to clarify the range of forms they can take is urgent, given the trend for many developing economies to embark on transitions from public to private systems and the dangers that are often inherent in moving wholesale

from one side of the public-private continuum to the extreme of the other.

The motivation for this chapter stems from the author's involvement in researching the privatisation experience in different national settings. However, the United Kingdom is used here as a contextual base mainly because its program of "rolling back the frontiers of the state" has been more far-reaching than that in any comparable country and, indeed, has been the hallmark of the Conservative government since the premiership of Margaret Thatcher.

Privatization and Organizational Classification

The weakness of current paradigms about what privatisation is and the organizational forms it creates has become more apparent as the consequences of privatisation are analyzed. At a broader level, there is growing speculation about how organizations might be characterized in the future. The conventional textbook approach to enterprise classification has accordingly come under severe strain, leading some researchers to assert that it no longer works. A new approach is, therefore, necessary to produce a more sensible explanation and understanding of modern organizations, especially those that differ markedly from the popular typologies in the degree to which they might be characterized.

Public-private Organizational Paradigms

The literature is replete with studies addressing the similarities and differences between public and private enterprise organizations. Among the relationships that have been examined are control systems; equity ownership; managerial autonomy; work-related employee attitudes; performance norms and outcomes; social roles; political influences; and economic incentives and strategic decision processes.

Although more recent studies have viewed public and private typologies as a continuum, very little help is on offer in terms of providing a framework useful for resolving the underlying taxonomical complications. The framework proposed here offers useful strategic insights into the delicate act of managing organizational change from traditional public forms of organization

to privatized ones. Due acknowledgment is, however, given to the literature base which reveals the existence of organizations that neither conform nor subscribe to the traditional assumptions about public and private entities organizational types that are collectively referred to as the third sector. Nevertheless, since the third sector cannot be comfortably positioned along a continuum at the extremes of which lie, respectively, the pure public and pure private enterprises, they may be unaffected by the dialectics of the public-to-private transition. To discuss this nascent organizational type, it is necessary, first, to set out the criteria for defining the concept of an enterprise and within it, the publicprivate configuration.

The Enterprise Concept

Popular attempts at defining the concept of an enterprise include Ramanadham's two-factor framework, Bohm tripartite characteristics and Liebenstein three tests. Formulating a generally agreeable definition of an enterprise is obviously problematic. However, it is pertinent to demarcate the boundaries of an enterprise in order to isolate public and third sector organizations that are not "enterprises." On the basis of synthesis drawn from the general literature, the following generalizations can be made about the common paradigm for enterprise:

- An enterprise is profit oriented. Theorists have argued against the reality of the notion of profit maximization behavior in enterprises, but none argues against the fundamental import of the profit motive.
- Resource generation and utilization and the associated notion of viability seem inextricably intertwined with the whole enterprise concept. The manner in which resources are generated and deployed differentiates the enterprise from other organizations. This differentiation is created by the degree of involvement in commercial activities, the extent to which revenue is derived directly from those activities and the level of dependence on market performance for survival.
- By implication, for an enterprise to become and remain viable and profitable, its products and services must not only be offered at a price to consumers but prices should reflect the real economic costs of activities.

- An enterprise is managed by personnel who have much discretion over how the organization's resources will be attracted and utilized.

The United Kingdom's "privatized sector" satisfies these basic criteria of an enterprise. In the section that follows, we examine the broad distinction that currently is being made between public and private versions of the enterprise.

The Public Enterprise

Views on the public enterprise are widely varied. Broadly, it may be defined as the enterprise that is publicly owned and controlled. A more rigid and universal definition may be elusive and may even seem undesirable in view of conceptual difficulties and the diversity of legal and organizational forms prevalent in the literature.

Nevertheless, it can be inferred from the general literature that public enterprises have three defining characteristics: they are government owned and controlled; they are engaged in commercial (business) activities; and they have sociopolitical goals alongside the primary economic goals. These characteristics are not precise, either in a conceptual or an operational sense partly because of the taxonomical problems.

Private Enterprise

The private enterprise refers to the enterprise that is privately owned and controlled by the market. Two principal factors have been applied in explaining the private enterprise: (1) ownership and (2) management of benefits. The crucial point of the private enterprise is that the organization and its management are solely answerable to the owners via the board of directors. As a consequence, management activities reflect the supremacy of shareholders' interests.

Ownership and control: The intractable controversy over issues such as where the public concept ends and the private concept begins (for example, over what proportion of public/private equity holdings classifies an enterprise in either domain) shows that ownership per se does not fully capture the dimensions of the public-private distinction. For example, privatized utilities represent the grey area where the public-private distinctions seem particularly weak. Experience in these industries has revealed the fallacy of assuming that ownership and control are the same thing.

The case of British Telecom (BT) is particularly insightful. At the time of privatisation in 1984, the government retained a 48.6 percent equity holding in the company (the largest single block shareholding). After the second and third flotations, the government divested itself of its holding. But the resultant change in equity structure did not result in any change in the regulatory control. Hence, BT is no freer now to respond to the dictates of market forces than it was in 1984.

With regard to British Gas, some early observers did argue that the change of ownership from public to private could be viewed as significant because the market behavior of the privatized British Gas did not seem different from that of any previous state utility. Although privatisation was supposed to introduce the discipline of the competitive mechanism, the initial market power of British Gas conferred by control over the grid largely insulated it from the chill winds of competition. However, following the government's adoption of a report by the Monopolies and Mergers Commission, the industry has been going through a major transformation-with full competition expected in 1998. Previously, only large industrial users could choose their suppliers. Beginning in April 1996, competition was extended to domestic consumers in some parts of the country. British Gas, however, is still tightly controlled and cannot respond to the challenges of free competition in the manner of a private enterprise.

In general, transfers of ownership by themselves have not succeeded in altering the market characteristic of some of the privatized utilities. This is confirmed in, for example, Parker where he provides a schema to illustrate that there has been little movement from the North (monopoly) to the South (perfect competition) attendant upon privatisation. Much of the movement has been from the West (public/political ownership but not control) to the East (private ownership).

Public versus private interests: Some enterprises, due to the nature of their products/markets, belong to the realm where it may be very difficult to separate public from private interests. The result is that such enterprises are closely monitored, for example, through specially tailored regulatory agencies. Furthermore, the notion of public interest is value-laden and notoriously difficult to define or measure. It may not, therefore, be possible to capture the public-private distinction on the basis of public versus private interests.

Identifying the National Enterprise

Having provided a definition of an enterprise and discussed the mainstream theoretical distinction between the public and private enterprise and some of the weaknesses in the current model for distinguishing between one and the other, it is now possible to isolate the national enterprise from other organizational types that have been mentioned in the general literature.

Concept of the National Enterprise

The national enterprise may be defined as the enterprise that is privately owned but still publicly controlled, or publicly owned but controlled primarily by the market (type II).The concept is derived by application of a series of criteria that seek to explain whether such an enterprise

- is publicly owned
- was once publicly owned
- is a natural monopoly
- is a national flag bearer
- dominates the sector of its primary activity
- provides social/political goods.

These criteria may be combined in several different ways in order to define a national enterprise. Accordingly, the approach is, to view a national enterprise as one that exhibits the generic characteristics of an enterprise and that is rated on a sufficient number of the above criteria. The following sections flesh out how these criteria are to be applied.

Public ownership/control: Enterprises of interest here are those Posner referred to as "one who sells and buys in the market place, but relies on the government to act as banker." Ownership per se is not absolutely crucial in marking the boundaries of the national enterprise. Classifying enterprises on the basis of government's equity involvement is fraught with complications. The determinant factor is the control system. This indicates the degree to which the enterprise is effectively controlled through public policy initiatives in order to achieve public interest objectives such as those highlighted by Majone. In this respect, one would be interested in finding out the extent of government's involvement in making investment decisions, in the management of trade surpluses (profits) and in the appointment of key executives.

Enterprises that fall into this category are those that display the public enterprise features specified earlier. Examples include British Rail (BR), Post Office, British Nuclear Fuels (BNFL) and regional transport companies such as the London Underground and tramway. There are no longer many large enterprises left in this category in the United Kingdom.

Once publicly owned (and still culturally bound to the public ethos): The list of companies falling into this category is now very large, although the great majority (well over one hundred) have entered the private sector via a trade sale or management buyout rather than via a public offer for sale. Considerable evidence shows, as in the examples of British Airways, British Petroleum and BT, that it takes many years to "privatize" attitudes and culture within large organizations, although this has been less problematic in respect of, for example, the National Freight Consortium.

Some privatizations are of more recent vintage, and there may still be a strong residual adherence to practices better suited to public ownership and control. However, the strength of this factor is clearly less than that of public ownership as such. The issue here is not whether ownership is private or public. Rather, the key question is under what conditions will managers be more likely to act in the public interest.

In theory, all privatizations via public issue of shares since Margaret Thatcher are of interest. Realistically, the chances of some of the privatized enterprises (e.g., Amersham International, Jaguar, Enterprise oil, National Bus Company, British Leyland) returning to the public sector are quite remote. However, it may not be sensible to begin to make distinctions as to which enterprises are more likely candidates for re-nationalization because some of the earlier nationalizations seem to defy economic logic and can only be explained by public choice theory. Broadly, all privatized companies will be scored on this attribute.

Natural monopolies: These typically are characterized by the presence of economies of scale, high sunk cost and strong entry barriers. From this it follows that natural monopoly features are generally associated with utility companies such as gas, water, electricity, coal, rail and telecommunications. These utilities are not natural monopolies in their entirety. Advances in technology, for example, have greatly eroded the natural monopoly features in the

telecom sector. Only certain aspects of their operation qualify in effect, the network, and for gas and electricity, their "grids." The supply into the grid and distribution from grid to customers are not natural monopolies. This point was glossed over at the time of early privatizations such that, while BT was privatized in its entirety, the electricity generators were separated from the grid and the grid from the distribution companies. This issue is currently being addressed in respect of the planned privatisation of British Rail.

A strong case may be made for retaining public ownership of a grid; the Labour party is committed to a reversal of the present government's privatisation program in some sector. Nevertheless, the case for public ownership is not absolute. This is because, even where ownership is passed into private hands, it is possible to stimulate public ownership via special share restrictions combined with a tough regulatory regime. It has always been fallacious to argue that major utilities can be left to their own devices in a free market if they are allowed to retain monopoly elements at the time of privatisation. Either strong competition must be introduced at the time (which may be difficult to achieve), or a regulatory body must be created in order to exercise surrogate ownership controls.

Tailored regulation: Accordingly, the creation of a regulatory body *specifically* in respect of a single company or companies is also to be viewed as a defining characteristic of a national enterprise. However, it must be recognized that in certain cases, for example, BT, an attempt was made to introduce competition at the time of privatisation. Further competition has been introduced subsequently, so it is appropriate to score it fully in respect of its natural monopoly element and its regulatory body. Other utilities in this category include electricity, gas and water.

Market or sectoral dominance: The extent of dominance associated with an enterprise in a given economic sector constitutes another issue that sheds light on the concept of national enterprise. Such dominance may be defined according to Shepherd as existing where one firm controls over 40 percent of the market and is more than twice the size of the next largest firm.

The greater the dominant firm's market share, the closer it moves toward becoming a textbook monopoly. However, the key factor is that, even though its market power is not absolute, a dominant firm can behave more or less as though it were a monopoly.

Table 2.1. The National Enterprise Attribute Score

Organizations	ATTRIBUTES								
	Public Enterprise	Privatized Enterprise	Natural Monopoly	Tailored Regulation	Sectoral Dominance	National Flag Bearer	Common Goods Provider	Golden Share or Other Restriction	Total Score (Max = 8)
Regional Electricity Companies	0	1	1	1	1	0	1	1	6
Water Companies	0	1	1	1	1	0	1	1	6
British Gas	0	1	1	1	1	0	1	1	6
Electricity Generators	0	1	1	1	1	0	1	1	6
British Airports Authority	0	1	1	1	1	0	1	1	6
British Telecom	0	1	1	1	1	0	1	1	6
British Rail	1	0	1	1	1	0	1	0	5
Regional Transport Companies	1	0	1	1	1	0	1	0	5
Post Office	1	0	1[2]	1	1	0	1	0	5
British Aerospace	0	1	0	0	0	1	1	1	4
British Airways	0	1	0	0	1	1	0	1	4
Rolls-Royce	0	1	0	0	0	1	0	1	3

Sectoral dominance is commonly associated with a regulatory body in the sense that the official definition of a monopoly for regulatory purposes is a firm that controls one quarter of a specific market. However, in practice, many unitary monopolies, though falling within the terms of reference of antitrust legislation, have been left wholly to their own devices, while the others have typically only been required to modify their behavior in some minor way. Thus, regulation is significant only where it is industry specific.

It is evident, therefore, that there is no presumption that market dominance and tailored regulation go hand in hand, and they can both be treated as shedding light independently on the concept of the national enterprise.

National flag bearer (national champion): This may be taken to be, quite literally, an organization that flies the national flag (in the case of the United Kingdom, the Union Jack for example, British Aerospace (BAe). For our purposes, however, it will be taken to be a company that is prominent in international markets where it is regarded as symbolic of the state of the economy, and where that factor is played up in the way in which the organization represents itself to the outside world.

This is clearly a two-way process. Where a company affects a symbolic image, the government is necessarily under pressure to support that image in some way. Such support may be extremely substantial. For example, the government negotiates reciprocal landing rights with other countries, which it then awards to specific U.K. carriers. British Airways has traditionally received the lion's share of international landing rights in this way. Equally, Rolls-Royce engines are a potent symbol of the excellence of British engineering (which is in need of such symbols now that the Victorian era is but a memory). As this indicates, a company does not cease to be a flag bearer simply by virtue of its transferral into the private sector. From a practical perspective, therefore, a national flag bearer is a company that the government either has been, is or will be protecting against certain market circumstances. Among these circumstances, the most obvious and traumatic is the threat of bankruptcy. In this respect, it may be noted that Rolls- Royce and British Leyland (as was) only came into public ownership as a result of bankruptcy. Clearly, therefore, no government, be it ever so right wing/free market in its outlook, will let a national flag bearer

disappear without trace. At a less dramatic level, the government might refuse to allow a company to fall into foreign ownership. This might be the direct result of a special share provision at the time of privatisation (for example, Rolls-Royce), but it might also be inferred from the government's behavior. In certain cases, such as British Steel, it is necessary to presume that the government would behave in that way were a similar circumstance to arise, so there are certain ambiguities at the margin. One additional difficulty is that it is possible to make out a case for the belief that whenever a company has sectoral dominance, it cannot be permitted to go to the wall. Since such an argument is hypothetical, it may be impossible to lay to rest satisfactorily. A discretion has been exercised to the effect that a company that is manifestly a flag bearer should be scored on the merit of this criterion.

Special (golden) share: The retention of the golden share represents a key feature of the national enterprise. The golden share is a generic name for the special rights preference share held by the government. (Face value usually equals one pound.) It is a share "which may secure a certain kind of national interest and guarantee the company independence". It is widely believed that the government uses the golden share to express political sensitivity over possible foreign takeovers of large U.K. companies. This happened recently when the government signaled its intention to block the bid approach by Southern Company of the United States over National Power. Chiefly, this share imposes the following restrictions and conditions on privatized enterprises:

- restriction on shareholding by a specific individual
- restriction on the property disposal of business belonging to the group
- restriction on the closure and dissolution of the company
- condition of representative appointment
- restriction on shareholding by foreigners
- condition of domestic director specification

These provisions, intended to preserve the national interest, may be seen as the final band that ties the state and the privatized enterprises. It is thus doubtful whether those companies with a special share can be truly defined as private companies.

In many cases (e.g., British Steel, Jaguar, Enterprise Oil, Amersham International), the special share was given a terminal date whereby it would have to be redeemed on or before that date. In other cases (e.g., BAe, BT, British Gas, Sealink), the share is open-ended. Here again, there might be a case for the first cases to be scored only a half point, while the second are scored a full point. From a practical point of view and judging from how the government has sought to apply its special share privileges, such distinction might be unnecessary. For example, it might be difficult to explain why the government, in the last week of April 1996, blocked PowerGen's (U.K.-based electricity generator) bid for Midland Electricity (regional electricity distribution company) as well as an offer by National Power (generator) for Southern Electric (distributor) but in the first week of May 1996 allowed the offer by two U.S. utility groups led by General Public Utilities of New Jersey to go through. As an industry insider noted, "this is a game that doesn't have any rules; you get the feeling that they are making it up as they go along."

Provision of social/political goods: The focus here is on the wider noneconomic functions of organizations that include political, social and environmental considerations. In particular, it encompasses situations in which there are significant differences between social costs and benefits, and the enterprise is obligated, or chooses, to provide socially desirable but economically unprofitable goods and services.

There is a common goods provision in respect of utilities in that they are obligated to supply customers in outlying areas or to transport any goods whatsoever upon request. In other words, characteristically a national enterprise does not have complete freedom to choose its customers.

On the political front, the major consideration is in respect of defense-related goods and services where, for reasons of safety of the realm, the government wishes to ensure that British companies produce certain commodities. This may require specific contracts to be awarded to such companies by the government, even where the product could more economically be provided by some other party. It has been suggested that such companies (e.g., BAe) may become so dependent on public contract that they begin to take on attributes of government agencies. This seems rather speculative because, with

defense contracts, the Ministry of Defence is now more willing to buy abroad.

Systemic Considerations: A Synthesis

The process of attributing scores to individual companies has proven to be a difficult exercise, and it is probable that individual readers will take issue with some of them. However, it is unlikely that the overall pattern of scores will be materially affected in the process. Still, it is to be hoped that this study will be the first of a number that will help clarify the meaning of the national enterprise, and its purpose is to provoke discussion as much as it is to lay down a definitive approach to the problem.

In terms of Table 2.1, it is possible to argue that a score of 3 is the dividing point in the data. The organizations with very low scores (0-1) are predictable enough, and no one could possibly claim that they could be deemed to be national enterprises. There are 6 such among the 28 organizations listed.

Interestingly, six organizations with a low score of 2 were once public enterprises. This fact, besides reminding us that any evaluation of national enterprise status takes place at a point in the evolution of the organization being evaluated, also demonstrates that an organization can be privatized and in the process lose almost all its national enterprise characteristics. It may be argued. that these characteristics were not very strong in the first place, but British Steel represents one interesting illustration of a company that required massive state subsidies over a period of many years, and yet has grasped the mettle postprivatization and turned itself into a paragon of private sector virtue compared to the major (often state-owned) operators elsewhere in the European Union. The obvious implication is that a public-to-private status change alone is no guarantee that an organization will act in the stereotypical private way. Genuine market competition holds the key to understanding the changes in organizational systems and structures needed to achieve private sector organizational transformation.

The nearest parallel that scores in excess of 3 is British Airways (BA), which has recently been voted the world's best airline (which is not the way customers felt in pre-privatisation days). Nevertheless, BA differs from British Steel insofar as it controls more of its market

(via landing rights); has a strict regulatory regime geared to safety standards; and flies the flag for Britain. Although Virgin Airlines may be permitted to nibble at the edges of its routes, BA is too important a national flag bearer to be treated as the equivalent of TWA or Continental in the United States, which have been permitted to become bankrupt because there are other major operators in the market. In these respects, it shows a set of characteristics that incline one to put it in the national enterprise category, although it is one of those organizations where a case both for and against could be made.

The high scores are also predictable enough insofar as it is clear that such organizations either remain in public ownership or have been released to a free market by the act of privatisation. They tend to exhibit elements of natural monopoly, to dominate their sectors, to provide common goods and to be tightly regulated as a consequence of these factors. These are exhibited more clearly in the case of privatized water companies and electricity distribution companies, which tend to give the lie to assertions by their top managers that they are just like other standard market operator (and hence executives should receive competitive salaries). According to our schema, they remain unambiguously national enterprises, and this has been barely affected by the nominal transfer of ownership.

The difficulties arise in the middle ground score of 3, of which there are four examples. Interestingly, one of these is yet to be privatized, namely, British Coal, but most of the pits are currently being shut down and the rest will be privatized. Thus, this latter group will sit fairly comfortably outside the national enterprise definition, especially when account is taken of the fact that its sectoral dominance will be much reduced and the degree of competition from other fuels much more severe. Nevertheless, at the present time, it is sensibly allocated to the national enterprise category.

The National Health Service, as currently constituted, cannot be deemed an enterprise, but it is slowly beginning to operate more like a private sector organization. However, it is difficult to use it to shed much light on our problem of definition. BNFL is also something of an oddity. An Act of Parliament requires the state to hold a majority shareholding because of its nuclear activities, but it has long been a profitable company, with full order books until the year

2003. On balance, BNFL has to be allocated to the national enterprise category.

Thus, out of a list of 28 organizations, 16 qualify for classification as national enterprises. Of these, 6 are state-owned but 10 have been privatized. What the latter share is a tendency to market dominance, with consequent great potential to operate against the public interest. It follows logically that there is only one straightforward way to denationalize a national enterprise, namely, through the introduction of market competition.

One final point is worthy of note. Given the government's slow but steady process of disengagement from the marketplace (evident in the outright privatisation or continual withdrawal of financial support to a widening range of organizations). For utility industries such as telecommunications and Gas, exposure to full competition, as it is now beginning to unfurl, will necessitate a migration from the national enterprise domain to the private sector. Contrarily, it is possible for the national enterprise, depending on political exigencies, to fall back into more political control as to occasion renationalization. Although this hag not happened, there is a veiled threat by the Labour party, if elected, to reverse any possible privatisation of British Rail. Organizations providing ancillary services that the government is becoming reluctant to fund and that may not be sustainable under market control might be allowed to undertake pa sage to the third sector where they either settle permanently or are subsequently taken into market or political control.

Conclusions

Many countries in the developing world and the emerging democracies of Eastern/Central Europe have embarked on a privatisation policy as a way of freeing their economies from perceivably unattractive bureaucratic control. The problems being encountered are many and varied. These problems may stem in part from the fact that many adopters of the privatisation experiment have not addressed some of the conceptual issues, such as those relating to the goals and limitations of privatisation as a policy instrument in widely diverse social contexts. This has resulted in a whole variety of implementation problems; a major one, for example,

is the task of confidence building among the citizens and major institutional stakeholders such as the banks and citizen action groups. Sections of the populace, for instance, may worry about the sale of enterprises previously seen as symbols of collective ownership and may be less than supportive due to misconceptions about the free market system such as no interference and survival of the fittest.

One way of addressing these problems is by articulating the concept of the national enterprise which should demonstrate, for example, that whereas the assets of some enterprises might be in private hands, those enterprises may not necessarily shirk traditional public service objectives or fall outside the political purview. To this extent, the concept of the national enterprise provides an alternative strategic route towards a market economy. This type of route, and clear articulation of it, are particularly pertinent now that many developing (as well as erstwhile command) economies are beginning to chart a course geared toward removing the government of business from the business of government.

3

Multinational Market Groups: Trends and Innovations

Introduction

It has been argued that free trade is good and that all parties benefit. This is especially true for the world's principal trading nations (i.e., the three major regional trading blocs of North America, the European Community, and industrialized Asia). While these blocs account for only 15 percent of the world's population, they produce 72 percent of its wealth. NAFTA, the North American Free Trade Agreement between the United States, Canada and Mexico, is the world's largest single trading zone with over 360 million consumers. Given the proximity of the three countries to one another, this can be considered a natural trading bloc. Officially, NAFTA will gradually eliminate all tariffs and lower most other trade barriers between Mexico, Canada and the United States over a period of 10 years. Before NAFTA, the textile industry in the United States and Canada was highly protected. Wu and Gaspar have predicted that under NAFTA, U.S. and Canadian textile production will become more competitive through the use of Mexican labor. In addition, under the provision of the local content requirement, NAFTA should allow automobile production to increase in the three nations.

In the 1990s, the eight East Asian countries as a group became the United States' most important trading partner. Asia's sudden growth as a competitor in world trade can be attributed to several coordinated events, especially the area's private domestic investment and rapidly growing human capital. Additional factors are East Asia's fundamentally sound development policies, timely government interventions, and rapid accumulation of physical capital.

Latin America's trading blocs, though viable, currently operate on a much smaller scale. Their trade is primarily between each other and less with the larger trading blocs. For instance, in 1992 U.S. exports to Latin America, excluding Mexico, totaled $35 billion, less than U.S. exports to Singapore, Taiwan, and South Korea combined during the same time period.

Advantages of Regional Trading Blocs

Some argue that these new regional trade groupings are a faster route to global free trade. Over the years, GATT (the General Agreement on Tariffs and Trade) has encouraged free trade and the elimination of tariffs; however, some researchers (e.g., Joseph L. Brand) believe that it has failed to deal effectively with nontariff barriers such as import quotas and has therefore outlived its usefulness. They also cite statistics showing that trading blocs help reduce national tariffs and trade barriers and generate huge increases in trade among the partners. However, because GATT does not adequately address nontariff barriers and because Japan's exports therefore receive equal treatment, trading blocs have become an effective way of competing with Japan.

On the other hand, Panagariya emphasizes that future GATT rounds could facilitate the formation of regional trade blocs, owing to the decreasing level of trade between individual countries. The consolidation of countries into three regional trading blocs will make it much easier to adopt global reductions in trade barriers. These regional trading blocs can be laboratories for free trade initiatives (e.g., agreements on intellectual rights or service industries). In addition, trading nations have been both unable and unwilling to implement these initiatives on the global level. Consequently, regional trade groupings will inevitably become building blocks

rather than obstacles in the move toward global economic integration.

Other researchers support the existence of trading blocs because they expect the "trade creation" among member states or among natural trading blocs like the United States, Mexico and Canada to be more than a "trade diversion" from nonmembers. Neighboring high-income countries that are natural trading partners because of geographical proximity, complementarities in factor endowment and supply patterns could be net welfare-enhancing for the group itself without doing harm to nonmembers. This simply means that the amount of trade between the member countries (i.e., the United States and Mexico) will increase, but this increase will not affect the amount of trade between nonmembers (i.e., the United States and Japan). Trade in these nonmember countries is anticipated to remain the same.

In addition to these reasons, Panagariya states that trade blocs, representing a large market enjoy more market power than individual countries. The net result is lower prices for the trading bloc members. When dealing with nonmember countries, member countries or a particular trading block need to observe the issue of reciprocation. Fear of retaliation for unfair trade practices assures a certain level of fair trade between different trading blocs/countries/ members. Therefore, given the vital role that extraregional trade plays in their economies, it is not in the interest of any one trade region to strengthen trade barriers with the rest of the world. As Langhammer has observed, trade blocs can have a immense economic implications in addition to tariff removal: "For instance, they can provide technical assistance for policy reforms including monetary integration, debt relief, economic aid, free capital movement, and technology transfer".

Disadvantages of Regional Trading Blocs

Some researchers have urged caution concerning the emergence of regional trade blocs. For instance, "a world organized around regional trade blocks unconnected to a larger global trade framework would have devastating consequences for those nations left outside the regional blocks, particularly in the poorest and least developed of the world's nations." These outsiders, including some of the poorest and least secure in the world, "fear being left out in the

cold" because they have less to offer to the rest of the world. These countries, preoccupied with the demands of their domestic market, are less prepared to become players in the world trade arena. Thus, as nonmembers, they will likely encounter trade barriers (e.g., tariffs or quotas) when they engage in trade with members of trading blocs. The outcome leaves these nonmember countries at a disadvantage and in desperate need to build their economies. Even if these poor nonmember countries were to join a trading bloc, they would gain less than their rich counterparts.

Others fear that negotiations between just three parties would also increase the potential for conflict. Larger trading blocs would be more powerful and would want to protect their markets by imposing restrictions on imports to nonmember countries. Accomplishing the goal of having only three main trading parties (the North American, Asian and European blocs) would require that a large number of countries would have to join together. These negotiations would be a daunting task (a case in point is the EC). In addition, in some cases, regional trade blocs would require the cooperation of long-time political rivals. If these blocs were to turn hostile toward each other, then significant trade gains could be lost. Therefore, small numbers of trading blocs does not necessarily mean faster progress in trade.

Another cautious observation concerns the possibility that major trading blocs might lead to a regression away from multilateral free trade by restricting external trade. This regression is attributed to trade barriers and discriminatory preferential trade. The net result could be a diversion away from the most efficient producer in the world to the least efficient producer within the bloc.

Trade experts have proposed that the ideal goal is complete free trade or a multilateral trading system. They believe that "regionalism is slower and less efficient than multilateralism and will not produce any better results than a multilateral approach". In addition, regionalism might act as an obstacle because it could make multilateral free trade more difficult to obtain, ultimately diverting attention and support away from the multilateral approach and to the second best approach of regional trading blocs. Various researchers have argued that the potential for increasing trade frictions between rival trading blocs could lead to an intensification

of trade barriers between them, which, over time, could erode the multilateral trading system.

Conclusions

The recommendations made in the reviewed literature are continuing the extraregional commerce by the three big trade powers (the United States, Japan, and the Eastern Caribbean) and using the regional trade integration as a vehicle for multilateral liberalisation. Specifically, simultaneous liberalisation in all the major countries would lead to minimal adjustment costs, and the ideal policy would be unilateral free trade for each country.

In conclusion, member and nonmember nations, together with their multinational companies, have been forced to face the new marketing realities created by the unification of regional trading blocs. Although we do not yet know the full consequences of these unifications, members and nonmembers and their multinational companies can take steps now to prepare to operate within the newly structured global/regional market. They will need not only effective strategies, but also contingency planning at an early stage. Through such flexible strategies they can avoid being "trampled under foot" by the rising economic power of the trading blocs.

4

MNCs Technology for Equity Joint Ventures

Introduction

The economies become increasingly market-based, and countries reduce international trade and investment barriers, new local firms and foreign firms (multinational corporations MNCs) intensify competition in the domestic market. In this highly complex competitive environment, it becomes increasingly difficult for existing firms with old technology to sustain their survival and growth. To retain competitiveness and successfully respond to these challenges, it is imperative for these firms to acquire new technology from MNCs. Here, the term *technology* is used broadly, and includes manufacturing, marketing and management skills and knowledge required to operate a business efficiently.

Second, what organizational governance mechanism (license or equity joint venture) should a firm choose to acquire the new technology? According to transaction cost economics, factors such as uncertainty/complexity, opportunism and asset specificity increase the cost of monitoring the performance of parties in a contract, resulting in inefficiency and failure of the contract. To overcome the cost/inefficiency of transacting with external agents,

firms internalize the transaction within the organization by using more efficient hierarchical mechanisms such as equity joint ventures. This chapter uses the transaction cost framework to explain why an equity joint venture is more efficient than a license in overcoming Williamson's transaction costs associated with the acquisition of technology by local firms from MNCs.

Although the transaction cost theory has been used in the literature to explain the use of IJVs by MNCs for direct foreign investment (DFI), the perspective is usually one-sided since it largely discusses only the MNCs viewpoint, with only a casual reference to the needs, requirements and preferences of the local firm. This chapter contributes to our understanding of IJVs from the perspective of the local partner. It uses transaction cost theory to explain why local firms use IJVs to obtain technology from MNCs.

Understanding the rationale of local firms for a joint venture is important for two reasons. First, as the number of alternative technologies and its suppliers (MNCs) increases, there is likely to be increasing competition among MNCs to form joint ventures with good local firms. Adoption of a customer-oriented marketing approach, with an emphasis on understanding the prospective customers' (local firms') technology needs, and tailoring the technology package to effectively fulfill those needs, would increase the MNC's chances of forming a successful joint venture with a local firm. Second, any one perspective offers only a partial account of a complex phenomenon. According to Van De Ven and Poole "juxtaposition of different perspectives brings into focus contrasting worldviews of social change and development." Since an IJV is a complex organizational arrangement, seeing it from the perspective of both partners will enhance our understanding of the factors that determine the formation, performance and long-term success of the joint venture relationship.

Imperative to Acquire Technology from MNCs

In the last few years, the economies of several developing countries, including India, China and many Asia-Pacific and East European countries, have undergone significant structural reforms. These changes, which are in two broad directions, are resulting in the emergence of new competitive patterns, shown as C1, C2 and so

on. Market is defined with reference to the local firm. Thus, domestic market is the national market in the country of the local firm, whereas international market is the market in countries outside that of the local firm. These centrally planned economies are undergoing rapid transformation toward market-based economies. This competition either did not exist in centrally planned economies or had a low level of competitive intensity before the market reforms were introduced. While competition of type C1 is an important issue for local firms, it is not very difficult to manage since it is symmetric in character. Symmetry implies that the factors on which the local firms compete (i.e., their sources of sustainable competitive advantage), are similar. This competition poses only a small threat, since at this stage of transformation of the economy the local firms are largely immune from the intense competition among foreign firms (MNCs) in the international market.

These countries are opening their borders to international trade and investment flows, due partly to bilateral agreements and to multilateral agreements such as GATT. The reduction in barriers to the inflow of foreign goods and capital is attracting multinational firms into these large and apparently profitable markets. The entry of foreign multinationals, with large capital resources and better technology, has added a new dimension to competition in the domestic market. Not only are these multinationals competing among themselves in the domestic market, as represented by C3.

The competition between local firms and foreign MNCs in the domestic market, poses the greatest threat as well as a challenge to local firms since it is not only more intense and complex, but also asymmetric. Asymmetry implies that the factors on which local and foreign firms compete (i.e., their respective sources of sustainable competitive advantage) are significantly different, both in number and characteristics. The threat that this competition poses to the survival of local firms, together with the most efficient means of overcoming the threat.

To complete the picture, it may be stated that a few strong and internationally competitive local firms, spurred by the growth opportunities offered by unshackling the economy, are growing overseas and competing among themselves as well as with foreign multinationals in the international market.

In addition to competitive forces, the change/decline in domestic competitive position of local firms is also triggered from the consumer end. While industrial product buyers in different countries generally demand globally standardized products, there is evidence of an increasing trend toward homogenization of preferences across countries even for consumer products. Ohmae, for instance, considers North American, Western European and Japanese consumers to be increasingly homogeneous in their preferences. According to Levitt, the increasing obliteration of national differences among consumers provides good opportunities for firms to produce standard products for global markets. Faster and frequent travel and communication are also informing and encouraging consumers to expect, seek and get the best products and services from local firms.

The two forces namely, the use of world-competitive technology by new local and foreign firms, combined with world-standard consumer preferences in the domestic market are driving the technology foundations of domestic competition to become increasingly international. In the new competitive and consumer environment, it is imperative that local firms both large and small-view their product-market technology from a broad international perspective rather than a narrow national perspective. Existing firms, with old technology from a competition-free era, are likely to find it increasingly difficult to survive and grow in the new environment created by a free economy. This does not imply that existing local firms do not possess any competitive advantage. Although plausible, such an assumption seems unreasonable, especially since many of these firms have survived and grown successfully over a long period of time. What this implies, rather, is that under the new competitive scenario, these firms' existing competitive advantage in some areas is inadequate for survival and growth in the future. To sustain and strengthen their competitive position in the face of these changes, and to avoid the risk of failure and even extinction, local firms must acquire new technology to overcome their weaknesses in manufacturing, marketing or general management. The next section discusses the mechanisms by which a local firm can acquire technology from MNCs, and uses the transaction cost theory to explain why the firm may prefer IJV over license for this purpose.

Transaction Cost Explanation of Equity Joint Ventures

The literature on strategic alliances and joint ventures (JVs) encompasses a wide range of interfirm relationships, we should delineate the boundaries of the type of JV discussed in this chapter. Although JVs can be classified along several dimensions, wherein a joint venture is classified along two dimensions: (1) venture location national or international, and (2) partners' nationality the same or different. In a type 1 JV, both partners have the same nationality as the joint venture, whereas in a type 2 JV, the same-country partners set up a joint venture in another country. In a type 3 JV, on the other hand, different country partners create a joint venture in a third country, whereas in a type 4 JV, different country partners form a joint venture in the country of one of the partners, and thus are located internationally for the other partner. Although Geringer and Hebert consider ventures of all the three types (2, 3, 4) as IJVs, what distinguishes IJVs, and makes them an interesting and important topic of study, is the international/different nationality of the partners (as in types 3 and 4) rather than merely the international location of the venture (as in type 2).

These IJVs (types 3 and 4) are interesting because they involve a strategic alliance between partners from two different nationalities or cultures. In addition to the issues of managing an overseas venture, these IJVs have the complexity of sharing coordination and control between firms from diverse cultures. Despite their apparent complexity, they are preferred by current and prospective MNCs as a means of entering new markets as well as for acquiring new technology. The Australian Bureau of Industry Economics (BIE) report, extracts from which were published in the *Australian Financial Review*, provides evidence of increasing DFI by Australian firms in the developing economies of Asia. Although it does not indicate the form of investment (wholly-owned subsidiary or a joint venture), anecdotal evidence suggests that a large proportion of this investment is in the form of IJVS. Thus, Australian firms are creating IJVs in increasing numbers and size, and across a diversity of countries, and we can expect this trend to be reflected by firms in other industrialized countries as well. Type 4 IJVs, which bring together firms from two (rarely more) countries, to form a joint venture

located in the country of one of the partners (and thus located internationally for the other partner), are most common.

Transaction Cost Theory

This section briefly discusses the transaction cost theory, which will explain the governance mechanism (market, contract or hierarchy) chosen by firms for pursuing internationalization strategy. Firms can carry out transactions for inputs and outputs using three broad types of institutional mechanisms market, contract and hierarchy. Markets, in the classical economics sense, are considered to be a frictionless institution characterized by perfect competition that is, with a large number of buyers and sellers transacting at prices and quantities in perfect equilibrium. Failure of markets under certain conditions, such as the increasing need, difficulty and cost associated with policing the behavior of parties involved in a transaction, impels firms either to write complex contracts or to partially or fully internalize transactions within the firm's hierarchy.

Contracts are nonequity JVs and can be of several types, such as supply and distribution contract; technical assistance and management contract; licensing and franchising; and cooperative R&D arrangement. Thus, depending on the type of contract, it has characteristics that are close either to market mechanisms at once end or to hierarchies at the other end. Williamson transaction cost associated with a contract can therefore vary over a wide range, depending on the nature of the transaction. For example, a purchase/sale transaction, with low transaction cost, can be effectively governed by a simple supply agreement close to a market mechanism. On the other hand, a franchise or a cooperative R&D arrangement involves high transaction cost and requires a complex, contingent claim, sequential contract close to a hierarchical mechanism for effective governance. Thus, the boundaries of a contract cannot be easily delineated within the markets versus hierarchies debate. Although markets and contracts are classified separately to help explain their distinction, in the following sections, the term *market failure* is used to refer to the failure of both the market and contract mechanisms.When the cost of writing, administering and enforcing complex, contingent claims contracts becomes excessive, firms prefer to internalize the transaction to reduce the cost (increase the efficiency) of the transaction process. Internalization implies that the transaction is carried out internally

within the organizational hierarchy rather than externally with parties outside the organization. Depending on the nature/degree of internalization, the equity form can be of three types joint venture (JV), acquisition and greenfield, with the last two combined into a single category called wholly-owned subsidiary (WOS).To reduce the cost associated with monitoring the performance of parties in a transaction in imperfect markets, firms internalize the transaction, either partially through a JV or wholly through a WOS (acquisition or greenfield). Furthermore, the higher the cost of market failure, the greater the benefit from internalizing transactions. This economic rationale impels firms to establish hierarchical operations instead of transacting through market mechanisms.According to Williamson, firms choose the level of integration that minimizes the sum of production and transaction costs. Although production costs differ between firms owing to the scale of operations, learning or proprietary knowledge, transaction costs arise due to market imperfections that are caused by seven factors. These factors can be classified into three groups: (1) the three environment factors of uncertainty/complexity, commitment/small numbers and asset specificity and intensity; (2) the two human factors of bounded rationality and opportunism; and (3) the two derivative factors of transaction frequency and information impactedness. Drawing from Beamish and Banks and Kogut, we may briefly explain these factors as follows.

1. **Uncertainty/complexity.** According to this factor, the higher the uncertainty/complexity of a transaction, the more difficult it is to write, administer and enforce a complete, contingent claims contract, resulting in market failure for such a transaction.
2. **Commitment/small numbers.** If there are only a small number of buyers and/or sellers in the market, this factor results in a situation of bilateral monopoly/oligopoly. It gives rise to a greater degree of interdependence between transacting parties and an increased need for fulfillment of reciprocal commitments. It may also involve costly haggling and bargaining over contract terms and sharing of profits. In a situation of small numbers, since it is difficult to align incentives for both parties to perform effeciently, it can be a

potential cause of market failure, especially when accompanied by opportunism.

3. **Asset specificity and intensity.** This implies that when transactions involve specialized assets of high value, switching costs are high, especially if accompanied by a small number of alternatives for the utilization of these assets. When accompanied by uncertainty and opportunism, market for the deployment of such assets is very likely to fail.
4. **Bounded rationality.** This factor implies that human beings have limited ability to comprehend complexity and are unable to anticipate and include all present and future contingencies in a contract.
5. **Opportunism.** This is another human condition that involves strategic manipulation of information and seeking self-interest with guile. It encourages firms to cheat in their commercial dealings if it is in their long-term interest to do so. Both bounded rationality and opportunism are human conditions that result in increased market inefficiency and failure.
6. **High transaction frequency.** According to this factor, if the transactions associated with market-failing factors are executed frequently, the result is greater haggling and bargaining, as well as increased exploitation of the weaker party in the contract, accelerating market failure.
7. **Information impactedness.** This factor is associated with asymmetry of information between the parties to the transaction. This, combined with opportunism and uncertainty/complexity, can be a strong determinant of market failure.

In summary, the seven transaction cost factors, rarely individually but more often in combination, create market imperfections. These imperfections result in inefficiency (high cost) and failure of markets for tangible and intangible goods, although the specific combination that causes failure depends on the productmarket context of the transaction.

There is a large body of literature on the application of transaction cost theory for explaining the formation of international equity joint ventures by MNCs. Detailed explanations are provided by Hennart for seal and link JVs; Stuckey and Stuckey and White for vertical integration IJVs; and Beamish and Banks and Kogut for horizontal

integration IJVs. Since the arguments for international equity joint ventures by MNCs are extensively discussed in the literature, these are not reproduced here. The next section provides a plausible transaction cost explanation for equity joint ventures by local firms seeking technology from MNCs.

Transaction Cost Explanation of Equity Joint Ventures by Firms Seeking Technology from MNCs

Based on the transaction cost framework, this section explains why local firms use equity joint ventures to acquire technology from foreign MNCs. As stated before, the term *technology* is used broadly and encompasses manufacturing, marketing and management skills and knowledge required to efficiently operate a business. First, a WOS is usually infeasible since local firms may not possess all the technological capabilities required to compete successfully with new local and foreign firms. Second, efficient markets may not exist for intangible assets such as brand name and technology, which a local firm seeks in order to improve its competitive position. In such a situation, the only comparison required is between an equity joint venture and a long-term contract such as licensing.

Local firms usually need and seek complex, difficult-to-learn technologies for growth, diversification or simply survival. Theoretically, the technology supplier and the technology receiver can be either from the same country or from different countries, and these countries can be either industrialized or developing. In this chapter since the focus is on newly industrializing country/ developing country firms seeking technology, it is assumed that the technology is not available locally even if there are a few local MNCs. It is more likely to be available from foreign rather than local multinationals, since the foreign, owing to their relatively greater size and resources, are likely to have larger R&D budgets for developing new technologies. Hence, the technology transfer process inevitably becomes international in scope, in which technology is supplied by a foreign firm (MNC) in an industrialized country to a local firm in a developing country. In the following paragraphs, it is argued that since an equity joint venture economizes on the seven transaction cost factors discussed earlier, local firms use it as the preferred mode for obtaining technology from foreign firms.

Many technologies (such as marketing and management) required by local firms embody tacit knowledge which is embedded

in organizational routines, and difficult to express, evaluate and transfer. Although manufacturing technology can be transmitted through designs and drawings, substantial managerial/ organizational knowledge is required to overcome the uncertainty associated with adapting the product/process design to the local firm environment. Because of the inherent uncertainties and complexities of technology, it is difficult to write, administer and enforce a license for its transfer, resulting in inefficiency and failure of a technology transfer license. In contrast, an equity JV overcomes this problem since the local firm does not need to resolve all uncertainties a priori. The foreign MNC's ongoing interest in the JV provides the incentive to share technology and information to overcome the uncertainty and complexity associated with technology transfer to the local JV. Thus, the local firm prefers an equity JV to a license to overcome the transaction cost associated with this uncertainty/complexity.

The number of foreign suppliers that have the appropriate technology depends on the product-market of the local firm, it can be reasonably assumed that few satisfy the local firm's choice criteria in terms of price and quality of technology, and the capability and reputation of the technology supplier. A small number of suitable technology suppliers results in the local firm's greater degree of dependence on the foreign MNC, both for adapting the technology to the local environment, and for ensuring its future development. The MNC's real/ perceived failure to fulfill its commitment under the license would result in costly haggling and bargaining over contract terms. With the local firm having no or few alternative sources for the supply of technology, the situation of small numbers potentially threatens failure of a technology transfer contract. However, the local firm's dependence on the MNC can be alleviated by structuring a JV that offers incentives to the foreign partner to voluntarily fulfill its commitments. This convergence of incentives of local and foreign partners for JV success is achieved through mutual investment in JV assets and through rules for sharing JV costs and benefits. The alignment of incentives ensures that JV problems are resolved for mutual benefit and in a spirit of cooperation rather than conflict. Thus, an equity JV can overcome the transaction cost due to small numbers more efficiently, and is preferred over license as a means of obtaining technology from MNCs.

Since local partners usually seek technology for growth and diversification, it involves the commitment of a large amount of financial and managerial resources. These investments are largely in assets in the form of plant and machinery and learning, which are specialized and dedicated to a specific process or product. If the foreign technology licensing firm acts opportunistically, and the local firm has no alternative use of these assets, especially when there are only a small number of alternative technology suppliers, the technology transfer license is likely to fail. In the case of a JV, since both partners have a mutual commitment in dedicated assets, it is in their interest to ensure its success. This reduces the likelihood of opportunism, and alleviates the potential problem associated with asset specificity and intensity. According to Kogut, "it is by *mutual hostage positions* through joint commitment of financial or real assets that superior alignment of incentives is achieved, and the agreement on the division of profits or costs is stabilised" (italics in original). A JV is therefore more efficient in overcoming the transaction cost associated with asset specificity *and intensity*, and is the preferred mode for obtaining technology from foreign MNCs as compared with licensing.

When a local firm-licenses technology from an MNC, it faces the risk of opportunistic behavior by the foreign technology supplier: such a supplier might supply outdated technology, refuse to provide managerial support to ensure succesful technology transfer or grant entry into a local market either directly or through another licensee in contravention of the license agreement. Such actions could create problems in the administration and enforcement of license terms, resulting in failure in the form of license renegotiation or termination. According to Beamish and Banks, "if a JV is established in a spirit of mutual trust and commitment to its long-term commercial success, opportunistic behavior is unlikely to emerge." Similarly, according to Williamson, if these positive attitudes are reinforced with mechanisms for an equitable division of JV costs, benefits, planning and decision making, the partners will be able to pursue self-interest without guile. In such a situation, the local firm would use a JV instead of a license for obtaining technology, since it is more efficient in overcoming the transaction cost due to the MNC's opportunistic behavior.

When a local firm imports a new technology, it inevitably experiences a number of teething problems during its introduction, as well as with the lower-thanexpected level of subsequent performance, because of inadequate adaptation. Due to bounded rationality, not all contingencies can be foreseen and included in the license agreement. The technology supplier may refuse assistance to overcome unanticipated problems unless the license terms are renegotiated. Frequent bickering and renegotiation signals failure of the technology transfer license, even if it is not terminated. In contrast, bounded rationality is not a serious problem in a JV, since both partners are interested in and committed to the JV's success. The foreign partner monitors JV performance and provides the needed technological support to ensure that it remains competitive in the face of changing internal and external environments, such as firm capabilities, competitive conditions, consumer tastes and preferences, and government regulations. A JV is therefore a superior option to a license to overcome the transaction cost associated with bounded rationality.

To adapt a new technology to the local environment, the local firm needs frequent assistance from the technology supplier. In addition, the local firm needs the MNC's support to improve the technology for successfully responding to changes in the competitive and consumer environments. The local firm may also seek help from the MNC to develop its technology for export to world markets. These technological adaptations and improvements require frequent transactions between the local firm and MNC; this may not be agreeable to the technology supplier because of the high cost of transactions, as well as the risk of loss of proprietary knowledge. These transactions cannot be planned and included in the license agreement, owing to the dynamic nature of the environment that drives these exchanges. The MNC may therefore seek frequent renegotiation of the license terms, indicating failure of the license agreement. On the other hand, since both partners will benefit from the superior performance of the JV, frequent transactions of the foreign partner with the JV to monitor and enhance its performance may be perceived as a functional rather than a dysfunctional activity. Thus, a JV is more efficient than a license in reducing the cost associated with high transaction frequency, and is preferred by the local firm as a means of obtaining technology from MNCs.

Information impactedness refers to the failure of markets due to the asymmetry of information available to the parties to the transaction. In the licensing mode, the technology supplier may not reveal information that is critical for successfully exploiting the new technology. For example, the MNC may refuse to disclose full information about the limitations of and opportunities associated with using the new technology. It may also share only the know-how and not the know-why of the new technology. The "know-why" may enable the local firm to develop the technology for other applications, resulting in a potential loss to the MNC in appropriating returns from these new applications. Because of these limitations, a local firm may prefer not to use the licensing mode for obtaining technology, causing the market for such transactions to fail. In a JV, however, mutual trust, investment in dedicated assets and the rules for sharing costs and benefits result in alignment of interests, and ensure the commitment of both partners to the JV's long-term success. The foreign partner perceives a lower risk of misappropriation of technology and is more open to revealing the technological know-how and know-why, as well as providing state-of-the-art technology to the local JV. In such a situation, a JV is more efficient than a license in reducing the costs associated with information impactedness, and so local firms prefer it for obtaining technology from MNCs. In summary, a joint venture is more efficient than a license in overcoming Williamson's transactions costs associated with the local firm's acquisition of technology from foreign MNCs. Since a joint venture is perceived to be more efficient in fulfilling the short-term and long-term needs of the local firm, it is preferred over the license for obtaining a new technology.

Conclusions

Rapid transformation of centrally planned economies to market-based economies, and removal of barriers to international trade and investment flows. This change has generated new and complex dimensions of competition between local and foreign firms, with the technology foundations of these new competitive forces becoming increasingly international. In addition, there is evidence of increasing homogeneity of buyer behavior (both consumer and industrial) across countries. To sustain a competitive position in

the new environment, existing local firms are forced to acquire new technology from foreign MNCs. Although firms can obtain technology through a license or a JV, it is argued that under a given set of conditions, a JV is more efficient than a license in overcoming Williamson's transaction costs associated with acquiring a new technology.

Although the transaction cost theory has been used in the literature to explain the use of IJVs from the perspective of foreign MNCs, this chapter contributes to our understanding of IJVs by explaining its rationale from a new perspective of the local partner. Since IJV is a complex organizational arrangement, seeing it from the perspective of both partners will enable firms to better understand and successfully create and manage the IJV relationship.

The chapter also has several limitations. First, the higher efficiency of IJVs under certain conditions does not imply that the IJV is the best choice for all firms under all conditions. When the transaction cost is not significantly high, or when the transaction is simple and not repetitive, firms may use the licensing mode to obtain technology from foreign MNCs. For example, if a firm is interested in solving a specific problem, such as the redesign of a standard component or a subassembly for an automobile, it may be more efficient to acquire the technology through a one-shot license instead of forming a joint venture. Thus, if the technology is simple, static and inexpensive, a license may be adequate, but if it is complex, costly and dynamic/adaptive requiring continuous improvements, a JV may be preferable. The choice of whether to obtain technology through a license or a JV, therefore, has to be evaluated on a case-by-case basis, and is contingent on factors such as the local firm's short-term and long-term goals, firm needs and capabilities, the availability of technology suppliers and their preferences, the product-market in which the firm is operating, as well as consumer, competitive and regulatory environments. Future research may use the transaction cost theory to provide a detailed explanation of the conditions under which a license, rather than a joint venture, is more efficient (transaction cost economizing), and should therefore be used as the preferred mode by local firms to acquire technology from MNCs.

Second, the transaction cost theory is static and does not explain the inherently dynamic characteristics of the JV process. According to Hennart, "one way to make it dynamic would be to focus on the

speed and predictability of the rate of decay of some of the advantages traded in JVs, particularly knowledge."

Third, since opportunism is an unobservable construct, it cannot be easily operationalized and measured. The empirical validation of transaction cost theory therefore becomes difficult. Furthermore, as opportunism can only be realized *ex post* (and in certain ambiguous situations not realized at all), the transaction cost framework can only be used for *ex post* rationalization, and not for *ex ante* prediction of entry mode choice.

Finally, firms may have considerations other than efficiency for choosing a specific mode for acquiring technology from the MNC. For example, a local firm may have a strategic/competitive objective of creating entry barriers and eliminating competition through arrangements such as exclusive rights to new technology in a country or a region. Future research may be directed towards empirically testing the ability of transaction cost theory not only to explain the use of IJVs by local firms, but also to provide explanations beyond that offered by strategic/competitive considerations.

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Managing Diverse Human Resources for Globalisation

Introduction

Globalisation of markets is a reality, and managing workplaces for competition in global markets is the challenge that managers face today and in the future. The global workforce is recognized as an important resource for competition, and mobility of the global workforce poses a challenge to managers to manage this important resource efficiently and effectively. Mobility of workforce from developing to developed countries is increasing the diversity of the workforce in indiustrialized nations, particularly in North America which relied on immigrants to meet the demand for knowledge workers. Increasing investment opportunities in developing nations through joint ventures are not only facilitating the transfer of knowledge, but are also increasing the diversity of knowledge workers in developing countries. The diversity of workforce in developed and developing countries has also been increasing steadily during the last three decades due to the increasing participation of women and other segments of the population in labor markets.

Human resource management policies and practices in the past were developed for a workforce that was not as diverse as it is today. In the organized sectors of the industry, they were developed jointly through negotiations between managers and unions which represented the interests of the majority of their membership. Management policies and practices in unionized workplaces and in large bureaucratic organizations were standardized and implemented uniformly regardless of the increasing diversity of the workforce. The "one-size-fits-all" model of management resulted in "advantaged" and "disadvantaged" groups of a diverse workforce. Managers of workplaces, now and in the future, face the challenge of managing a diverse workforce fairly so that all human resources will be utilized for competitive advantage in global markets. "Making Full Use of the Nation's Human Capital," according to the Federal Glass Ceiling Commission of the United States, is "Good for Business."

Workforce diversity has been recognized in the United States, and the experience of managing diversity is expected to improve the competitive advantage of American workplaces in global markets. Diversity of workforce and disadvantages of groups of a diverse workforce are also recognized in Canada. Disadvantaged groups in the labor markets of the Asian developing countries such as India, Malaysia and Sri Lanka, too, were recognized soon after their independence. Policymakers in the United States, Canada and the Asian developing countries developed policies for improving the employment opportunities of the disadvantaged groups, and those policies are expected to influence the management of workforce diversity. Managers' reactions to public policies might improve the employment opportunities of the disadvantaged groups. However, to manage diverse human resources for competitive advantage in global markets, managers have to recognize the challenge of diversity and have to become innovative agents of change for management in modern workplaces.

In order to appreciate the importance of managing workforce diversity, managers need to recognize workforce diversity. In the following section, diversity of workforce in developed countries, the United States and Canada, as well as in the developing Asian nations, India, Malaysia and Sri Lanka, is briefly described. Since the public policies for improving the employment opportunities of

the disadvantaged groups in a diverse workforce might influence management of workplaces, they are analyzed briefly in the second section of this chapter as equality, equity, job preference and job reservation models of managing workforce diversity.

Workforce Diversity in Developed Countries

Gender, age, ability, race, ethnicity, education, skin color and language are some of the many dimensions of workforce diversity in North America. Workforce diversity in North America has been increasing since the introduction of color-blind immigration policies in the 1960s and the increasing participation of women in the labor force in the 1970s. Women now constitute 45 percent of the workforce in both the United States and Canada, compared to only one-third in 1971. Their participation in the labor force increased to sixty percent in 1991 from 40 percent in 1971, while that of men remained the same at 76 percent during the last two decades in Canada. Women will comprise three-fifths of the new entrants into the workforce until the year 2000 and they are expected to constitute half of the workforce in North America in the twenty-first century. Not only the labor force participation of women increased, but also their university level education, indicating their greater abilities and aptitudes for higher level occupations. By 1991, almost as many women held university degrees as did men, whereas in 1971 women's share of the degree holders was less than half. Both men and women in today's workforce are more mature than they were three decades ago: the median age of the workforce is currently 34 years, in spite of the decreasing labor force participation of both men and women over 55 years of age.

The share of nonwhites, like that of women, in the North American workforce has been steadily increasing during the last three decades. They will constitute 29 percent of the American workforce in the year 2000 whereas they were only 18.4 percent in 1985. The number of nonwhites, known as visible minorities in the Canadian workforce, increased by 60 percent between the last two census periods of 1986 and 1991. In 1991, they constituted 9.1 percent of the Canadian workforce as against their share of 6.3 percent in 1986. Canadians of Asian and African origin are the most highly educated in the workforce compared with any other ethnic group:

21.24 percent of Canadians of Asian and African ethnic origins have university degrees, whereas only 9.45 percent of British origin and 8.64 percent of French origin have university degrees. Only 1.78 percent of aboriginals in Canada have university degrees, and 29.36 percent of them have less than grade 9 education, the highest in comparison with any other ethnic group. Like Canadians of Asian origins, Asian Americans are also highly educated, and they are considered model minorities in the North American workforce.

Religion and language enhance the cultural diversity of the Canadian workforce. While America is a secular state, Canada recognizes and protects the interests of the two majority religious groups: 45.38 percent of Canadians are Catholics and 34.21 percent are Protestants. In the province of Quebec 86 percent of the people and in Ontario 35 percent are Catholics. In both provinces, primary and secondary school level education controlled by Catholics is supported by public taxes. The U.S. Constitution, on the other hand, prohibits religious teachings in the public school system. In the United States, English is the only language in the workplace, while in Canada, English and French are the two official languages recognized in the Canadian constitution. Specifically, 67.12 percent of Canadians have knowledge of English only, while 15.27 percent have knowledge of French only; 96 percent of those who have knowledge of French only are the residents of the Province of Quebec, and the official language of Quebec is French; 16.12 percent of Canadians have knowledge of both official languages, and of those 55 percent are residents of Quebec. Language is a dimension of workforce diversity in the three Asian developing countries, too.

Workforce Diversity in Asian Developing Countries

India is a land of languages; 14 languages were recognized in 1950 when the sovereign republic adopted its own constitution. In 1972, Sri Lanka adopted Sinhalese as the official language and Buddhism as the official religion for a country with 74 percent Sinhalese, 18.2 percent Tamils and 7.4 percent Muslims. Similarly, Malaysia adopted Malay as the official language and Islam as the official religion for its population, with 61.3 percent Bhumiputras (sons of the soil), 30 percent Chinese and 8.2 percent Indians. Unlike

Sri Lanka and Malaysia, India is a secular state, even though 83.4 percent of Indians follow Hinduism, in addition, 11.19 percent of Indians are Muslims that follow the Islamic faith.

The caste system among Hindus is the most important dimension of diversity in the Indian workforce. There are over three thousand caste groups among Hindus in India, and the castes have a close association with occupations. The occupational hierarchy coupled with the caste hierarchy has created a society of forward, backward and depressed classes in India. Hindu caste groups that were engaged in "untouchable" occupations such as cleaning services and cremation of dead bodies were categorized as the depressed class in the 1931 census. The depressed class castes were listed in the schedule of the Indian constitution, and since then they have been referred to as the scheduled castes (SCs). Similarly, the tribes that, were also identified as a depressed class were listed in the schedule of the Indian constitution, and they are called the scheduled tribes (STs). Today 15.05 percent of Indians belong to SCs and 7.51 percent to STs.

The Backward Classes Commissions in India identified other castes in 1955 and 1980 in addition to the SCs and STs, as economically and socially backward. They identified 43.70 percent of Indians of other Hindu castes and 8.4 percent of non-Hindu religious groups as backward, and they known as other backward classes (OBCs). The Second Backward Classes Commission, known as the Mandal Commission, categorized 22.56 percent (SCs and STs) as backward classes, 52 percent other backward classes (OBCS) and 25.44 percent forward classes. Among the forward classes, Brahmins constitute 5.52 percent and Rajputs 3.9 percent of the Indian population. Brahmins and Rajputs, due to their priestly and ruling occupations in pre-independent India, respectively, were the most privileged among Indians. They also had access to education and wealth. After independence, Brahmins had access to higher level occupations in the civil service. The prime minister of India and chief ministers of most of the states soon after dependence were Brahmins. The policymakers of independent India recognized the inequality of employment opportunities among India's diverse workforce and proclaimed the principle of equality in the country's constitution in 1995.

Public Policies and Diversity

Administrative agencies enforce the equality policy, and they are expected to be more accessible to disadvantaged workers than the judiciary. Accessibility and wider applicability of the civil rights and human rights legislation are expected to have more influence on workplace management policies and practices than the constitution's equality principle. Hence, the effects of the human rights and civil rights legislation on human resource management policies and practices in the workplace are analyzed under the equality model.

Equality Model

Every person, according to the *Ontario Human Rights Code of 1962*, "has a right to equal treatment with respect to employment without discrimination because of race, ancestry, place of origin, colour, ethnic origin, citizenship, creed, sex sexual orientation, age, record of offences, marital status, family status or handicap." Separate human rights legislation is applicable in the federal and each provincial jurisdiction in Canada, and they all have more or less similar equality policy.

Title VII of the U.S. Civil Rights Act of 1964 provides that it "shall be an unlawful employment practice for an employer" "(1) to fail or refuse to hire or discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, colour, religion, sex, or national origin"; or "(2) to limit, segregate, or classify his employees or applicants for employment in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee, because of such individual's race, color, religion, sex or national origin." The *Civil Rights Act* that was legislated after prolonged debates in the U.S. Congress was consolidated in 1972 in the *Equal Employment Opportunities Act*. The *EEO Act* is enforced by the Equal Employment Opportunities Commission (EEOC), and the Human Rights legislation in Canada is enforced by the Human Rights Commissions (HRCs).

The equality policy is very broad and vague in offering employment opportunities for a diverse workforce in North America.

However, enforcement of the policy and its interpretations have specific implications for human resource management policies and practices. In order to initiate the enforcement process in the equality model, an individual has to complain of discrimination by an employer. The EEOC in the United States and the HRCs in Canada will process the complaints, and the process includes investigation and conciliation. In the event a complaint is not resolved, the EEOC submits it to the federal courts. In Canada, the HRCs recommend appointment of administrative tribunals, known as human rights tribunals and boards of inquiry, to adjudicate on the complaint. Adjudicators' decisions in Canada, like the federal court decisions in the United States, can be appealed all the way to the Supreme Courts of the respective countries. The Supreme Court interpretations have clarified the equality policy, and the courts have judged certain human resource management policies and practices as discriminatory.

The U.S. Supreme Court, in a landmark decision in 1971, clarified the equality policy by stating that unintentional discrimination, like the intentional, is prohibited by legislation. An unintentional discriminatory employment policy or practice that has an adverse effect on an individual or a group of workers, according to the U.S. Supreme Court, is systemic discrimination. In one case, an employment policy required a high school diploma and a specified intelligence test score for recruitment and selection of workers for semiskilled and unskilled jobs. When the employer failed to prove those requirements as bonafide occupational qualifications (BFOQs) for the jobs, they were found to be discriminatory.

The U.S. Supreme Court's interpretation of the BFOQ requirement has been adopted by the tribunals and courts in Canada. In 1979, a tribunal found that height and weight requirements in the recruitment of police officers were discriminatory, for they were not proven to be BFOQs. The Supreme Court of Canada found that an employment policy regarding the retirement of firefighters at a specified age (60 years) violated the equality policy since that age was not proven to be a BFOQ. The Supreme Court of Canada also found that termination of employment of workers for their inability to work on certain religious days was discriminatory since work on those specified days was not proven to be a BFOQ. The Supreme

Court of Canada further clarified that the equality policy requires an employer's duty to accommodate a diverse workforce if the employment policies that are not proven as BFOQs have an adverse effect on an individual's or group's access and advancement in a workplace. The employer's duty to accommodate a diverse workforce, if necessary through special measures and programs, is an important requirement of the employment equity model.

Equity Model

Employment equity, according to the Canadian federal Employment Equity Act of 1986, means "more than treating persons in the same way but also requires special measures and accommodation of differences." Human rights legislation in Canada provides protection for employers who adopt special programs and plans to improve the employment opportunities of disadvantaged groups against the reverse discrimination complaints of advantaged groups. The Supreme Court of Canada interpreted that indeed, a human rights tribunal had the authority to impose on an employer a special program for increasing the representativeness of a disadvantaged group of workers since their representatives in the workplace was less than their share in the labor markets. An employer was required to hire one women of every four workers hired until the representatives of women among the blue-collar skilled trades in the workplace was proportionate to their share of the skilled trades in the external labor markets. In other words, the equity model, unlike the equality model, recognizes the importance of results of an employment program. An effective program for managing a diverse workforce is not only fair in offering employment opportunities regardless of individual differences unrelated to job performance, but also ensures diversity of workforce in a workplace proportionate with the diversity in the labor markets.

The U.S. Supreme Court has approved affirmative action programs adopted by employers for increasing the representatives of disadvantaged groups. In one case, an employer in agreement with a union developed a temporary training program of skilled trades in which half the trainees would be blacks until their representativeness among skilled trades in the workplace was proportionate to their share in the labor markets. In another case, an employer adopted a temporary program to promote women into

supervisory positions until their representativeness in the workplace was proportionate to their share in the labor markets. However, affirmative action programs are being challenged, and the U.S. Supreme Court is finding that the U.S. Constitution does not provide for such programs. The Canadian constitution, on the other hand, does protect such programs, for its Section 15(2) "does not preclude any law, program or activity that has as its object the amelioration of conditions of disadvantaged individuals or groups including those that are disadvantaged because of race, national or ethnic origin, colour, sex, age, mental or physical disability."

The Canadian federal government in 1986 and the Ontario provincial government in 1994 enacted employment equity legislation. This bill was repealed in 1995 soon after the Conservatives were elected and formed the Ontario government that replaced the New Democrats. In 1987, the Ontario government passed pay equity legislation, and most of the provinces in Canada have enacted such legislation since 1987. While the purpose of the pay equity legislation in Canada is to reduce and eventually to eliminate pay differences between men and women performing work of equal value, the purpose of the employment equity legislation is wider and covers more diverse groups of the workforce than women only.

Employment equity legislation requires that employers develop special measures to improve the access and advancement of women, aboriginals, persons with disabilities and racial (visible) minorities. In Canada these four groups are designated as disadvantaged in employment. According to the Ontario policymakers, as stated in the preamble of the *EE Act*, 1994, the four groups "experience higher rates of unemployment than other people in Ontario," and they also "experience more discrimination than other people in finding employment, in retaining employment and in being promoted." As a result of the barriers of access and advancement in workplaces, the policymakers stated that "they are underrepresented in most areas of employment, especially in senior and management positions, and they are overrepresented in those areas of employment that provide low pay and limited chance of advancement."

The Canadian federal *EE Act* and the Ontario provincial legislation require that employers compare the representativeness

of the four designated disadvantaged groups in their respective workplaces at different occupational levels with those in the labor markets. To facilitate comparison, the federal government has made available to employers statistical information based on the 1986 census data, known as "availability data," relating to the distribution of the four designated groups in different occupations in Canadian labor markets. According to those data, 2.5 percent of all men in the Canadian workforce were employed in upper level management positions, while only 0.6 percent of all women and 0.9 percent of all visible minorities were in these positions. In contrast, proportionately more women (14.6%) than men (10.0%) were employed in professional occupations, which required high levels of education and human capital investment. Since visible minorities are highly educated relative to other groups, proportionately more visible minorities (13.6%) were employed as professionals than men (10.0%) in general in Canadian labor markets. Visible minorities were, in fact, overrepresented among aerospace engineers (21.5%), chemical engineers (16%), electrical engineers (15.4%) and pharmacists (16.5%), while the racial minorities constituted only 6.3 percent of the total Canadian workforce. The distribution of women and Asian Americans in upper level management and professional occupations in American labor markets was similar to that in Canada.

The availability data in Canada support the statements of the Ontario policymakers that there was less diversity in upper level management positions and skilled trades, and more concentration of women and racial minorities in lower level clerical and service operations. Proportionately more women (30.9%) than men (6.1%) were employed in clerical positions, and more visible minorities (13.2%) than men (6.8%) were in low-paying service occupations: 98.8 percent of secretaries and stenographers, 96.7 percent of typists and clerks and 93.9 percent of receptionists were women; and 29.6 percent of fabricating, 28.1 percent of sewing machine operators, 26.6 percent of knitting and 21.6 percent of laundering operators were visible minorities in Canada. In the United States, too, women were mostly in clerical occupations, and blacks and hispanics were concentrated in declining occupations with no prospects of advancement. Both in the U.S. and Canadian workplaces, access of women and of nonwhites was restricted in union-controlled skilled

trades and crafts. Very few women (1.4%) and racial minorities (4.6%) in comparison with men (12.5%) were in the skilled trades and crafts in Canada.

Employers, as required under the federal EE Act, filed their first annual statistical reports of distribution of the designated groups in their respective workplaces to the enforcement agency. Employers' reports also confirmed the low representativeness of the designated groups in upper level management positions and skilled trades, and the concentration of women in clerical positions and of visible minorities in professional occupations. Only 0.1 percent of all women and 0.7 percent of visible minority men, as against 1.3 percent of men, were engaged as upper level managers in workplaces covered by the federal EE Act; 13.6 percent of visible minority men were employed as professionals, while only 5.6 percent of all men were in similar positions. If professionals were developed for decision-making occupations, proportionately more visible minorities could have advanced into upper level management positions. Only 0.4 percent of women were employed in skilled crafts and trades, while 17.4 percent of men were in those occupations. Over 60 percent of all women were concentrated in clerical occupations, which attracted only 6.9 percent of men.

The representativeness of designated groups in different occupations in workplaces covered by the federal EE Act was more or less similar to that in the Canadian labor markets. Employers in Ontario, just as those in the federal jurisdiction, were required to undertake analysis of their workforce and to develop employment equity plans for improving workforce diversity at different occupational levels. Each employer was also required to review workplace human resource management policies and practices, and to eliminate those that are barriers of access and advancement of diverse groups. Results of review of employment policies and practices, as well as the workforce analysis, would be included in an employer's equity plan submitted to the enforcement agency in Ontario, the Ontario Employment Equity Commission. Improvement of workforce diversity at different occupational levels will, of course, depend on the effectiveness of enforcement of the legislation.

Research evidence indicates that the federal EE Act has not been very effective in increasing the representativeness of the designated

groups in different occupations. Employment programs in the federal public service, which is also supposed to be a model employer, were not very effective. Visible minorities were appointed to only 2.4 percent of the executive positions, and women constituted only 17.6 percent of the executives. However, visible minorities constituted 13.2 percent of chemists, 13.4 percent of mathematicians and 12.8 percent of medical doctors, and 98.8 percent of stenographers and 81.3 percent of clerks were women in the federal public service. The federal EE Act does not apply to the federal public service. However, the government developed employment equity programs for the federal public service under the Financial Administration Act. The effectiveness of the EE programs depends on employer commitment and legislation enforcement.

Enforcement of the EE Act seems to be similar to that of the human rights legislation. The Royal Commission on Equality in Employment observed that the complaint-based enforcement of equality policy "is increasingly under serious attack for its statutory inadequacy to respond to the magnitude of the problem of discrimination" in workplaces. The Commission added that the caseby-case approach of enforcing equality "is in the position of stamping out brush fires when the urgency is in the incendiary potential of the whole forest." The Ontario Human Rights Code Review Task Force also found four impediments to enforcement of equality policy: (1) unconscionable delays in handling of claims (complaints); (2) denial of hearings to all but the smallest number of claimants (complainants); (3) disempowerment of those who try to claim their rights under the Code; and (4) an enforcement approach that continues to be out of date and out of touch with present-day realities. The EEC's case-by-case approach in the United States, was as ineffective as that of the HRCs in Canada. However, the enforcement of the United States' Federal Contractors Compliance Program, and the language-based programs have been more effective than the equality or equity programs in Canada.

Job Preference Model

This Executive Order required each contractor to submit along with the tender an affirmative action plan to hire racial minorities, women, persons with disabilities and veterans, and to implement

the plan when a contract was awarded. In Philadelphia where onethird of the workforce was black, the building contractors failed to implement the plans when the construction unions refused to train blacks for skilled crafts and trades through their apprenticeship programs. The contractors could not hire blacks because their collective agreements with the construction unions required them to hire the skilled trades and crafts workers through the union "hiring halls." In 1972, the Nixon administration developed a plan, which was known as the Philadelphia plan, in which one-third of the contracts would be issued to either racial minority contractors or those who hired racial minorities.

The U.S. government found it necessary to implement an affirmative action plan with preference for hiring of blacks. Blacks in the urban ghettoes were the underclass, and the "truly disadvantaged" in the U.S. workforce needed distributive justice in employment. The job preference plan was subsequently applied to all major contractors in other industries such as transportation, education and defense. However, the Reagan and Bush administrations of the 1980s were not committed to either affirmative action or job preference plans, and in the absence of political commitment, the programs were ineffective.

The language-based job preference policies of Malaysia, Sri Lanka and Canada have the commitment of policymakers and the governments. In fact, the policymakers in Malaysia and Sri Lanka represented the majority of the population in their respective countries, for whose benefit the language-based employment policies were developed and implemented. The official language policy of Malay was to benefit Bhumiputras (sons of the soil) that constituted 61.3 percent of Malaysians, and the official language policy of Sinhala was to benefit Sinhalese that constituted (74 percent of Sri Lankans). The official language policy of Malaysia benefited Bhumiputras in the civil service. However, it was not as effective in the private sector as it was in the civil service. In the private sector workplaces, Bhumiputras were employed in 28.4 percent of the decision-making positions, while Chinese who constituted 30 percent of the population were in 66 percent of the decision-making positions. Prior to independence when the language of work in Sri Lanka's civil service was English, Tamils, who constituted 18 percent of the population, were in 30 percent of the administrative positions.

By 1970, their share of the decision-making positions dropped to 6 percent.

The *Canadian Official Languages Act of 1969* proclaimed English and French as the two official languages of Canada. As required under the legislation, a policy of institutional bilingualism was adopted for the federal civil service and for the crown corporations of the government of Canada. Institutional bilingualism required specification of proficiency in English and French for certain jobs, particularly supervisory and decision-making positions. The Royal Commission on Bilingualism and Biculturalism observed that until 1969 "bilingualism was demanded of most Francophones but not most Anglophones" and "in the struggle up the corporate ladder, the present work system in the large corporations gives Anglophones a built-in advantage over the Francophone colleagues." As a result, the Commission further observed that "Canadians of French origin in all regions of the country participate less in the high level occupational categories (particularly those of managers, professionals and technical personnel) and more in the blue collar and unskilled occupations." After the bilingualism policy was implemented, the representativeness of Francophones, increased to 21 percent of management positions in 1989 from 18 percent in 1978 in the federal civil service. In 1989, they also constituted 22 percent of the scientific and professional occupations in the federal civil service. Bilingualism was specified as a job requirement for 29 percent of the civil service positions in 1989, and it was required for only 21 percent in 1974. The languagebased employment policies of Canada, Malaysia and Sri Lanka, like the job preference affirmative action plans of the United States, are expected to increase the employment opportunities of disadvantaged groups in the respective countries' workforce.

Job Reservation Model

Job reservation policy in India, also was designed to improve the employment opportunities of the truly disadvantaged. In 1950, the government of India developed a results-oriented policy of employment to accommodate the backward (depressed) classes, the SCs and STs. The Indian constitution adopted the job reservation policy as a temporary 10-year program that was to be terminated

once the representativeness of the backward classes in the civil service and in the public sector (government) enterprises (PSEs) was proportionate to their share in the labor markets. Article 16(4) of the constitution of India provided "for the reservation of the appointments or posts in favour of any backward class of citizens which, in the opinion of the state, is not adequately represented in the services under the state." Because the representativeness of the SCs and STs in the civil service and in the PSEs, particularly in professional and decision-making positions, never reached the expected proportionate levels, the reservation policy has been extended every tenth year. Even after four decades of implementation of the reservation policy, the SCs and STs constituted only 5.68 percent of the upper level decision makers in the civil service, while they were 22.5 percent of the population. However, they constituted 24.40 percent of the cleaning and clerical workers in the civil service, and 81.93 percent of the sweepers in the PSEs were SCs and STs.

The state governments, too, developed employment reservation programs for other backward classes (OBCs), in addition to those for the SCs and STs, as was recommended by the Second Backward Classes Commission in 1980. In some states such as Karnataka, 66 percent of jobs in the state civil service and in the state PSEs were reserved for SCs, STs, and OBCs, since the three disadvantaged groups together constituted two-thirds of the state's population. The Supreme Court of India, however, found that reservation of more than 50 percent of the vacancies was unconstitutional since such a reservation would violate the constitutional requirement of maintenance of efficiency in administration. India's policymakers are now contemplating an amendment to the constitution to provide for reservation of more than 50 percent of jobs in the civil service and the PSEs to accommodate SCs, STs, and OBCs. Nonetheless, the representativeness of these groups, as reported by the Commissioner of Scheduled Castes and Scheduled Tribes, was very low in decision-making positions, and it was very high in the cleaning services in the states' civil services and PSEs.

The job reservation model, like job preference models, is results-oriented. Both are concerned with increasing the employment opportunities of specified disadvantaged groups. In countries like India and the United States, the population for whose benefit the job reservation and job preference models, respectively, were developed,

were "truly disadvantaged." From a social justice perspective, the truly disadvantaged population deserved employment policies for increasing their opportunities of access and advancement in the workplace. The policies developed for specified groups were applied to workplaces in the civil service and to those that were supported by Taxpayer money. Similarly, the job preference models were also applied to civil service and governmentfuned workplaces. These workplaces do not compete in global markets, and their human resource management policies and practices might not be emulated by managers of workplaces that compete in global markets for survival and expansion.

The equity model, like the job preference and job reservation models, is results-oriented. It also focuses on review and refinement of human resource management policies and practices, such as recruitment, selection, development, appraisal and reward of employee performance. The purpose of review and refinement is not only to make them fair, but also to assure fairness as perceived by a diverse workforce. The equality model also requires fairness of human resource management policies and practices. However, the equality model does not provide for measures of its effectiveness in implementation. The equity model, on the other hand, focuses on the results of distribution of a diverse workforce, which is proportionate to workforce diversity in labor markets. Such a distribution of a diverse workforce at different levels in a workplace confirms employees' perceptions of equity of management policies and practices. Perceptions of fairness motivate employee performance, which, in turn, contributes to workplace effectiveness. A model of management that focuses on the equity and representation of a diverse workforce is considered appropriate for workplaces to complete in global markets.

Representation Model

A representation model of management requires change, and managing change is important in workplaces that function in global markets. Along with globalization of product markets, global labor markets are also emerging with changes in the global workforce. Trends in the global workforce suggest that the vast majority of the new workers will join the workforce from developing countries. The

global workforce is projected to grow by 600 million between 1985 and 2000, and 570 million of them will enter global labor markets from developing countries. Between 1970 and 1992, the low-and middle-income countries' share of the world's workforce rose from 79 percent to 83 percent. The workforce in developing countries is growing at an annual rate of 3 percent, compared to less than 1 percent in the developed countries, such as the United States and Canada. Moreover, new workers entering the global labor markets from developing countries will be younger and more educated than those in developed countries. The share of total college graduates, particularly in engineering and sciences from the developing world, leaped from 23 to 49 percent between 1970 and 1985, while the share from the United States, Canada, Europe, the Soviet Union and Japan dropped to 51 percent from 77 percent. The low-and middle-income countries' share of the world's skilled workforce with at least secondary education jumped form a third to nearly a half between 1970 and 1992. In both developed and developing countries, workplaces need to recruit, develop and retain skilled and professional (knowledge) workers to compete effectively in global markets.

Demand for knowledge workers and mobility of an educated workforce in global markets necessitate changes in human resource management policies and practices. In the absence of change, the diverse workforce will be distributed along functional lines in workplaces. The racial minority workforce with science and engineering skills, including those with management training, are being steered into technical occupations and away from decision-making positions in developed country workplaces. In the developing countries, expatriates from developed countries are assigned to positions with power and financial control in joint venture and multinational corporations, whereas the local professionals are appointed to manage relations with the government, the public and workers. Both in developed and developing countries, women's opportunities are also limited to less powerful nondecision-making positions. Limited opportunities to advance into decision-making positions, and the distribution of women and racial (ethnic and caste) minorities along functional lines are unlikely to motivate their performance, and so they are likely to be underutilized in workplaces.

The functional distribution of a diverse workforce will also affect the access and advancement of new entrants into a workplace. Sponsorship facilitates access and advancement, and personal networks promote sponsorship. Personal networks of women and racial minorities are more expressive than instrumental for access and advancement to decisionmaking positions since their networks do not cover power centers in workplaces. Employees sponsor and refer candidates for positions, and the sponsored candidates are preferred in recruitment and selection. A sponsor refers a candidate from his personal networks, and networks are more homogeneous than heterogeneous. In other words, persons in decision-making positions sponsor and refer members of their personal networks for positions of power; the system unintentionally denies opportunities of access and advancement to a diverse workforce, particularly in workplaces with little diversity in management positions.

Personal networks are also important for mentoring, and mentoring is necessary for socialization, career development and advancement in a workplace. A mentor facilitates early socialization, helps the worker avoid performance pitfalls, counsels the availability of appropriate training and rewards a protege's opportunities. A mentor-protégé relationship is more common among members of a homogeneous group than between members of diverse groups. Members of a group with little or no representation in decision-making positions are at a disadvantage, for they are unlikely to have access to instrumental networks and mentoring in a workplace. Women and racial minorities are disadvantaged in access and advancement opportunities, for they are not adequately represented in decision-making positions.

Ontario recognizes the importance of representation of diversity in its employment equity legislation. The legislation provides for representation of a diverse workforce by a bargaining agent in the process of review of workplace human resource management policies and practices, and employers are required to negotiate with their respective bargaining agents in developing employment equity and pay equity plans. However, unions have no jurisdiction over recruitment, selection, development and compensation of managers, and they are unlikely to be effective in increasing the representativeness of a diverse workforce in decision-making positions. Moreover, unions represent the interests of the majority of

their membership, and the racial minority workforce is unlikely to benefit. The collective agreement between the University of Ottawa and the Association of Professors requires the representation of women on faculty recruitment and selection committees, but not for promotions into the university's decision-making positions. In other words, representation of diversity in human resource management committees is becoming an important component of a model of managing workforce diversity.

A diverse workforce is representation on workplace committees will offer an opportunity to understand the interests and concerns of different groups in reviewing human resource policies and practices, and in making personnel decisions. Recruitment committees with representation of diversity could search appropriate sources and recruitment methods for attracting qualified knowledge workers in diverse labor markets, instead of relying on the sponsorship of a dominant group. Diverse selection committees would be more fair in selecting from a group of diverse applicants than a committee consisting of only members of a dominant group in as much as their decisions are susceptible to stereotypes and biases. Equitable appraisal of a diverse workforce's performance is possible if the performance evaluation committees include representatives from a diverse workforce. Inequitable evaluation of knowledge workers' performance, such as in the cases of the Ontario Liquor Control Board.

Representation of women in job evaluation and pay survey committees is required to conduct gender-neutral evaluation of jobs in a workplace and to undertake an unbiased survey of pay rates in labor markets for developing an equitable pay system. The decisions handed down by recruitment, selection, appraisal and pay committees that consist of diversity representatives are likely to be perceived by a diverse workforce as fair. Human resource processes that are managed by committees consisting of diversity representatives are more likely to yield more representativeness at different occupational levels than those managed traditionally by a dominant group. Representativeness is expected to influence employee perceptions of fairness, and it could also contribute to equitable employee relations. Representativeness would reinforce employee involvement in management of a workplace through representation in human resources process committees. Employee

performance and export performance of a workplace would reinforce an employer's commitment to representation of a diverse workforce.

Export performance is an important incentive for managers to become agents of change. Exploration and expansion of global product markets, as well as improvements in employee performance, are important for increasing export performance. Managing workforce diversity is important on both counts. Members of a diverse workforce can be assigned to explore global markets with which they are familiar and in which they are able to function better than the members of a dominant group. In other words, globalization of product markets and the emergence of a diverse global workforce, particularly among skilled and knowledge workers, are the two most important external factors that are influencing human resources management. Public policies also influence management of human resources because employers would want to avoid litigation and damage to workplace reputation. However, the job preference policies are unlikely to be extended to cover workplaces in the private sector, particularly those that compete in global markets. The policy of equality as interpreted to include accommodation of a diverse workforce through special measures, on the other hand, is important and will influence management in workplaces of all sectors.

Conclusions

The equality principle as interpreted by the judiciary and employment equity as developed by policymakers are not significantly different. Both require fairness of human resource processes, and fair and equal treatment of a diverse workforce are required in both equality and equity models. The equity model provides for a measure of effectiveness. An effective equity model of management, the policymakers suggest, will yield representativeness of a diverse workforce in a workplace proportionate to the diversity in the labor markets. The measure of effectiveness is important for an employer functioning in diverse labor markets. Otherwise, an employer would recognize management problems only when confronted by complaints of discrimination, as employers of Japanese multinationals in the United States are facing legal challenges of discrimination of whites in the selection of decision makers. External enforcement of the equity model may be weak, but

enforcement of the equality policy will be strengthened in as much as even those policymakers who oppose affirmative action and employment equity policies are also committed to enforcing equality policy.

Internal enforcement is better than external bureaucratic enforcement, which is not only costly but also disruptive to management. External enforcement also affects employee relations adversely when equality and equity policies are enforced only in response to employee complaints. An employer committed to human resources will develop methods of internal enforcement of equality and equity policies to motivate employee performance and promote equitable employee relations. Employee involvement in the management of human resources is a method of internal enforcement, and representation of a diverse workforce on workplace committees constituted to manage human resource processes is an efficient mechanism for improving employee perceptions of equity and equitable employee relations. Efficient internal enforcement of equity policy is likely to yield representativeness of a diverse workforce at different occupational levels. Efficient utilization of a diverse workforce not only attracts qualified knowledge workers but also improves employee performance. Employee performance and export performance are important to the survival and expansion of workplaces in competitive global markets. Managers in developed and developing countries that compete in global markets are expected to be agents of change in managing a diverse workforce.

6

Globalisation and Economic Regionalism

Introduction

A common theme is that it generates increasingly intense interactions between nation-states and societies through flow of goods, money, people, ideas, images and information, in the process making territorial boundaries less salient. This makes the recent growth of economic regionalism amidst globalisation rather a paradoxical phenomenon, and has generated considerable scholarly interest in the relationship between them. While globalisation tends to de-emphasise boundaries, regionalism appears to be an attempt by state actors at re-imposing them at a different level, consequently creating a new, larger space out of smaller territorial spaces bounded in nation-states although the larger space is rarely, if ever, a new political unit or super-state.

Recent works in IPE identify two ways in which regionalism might emerge as an outcome of, or a response to, globalisation, depending on whether the relationship is conceived of as being accommodating or antagonistic. The former open regionalism is the dominant model in the literature, conceptualising regionalism as a way station to globalisation, a means through which policymakers

enhance the participation of their respective national economies in globalisation processes. It is a model that is informed by the liberal political economy perspective on IPE. A contrasting model, privileging domestic political dynamics, explains regionalism as an attempt by state or other domestic actors to resist the negative effects of globalisation. The main aim in this case is to preserve domestic social, including distributive agendas that are threatened by globalisation. Although providing considerable insight into developments in the contemporary world economy, these ideal-type models suffer two weaknesses, which consequently have implications for how they allow for the interpretation of empirical trends. Briefly, these models lack an adequate conception of the relationship of the state to domestic society on the one hand and to global market actors and other states on the other. These limitations, however, can be addressed by using a more appropriate theoretical tool, namely an analytical framework that integrates the economic realist theoretical perspective on IPE with domestic politics. This approach, which is discussed in detail in this chapter, offers substantial analytical purchase in explaining *why* regionalism may emerge out of globalisation and the *forms* it might take.

Before embarking on this discussion, it is necessary as a first step to advance a conception of economic globalisation that will help to extend our understanding of how globalisation might relate to regionalism as well as provide a frame of reference when operationalising the concept for empirical analysis. In the next section, globalisation is conceived of as a multi-dimensional structural phenomenon, which takes us beyond the still fairly common but rather narrow, liberal economic interpretation of globalisation as the extent and depth of economic integration between countries.

Conceptualising Globalisation

In conceptualising economic globalisation, three key features are salient. The first stresses the notion of globalisation as structure. Structure, as was discussed in the previous chapter, asserts or manifests its effects on actors through agency, or the policy choices and actions of a variety of agents-governments, businesses, international organisations and individuals. Not only does this

particular characterisation reject the idea of globalisation as an inexorable economic force, it also introduces into the equation the scope for human agency to resist, control or manage globalisation.

The second emphasises the multi-dimensional nature of globalisation, involving not just material economic factors but also ideational/cognitive and institutional forces operating in the world political economy. Consequently, the pressures of globalisation are not solely manifested through the material economic changes associated with global market competition, such as shifts in prices, market shares or profit rates, they can also emerge through cognitive and ideational influences as well as through institutional prescriptions and proscriptions. The interplay between these three dimensions of globalisation the material, ideational and institutional constitutes the 'context of habits, pressures, expectations and constraints within which actions take place'. Governments, businesses and other social groups have to respond to these forces in one way or another, but they cannot ignore them. In other words, even if states participate only marginally in world economic activities, that does not mean that they are not 'part' of globalisation, or unaffected by it. They are still very much subject to the forces of globalisation, which structure the environment in which these states are located. Conceptualised in this manner, globalisation is clearly much more than the sum of economic interactions and interdependencies between countries.

The third feature of globalisation, emphasised by Scholte, is its tendency to disengage human activity from territory. Hughes suggests that globalisation is qualitatively distinct from internationalisation and liberalisation, two phenomena often conflated with globalisation, because of its potential to 'reconfigure social space away from and beyond notions of delineated territory'. It is important, however, to avoid the 'hyper' globalisation thesis that the world is moving inexorably towards a borderless world. The 'de-territorialisation' that some argue to be the essential feature of globalisation is still a limited phenomenon, with national borders continuing to constrain the unfettered flow of global market forces. 'De-territorialisation' is perhaps confined largely to the world of global financial flows and the internet where finance and information flow instantaneously around the globe unconstrained by territorial borders and removed from territorial space.

Nevertheless, Hughes raises a crucial point about the tendency of globalisation to reconfigure social, including economic space beyond prevailing notions of territoriality, namely nation-states. But, what exactly is it about globalisation that has the potential to reconfigure economic space? More specifically, how is economic space being reconfigured and how might this relate to regionalism? A closer look at the constituent dimensions of globalisation is instructive in this regard.

The Material Dimension: the Changing Dynamics of Competition

Historical similarities exist in patterns of trade, finance and production between earlier periods and the present, post-1970s world economy, which is argued to represent most clearly the globalisation period. Yet, many students of globalisation point to the sharp differences in the volume, scope, speed, clustering and depth of the processes and interactions in the world economy between the two periods. More to the point, contemporary global linkages are argued to be 'organically different' due to changes in the 'manner in which firms organise production and both cooperate and compete with each other'. This is a valuable point, because it draws attention to the underlying firm-level dynamics that underpin globalisation processes and which drive the tendency to reconfigure economic space.

One of the most important driving forces of globalisation is the diffusion and adoption of the post-Fordist or flexible model of corporate and industrial organisation, particularly in the post-1970s world economy. Flexible production systems increasingly underpin the growing prominence of functionally integrated transnational production patterns that has been noted in the contemporary period. Governments and firms concerned respectively about economic growth and profitability find themselves having to respond in one way or another to the implications of the shifts in the way production is becoming increasingly organised.

First, the growing turn to more flexible modes of production has been accompanied by a shift in the sources of wealth creation from natural assets such as unskilled or low-skilled labour, land and natural resources to 'created' assets centred on information, technology and management/ organisational competencies. Although broad generalisations need to be made with care, since

natural assets remain important in a number of economic sectors, it is also evident that technology and skills have become crucial in manufacturing and service sectors, particularly in the higher value-added segments. Created assets, which tend to be firm specific and thus, potentially mobile, lend considerable structural power to global capital. Governments concerned about high value economic growth are increasingly reliant on the firms that possess these created assets to establish production activities in or involving their respective economies, underscoring the crucial importance of FDI, particularly for the developing world, and the intense competition for it among governments.

Production decisions remain, however, within the purview of the global firms that governments are increasingly trying to attract. Competition for FDI among countries has, therefore, become far more intense since governments are all courting essentially the same types of firms to their respective economies than in previous times, having adopted broadly similar export-centred economic policies. The worldwide liberalising trend has widened the location choice available to the firms that own these mobile assets. Storper suggests that particular geographic locations are entirely substitutable apart from nominal cost differences. It seems as though economic space worldwide is becoming increasingly homogenised with regard to economic policy. Although this homogenising trend should not be exaggerated, the point remains that coupled with technological advances and the deregulation of financial flows worldwide, production can now be located worldwide with considerably more ease than in previous decades. This makes competition for FDI likely to be more intense than ever, even if the ability of a firm to relocate, once established, is more restricted than is commonly presumed. Governments will more than ever compete with each other to attract these mobile assets before they become location bound once production is established.

Apart from governments, firms too are compelled to respond to the new competition. Globalisation has led to a more complex business environment for firms and more intense competition, particularly as the 'coordination and configuration of production chains has become the key to creating and sustaining competitive advantage'. This imposes an enormous burden on emerging firms, especially in the developing world, that are new to the game and

which also usually lack the ownership-specific assets to compete with well-established global corporations from the advanced countries in global competition.

Apart from this, the growing turn to flexible production methods also has implications for the manner in which economic space might be reconfigured. On the one hand, it would seem logical for firms to have an inherent preference for a global division of labour in line with the expansionary logic of capitalism. The turn to flexible production systems, however, may well be contributing to a phase of economic agglomeration through global capital's need for the spatial concentration of production activity. The agglomeration logic arises because the flexible modes of production are highly dependent on physical proximity between producers and suppliers on the one hand, and between producers and customers on the other. Thus, globalisation processes may help to re-define economic spaces beyond existing notions of territoriality, namely the nation-state, but not necessarily towards a global economic space. In short, both centrifugal forces (expansionary logic of capitalism) and centripetal tendencies (the agglomeration logic) co-exist in globalisation. Although this does not in any way imply in deterministic fashion particular forms of geographical clustering of production activities, it does explain the growing prominence of regionally, as opposed to globally, integrated production in the world economy. In an interesting case study, Studer-Noguez documents how Ford Motor Company's global corporate strategy shifted from one based on a single global production chain dispersed worldwide, which proved unworkable, to one that relied on setting up self-contained regionalised production chains replicated in different parts of the world. Ford's revised global corporate strategy was, therefore, premised on a number of distinct regional production operations located worldwide.

These new forms of production, driven by the shifting corporate strategy of global firms, are different from the cross-border economic activity that was prevalent during the 1960s and 1970s. Then, MNCs had exploited low labour costs in offshore production sites, producing for export to markets outside the region, usually to the industrial world and the MNCs' home markets. Although involving cross-border economic interactions, this form of internationalised economic activity did not involve any fundamental reconfiguration

of production space. Production was still organised *multi*-nationally on the basis of territorial nation-states, even if cross-border economic interactions were prominent. Since then, the dynamics of global production have altered towards an increasingly *trans*-national production pattern with different segments of a single production chain established in a number of sites, often straddling or crossing state boundaries. Critics of the globalisation thesis point to the regional clustering of economic activity as evidence against the emergence of a single global market place, and thus of globalisation as a meaningful or salient phenomenon. On the contrary, this chapter argues that these regionalising tendencies are the very outcomes of globalisation, emerging out of the shifting microeconomics of production.

Where such regional clusters emerge depends both on the policies adopted by governments as well as on the corporate decisions of firms. Because much of the assets required for production are located within firms themselves, firms are theoretically able to relocate worldwide, provided local conditions meet their production needs. Walter notes that foreign investors privilege, among other factors, market size and 'access to large regional markets' when deciding where to locate their investments. Interestingly, governments may be able to meet firms' growing need for proximity to regional markets through participating in regional cooperation schemes.

Ideational and Institutional Underpinnings of Globalisation

Far from being purely a material phenomenon, globalisation is sustained and reinforced by a coherent set of, by now, widely practised neoliberal economic ideas, which are increasingly institutionalised through the rules and practices of multilateral institutions, notably the World Trade Organisation (WTO).

The dominant neoliberal ideas underpinning globalisation emphasise and advocate, among other things, a free market economy with limited government involvement in and control of economic activity through policies of liberalisation, deregulation and privatisation, as well as the ideal of market competition. These ideas have become especially prominent from the middle of the 1980s, and are widely practised in both the industrial and developing world, although they do not go unchallenged. In fact, part of their

appeal lies in the seemingly simple and effective recipe for growth and wealth creation they offer to governments, compared to the failed interventionist alternatives tried during the 1960s and 1970s. Then, a variety of economic ideas prevailed, ranging from neoclassical ones about free trade and free markets, interventionist approaches to economic management, to more radical dependency thinking that emphasised withdrawal from the exploitative processes of the world economy. The extensive adoption today of neoliberal ideas globally facilitates the worldwide spread of economic activity, allowing corporations the flexibility to organise production in whatever spatial configuration that best maximises their goals. Although there is growing opposition to these neoliberal ideas and practices, they nonetheless retain their considerable influence on state actors, and, consequently, play a substantial role in reinforcing the material dimension of globalisation.

While neoliberal ideas are a crucial component of globalisation and sustain it, at a more fundamental level it is perhaps the growing instantiation of 'globalisation' itself and of global economic competition especially that influences how people respond to global economic change. Mittelman notes that 'globalisation has become normalised as a dominant set of ideas'. Palan and Abbott argue that the perception of globalisation is possibly the main cause for changing patterns of behaviour today. Actors, in their view, respond not only to actual external pressures or changes, they are increasingly responding to *perceived* environmental change. This is not an unusual point. Perceptions are, after all, of considerable importance in practical politics and policymaking. Policymakers, as do corporate actors, may respond in an anticipatory fashion to perceived global market competition to stay one step ahead of the game even if there are no immediate or serious market pressures on the economy. We should, however, reject the suggestion that only one kind of behaviour is possible that which accommodates to globalisation. Not all governments wish to act out the 'neoliberal script' underpinning globalisation. Ultimately, actors will respond to these perceptions in ways that are also governed by their location within distinct domestic social and political contexts.

While governments may be attracted to neoliberal economic ideas that promise simple recipes for creating economic wealth for societies liberalisation, deregulation and privatisation it is becoming difficult

for governments to select particular elements from this package of policy prescriptions while ignoring others, or even to reject them altogether, should they wish to do so. It is increasingly the case that international organisations, especially the World Bank, the International Monetary Fund (IMF) and the WTO underwrite globalisation processes by developing neoliberal rules to which national governments eventually have to conform. Either these rules are binding on governments if they are members of the WTO, or governments have to subscribe to the neoliberal policies dictated by the IMF or the World Bank in return for financial assistance during economic crises. In short, the post-World War II period of 'embedded liberalism' has given way since the 1970s to what Hoogvelt terms 'unembedded liberalism'.

Embedded liberalism allowed governments to intervene in the domestic economy to safeguard domestic social stability, provided border barriers to international trade were progressively reduced. This compromise, which effectively allowed governments to deny market access and national treatment to foreign firms if they so wished, began unravelling over a period of time beginning from the early 1970s. It was only from the mid-1980s, however, that new rules in world trade were adopted that redefined or more precisely markedly reduced the purposes for which the government could legitimately intervene in the domestic economy, including restricting or discriminating against foreign firms. The new rules consequently advanced the interests of the transnational corporations (TNCs) that are key agents of globalisation. In short, the neoliberal ideas associated with globalisation have been increasingly institutionalised through a multilateral rule-based framework that has substantial authority over national governments, especially through the WTO.

To date, the WTO, previously the General Agreement on Tariffs and Trade (GATT), has been perhaps the pre-eminent institutional agent of globalisation, having a more extensive reach both in terms of geographical coverage and ever widening scope compared to other global institutions. Unlike the IMF, which enters the scene during times of economic distress when governments need emergency financial assistance, the WTO is a more constant influence or constraint on national governments and firms. Not only does the WTO boast 144 contracting parties with others awaiting entry, its

functional scope has dramatically expanded and its authority strengthened compared to the GATT.

Since the GATT Uruguay Round negotiations of 1986-94 that launched the WTO, disciplines addressing intellectual property rights protection, negotiable market access and national treatment for foreign service firms, as well as trade-specific investment measures were explicitly incorporated into the multilateral trade regime. Rules on domestic competition and investment liberalisation are expected to eventually fall under the ambit of the WTO. In these new issue areas, rules are expected to prescribe market deregulation while proscribing state intervention in the market, thereby constraining government direction of the economy. While the WTO is constructed in a way that provides ample opportunity for dissenting governments to veto its liberalisation agenda, there are costs to such recalcitrance. Valuable market access concessions from industrial countries might not be forthcoming while governments lose credibility in the eyes of the corporations that increasingly hold the key to wealth creation.

These trends raise expectations among governments, particularly in the developing world, that the new rules that will be written into the multilateral trading regime will increasingly restrict the rights of governments to intervene in the domestic economy even for what would have been previously considered to be legitimate domestic social purposes. While such rules will offer TNCs a global trading and production environment that is increasingly tailor-made to their needs to pursue 'maximum profit', emerging firms from the developing world may become increasingly disadvantaged. Should these rules be adopted, developing country governments, while obliged to allow foreign firms domestic market access, will become increasingly constrained in providing preferential treatment to domestic firms. This, coupled with the competitive pressures discussed above, further reinforces perceptions in the developing world of globalisation as heightened global market competition. The fear that fledgling firms will suffer from direct competition with TNCs is a growing feature in many developing country policy circles.

Globalisation: Structure, Process and Agency

Three points need to be kept in mind from this discussion. First, while globalisation involves the reconfiguration of economic space,

this does not necessarily imply either re-definition towards a global economic space or a single global division of labour, or the absence of territoriality. Instead, the optimal economic space appears to be regional. This is not to suggest a functionalist line of explanation for the relationship between regionalism and globalisation. Nevertheless, the functional relationship between these two phenomena implies that corporate actors may respond positively to regionalism, particularly of the kind that further entrenches globalisationopen regionalism. Globalisation, in other words, opens up space for agency, particularly on the part of state actors to influence corporate behaviour.

The discussion also identified three sets of potential globalisation pressures that might result in the adoption of policies for regional cooperation material economic pressures, cognitive influences and institutional rules. There is, however, no determining logic that points to open regionalism as the only policy response to globalisation. Countervailing tendencies may well result in other forms of regionalism, notably the resistance model. Much depends on how the actors located within domestic social and political contexts respond to the structural pressures associated with globalisation on the one hand and to domestic political and social imperatives on the other that may collide with the globalisation logic. There are today significant counter-currents in the world economy that challenge both the neoliberal discourse and globalisation itself. It is in this sense that globalisation is not a stable structure or a fully entrenched order, but one that can be challenged.

While it is true that globalisation is partly driven by technological innovations and the uncoordinated individual actions of rational economic actors out to maximise economic gains the liberal economics reading this is not the same as saying that globalisation is an inexorable economic force. It is necessary to recognise that globalisation is a process driven by the policy choices of a variety of actors governments, corporations, international organisations and individuals who put in place the necessary institutional structures that support globalisation processes. What this also implies is the possibility for human agency, including that of governments, to manage the process or to attempt to shape it in

preferred ways. It is out of such attempts that regionalism emerges in response to globalisation.

Open Regionalism

The preceding discussion suggests that the relationship between globalisation and regionalism may be complementary. The outward-looking nature of most contemporary regionalist projects leads many observers to surmise that these projects are designed to enhance the participation of member countries in global market activity. This is the notion of 'open regionalism', which is a striking contrast to the 'closed' regionalism of the 1960s and 1970s that had been aimed at insulating members from the world economy in line with dependency thinking. Open regionalism is the dominant theoretical model of the globalisation-regionalism relationship in the literature, as well as the most common form of regionalist project found in the contemporary world economy.

Open regionalism, as the term was originally used, meant a form of regionalism based on the principles of unilateral liberalisation rather than formally negotiated liberalisation, as well as non-discrimination, meaning that regional concessions were offered to both members and non-members alike. While retaining these liberal economic underpinnings, the term is now used in a more general sense to characterise regionalist schemes that are fundamentally about engaging with globalisation and the global market. Therefore, in regionalist schemes characterised as open regionalism, the exchange of preferences among regional partners is not accompanied by the imposition of new barriers to non-partners. Some scholars also define an open regionalist project as one whose members are willing to admit new members into the grouping provided they conform to group rules and arrangements.

Underwritten by the liberal political economy perspective on IPE, the primacy of economic incentives and the search for efficiency and competitiveness are emphasised in explaining open regionalism as a policy response to globalisation. Consequently, much of the literature explains open regionalism as a project of governments responding to the needs of corporate actors to improve competitiveness in global markets, using regional action as a means to engage with the global economy. The liberal interpretation also

suggests that these projects are likely to include a strong neoliberal agenda requiring extensive domestic deregulation, apart from trade liberalisation, aimed at reducing the state's role in economic life in order to yield efficiency gains. The effect of such actions is to markedly reduce transaction costs for firms engaged in transnational economic activities. In short, this form of regionalism neoliberal regionalism subordinates the economies of member countries to what are seen as the beneficial forces of the global market. Aimed at deep engagement with the process of globalisation, open regionalism is an instance of 'meso-globalisation'. Open regionalism and neoliberal regionalism are often regarded as synonymous in the literature.

This still leaves open the question of why corporate actors and national policymakers would advocate a policy of *regionalism* if their ultimate aim is to engage with the global market. While the discussion in the previous section suggests how globalisation may be functionally related to regionalism, this does not explain regionalism as a *political* choice. The liberal perspective underpinning the notion of open regionalism provides only limited answers to this question. A strict liberal interpretation would, in fact, see global liberalisation to be superior to regional liberalisation even if corporate strategies dictate regional production networks as the optimal configuration under flexible modes of production. Even if their preference is to organise production regionally, global liberalisation allows corporations maximum choice of where to invest and in whatever spatial configuration best accommodates the firm's needs. This is borne out by actual trends in the world economy, as the previous discussion made clear. While global corporations today tend to organise production on a regional basis, locating regionalised production operations in different parts of the world, this is usually part of a global strategy.

The regime literature (neoliberal institutionalism), a variant of the liberal perspective, provides an answer to the 'why regionalism?' question by suggesting that governments opt for regionalism because cooperation is easier to negotiate with smaller numbers than would be the case for negotiating global liberalisation. Regionalism is a solution to the collective action problems that impede cooperation among large numbers. Moreover, by creating both an incentive and a potential bargaining tool for further negotiations, regional cooperation can potentially advance global liberalisation. Liberal

readings of regionalism thus see the phenomenon as a building block to global liberalisation. This particular interpretation suggests that we are likely to see ever-widening processes of regionalism, as more and more nation-states are brought into existing regional projects in an effort to build up global liberalisation. Regionalism, then, constitutes an efficient but possibly interim approach to global liberalisation.

Although providing useful insights into the globalisation-regionalism relationship, liberal interpretations of regionalism are, nonetheless, limited because they lack a deeper notion of international politics. The decision to participate in regionalism is made in order to subordinate the national economy to what are seen as the given and beneficial forces of the global market. In this liberal model, regionalism involves very little purposeful political action by governments of states to attempt to intervene in globalisation processes—in short, the absence of any notion of political struggle, both domestically and externally. Instead, governments acquiesce in and act in accordance with the logic of global market forces asserted through the pressure of market competition. This interpretation of regionalism is based on a somewhat simplistic characterisation of the international political economy, while it also privileges structurally derived interests in explanation. There is an implied coincidence of interests between state actors and those businesses in favour of (regional/global) liberalisation, with both sets of actors responding similarly to the pressures of global market competition. The liberal perspective is silent on domestic distributive issues, since in the liberal world the search for efficiency and the resultant economic growth leads to gains for all in the long run.

Like its circumscribed characterisation of the international political economy, the neglect of the distribution question is a serious limitation of the liberal political economy reading of regionalism. Moreover, its framing of the relationship between state and corporate actors is overly simplistic. In particular settings, the distinction between foreign-owned and domestic-owned capital is often the more salient one, rather than between inward-focused and outward-oriented businesses. Although broad generalisations need to be made with care, domestic-owned capital is often harnessed to attain vital domestic social and political goals aimed at by political leaders, while foreign capital addresses the broad growth priorities of

national governments. For this reason, it is important to take seriously domestic distributive dynamics. In parts of Southeast Asia, for instance, domestic-owned capital is central to domestic distributive agendas. In settings such as this, governments may well respond to globalisation in ways that attempt to preserve and/or nurture domestic capital, particularly if emerging domestic capital that is also politically important is in danger of losing out to global capital in market competition. To the extent that such responses include regionalism as a policy choice, the nature of the regionalist project adopted is likely to differ from the liberal model of open regionalism.

Regionalism as Resistance to Globalisation: Legitimacy and Domestic Politics

The second ideal-type model of the globalisation-regionalism relationship in the literature explicitly brings in the domestic level, and is thus a useful corrective to the basic model of open regionalism that focuses on systemic level forces only. Although encompassing a range of variations, the essential feature of the basic resistance model is that it seeks to preserve through regionalism particular forms of national policy instruments or domestic social and economic arrangements that are difficult to sustain individually amidst globalisation. The resistance model thus emphasises concern with non-economic or social values like distribution and social justice as the main driving force for regionalism, in contrast to the basic model of open regionalism that emphasises the search for efficiency and competitiveness as a key driving force. Although systemic forces globalisation do come into the picture, the response to them resistance regionalism is mediated through the domestic political economy.

Legitimacy is usually an underlying concern for policymakers contemplating this form of regionalism. Governments, deriving political legitimacy from their capacity to undertake traditional social responsibilities for the societies they govern, may be compelled to turn to regional collective action as the only viable option to maintain national social/economic arrangements like the welfare state apparatus. Globalisation arguably makes such arrangements more costly to maintain at the national level. Kurzer, for instance, suggests that the future of national social democratic economic systems and re-distributive policies in European countries lies in a European regional project.

Notwithstanding the theoretical possibility of the resistance model, most instances of regionalism in the world economy today are examples of open regionalism, including the European Union. Nevertheless, there is always the possibility of a dialectical process emerging out of globalisation to challenge the neoliberal trend in regionalism. The resistance model may consequently emerge as an empirical feature as regional projects originally designed to engage fully with globalisation are themselves challenged by domestic groups suffering the effects of regional liberalisation, particularly if social protection or compensatory measures are unavailable as a result of neoliberal approaches to market liberalisation. Neoliberal regionalism consequently may challenge the authority and legitimacy of governments under these conditions. In such instances, governments may attempt to withdraw from the regionalist project, or alternatively seek to change the project's original terms and conditions. The tendency to use regionalism to ride on globalisation may not be a lasting one. Regionalism should, therefore, not be viewed only in static terms as the outcome of a one-off decision to cooperate. New forms of regionalism could emerge from what was originally a neoliberal project, especially if the re-negotiation option is adopted rather than outright abandonment of the project.

Although offering an alternative to the model of open regionalism through emphasising the domestic legitimacy concerns of governments, the resistance model unfortunately imposes a separation of economics and politics by conceptualising growth or efficiency (economics), the primary goal of open regionalism, and legitimacy (politics) as opposed to one another. This is because the analysis of domestic politics in the resistance model does not extend to uncover the bases of legitimacy. Instead, this model adopts a somewhat Euro-centric understanding of legitimacy based on the European welfare state. If we explore the dynamics of political legitimacy in other settings, we are likely to find that in certain political contexts, growth/efficiency and legitimacy may be closely interrelated, and complementary rather than opposed. Much, therefore, depends on the sources of political legitimacy in a particular society.

The ASEAN case illustrates this point particularly well. In this setting, it is the governments' ability to deliver material economic well-being, in addition to social and political stability, that accords

them legitimacy, rather than representation and process as in liberal, western democracies. In these countries, high rates of economic growth not only satisfy mass aspirations to material well-being they also allow elites to maintain their right to rule. In such instances, the presumed tension between legitimacy and growth/efficiency is either relieved or, at least, reduced. Concern with legitimacy could thus entrench open regionalist projects if these contribute to growth, rather than result in challenges to them. Clearly, we need to pay closer attention to domestic state-society relations that help us to identify what the bases of legitimacy are, and the conditions under which growth or efficiency considerations prevail over distributive agendas, and vice versa.

Conceptual Gains from the Economic Realist Perspective on IPE

The two models of regionalism offer a limited treatment of the *political* relationship between states and markets (both the domestic and the global market) as well as between states themselves. In open regionalism, global market forces are taken as a given and are regarded as benign, conferring benefits on all states in a positive-sum manner. State actors engage in regionalism because it is an *efficient* means of facilitating the integration of the national economy with the global economy. In the context of this book's study of AFTA, this model cannot explain why the ASEAN governments opted to make a distinction between foreign and domestic-owned capital in regional investment liberalisation, which is clearly an attempt to block the workings of (global) market forces, thereby contradicting the model of open regionalism. The resistance model, in contrast, explains regionalism as an attempt to block global market forces. This model is similarly unable to explain why the privileging of domestic-owned capital in AFTA's investment programme was only temporary and partial. How do other theoretical perspectives fare in modelling the relationship between globalisation and regionalism?

Alternative theoretical approaches structuralism and economic realism in IPE would dispute the liberal reading of the international economic order. Both these perspectives regard the global economy as an inherently political space in which economic interactions and activities reflect redistributive, zero-sum games. By doing so, both perspectives allow for the possibility of human agency, as actors try and manipulate prevailing patterns of economic activity and

economic relations in order to gain an increasing share of the benefits of global market activity. Nonetheless, the structuralist perspective is rejected as a useful theoretical model for this study because of its strong element of economic determinism. Actions and outcomes in international politics are driven by the logic of global capitalism, with the state acting as the instrument of capital. Although states are considered in analyses, they are not seen as political communities in their own right but merely as constituent units of a world capitalistic system. Domestic considerations and priorities stemming from domestic political constituencies are marginalised in structuralist approaches, which tend to focus almost exclusively on social groups derived from the capitalist mode of production capital and labour, whether national or transnational while ignoring other social groups that are significant in a number of ASEAN countries, ethnic groups for instance. Ethnicity often gives rise to vertical cleavages within capital and labour groups.

On the other hand, the economic realist perspective offers greater scope for our analysis. Its view of nation-states as independent political communities, notwithstanding their interdependent relations with other states and with non-state actors, is one that accords with much real world dynamics. One of its central arguments is that 'states seek to influence markets to their own individual advantage', making the geographic location of economic activities their leading concern. This implies that governments are likely to marshal power in an attempt to interfere in global markets to attain the interests of their respective states in competition with other states, or in response to non-state actors such as TNCs in the global system. For smaller, less powerful states, this can occur through cooperation between similarly situated states, for instance, in much the same way that alliance formation meets the shared strategic interests of a group of states vis-à-vis other state(s). This particular view of agency in the international political economy concurs with classical realist thinking. Morgenthau, for instance, acknowledged that states have the potential to transform the international system 'through the workmanlike manipulation of the perennial forces that have shaped the past as they will the future'. Economic realism recognises, therefore, that state actors can attempt to, and often do, manipulate inter-state politics to try and influence some aspect of the international political economy. While the actual success of such

agendas may be limited, especially in the case of developing countries, nevertheless by allowing for the possibility of purposeful action, the economic realist perspective introduces a more realistic notion of politics into liberal frameworks of regionlism.

Modifying Understandings of Open Regionalism: The FDI Variant

The economic realist perspective offers valuable insights into the globalisation-regionalism relationship based on the notion that there is room for 'purposeful action to alter or transform prevailing patterns of economic capability and advantage'. This point of view suggests that even in the case of open regionalism where governments seek to integrate their economies with the global economy, governments may be using regionalism in a purposeful manner to manipulate particular aspects of globalisation processes to benefit the state and its society, or particular members of the political community. It encompasses the idea that governments are not always totally helpless in the face of globalisation, and may find the space to engage in actions through cooperation that alter or interfere with global market outcomes in certain desired ways.

Mittelman alludes to this when he suggests that the logic of global capital, namely its tendency to engage in regional production, offers nation-states an incentive to collaborate 'to attain market shares and augment trading and investment opportunities'. Regionalism, thus, presents one means to help re-direct beneficial global capital to the region in question through the carrot of the single regional market. As the previous discussion has shown, corporate actors are likely to respond positively to the presence of regional markets when deciding where to invest. In such instances, open regionalism is driven less by narrower concerns with economic efficiency and more by concerns with attracting FDI, which is a key source of economic growth for many countries. It is an agenda that is likely to appeal to developing countries.

Governments may respond to the structural power of transnational or global production capital by actively using regionalism to attract new production capital to the region and through the process to individual national economies. Developing countries, usually with limited indigenous capabilities for global production, often look to attracting TNCs that do possess these assets to their respective economies. In a situation where FDI can

theoretically locate in a variety of sites, developing countries will want to prevent the potential loss of these wealth-creating assets owned by TNCs to other locations. TNCs may not be involved in direct lobbying or bargaining with governments, but policymakers are likely to make policies with this thought the need to attract or retain global capital in mind. Although this may be accomplished through providing a more liberal national regulatory environment for investors, market size and access to large regional markets are among the main criteria now influencing the decision about where to invest.

Engaging in regional cooperation, thus, allows governments to exploit global capital's functional preference for regional markets. Policymakers are likely to respond with a policy of regionalism to external developments that are seen as having the potential to divert investment away from the national economy, provided they recognise the potential of regionalism in retaining or attracting production capital. They may become aware of the potential of regionalism as a magnet for FDI once they realise that foreign investors are registering strong interest in, and are actually investing in regionalist projects established elsewhere.

Regionalist projects driven primarily by the desire to attract global capital are instances of open regionalism to the extent that they are about engaging with globalisation processes. In that sense both economic realist and liberal theoretical perspectives provide similar readings of regionalism. These contrasting perspectives offer distinct views on two issues, however the precise form or features of the regionalist project and its likely future trajectory.

Regionalist projects designed primarily to attract FDI need not necessarily encompass the strong neoliberal, deregulatory agenda often associated with neoliberal regionalist projects driven by efficiency concerns. The overriding concern in the former is more broadly with economic growth. Efficiency is attained to the extent that the incoming capital operates efficiently, but the regionalist project is not necessarily underpinned by neoliberal ideas nor associated with a strong neoliberal agenda. There is substantial empirical evidence that foreign investors privilege other factors above the policy regime when making investment decisions, although they would clearly prefer less rather than more government intervention

in markets. Provided key areas of economic life that are crucial for foreign investors are relatively unrestricted, such as trade flows and financial regulations on profit repatriation, investors appear able to live with some degree of government restriction in markets. Regionalism primarily motivated by the desire to draw in FDI may therefore display only limited neoliberal characteristics. These projects are best termed 'embedded neoliberal projects'. While they are, nonetheless, instances of open regionalism designed to remain engaged with global market forces, these projects are entirely consistent with a degree of government intervention in markets.

An economic realist reading of open regionalism also suggests that the prospects for extending the regionalist project to include new members will be contingent. Since regionalism is directed at offering global capital a distinct functional space of production, extending the project to new members could weaken the distinctiveness of the original regional project. This will be the case especially if the new member itself is a very attractive site for FDI, potentially able to draw in substantial amounts of incoming FDI with limited spillover benefits to other members in the project through vertical and horizontal production linkages. Although there is always an element of competition among the members of a regional project for incoming FDI, the presence of complementarities among members usually ensures that some form of balance is achieved. In contrast, regional projects involving a group of small countries may not necessarily benefit from the membership of a large country such as China, which itself effectively offers foreign capital a 'regional' site of production by virtue of its size and wide-ranging industrial complementarities. There is a strong possibility that foreign investors may prefer to establish production networks within the Chinese territory but trade the resultant output to the other members of the regional scheme, thus defeating the purpose of the regional exercise for its original members. The benefits of extending FDI-centred regional projects to new members are not unequivocal, unlike the case of efficiency-driven neoliberal regionalism.

Although the dominant open regionalist model emphasises globally oriented capital in analysis, with foreign capital a key focus in the FDI variant, domestic capital is thus far invisible. There is little attempt to consider the relationship between governments or political/state actors and fractions of capital distinguished by their

ownership domestic- or foreign-owned capital. The conventional focus in the literature has usually been on segments of capital distinguished by their market orientation, either towards the domestic market or the international market. Although it may be increasingly difficult to distinguish business in terms of its nationality the 'who is us?' question posed by Robert Reich such a distinction, nevertheless, remains relevant in particular political contexts where policymakers and politicians do consciously make this distinction for various political reasons. In these settings, and this is especially true for developing countries where domestic capital is usually not as well developed as foreign capital but often plays a crucial social/political role, governments may well respond to globalisation in ways that attempt to preserve and nurture domestic capital. Clearly, we need to consider theoretically plausible models of regionalism in which domestic capital is accorded analytical priority.

Developmental Regionalism: Privileging Domestic Capital

Making an analytical distinction between foreign and domestic capital reveals a fourth model of regionalism, what I call 'developmental' regionalism. Deriving from the notion of the developmental state, developmental regionalism encapsulates the developmental state idea of state intervention in markets to promote national development agendas, in this case by adopting an approach to regionalism through which to nurture emerging domestic firms to eventually become internationally competitive. This is achieved through two instruments: one, the expanded regional market generated through inter-state cooperation and two, temporary protection or privileges for domestic capital in this expanded market. According to strategic trade theory from the international economics discipline, both measures can help to secure benefits for domestic firms over their foreign competitors.

Insights from Paul Krugman's 'import protection as export promotion' strategic trade model reveal that when a domestic firm is given a privileged position in the home market, it enjoys an advantage in scale over foreign rivals that enables the firm to realise 'learning by doing' benefits. A larger protected home market offers greater dynamic scale and learning effects to the privileged firm. Thus, by employing selective protection or privileges for group members only and market expansion through regional cooperation,

governments can use regionalism to help develop competitive domestic industries to survive global market competition and eventually become world market leaders, at least in theory. Developmental regionalism is clearly in the economic realist tradition, encompassing as it does the idea of state activism in the international system, in this instance through inter-state collaboration to manipulate economic activity to serve the perceived interests of the state.

We may regard the concern with domestic capital as a preoccupation with distribution, or with the selective allocation of economic benefits including rents to domestic businesses, in contrast with the generalised growth/efficiency imperative that underpins open regionalism. Nevertheless, concern with growth is not entirely absent in developmental regionalism. Rather, the growth imperative is infused with distributive concerns. Developmental regionalism is, therefore, not about resisting globalisation completely, but neither is it about complete acquiescence to global market forces. Instead, it encompasses a period of temporary and limited resistance to aspects of globalisation through which attempts are made to enable domestic businesses to eventually participate in global market activities. This model of regionalism, therefore, allows us to consider departures from open regionalism as representing a distinct approach to regionalism rather than merely as inconsistencies in open regionalism or as instances of protectionism.

The question that remains, however, is why political actors would seek to nurture *domestic* capital. Why would they prefer to maximise the wealth of a segment of society instead of maximising the wealth and efficiency of society as a whole through full embrace of global corporations, arguably the primary source of wealth creation in the global economy? In fact, we should extend this question to also ask why and under what conditions state actors would opt for a form of regionalism that privileges FDI instead of the neoliberal or the developmental versions.

A strict realist interpretation would see state authorities seeking consciously to manipulate patterns of international economic activity for strategic, power-political purposes, and may arguably apply to the interactions of the major powers and potential strategic rivals like the US, Japan or the EU. It applies less well in other settings, developing countries included. The latter are more likely to be driven by concerns rooted in the domestic political economy rather than by

a concern with inter-state power political competition. This line of thinking is not such a radical departure from the realist notion of national security. Security for developing states is generally framed in terms of the security of *domestic* political institutions and governing regimes. The realist tradition, after all, does not completely ignore the domestic level unlike its neorealist counterpart. As such, it is conceptually consistent to argue that an economic realist external orientation is underpinned or driven by domestic regime security imperatives more specifically, and by domestic political determinants more broadly. This book, therefore, argues for attention to be paid to the domestic level in explaining the turn to regionalism. Although the FDI variant of open regionalism and developmental regionalism are both informed by economic realist insights, analysis moves beyond the strict realist conception of state interests in terms of security and survival of the state in inter-state power political competition. Instead, these interests are defined primarily in relation to domestic political dynamics. The question, of course, is how the domestic and international levels are related, to which the next section turns.

Incorporating the Domestic Level

Political actors everywhere are usually confronted by the choice of adopting policies that maximise wealth in society as a whole or that benefit particularistic interests; in other words, between concern over growth or over domestic distributive priorities. Distribution is defined in this book as the conscious allocation of income, rents and other economic benefits by governments to particular individuals, groups or firms who would otherwise not have received these gains through the workings of the free market. Policy responses to external events, including choices about regionalism, are quite likely to involve tension between the growth and distributive imperatives. In most domestic settings, economic policies, including foreign economic policies, are influenced by these basic priorities, with policymakers driven by whichever goal best secures their chances of remaining in power. Which priority dominates growth or distribution will depend on the political costs to incumbent leaders of adopting policy choices that emphasise/ de-emphasise one or the other goal, and thus, will be contingent on prevailing economic as well as political circumstances. It will also depend on the nature of political legitimacy.

This is best illustrated by exploring more closely the case of the ASEAN states, which may be characterised as elite governance political systems where political elites are preoccupied with maintaining both the prevailing regime or political system and themselves in power. Many developing countries share similar preoccupations.

Conceptualising Domestic Politics in ASEAN

Political systems in ASEAN during much of the 1990s ranged from democracies to semi-democracies and authoritarian regimes, all the ASEAN countries shared the basic characteristics of elite governance political systems where political power was largely in the hands of elites despite the presence of mechanisms for citizen participation. The political elite was, however, not completely insulated from domestic society, and needed to respond to concerns arising from this level in order to maintain elite rule and its legitimacy, which remained fragile throughout the 1990s. In such settings, political elites depend on two key policy instruments growth and distribution to maintain themselves in power and to ensure stability of the domestic regime or political system.

On the one hand, political elites need the support of citizens to maintain their right to rule and to ensure political order, and this is largely achieved through creating material wealth for citizens the notion of performance legitimacy, which remains relevant to date. This explains the preoccupation of political leaders with securing and maintaining key sources of growth in the economy, of which FDI is pre-eminent in ASEAN. On the other hand, elite rule is also sustained by unity and accommodation between members of the elite/ governing coalition. Political elites selectively distribute economic benefits to their elite partners as a primary means to achieve elite unity.

It was the accommodation between the political elite and an emerging domestic business class that was crucial in much of ASEAN. The material and other forms of political support provided by domestic businesses helped incumbent political elites maintain their power base, while the former in turn received economic privileges through preferential policies instituted by the latter. In addition, domestic businesses were often privileged because they helped political actors fulfil broader social equity goals in society.

This was especially clear in the Malaysian and Indonesian cases, where political legitimacy also rests on the capacity of the state to develop respectively an ethnic Malay and indigenous Indonesian domestic capital class, particularly to offset the dominance of ethnic Chinese capital. There is also a wider distributive agenda in parts of ASEAN that may lead policy makers to privilege non-elite or broad social groups in policy choices, provided these represent key constituencies for ruling elites and vital to sustaining elite rule and the stability of the regime.

The importance of the distributive agenda in maintaining elite unity does not imply that economic growth is unimportant in this process. Even though economic distress is not the primary source of factional or inter-elite conflicts, it is likely to exacerbate them. Fewer internal divisions within the ruling elite are likely when economic growth is strong. Declining economic performance often disrupts the political bargain rulers typically forge with other elite groups in the society. Under these circumstances, political elites are unable to provide their elite partners with the basic conditions that support wealth creation, while the latter become unable or unwilling to continue to offer material and political support to the ruling incumbents. The end result is a weakening of elite cohesion and the power base of incumbent elites, while opposition groups gain from the defection of business and other elites previously aligned with the incumbents.

The challenges posed to ruling elites by declining economic performance have been amply demonstrated in the case of Indonesia and Malaysia. In Indonesia, political turmoil and the ousting of incumbent ruling elites quickly followed financial and economic troubles as a result of the Asian financial crisis that began in mid-1997. Malaysia too has witnessed substantial elite cleavages as a result of the financial crisis, although an emergent mass challenge to the ruling incumbents has been contained. In short, while the selective distribution of economic benefits to elite partners is a primary means of maintaining elite cohesion, broad-based economic growth is not unimportant. Political elites often have to engage in difficult balancing acts in their policy choices, particularly when these involve significant trade-offs between the growth and distributive imperatives, or between maximising wealth and efficiency in society as a whole and maximising the wealth of a segment of society.

In much of ASEAN, foreign capital remains a key source of growth and exports, particularly in the high value-added and advanced sectors of the economy that virtually all governments are increasingly targeting, although domestic-owned firms are not entirely absent from this picture. A simplifying, though not unreasonable assumption made in this book is that the foreign capital governments are targeting is internationally-oriented and thus in favour of liberal market policies that maximise growth. On the other hand, the distributive imperative in ASEAN, where it exists, is usually aimed at privileging domestic-owned capital or segments of it that are also close allies of the political elite. Domestic capital may be either internationally oriented or emerging/inward focused. To the extent that both foreign investors and internationally oriented domestic-owned capital are likely to favour similar types of policies, essentially growthcentred, liberal market policies, little or no conflict should be expected between the growth and distributive imperatives even if internationally oriented domestic capital is closely allied to the political/state elite. It is when the political elite is closely allied to inward-focused or emerging domestic capital that the tension between growth and distribution becomes pronounced. Since this segment of domestic capital is not as well developed as foreign capital, policymakers may well adopt measures to protect, preserve and/or nurture emerging domestic capital vis-a-vis foreign capital if the former is to survive direct competition with the latter.

While government policies for distributing economic benefits to politically important individuals, firms or groups do not necessarily mean that the economy is on course towards economic decline, distributive policies may involve trade-offs with the growth imperative. Trade-offs are especially likely when economic rents are created through artificial restrictions on market competition by governments, which could undermine growth. When distributive policies involve restricting the domestic operations of foreign (or internationally oriented) firms, growth prospects may be weakened if the latter are significant agents of growth. Growth need not, however, be disrupted if the extent of distribution is limited, either to particular sectors or in terms of time. On the other hand, governments may find it necessary to limit their distributive agenda during times of economic distress, or expected economic hardship, which will affect citizens in general through unemployment, for

instance, as well as threaten elite unity. By threatening the political future of incumbent political elites, economic decline, or the prospect of it, often compels governments to restore the conditions favouring growth, particularly since growth will allow distribution to take place with fewer costs than under conditions of generalised economic decline.

Although the discussion thus far has been framed in terms of how governments may be driven by concerns related to capital, it is important to note that these concerns are not derived from the logic of global capitalism, nor in relation to freeing up the market for business in some technical sense, but instead stem from domestically derived political priorities. Although the book focuses on the relationship between *capital* and state/political elites in explaining particular outcomes in regionalism, this is not to suggest a Marxist or neo-Marxist conception of capital and of state-capital relations. The discussion on the specific case of ASEAN illustrates how the relationship between state and capital in the ASEAN countries is one conditioned by the domestic political imperatives of elite rule rather than the imperative of capitalist production.

Conclusion

The analytical framework adopted in this study that combines the economic realist perspective on IPE with a model of domestic politics offers substantial analytical purchase over liberal perspectives in explaining regionalism as an outcome of globalisation. The value of economic realism as a theoretical tool comes from its recognition that states continue to matter, and more importantly, that the governments of these states can, and often do, consciously manipulate inter-state relations to try and intervene in the international political economy in line with domestic interests. Regionalism can be interpreted as one such instrument for states to pool their resources in order to influence the international political economy. By using the economic realist theoretical perspective, it was possible to, first, identify two variants of open regionalism, and second, to advance a fourth ideal-type model of the globalisation-regionalism relationship in addition to the two existing ideal-types in the literature, namely developmental regionalism. These four distinct models differ in terms of how they engage with globalisation,

their relationship with different segments of capital and with other social groups, whether driven by growth, efficiency or distributive concerns, and their key features.

Despite according attention to the systemic level, and the privileging of globalisation as a key explanation for regionalism, it is clear that attention must be paid to the domestic level as well. A key assumption of the study is that governments respond in the first instance to domestic political constituencies on whom they rely for political support and for their legitimacy. Therefore, it is dynamics operating at the domestic level that determine which of the four ideal-type models of regionalism outlined in this chapter will emerge in response to globalisation.

The central argument advanced in this chapter is that the type of regionalism that emerges as a result of globalisation is mediated by domestic political economy dynamics centred on the tension between growth/efficiency concerns on the one hand, and distributive priorities on the other, even in the case of regionalist projects that seek engagement with globalisation. Political and state actors interpret external events and developments globalisation through lenses grounded in domestic political priorities, which also influence their responses to these external impulses, including their particular approaches to regionalism.

The first proposition is that AFTA is likely to encompass the features of *both* open regionalism and developmental regionalism due to the political significance of *both* foreign and domestic capital in the domestic political economy of member countries. Although both forms of regionalism are the outcome of globalisation, and driven by a concern with economic growth and engaging with globalisation, domestic priorities centred on nurturing domestic capital infuse the growth imperative in the case of developmental regionalism, leading to departures from open regionalism in the design of regional cooperation.

The balance between the two approaches to regionalism depends on the cost to ruling elites of privileging either foreign or domestic-owned capital vis-a-vis the other.

The second proposition is that the distributive imperative may be so overwhelming in particular instances, despite initial commitments to cooperate driven by the growth dynamic, that

Table 6.1. Four Models of the Globalisation-regionalism Relationship

Ideal-type models	Relationship to globalisation	Key driving force	Key features	Relationship to foreign and domestic capital
Neoliberal regionalism [A variant of open regionalism]	Engages with globalisation	Concern with efficiency	No new barriers to non-members imposed; Full deregulatory agenda contemplated; Also associated with agenda to reduce government's role in all aspects of economic activity; Hence the neoliberal credentials	Does not distinguish between foreign and domestic-owned capital; All globally oriented capital privileged
FDI model [A variant of open regionalism]	Engages with globalisation	Concern with attracting FDI, which is a crucial source of growth; Efficiency may be a primary or secondary concern	No new barriers to non-members imposed; Deregulation agenda could be extensive or limited; Ambivalent with regard to government's role in the economy; More likely to be an instance of embedded neoliberal regionalism	Foreign capital (FDI) is targeted
Resistance model	Resists globalisation	Concern with social/ distributive issues	Seeks insulation from global market forces; Dominant agenda is social/ distributive.	Other social groups, apart from capital privileged, notably labour
Developmental regionalism	Engages globalisation eventually, though initially has a period of limited and temporary resistance to it	An initial concern with domestic distribution, with growth a long-run aim	Employs temporary protection of, or temporary privileges for domestic capital; Distribution is thus directed towards domestic capital	Domestic capital privileged

governments opt to shield affected elements of domestic businesses from the liberalisation required under both open regionalism and developmental regionalism. Sectors most likely to be shielded are those in which politically important businesses are prominent. Disputes among regional members are likely to emerge, as governments renege on their original commitments as they attempt to balance growth and distributive concerns.

This leads to the final proposition that implementation becomes a political process rather than a technical one of complying with commitments already made earlier. This requires some form of regional mechanism to address the tension between growth and distribution and to enable cooperation to be sustained and advanced rather than abandoned.

7

Foreign Capital and Open Regionalism

Introduction

The FDI explanation has been discussed at length in the literature and will not be repeated here, except to re-iterate its main points. The chapter emphasises how the structural power of foreign investment capital, reinforced by its key role in the domestic political economy of the ASEAN countries, made AFTA vital as a means of defining a distinctive space of production for global capital in the wider Asia-Pacific region, particularly in competition with China. The chapter also emphasises three additional points. First, it explains why the ASEAN countries, already fairly well integrated with global trade and investment flows and already embarking on economic liberalisation programmes domestically, decided to engage in *regionalism* as a response to concerns about FDI diversion. Why not continue with and hasten domestic economic restructuring, which had proved eminently successful in drawing FDI to these countries from the late 1980s? Second, the chapter shows that although AFTA was a project of open regionalism aimed at engagement with the global economy, it displayed only limited neoliberal characteristics. Third, the discussion reveals that there was also a clear departure

from open regionalism when member governments agreed to privilege domestic investors over foreign investors in investment liberalisation, albeit for a temporary period of time.

Structural Power of Foreign Capital

The pressure to establish a regional free trade area in ASEAN did not come from investors engaged in some form of direct lobbying of ASEAN governments. Instead, it was exercised through the structural power of foreign capital given by its vastly growing potential to relocate to alternative investment sites and its value as a source of key productive assets for governments wishing to integrate their respective economies with an increasingly competitive world economy. While globalisation shaped these two elements, the dynamics of the domestic political economy reinforced these structural pressures through the key role assigned to foreign investment capital in national economic growth.

Foreign investors had not been active in the deliberations that led to the 1991 decision to establish AFTA. In fact, many foreign investors, including Japanese investors who were key investors in ASEAN were surprised by the ASEAN decision, with some decidedly pessimistic about the project's viability. Although Japanese firms, particularly automobile firms, had already begun to engage in a regional division of labour in ASEAN by the early 1990s, the Japanese did not push for a regionwide free trade area. This was because Japan's 'private, public-private and state-level arrangements' helped to coordinate and support the regional activities of Japanese firms that would have otherwise required a formal regionalist scheme. As such, a generalised free trade area had been somewhat unnecessary to Japanese investors, and might have even eroded Japan's comparative advantage in the region over other foreign investors who were not backed by the kinds of informal institutions that supported the regional activities of Japanese firms. Despite some initial doubts in Japanese business and policy circles, the Japanese government and the powerful Japanese peak business organisation, the *Keidanren* or Japan Federation of Economic Organisations, quickly registered their support for AFTA. A senior official of the Japanese Ministry of International Trade and Industry lauded the 'positive move on

ASEAN's part in taking the initiative without having been asked by the major foreign investors'.

Rather than direct pressure by investors, it was the structural power of foreign capital that was significant in influencing the AFTA decision, and later, its consolidation and expansion. Officials preparing for the 1992 Singapore Summit, at which the decision to establish AFTA was formally adopted, admitted that one of the most compelling arguments advanced for AFTA, and which convinced the leaders of its necessity, was its capacity to attract FDI to the region. Most observers of ASEAN had not expected such a decision to be adopted, given the difficulties the grouping had experienced in pursuing economic cooperation in the past, and its rejection of the idea of a free trade area as recently as 1987 at the Third ASEAN Summit in Manila.

It is worth emphasising this point as it shows that the ASEAN leaders were convinced of the utility of AFTA only when it was expressed in terms of the project's economic benefits for their respective economies. It weakens the argument advanced in the literature that AFTA was primarily adopted as an economic instrument to achieve strategic purposes to keep ASEAN relevant as a regional organisation in the changing strategic environment. At most, the strategic motivation driving AFTA was an initial objective that was soon overtaken by the FDI imperative. A senior Malaysian trade official acknowledged, 'since 1992, the picture got clearer with regard to the economic motivations behind AFTA'.

It is inconceivable that the ASEAN leaders would have embraced a project that had the potential to introduce real changes to domestic economies if AFTA had not also promised economic benefits. These economic benefits came in the form of the potential to attract the necessary FDI to support high growth strategies in the core ASEAN economies and to ensure their engagement with the world economy. Thus, the initial idea mooted by the Thai Prime Minister Anand Panyarachun in 1991 quickly found support in all the ASEAN capitals. In the early 1990s, economic growth in the ASEAN countries was believed to be under threat as FDI inflows, a crucial source of growth, showed a declining growth trend in terms of relative shares.

The Lure of Regional and/or Large Markets

These pressures alone do not explain what prompted the *regional* response, since ASEAN governments could well have adopted further unilateral reforms or used incentives at the national level to make individual economies more attractive to FDI without engaging in regionalism. It was, however, the awareness, or at least perceptions on the part of ASEAN leaders and policymakers that FDI was attracted to large and/or regional markets NAFTA, the Single European Market (SEM) and especially China that convinced the ASEAN leaders of the potential utility of a similar project in ASEAN. It was, in short, the contagion effect at work. Policymakers from the core ASEAN countries, seeing regionalist projects established elsewhere potentially threatening to their respective economies, opted for a similar project in ASEAN. They had become aware that foreign investors were becoming increasingly drawn to these regional schemes, which thus posed a threat to the ASEAN countries for which FDI had become a crucial source of economic growth.

Two developments in the world economy during the early 1990s dominated the concern with FDI diversion, and helped shape the ASEAN response. The ASEAN governments had come to realise that the formation of regionalist projects in the developed world, notably NAFTA and the SEM, was not so much a threat to free trade as much as a potential source of competition for global production capital. Here, the analyses and views of European and North American economists and policy analysts on the implications of NAFTA and the SEM for other countries and regions, including ASEAN, were keenly followed by ASEAN policymakers, and were, no doubt persuasive. While many of these studies reached diverse conclusions, most agreed that the largest impact would be on FDI inflows to ASEAN rather than on trade diversion. In addition, the ASEAN governments saw the emergence of China as an alternative, and potentially more attractive location for foreign investors, compared to the far smaller individual ASEAN economies due to China's vast market.

The important point to note is that the interest shown by foreign firms in investing in NAFTA, the SEM and China demonstrated to ASEAN policymakers the potential of large and/or regional markets in attracting FDI inflows. It made the idea of a single regional market in ASEAN more compelling. The views of the ASEAN leaders can

Table 7.1. Flows of FDI to Host Region/economy, 1983-98 (US$ million)

	Total FDI flows	Industrial countries	All developing countries	ASEAN countries[a]	(%)	China	(%)
1983-88	91,554	71,779	19,757	3,708	*5.2*	1,823	*2.5*
1988	159,101	131,313	27,772	6,991	*25.2*	3,194	*11.5*
1989	200,612	171,722	28,622	7,591	*26.5*	3,393	*11.9*
1990	211,425	176,436	34,689	12,158	*35.0*	3,487	*10.1*
1991	158,936	114,792	41,696	13,400	*32.1*	4,366	*10.5*
1992	173,761	119,692	49,625	12,074	*24.3*	11,156	*22.5*
1993	219,421	133,850	78,813	15,994	*20.3*	27,515	*34.9*
1994	253,506	146,379	101,196	19,681	*19.4*	33,787	*33.4*
1995	328,862	208,372	106,224	21,643	*20.4*	35,849	*33.7*
1996	358,869	211,120	135,343	25,980	*19.2*	40,180	*29.7*
1997	464,341	273,276	172,533	27,813	*16.1*	44,236	*25.6*
1998	643,879	460,431	165,936	21,400	*12.9*	45,460	*27.4*

be summed up in the words of Thailand's Prime Minister in 1993, Chuan Leekpai, who cautioned, 'the possible diversion of direct foreign investment to emerging groupings such as the SEM and NAFTA is a perpetual reminder that smaller countries have to unite'. The Head of the Indonesian Board of Investment acknowledged that ASEAN investment officials had, in 1993, 'agreed to work together to invite foreign investors to invest in ASEAN'. The idea was for the ASEAN countries to cooperate in presenting AFTA as a single regional site for FDI. Trade officials from Malaysia confirmed that selling AFTA as an attractive investment location was a key objective of ASEAN.

China had become far more threatening as a competing investment location to ASEAN despite initial fears centred on NAFTA and the SEM. The call in January 1992 by Chinese leader Deng Xiaoping for faster and deeper economic reforms in China had sparked off an investment boom in that country. The sharp rise in FDI flows to China since then was seen as being increasingly at the expense of the ASEAN countries. Since 1992, the surge of FDI from the Asian newly industrialising economies (NIEs) to ASEAN had moderated, with an increasing proportion of Japanese, Taiwanese and Hong Kong investment flowing to China instead. Investments from OECD sources, including North American and European sources, to ASEAN similarly weakened. Thus, by the end of 1992, the FDI situation in the core ASEAN countries had become extremely worrying to policymakers and political leaders.

FDI in the Domestic Political Economy: Reinforcing the Structural Power of Foreign Capital

ASEAN policymakers, and in particular the leaders, recognised the threat to economic growth, and thus to regime legitimacy to which any diversion of FDI from the ASEAN region would contribute. FDI had, by the end of the 1980s, become a crucial source of economic growth in the core ASEAN economies. Between 1987 and 1992, inward FDI flows accounted for a large 11.3 per cent of gross fixed capital formation in ASEAN, compared to 3.9 per cent for developing countries as a whole, 3.3 per cent for Asian developing countries and 4.2 per cent for industrial countries. By 1990, total FDI stock in ASEAN accounted for 18.2 per cent of their gross domestic product (GDP) compared to between 10.3-10.5 per cent for Asian and all

developing countries and 8.4 per cent for the industrial countries. For Malaysia, Indonesia and Singapore, the role of FDI in the national economy was even higher than the ASEAN average. Total FDI stock in these three countries represented respectively 24, 37 and 74 per cent of GDP by 1990, up from 21 per cent, 14 per cent and 53 per cent a decade earlier.

It was through FDI that the core ASEAN countries had emerged from the recession of the mid-1980s to engage in outward-oriented industrialisation and become significant exporters of manufactured goods. FDI also introduced the necessary technology and management/organisational skills that enabled the ASEAN economies to plug into international production networks. Foreign investment was, thus, 'aggressively encouraged' by these governments. These economic concerns with FDI and growth were, moreover, underpinned by political imperatives as well, thereby reinforcing quite substantially at the domestic level the structural power of global capital.

Thailand

The initial idea for AFTA, which came from the Thai government of Anand Panyarachun in 1991, can be traced to concerns of the new, postcoup governing elite with the fall in FDI that followed the February 1991 military coup. While the military justified the coup as a means of ousting the corrupt government of Chatichai Choonhavan that was in place between 1988 and 1991, urban big businesses welcomed the fall of the Chatichai government under which the political influence and power of provincial business had grown at their expense.

Urban businesses aligned themselves with the military soon after the 1991 coup for two reasons. These Bangkok-based conglomerates were highly supportive of the military's appointment of Anand, a widely respected corporate figure and former career diplomat, as caretaker Prime Minister before democratic elections could be held. They also seized the opportunity provided by the military coup to constrain provincial businesses that had emerged and thrived during the 1980s under the previous administration. The rivalry between metropolitan conglomerates and provincial businesses had emerged during the 1980s, and continues to date. It was the latter's rapid rise in Thai politics that led to the ouster of

urban business elites from the lower house of the Thai parliament in the 1980s, the rivalry later fuelled by the encroachment of provincial businesses into the markets of urban businesses.

Whatever the internal political dynamics and motivations behind the coup, one result was a fall in foreign investor interest in Thailand as expectations of rising political instability in the country grew. This worried not only the caretaker government of Prime Minister Anand, who in June 1991 had initially broached the idea of AFTA to the other ASEAN leaders, it was also of concern to the Bangkok business elite, which benefited from FDI through extensive joint-venture arrangements. At a more general level, the Thai economy had become increasingly reliant on exports and FDI since the late 1980s. In 1992, the number of investment applications fell by 31 per cent, with the biggest decline 45 per cent registered in Japanese investment applications. Worried Thai investment officials, thus, planned 'offensive' strategies to promote FDI into Thailand.

In addition to these purely economic concerns, there was also the ever-present fear that the military would re-assert its influence should economic growth falter. The military had played a substantial role in Thai politics and economics in the past, but its power and influence had waned significantly since the late 1980s, notwithstanding the military coup in February 1991. The 1992 transfer of power from the military to the democratically elected civilian government of Chuan Leekpai of the Democrat party was expected to remove completely the armed forces from the political arena. The military, however, continued to assert itself behind the scenes during 1993 and 1994, demanding a large military budget, a role in development, and the rehabilitation of the army's political role in the interests of national security. This was worrying the new elite coalition in Thailand made up of reforming bureaucrats, ruling politicians, and the Bangkok-based big business elite. Although urban business had initially aligned itself with the military, the alliance was shaky from the start and these corporate leaders soon distanced themselves from the military. Their concern over FDI and growth took on added significance in this context, particularly since Thailand has had a long history of military coups during domestic economic upheavals, beginning with the first in 1932 that saw the overthrow of the monarchy during the economically troubled times of the Great Depression.

Malaysia

The country's policymakers were, nevertheless, worried. Approved investment inflows from Japan, a major investor, fell 30.6 per cent in 1991, while that from Taiwan, a growing investor, fell by 58.3 per cent. If petroleum projects are excluded from investment figures, manufacturing sector FDI in Malaysia registered a staggering decline of 60 per cent in 1992. Policymakers were especially anxious because of a fall in domestic investments in Malaysia coupled with a 42 per cent decline in foreign investment applications in 1992 over the previous year. Although part of the decline in FDI approvals was due to officials becoming more selective in their approvals, preferring projects involving higher levels of technology, skills and capital, policymakers were nonetheless worried by the unfolding FDI picture.

By this time, Malaysian policymakers had come to recognise that China was the country's prime competitor for FDI. They were conscious of the fact that foreign capital remained a critical source of economic growth as well as a means to technological and industrial upgrading, the latter a vital element of Prime Minister Mahathir's Vision 2020 programme to transform Malaysia into a developed country by 2020. This prompted the Malaysian Ministry of International Trade and Industry to step up its international investment promotions in order to 'pre-empt any slowdown (in FDI)'.

As in Thailand, ensuring the inflow of FDI also had important political implications in Malaysia through its role in ensuring growth, a crucial means to political stability. High levels of economic growth brought significant benefits to much of the Malaysian society while also enabling the government to maintain its affirmative action programme for the country's ethnic Malay majority without excessively eating into the wealth shares of other ethnic groups. It also provided the resources needed for the government's patronage machinery, which helped to maintain elite cohesion and thus, the stability of the government and regime.

Malaysia had embarked on FDI-led growth as a way out of the mid-1980s recession, during which time latent cleavages among the political elite had become extremely pronounced, threatening the ruling government, Prime Minister Mahathir's personal authority, and the Malay/ UMNO-dominated political regime. The rift was

especially deep within UMNO, and between the ruling Malay party and its ethnic Chinese coalition partner, the Malaysian Chinese Association. At the same time, rising unemployment and an increase in private bank-ruptcies led to a generalised public discontent with the government and regime, which inevitably led to communal tensions as each ethnic group in multiethnic Malaysia saw the other groups as the cause of its own difficulties. These ethnic tensions within Malaysian society were exploited, and thus, exacerbated, by incumbent elites and their challengers struggling for a platform to win votes, leading to expectations of a repeat of the May 1969 ethnic riots in the country. The deteriorating political situation was, however, arrested through political manoeuvring and coercive action by the ruling government in the short-term. The resumption in economic growth, the result of domestic economic reforms and the fortuitous inflow of FDI from the Asian NIEs during the late 1980s helped to restore growth and consequently, political stability. It is, thus, unsurprising that the FDI situation in the early 1990s caused concern among Malaysian policymakers, given the economic and political implications of a slowdown in growth in the light of the recent unsettling events in the country.

Indonesia

Although FDI increased in Indonesia in 1992, this was due to several large petroleum and mining projects. If these projects were excluded from the figures, FDI actually fell by 54 per cent in 1992, compounded by the sharp 34 per cent decline in domestic investments. These developments prompted considerable concern in Indonesia. Since the start of the country's economic reform programmes in the 1980s, Indonesia had received significant amounts of FDI, especially from the Asian NIEs.

While the relative share of FDI in the Indonesian economy was less than that of domestic investments, its importance for the Indonesian economy and for growth rests on its high export propensity and its use of more sophisticated technology compared to domestic investors. Moreover, the government's plan to attain an average annual growth rate of 6 per cent during the Sixth Development Plan *(Repelita VI)* rested on an investment target of 60 trillion rupiah (US$28 million) over the Plan's five-year period. Domestic private and state investments were not expected to be able

to sustain the needed capital investment, especially in the light of the downturn in domestic investments during the early 1990s.

Foreign capital was vital to maintaining economic growth in the country. Growth was a crucial regime-legitimating device for President Suharto, which allowed him to consolidate his political rule over an essentially fractious nation by steadily improving living standards for Indonesians in general and enabling large numbers of ordinary Indonesians to engage in economic activity. The President also used the material benefits generated by that growth to win friends and co-opt potential adversaries within the state and more broadly in society. In short, economic growth provided the ruling elite, notably the President, with the resources necessary to accomplish economic and political goals through patronage politics. The flow of FDI from the NIEs to China rather than to Indonesia from 1993 was, therefore, viewed with alarm by the Indonesian authorities, which was made worse by indications that some firms already established in Indonesia were considering a move to China. A senior Indonesian investment official acknowledged China to be Indonesia's main competitor for FDI.

Singapore

The fall in FDI flows to Singapore during the early 1990s, as in the rest of ASEAN, gave its policymakers much cause for concern. China loomed as a significant magnet for FDI, particularly in view of its discussions with the US on China's possible entry into the WTO. Moreover, for Singapore, the situation was compounded by the potential indirect effects on its economy, should economic growth in Malaysia and Indonesia falter as a result of a slowdown in FDI to these regional partners. Singapore had, by the early 1990s, embarked on a services-led growth strategy as a way to reduce the island republic's dependence on traditional manufacturing-led growth. One key element of the new approach was to emphasise the city-state as the operational and business headquarters for the regional production operations of TNCs. The 'regional service strategy' was, thus, premised on the growth of manufacturing production, not so much in Singapore but in the other regional economies of Southeast Asia, which Singapore-based TNCs would help coordinate and service. Any fall in investment to the rest of ASEAN would, therefore, threaten Singapore's services-led growth programme.

This explains why Singapore's political elite constantly played on the issue of FDI diversion to China, even though Singapore was, at that time, not expected to suffer too much from the China factor due to the complementary rather than competitive relationship of the Singapore economy to the Chinese economy. Moreover, the political legitimacy of the Peoples' Action Party (PAP) that had ruled Singapore since independence in 1965 was derived from its capacity to preside over improved material conditions, making growth a political imperative as well as an economic one.

The Philippines

In the Philippines, the Ramos government elected in 1992, having inherited an economy in severe crisis, proposed an ambitious development plan-Philippines 2000 that aimed to take the country to NIE status by century's end, a mere eight years away. This required a minimum eight per cent average annual growth rate to be achieved by, among other means, economic liberalisation and FDI. The recourse to FDI took on added significance with the decision by the government to close the US air and naval bases in the Philippines in 1992, which led to the withdrawal of foreign assistance from Washington. This, coupled with the continuing high foreign debt burden, led to increased reliance on FDI for growth. In fact, the foreign sector assumed a dominant part in Ramos' 'Philippines 2000' programme.

Thus, the threat of FDI diversion was a serious one for the Philippines government, which had, like other states in the region, come to regard China as one of its main competitors in the FDI game. The economic liberalisation programme initiated by Ramos included a political dimension as well. It was designed to challenge the power of the old landed, agricultural oligarchy, which had re-emerged with post-Marcos democratisation as key players in the new Philippine 'elite democracy', this time in new areas of the economy like industry, banking and services rather than in agriculture.

Creating an Alternative Regional Space in the Asia-Pacific for Investment and Production

Concern in the region over the potential possibility of losing FDI to China was, therefore, quite pronounced. ASEAN policymakers were correct in identifying China as their biggest competitor for FDI. Although other markets, particularly regionalist schemes elsewhere,

did have the potential to attract FDI away from ASEAN, China was especially significant because it was part of the Asia-Pacific region. Global capital had, by the late 1980s, adopted a regional focus to its investment and production strategies. The TNCs were increasingly practising a regional as opposed to global division of labour, and establishing production in different regions Europe, North America, and the Asia-Pacific. While the aim of TNCs was to operate business globally, that goal was being increasingly achieved through the development of 'complete and integrated production and management systems within definable regions'.

China by itself offered investors a potentially competing 'regional' investment site in the Asia-Pacific region, particularly in view of its (potential) market size. What the ASEAN governments attempted to offer to foreign investors through AFTA, specifically through its CEPT tariff liberalisation component programme, was an alternate single regional space of investment and production, in effect exploiting the 'regional' logic of global capital. AFTA, thus, helped to define a distinctive functional space of production in the wider East-Asian/Asia-Pacific region. Only through AFTA did the ASEAN leaders and policymakers believe that they could meet the FDI challenge from China, particularly as they had reached a limit in terms of the individual investment incentives they were willing to offer potential investors. As an Indonesian investment official explained, 'they (the Chinese) give everything...they give all the incentives which we could not give.'

Thus, most scholars agree that fear over the diversion of FDI to China was a major reason why the ASEAN leaders agreed to consolidate the regional project and begin tariff reductions by January 1994 despite the emergence of domestic business resistance to AFTA in a number of member countries. Political leaders also found the potential threat to economic growth from slowing FDI inflows sufficiently overwhelming to advance AFTA further in 1994-95. ASEAN leaders consequently shortened, by five years, the time frame when tariffs in AFTA would reach the 0-5 per cent target, introduced new rules to govern the Temporary Exclusion List scheme, and agreed to adopt both a dispute settlement mechanism and an agreement to protect intellectual property rights in ASEAN. By doing so, they were signalling to foreign investors that they were committed to the development of AFTA as a single regional space of production.

Moreover, the AICO scheme was adopted as a compromise between the need to attract foreign investors through forming a single market and giving domestic industries sufficient time to adjust to AFTA tariff liberalisation. Notwithstanding the problems investors encountered in getting AICO approvals, the scheme effectively fast-tracked AFTA for selected products on application by investors.

The New Issue Areas

The FDI explanation was used also to account for the inclusion of agriculture, services and investment within AFTA in 1994-95. The ASEAN governments, it is argued, wished to keep AFTA relevant to FDI, given the advances made in the GATT, NAFTA and APEC during the mid-1990s in addressing new issue areas such as agriculture, services and investment. The additional commitments in AFTA were necessary in order to maintain ASEAN as a distinctive regional space of investment and production. This explanation is incomplete, however. It is unable to explain why ASEAN investors were treated more favourably than foreign investors in the AIA component of AFTA. While a case may be made that concern with FDI diversion was a factor prompting the inclusion of services and investment within AFTA.

In the case of agriculture, its incorporation into world trade disciplines as a result of the Uruguay Round agreements was largely responsible for its subsequent insertion into AFTA. The incorporation of agriculture into the GATT/WTO helped the Thai government, which had originally wanted AFTA to cover agriculture, a key export sector for the country, to successfully lobby for its inclusion in the CEPT, despite the reservations of other governments, notably Indonesia. The Malaysian, Philippine and Indonesian governments, however, insisted on having a separate arrangement to govern trade liberalisation of the more sensitive agricultural items. Despite making this request, the Indonesian government unilaterally withdrew 15 agricultural products that it had earlier included within the CEPT, which led to a dispute with Thailand. It is sufficient, at this point, to note that it would have been difficult for the Thai government to advocate including agriculture in AFTA if it had not already been incorporated within the WTO, given the significant reservations in the region on the issue. Nevertheless, the other governments agreed to its inclusion, despite these reservations, in order to reinforce AFTA as a project of open regionalism. As Malaysia's Minister of Primary

Industries said in 1994, 'it is a logical and natural action wanting to include agricultural products into CEPT since the world community is committed to free trade liberalisation.'

The Financial Crisis Period

The decision by member governments to further accelerate AFTA as well as introduce additional investment incentives in the region in 1998-99 was also driven by concern with FDI and growth. The core ASEAN governments had to make sure that their respective economies remained attractive to FDI amidst the economic turmoil of the regional financial crisis, and they attempted to partly accomplish this through regionalism. As huge amounts of portfolio capital began flowing out of these economies, the imperative of maintaining direct investment became paramount, especially since domestic investments had also suffered a sharp contraction in the region. AFTA became a tool in the process of maintaining foreign investor interest in the region, particularly as China still loomed as an alternative investment site.

Thus, Bowles points to the joint adoption of a temporary incentive package in 1998 that gave foreign investors additional incentives in each ASEAN country over a two-year period as evidence that the ASEAN governments were using regionalism to attract FDI. The most significant of these incentives was the temporary offer of 100 per cent foreign equity and market access, mostly in manufacturing. The acceleration of the CEPT and the temporary relaxation of the 30 per cent national equity requirement in AICO were the other measures jointly adopted by the ASEAN governments in order to maintain investor confidence during a time of economic distress. The recognition by ASEAN policymakers of the need for joint measures in ensuring foreign investor interest in the region was also reflected in their decision to embark on joint investment promotion missions in 1999-2000 to the major investor countries/regions, the US, Europe, and Japan a first in ASEAN's history.

Beneath the level of official discourse on open regionalism, however, protectionist elements emerged to strain intra-ASEAN relations as both tariff and non-tariff barriers were employed to shield domestic industries during the financial crisis. Some observers of ASEAN point to this development as evidence of AFTA's failure. This is too stark a position. While the adoption of tariff and non-

tariff barriers was a setback for AFTA and did strain regional relations, its significance for evaluating progress in AFTA should not be exaggerated.

Many of the import restrictions were announced as temporary for a one to two year period, and were generally part of a set of short-term fiscal measures designed to reduce immediate pressure on countries' external accounts. Thus, a large proportion of tariffs were used to restrict big-ticket items, including luxury imports, transport equipment, and capital goods like steel and heavy machinery. The Philippine government raised tariffs on textile, steel and petrochemical products in response to business demands, but only for one year, although it contemplated temporarily withdrawing petrochemicals from CEPT disciplines. The Philippine government rejected other business demands for protection, because as Trade Secretary, Jose Pardo pointed out, protection 'sends the wrong signal (to investors)'. The point to note is that these particular 'protectionist' moves were brought on by the pressures of recession, and should be assessed in that context. Despite these temporary deviations from the CEPT. The notable exceptions were Malaysia's 1999 request for a delay in liberalising tariffs on automobiles, and the Philippines' announcement in September 2002 that it may temporarily exclude petrochemicals from AFTA. No formal request on the latter has been submitted at the time of writing.

While Bowles sees the temporary incentive package as an indication of ASEAN's continued use of regionalism to sustain the FDI-led growth strategy in member countries, this chapter interprets the incentive package somewhat differently. While not denying Bowles' point, this chapter suggests that its significance lies in its temporary nature. The offer to remove restrictions on foreign equity and market access when it was announced was limited to investment applications made between January 1999 and December 2000 only, subject to further review. Moreover, the 30 per cent national equity requirement in AICO was waived for only two years until 2000, later extended by two years to the end of 2002. A number of scholars questioned the significance of these short-term measures when they were announced, and asked whether they would prove sufficiently attractive to investors during a period of economic turmoil. That these incentives were offered on a temporary basis is curious, given the overwhelming pressure in ASEAN during this period to

maintain investor confidence and interest in the region. They raised some doubts about the commitment of the ASEAN governments to neoliberal economic reforms.

The short-term nature of these measures suggests that equity ownership and market access remained a sensitive issue in the ASEAN countries. Although Malaysia extended the incentive period until the end of 2003, its temporary nature remains unchanged at the time of writing. While many of Thailand's and Indonesia's temporary liberalisation offers were eventually incorporated into these countries' unilateral and IMF-led reform programmes, this does not alter the main thrust of the argument that national governments were sensitive, for various reasons, about equity and market access issues.

These sensitivities were also reflected in the AIA programme. Although the AIA was accelerated in 1999 in direct response to the crisis, only ASEAN investors were scheduled to receive in 2003 full market access and national treatment privileges in the manufacturing sector, and in other sectors by 2010, while foreign investors were scheduled to receive full privileges in these areas only by 2020. This rather contradictory move, which did not appear to be helpful to the FDI cause, has still to be explained. It suggests that there were other dynamics apart from the FDI threat that shaped the development of AFTA, particularly its AIA programme. As the next chapter reveals, domestic political priorities centred on the need to nurture domestic capital influenced the design of the AIA.

AFTA: A Neoliberal Regionalist Project?

Despite the anomaly in the AIA, the open regionalist credentials of AFTA in general and the CEPT component in particular cannot be doubted given the project's primary purpose to engage with global capital. One key feature of open regionalist projects is that the exchange of preferences among regional partners is not accompanied by the imposition of new barriers to non-partners. AFTA, having no common external tariff, clearly met this condition. Apart from its broadly open regionalist character, is AFTA also a project of neoliberal regionalism? Scholars like Bowles believe that it is, despite instances of protectionism during the financial crisis period. The analysis focuses on three key indicators, namely the formal design

of regional trade liberalisation, the dominant discourse underpinning AFTA and the type of state-market relationship embedded in the AFTA project.

The Formal Design of Regional Trade Liberalisation

Apart from the absence of a common external tariff, AFTA's neoliberal credentials were reflected in the way members were allowed to unilaterally and voluntarily extend CEPT tariff preferences to non-members on an MFN basis. It meant that the ASEAN member governments were not denied the chance to adopt unilateral economic reforms that went faster or beyond the CEPT in order to meet the unique competitive needs of the domestic economy, provided CEPT commitments were met at the very minimum. Although member governments availed themselves of this privilege on a number of occasions, the extension of CEPT preferences to non-members was not always practised, however. Although member governments did not always multilateralise their CEPT tariff concessions, the mere presence of the option to extend CEPT tariff reductions to non-ASEAN members on an MFN basis reinforces the neoliberal credentials of AFTA.

Whether governments multilateralised their CEPT commitments was influenced by two factors, namely the presence of unilateral economic reform programmes and the need to reduce CEPT-induced tariff distortions. Malaysia, Indonesia, Thailand and the Philippines were engaged in an ongoing process of unilateral economic reforms from the mid-1980s. These economic reforms had initially been undertaken to overcome the economic recession of 1985-86, or, in the case of the Philippines, the economic crisis unleashed by the Marcos regime. They were designed to create the conditions for export-oriented, FDI-led growth. In that context, it made sense to extend AFTA tariff offers to all parties. Tariff reductions under the CEPT framework in AFTA thus dovetailed with unilateral tariff reforms.

In many cases, AFTA tariff reduction commitments drove or preceded unilateral (MFN) reform packages. Thus, the Indonesian deregulation package of May 1995 extended CEPT tariff reduction commitments, out-lined the previous year, to all parties. In the Philippines, AFTA forced a change in the pace of economic reforms, with AFTA used to push unilateral trade liberalisation. AFTA, more fundamentally, also altered the economic policy agenda in that

country. Jesus Estanislao, Chairman of the Philippine AFTA Commission, admitted in 1993 that AFTA would lead to 'a radical departure of the policy orientation' of the Philippine government. In Thailand, general tariff reform was undertaken as part of the country's preparation for AFTA. A senior Thai Finance Ministry official noted that 'CEPT actually pushes Thailand's MFN tariff reforms'.

A second reason why governments chose to multilateralise their CEPT tariff concessions was to restore the economic competitiveness of those sectors where divergent CEPT and MFN rates would worsen already existing tariff distortions. In Thailand and the Philippines especially, distortions in tariff structures required that the existing high import duties on raw materials and intermediate inputs be reduced on an MFN basis before or at the same time that CEPT commitments came into force. Because inputs that went into manufactured products like textiles were largely imported from outside ASEAN, high MFN tariffs on these inputs in Thailand and the Philippines made final goods less competitive compared with products made in Malaysia and Singapore where MFN input tariffs had been reduced much earlier. Once tariffs on final goods had been reduced to a uniform 0-5 per cent under AFTA, manufacturers in Thailand and the Philippines would have been at a disadvantage if MFN tariffs on relevant inputs had not reduced correspondingly. Final goods manufacturers in Thailand and the Philippines thus lobbied their governments to streamline tariff structures, and particularly to lower duties on imported inputs on an MFN basis to maintain the competitiveness of their products relative to those produced in the other ASEAN countries with less distorted tariff structures.

The textile industry in Thailand was among the worst affected. Thai textile firms urged the government to hasten tariff reform in Thailand before tariffs on final textile products fell to 0-5 per cent under the country's AFTA commitments. Thai textile producers were levied MFN import duties of between 20 and 40 per cent on raw materials and inputs, which were largely imported from non-ASEAN sources, thus placing them at an enormous disadvantage compared to producers from Malaysia. These concerns led to a review of Thailand's tariff structure in 1999 when the import duty

on raw materials and primary goods was set at between 0 and 5 per cent on an MFN basis, in line with the CEPT rate and those of the other ASEAN countries.

Trends such as these confirm the neoliberal characteristics of AFTA. The competitiveness of domestic industry was clearly not to be compromised by any desire to maintain preferential tariffs among AFTA member countries to privilege product sourcing only from within ASEAN. The aim, after all, was to use AFTA to create a regional space of production through removing internal barriers to the free movement of economic resources. It was not primarily designed to increase intra-ASEAN trade, although regional trade would be expected to eventually rise if investors established transnational production in ASEAN.

The Dominant Discourse: Globalisation, Competitiveness and Efficiency

While the specific design of the CEPT reflected its neoliberal credentials, the discourse associated with AFTA was also revealing of the kind of regionalist project that was being constructed in AFTA. Actors construct and use discourses to tell particular stories about the world. Discourses help in creating a cognitive structure that in turn helps shape the expectations of other actors about the world. They are the key elements in the 'mobilisation of bias', shaping the way society 'conceptualises the world or a particular problem', which also shapes the policy agenda by restricting the range of policy possibilities.

The discourse associated with AFTA was centred on the neoliberal tenets of competitiveness and efficiency. It thus reflected the dominant discourse in the core ASEAN countries that also stressed the importance of competitiveness and efficiency for firms and the economy in meeting the challenges of globalisation. In these countries, national governments used the notion of 'globalisation' to justify and push through domestic economic reforms through deregulation, liberalisation and privatisation. Moreover, competitiveness and efficiency were seen as vital for these economies in the competition to attract FDI and to ensure their integration with the world economy. While these countries cooperated in attracting FDI through regionalism, they also competed with each other to some extent, using individual investment incentive programmes to

direct FDI that had been attracted in the first instance by the prospect of the AFTA market to their respective national economies. The option to multilateralise the CEPT and the absence of a common external tariff in AFTA facilitated competitive dynamics within ASEAN amidst the broad commitment to cooperate.

The neoliberal or globalisation discourse in the ASEAN countries was constructed and dominated by policymakers, and directed largely at private business. Its goal was to shape business expectations about economic reforms in general, and tariff liberalisation in particular, to make private business aware that it would no longer enjoy tariff protection as in the past. Substantial domestic business opposition to AFTA had emerged since the project was initially announced, and governments attempted to use discourse as one means of shaping expectations about the direction of economic reforms, including unilateral and CEPT trade liberalisation.

Malaysian companies were continuously warned to brace themselves for international competition with the implementation of AFTA. Trade Minister Rafidah Aziz explained that liberalisation of the domestic market would 'enable local industries to build up the resilience required to face competition'. The Philippine Foreign Secretary urged domestic firms to shape up for AFTA, which would 'force ASEAN industries to be globally competitive'. In Indonesia, responses to globalisation were framed in terms of enhancing the international competitiveness of firms. Coordinating Minister for National Development Planning in 1996, Ginandjar Kartasasmita, re-affirmed the Indonesian government's commitments to AFTA during discussions with the business sector, warning businesses that the era of government protection of Indonesian firms was over.

Other groups apart from policymakers, notably pro-reform business leaders and liberal economists, were often active participants in the dominant neoliberal discourse as well. This is not to deny the presence of alternative discourses. These did exist, and were focused on the negative aspects of globalisation, including its environmental, social and cultural effects. Nevertheless, during the high growth period of much of the 1990s, the neoliberal discourse of adjusting to globalisation through promoting competitiveness

and efficiency was dominant in these countries and spearheaded by policymakers. This was also the discourse associated with AFTA.

In Thailand, during the 1990s, despite an ongoing debate between the globalisers and the localists, the globalisers were predominant. Thai policy-makers, notably the powerful technocrats in the civil service, interpreted globalisation as a force compelling neoliberal economic policies, and responded accordingly in policy formulation. Other advocates of the competitiveness discourse included the newly emergent commercial interests and the long established Bangkok business elite, in addition to the technocrats with liberal economic leanings in the Ministry of Finance, the central bank and the planning agency. Various policy documents were issued since 1994 that emphasise competitiveness as the primary strategy to respond to the pressures of globalisation.

Unsurprisingly, these policies were fully supported by elite business interests essentially the Bangkok-based conglomerates who favoured a liberal economic environment with an eye on the benefits that foreign capital brought to their own ventures as joint partners, in addition to boosting the stock market. For instance, large Thai corporations like Siam Cement, Charoen Pokphand, the Saha Union, and the leading banks were favoured partners for foreign investors. Other business players outside the group of Bangkok-based conglomerates were less embracing of liberalisation. The globalisers, however, dominated public policy and were able to implement their agenda of liberalisation, while the far less coherent localists were marginal in policy terms. The Thai discourse of competitiveness and efficiency surrounding AFTA was derived from this broader globalisation discourse. Despite the crisis, the predominant discourse in Thailand remained the neoliberal one, at least until the election of Prime Minister Thaksin Shinawatra in January 2001 whose government appears to be less embracing of the neoliberal discourse and the liberal economic policies of previous governments.

Unlike the discourse on globalisation in Singapore, which unambiguously emphasised competitiveness and market efficiency, the thrust of the globalisation discourse in countries like Indonesia and Malaysia was not unequivocal. Despite a preoccupation with competitiveness, alternative perceptions and responses to globalisation and its attendant neoliberalism were present in Indonesia and Malaysia even before the financial crisis, although

the latter brought these alternative discourses into sharper relief. Far from being the discourses of non-state actors or civil society groups as in the case of Thailand, these alternative interpretations of globalisation were, in fact, articulated by Malaysian and Indonesian policymakers and political leaders. Reflecting mixed concerns about the purpose of economic development, they led to the adoption of particular policy responses in AFTA that contradicted the project's open regionalist/neoliberal character.

The attitudes and responses of both Malaysian and Indonesian policy-makers were largely shaped by the ideas and responses of their respective leaders. As Welsh notes, a large portion of the Malaysian Prime Minister's Vision 2020 document outlining the strategies by which Malaysia would attain developed country status by 2020 emphasises neoliberal market reforms. Yet, Dr Mahathir did not fully embrace the western notion of globalisation and its associated neoliberal policies in all areas of policy. He also interpreted globalisation to emphasise its negative implications for developing countries and their firms. This particular view of globalisation was reflected in the Malaysian position on AFTA's investment liberalisation programme.

In Indonesia, President Suharto's broad response to globalisation was not to oppose it but to adjust to it. Although Indonesian economic policy during the 1990s moved in a broadly neoliberal direction, well-connected big business and powerful political groups were able to influence policy away from the neoliberal agenda in specific cases that were of direct interest to them. The ideal of competitiveness was a strong one in Indonesian policy circles, reflected in the extensive neoliberal reforms undertaken. As in the Malaysian case, these alternative discourses were also reflected in Indonesia's response to the AIA.

Contrary to the European experience, the competitiveness discourse in the ASEAN countries with regard to AFTA was initiated and constructed by public policymakers rather than corporate actors, as already noted. It was aimed at legitimising the withdrawal of protection that could disadvantage private businesses. It was also to create a set of expectations among businesses that the government was fully committed to regional tariff liberalisation and that business demands for protectionism would not be entertained. In the EU, on the other hand, it was the transnational business elite and their

allies who had successfully defined the discourse surrounding European integration in terms of competitiveness and efficiency, which required a reduction in the scale and scope of state involvement in national economies. The experience of ASEAN was different as far as the state-market relationship was concerned.

The State-market Relationship

If neoliberalism includes the notion of limited government involvement in or direction of the economy, then the competitiveness discourse associated with AFTA, and the nature of the AFTA project itself, reflected only a limited or partial form of neoliberalism. Although it incorporated the notion of business or private sector-led growth, this did not include the associated neoliberal idea of more market and less state at all levels of governance. Even in Singapore, the state retained a substantial role in the economy through the government-linked corporations.

In practice, neoliberalism was largely confined to the international trade regime, while at the domestic level, governments continued to regulate and impose restrictions on business activity, including that of foreign investors, despite domestic economic reforms in the core ASEAN countries. Moreover, all the core ASEAN governments were actively engaged in supplying the necessary public goods like education, skills and infrastructure to support business activity and attract FDI rather than leaving them to the free market to supply. As such, while AFTA, particularly through the CEPT, encompassed neoliberal features, the neoliberalism inherent in AFTA more broadly was only partial or limited.

Conclusion: Contradictions and Inconsistencies

One of the most notable contradictions in AFTA, and where its departure from the open regionalism of the CEPT is clearest, is found in the investment liberalisation programme. As already noted, the privileging of ASEAN investors over foreign investors in the AIA is curious, given the significant concern among the ASEAN member governments that the region remain attractive to FDI. Paradoxically, when the AIA was accelerated in 1999 in response to the financial crisis, the decision to bring forward the dates for removal of all exemptions from full market access and national treatment privileges was directed at ASEAN investors only, while the deadline for foreign

(non-ASEAN) investors remained at the original 2020. It is puzzling that member governments did not remove the discrimination against foreign investors in the AIA during the crucial period of the financial crisis when it would have seemed logical not to jeopardise the already precarious economic climate. The ASEAN Secretary General, in fact, sought to play down this distinction between ASEAN and non-ASEAN investors in the AIA scheme in a bid to reassure foreign investors.

How do we explain this particular anomaly in AFTA? Although the ASEAN governments removed the discrimination against foreign investors in September 2001, the fact that a distinction between foreign and ASEAN investors was adopted and maintained for a three-year period is puzzling given AFTA's acknowledged role as an instrument to attract FDI. It is insufficient to merely cite the emergence of protectionism in one or more of the ASEAN countries or of policy inconsistency as explanation. We need to delve deeper and ask what could have accounted for this departure from open regionalism even though the growth and FDI imperative remained strong during the 1990s, and particularly after the onset of the regional financial crisis in 1997. Clearly, other dynamics were at work in regional economies in addition to the growth and FDI dynamics. In essence, these dynamics revolved around the political economic role of domestic capital in elite governance political systems. The next chapter examines these dynamics in greater detail.

8

Domestic Distributive Concerns the Growth Imperative

Introduction

It is clear that the approach to investment liberalisation adopted in the AIA sought to privilege ASEAN domestic capital in the AFTA market, at least temporarily for up to a ten-year period. The decision to offer full market access and national treatment privileges to ASEAN investors ahead of foreign investors in the AIA is certainly puzzling given AFTA's acknowledged role as an instrument to maintain the region's attractiveness as a site for FDI. This chapter explains this as a move by ASEAN member governments spearheaded by the Malaysian authorities to use the investment liberalisation programme of AFTA as a developmental tool to build up domestic firms, in addition to employing AFTA's tariff liberalisation CEPT programme to attract FDI to the single regional market. It is a perspective on AFTA that has so far been missed in the literature.

Specifically, the idea was to nurture domestic capital in the face of globalisation pressures by using both the expanded regional market and the offer of temporary investment privileges to domestic-owned capital ahead of foreign investors. These temporary investment privileges took the form of earlier market access and

national treatment for ASEAN national investors in the ASEAN regional market, particularly in non-manufacturing sectors. It represents an attempt at developmental regionalism. In other words, AFTA displayed the features of *both* open and developmental regionalism due to the political significance of foreign- and domestic-owned capital in ASEAN. While both forms of regionalism were driven by the imperative of growth, distributive concerns tempered the concern with growth in developmental regionalism.

Although developmental regionalism was not about disengaging from globalisation, policymakers and leaders in at least two countries, namely Indonesia and especially Malaysia, were not prepared to accept the hegemony of foreign TNCs that was a growing feature of globalisation. Fearing that politically important domestic-owned businesses, especially emerging firms, would be adversely affected by unfettered market competition, these governments attempted to nurture firms such as these ahead of what they saw as the inevitability of global market competition by inscribing a developmental approach to AFTA.

Before elaborating on this argument, it is necessary to consider alternative explanations for the AIA puzzle. One possibility would be to view the investment liberalisation programme as an additional tool adopted by member governments to reinforce AFTA as a project of open regionalism and a means to sustain foreign investor interest in regional economies. In this account, the temporary discrimination of non-ASEAN/foreign investors is simply a way of offering domestic capital in the different ASEAN countries sufficient time to prepare for full investment liberalisation in 2020. This explanation appears to have some merit if we consider the way the AIA Agreement was framed. The original agreement, in fact, specified that full market access and national treatment privileges were to be accorded to *all* investors immediately where possible, but allowed governments to maintain temporary exemptions in a variety of sectors and policy areas as they saw fit. If the exemptions were indeed aimed at offering domestic capital sufficient time to prepare for full investment liberalisation, then why were the exemptions from full market access and national treatment privileges scheduled to be removed for *ASEAN* investors at least ten years earlier than for foreign investors? The exemptions, which were fairly extensive, were to be removed by 2003 and 2010 for ASEAN investors and by 2020 for all other foreign

investors. This would not have protected domestic investors from all external investors, since other ASEAN investors were to be treated as domestic investors from 2003/2010. Any explanation of the AIA puzzle must be able to account for this point.

A second possibility is simply that the AIA distinction between ASEAN and non-ASEAN or foreign investors was irrelevant or redundant in the first place due to essentially liberal FDI regimes in ASEAN. This interpretation can be challenged in two ways. First, if the distinction is indeed irrelevant, the question of why policymakers would choose to make it in the first place needs to be answered. It is insufficient to assume that policy-makers were acting irrationally or were misinformed, since the implications of instituting such a distinction were actively debated during the three years of discussions leading up to the formal adoption of the AIA Agreement in 1998, and continued to be debated until September 2001 when this particular clause was dropped. Clearly, there were some quarters for which the distinction was salient. In fact, when member governments revised the terms of the AIA Agreement in 1999, a year after its initial adoption, they chose to continue privileging ASEAN investors over foreign investors.

Second, the argument that the foreign-ASEAN distinction is irrelevant or redundant is easily challenged on empirical grounds. Foreign investors continued to face investment restrictions in many of the original ASEAN countries during the 1990s in selected sectors and in particular policy areas despite liberalisation of national FDI regimes, thus making the AIA distinction between domestic and foreign investors significant. This was especially true for the non-manufacturing sectors where fairly restrictive FDI conditions prevailed. These restrictions ranged from equity ownership conditions, market access to certain sectors, land ownership regulations, and access to domestic sources of funds.

Following this, the rest of the discussion elaborates on the chapter's central argument that globalisation, manifested through changes, or expected changes in multilateral investment rules, raised concerns in some ASEAN countries with regard to the future of politically important domestic firms in global competition, which in turn led to the adoption of a developmental component in AFTA through the AIA.

National FDI Regimes in ASEAN

Investment regimes in the core ASEAN countries comprise at least seven categories in which restrictions or differential treatment of foreign over national investors can be maintained. These seven categories cover (a) sectors open to investment, (b) equity ownership, (c) fiscal incentives, (d) taxation, (e) banking and financial regulations, (f) employment conditions and (g) land ownership. While the first category relates to the market access issue in the AIA, the rest of the six categories are relevant to the national treatment issue. If significant conditions or restrictions were imposed on foreign investors compared to national investors in one or more of these categories, then the AIA proposal to accord full national treatment and market access privileges to ASEAN investors ahead of foreign investors would indeed be meaningful.

Thailand

During the 1990s, Thailand's investment regime was governed by two pieces of legislation. The Investment Promotion Act of 1977 outlined all incentives available to both Thai national and foreign investors in priority investment sectors while the 1972 Alien Business Law provided guidelines on foreign equity participation. The latter was especially restrictive, and long subject to demands from foreign business for its review or repeal. ABL-72 protected sixty-three business categories across a range of sectors in manufacturing, services, commerce, agriculture, transportation and construction from full and/or majority foreign participation, unless export conditions and/or promoted status were fulfilled. Under the Thai Land Code, foreign investors were not permitted to purchase land unless operating in a priority sector, although limited 30-year leases were allowed. Investors generally prefer longer periods of lease for security of tenure, with 99-year leases being the norm in industrial countries, while owned land is useful as collateral for local borrowing provided it is permitted. When the AIA was initially adopted, these restrictions on foreign investments were in force under ABL-72, making the AIA distinction between a national investor and a foreign investor significant.

In March 2000, ABL-72 was replaced by the Foreign Business Act of 1999, which liberalised conditions for foreign investment in Thailand. It reduced the number of business sectors restricted to

foreign participation from 63 to 42, allowed greater access to foreign majority ownership in Thai industries, and offered liberal land leases of fifty years, renewable for a further fifty years. On the other hand, restrictions on foreign participation remained in many sectors including agriculture and services, particularly computer and electronics services while new, more restrictive investment rules were introduced to tighten the conditions under which foreign businesses operate in Thailand. For instance, the 1999 Act expanded the definition of 'foreign' business to include ventures in which foreigners exercised virtual management control despite owning less than 50 per cent equity. In contrast, ABL-72 had only considered businesses in which foreigners held more than 50 per cent equity to be alien or foreign businesses.

The terms of the 1999 Foreign Business Act, thus, continued to make the AIA distinction between foreign and ASEAN investors a significant one indeed, particularly in the non-manufacturing sectors. Many of the restricted activities under the new Thai law fell under the AIA categories of forestry, fisheries, mining, agricultural activities and in services 'incidental' to manufacturing. While the Thai government, under the terms of the AIA, was only obliged to accord full investment privileges in these sectors by 2010, the point to note is that the AIA distinction between ASEAN and non-ASEAN investors had not become irrelevant under Thailand's new investment law.

In fact, the then Thai Deputy Prime Minister, Dr Supachai Panitchpakdi, had insisted in 1997 that any new law replacing ABL-72 would not accord national treatment to foreign investors despite the latter's strong preference for it. Moreover, the new, populist government of Prime Minister Thaksin Shinawatra elected in January 2001 began to show signs that it was considering tightening the conditions of foreign participation in the economy, especially in still protected sectors like insurance, finance, and even in heavy industries like steel. Thaksin's promise to the Federation of Thai Industries in February 2001 to amend laws that 'work against Thai interests' and for Thailand to cease being a 'slave to the world' won the new government much political support. It reflected the anti-western and anti-globalisation mood in the country, which was a response to the extensive liberalisation undertaken by the previous Chuan government both unilaterally as well as under the conditions

imposed by the IMF in its bailout package for Thailand during the financial crisis.

Malaysia

Malaysia has maintained a liberal FDI regime in manufacturing since the mid-1980s, the only significant restriction being that on foreign equity ownership. Nevertheless, majority and full foreign ownership is permitted, but only if certain export conditions are fulfilled. The Promotion of Investments Act that liberalised the FDI regime after the 1985 recession allows full foreign ownership in manufacturing provided more than 80 per cent of production is exported, while majority foreign ownership is allowed if more than half the produced output is exported. As in Thailand, the presence of these restrictions on foreign ownership made the AIA clause offering earlier national treatment to ASEAN investors potentially significant.

During the financial crisis, the Malaysian government temporarily relaxed foreign investment rules, as did the other ASEAN countries. While the more relaxed FDI regime initially applied to investments made between 31 July 1998 and 31 December 2000, it was later extended until the end of 2003, subject to further review. Despite these changes to FDI rules, equity restrictions remained in several categories of manufacturing activities to protect the operations of small- and medium-scale Malaysian-owned enterprises that dominated these activities and that had the potential to act as suppliers to the larger MNCs. Many were, in fact, already doing so. These activities were also likely to be attractive to national investors from the other ASEAN countries. In any case, official Malaysian government policy on equity encourages joint ventures between foreign and domestic partners as a means to increasing Malaysian participation in manufacturing.

The other significant restriction that Malaysia maintained was on the amount that foreign investors could borrow from domestic banking sources. This particular policy on domestic borrowing was especially likely to hinder investment from medium-scale enterprises from the ASEAN countries. National treatment of ASEAN investors in this area removes at least one key obstacle preventing such firms from expanding their operations in the ASEAN region. All things considered, the AIA commitment to offer earlier market access and

national treatment to ASEAN investors was a significant policy move for Malaysia.

The Philippines

The 1987 Omnibus Investment Code substantially liberalised the FDI regime in the Philippines, allowing up to 100 per cent foreign equity in priority sectors. Although the 1991 Foreign Investment Act further liberalised investment rules, the government continued to maintain equity limits and other conditions on foreign investors as part of the 'Filipino First' clause of the Constitution. Importantly, a negative list of manufacturing activities either closed to foreign participation or in which only limited foreign participation is permitted was maintained, although this list was progressively shortened throughout the 1990s. Apart from this negative list, full foreign equity ownership was permitted in all manufacturing activities open to foreign investors provided at least 60 per cent of output was exported. Otherwise a 40 per cent foreign equity limit was imposed, or 65 per cent in the iron and steel sector. The provision of investment incentives was also dependent on equity conditions. Non-Filipino companies were required to become Filipino companies within thirty years by reducing the foreign ownership ratio to less than 40 per cent. Companies that exported all their output were exempted from the divestment requirement, however.

As for land ownership, only Filipino companies, and/or companies with at least 60 per cent domestic equity were allowed to own land. Otherwise, foreign investors were permitted to lease land for fifty years. Although former President Joseph Estrada proposed to remove all restrictions on foreign ownership of land and utilities, substantial domestic opposition prevented such a move. Even Estrada's predecessor, Fidel Ramos who had presided over extensive neoliberal reform of the Philippine economy, opposed offering parity of equity rights to foreign nationals. Thus, the Philippine FDI regime maintained significant restrictions on foreign investment ownership and participation in the economy. This meant that the AIA distinction between national, and thus ASEAN, investors on the one hand, and foreign investors on the other was significant, provided Philippine nationalistic sentiments were not also directed at investors from the other ASEAN countries.

Indonesia

The FDI regime in Indonesia was liberalised from 1985, albeit gradually to avoid arousing nationalistic sentiments over control by foreign interests of national economic resources. As in the Philippines, the Indonesian Constitution, specifically Article 33, mandates state control over key economic sectors. Extensive liberalisation was introduced in 1994 in which the divestment clause requiring foreign equity to be reduced to below 50 per cent within fifteen years was eliminated, although with certain conditions attached. Also, nine previously closed strategic sectors in services, industry and utilities were opened to foreign investment through joint venture operations. Full foreign ownership was permitted with few conditions attached while the minimum Indonesian national equity required for joint ventures was reduced to 5 per cent from 20 per cent.

Furthermore, the IMF restructuring programme adopted, as a result of the financial crisis, removed all foreign investment restrictions in the wholesale and retail trade sectors from March 1998, both of which had remained untouched by earlier deregulation packages. Nevertheless, significant restrictions on land ownership remained, which restricted foreign corporations to own only the buildings for a maximum period of fifty years. Apart from this, the FDI regime in Indonesia was fairly liberal, making the foreign-ASEAN distinction in the AIA somewhat irrelevant in Indonesia, although Indonesian investors could potentially gain from preferential investment treatment elsewhere in ASEAN.

Singapore and the Other ASEAN Countries

Singapore maintained a liberal FDI regime, with virtually no restrictions on foreign ownership or market access except for national security reasons and in certain industries like banking, shipping, airlines and the utilities. Brunei also maintained a relatively liberal FDI regime. The new members of ASEAN Vietnam, Myanmar, Laos and Cambodia generally treated foreign investors better than national investors when offering incentives and in taxation. While their foreign equity policies were often far more liberal than those in the core ASEAN countries, these governments maintained fairly stringent restrictions on land ownership and leasing, while domestic borrowing was generally not permitted. In these areas, the AIA

clause with regard to foreign versus ASEAN investors was, therefore, significant.

National FDI Regimes and the Foreign-ASEAN Distinction in the AIA

The above survey of FDI regimes in the core ASEAN countries reveals that foreign investors faced particular restrictions when investing in these countries despite the overall liberal FDI climate. These restrictions ranged from equity ownership conditions, market access to certain sectors, land ownership regulations and access to domestic sources of finance, although the restrictions were not identical across the different countries. These restrictions meant that the AIA offer of earlier national treatment and market access privileges to ASEAN investors was meaningful, particularly if one considers the AFTA market as a whole. Although the further liberalisation of FDI regimes in the manufacturing sector, particularly in Thailand and Indonesia as a result of the financial crisis somewhat weakened the distinction between foreign and national/ASEAN investors in individual countries, this did not make the distinction redundant as far as the AFTA market was concerned. Malaysia's crisis-driven liberalisation was undertaken on a temporary basis, indicating that the foreign-national distinction in investment remained crucial. For the core ASEAN countries, the AIA distinction between ASEAN and foreign investors appears to be most relevant in the categories, services 'incidental' to manufacturing, forestry, agriculture, mining and fisheries. Nevertheless, full market access and national treatment privileges to ASEAN investors in these sectors were only to be accorded by 2010.

The very fact that the ASEAN governments chose to emphasise the distinction between ASEAN and foreign investors in the AIA is itself significant, irrespective of later developments in FDI regimes and in implementation. It is this that requires explanation, given that AFTA had become a key instrument to direct global investment capital to the ASEAN region. This chapter suggests that the answer lies in the way certain governments in ASEAN interpreted particular global developments in terms of their impact on the future of domestic capital, especially those segments of domestic capital that had close ties to the political elite and were important in sustaining elite rule. The rest of the chapter elaborates on these arguments.

Globalisation and Multilateral Investment Rules

The competitive pressures generated by the increasing mobility and changing patterns of global FDI flows, globalisation also manifested itself during the 1990s through the growing pressure from advanced country governments and their TNCs to negotiate multilateral rules to govern 'beyond the border' barriers to free trade. These new rules had the potential to markedly weaken the discretionary authority of governments on key aspects of domestic policy. Industrial country governments and the TNCs were especially keen to develop a global investment regime based on rules ensuring full market access and national treatment for all investors. Their efforts were channelled through forums like APEC, the WTO and most notably, the Organisation for Economic Cooperation and Development (OECD). If adopted, such a regime would effectively allow maximum freedom of operation for foreign investors in as many countries as possible.

Creating a Level Playing Field for Global Corporations

The Uruguay Round agreements, and since then the WTO, had significant implications for FDI, although no explicit set of rules governing FDI *per se* has so far been adopted in the multilateral trading system. The Trade Related Investment Measures (TRIMS) Agreement was limited to regulating investment rules that had trade effects, notably local content requirements. It was the General Agreement on Trade in Services (GATS)

negotiated under the Uruguay Round that first brought the specific issue of market access and national treatment for foreign investors to the forefront of global trade negotiations. Although the national treatment principle was watered down substantially in the GATS due to strong objections from developing country governments, WTO members were expected to reconsider the issue during the new round of trade negotiations scheduled for 1999-2000. They were also expected to debate the possibility of including investment under the WTO framework.

While the TRIMS did not sanction the right for foreign firms to market access and national treatment, it was clear that global firms were interested in just such guarantees. TNCs from the industrial world were increasingly keen on developing global rules that would maximise their freedom of operation globally. Industrial country

governments led by the US backed these demands, and in 1991 instructed the OECD to begin discussions on a more comprehensive investment regime that also included the national treatment principle. The US had turned to the OECD because of the difficulties Washington had encountered in negotiating the TRIMS agreement at the GATT. The goal, nevertheless, was to develop a new global regime in which non-OECD members would participate, since it was in the non-OECD world that TNCs faced the most restrictions, when investing.

The OECD began formal negotiations on a Multilateral Agreement on Investment (MAI) in 1995, which was to be open to accession by non-OECD countries. The MAI advocated national treatment, the right of entry and establishment of foreign investment, the right to full equity ownership, as well as national treatment rights in privatisation. The EU countries, in particular, wanted the MAI to eventually migrate to the WTO to enable trade leverage to be used in disciplining governments and resolving disputes over the free movement of investment. Although the MAI was eventually shelved in 1998 due to disagreements among OECD members as well as strong opposition from non-governmental groups representing labour and the environment, it generated enormous controversy in the developing world, including in ASEAN. The MAI episode revealed to ASEAN policymakers the rising interest among industrial country governments and global corporations in introducing global rules to guarantee the free movement of investment in the world economy.

The investment issue was also pursued in APEC, though with only partial success. Although the grouping's developing country members were opposed to adopting a binding trade and investment liberalisation agreement, the United States, backed by Canada, Australia and New Zealand, succeeded in getting APEC members to adopt a set of investment principles that included national treatment. Developing country member governments, however, ensured that the investment code was non-binding on members. Importantly for the argument developed in this chapter, this episode signalled to the ASEAN countries the keen interest of industrial country governments and the TNCs in negotiating global investment rules.

Although investment was kept firmly off the negotiating agenda in the WTO by a group of developing countries led by India and Brazil and including Malaysia and Indonesia, it was not certain that this state of affairs would continue. WTO members had agreed as a compromise to study the issue further and had set up a working group on investment in 1996. Its brief was not only to study the trade-investment nexus more carefully but also to assess the feasibility of incorporating investment into the WTO. Many governments regarded the reprieve as only temporary, particularly since the WTO was scheduled to review and re-negotiate the TRIMS in 2000. The expectation was that it was only a matter of time before such guarantees to foreign investors were written into the WTO regime.

These expectations were not misplaced. In 1998, the WTO General Council decided that the Working Group on Investment should continue its work until the Seattle ministerial meeting in 1999 when members would decide on whether to incorporate investment within the WTO. The European Commission was particularly interested in ensuring that the national treatment principle formed a key part of any future WTO regime on investment. The issue of investment rules was clearly a lasting concern for TNCs and their parent governments. The point to note is that the expectations of an impending global investment regime reinforced perceptions in ASEAN of the further intensification of market competition for domestic firms and of the further dominance by foreign corporations of national economies. They led at least two of the five original ASEAN member governments to contemplate providing preferential investment treatment for ASEAN firms in the AFTA regional market as a means to build up domestic firms.

The ASEAN Response to Multilateral Developments

Most of the ASEAN countries rejected the idea of a global regime for investment when it first became clear in the early and mid-1990s that many industrial country governments were considering such a project. Malaysia especially was opposed to the notion of national treatment. Trade minister Rafidah Aziz rejected the demand for free movement of investment across national borders and for national treatment, which will remove the right of national governments to implement national level investment policies which may either

restrict a foreign presence in certain sectors, or which may provide preferential treatment to national firms to enable them to grow and be able to compete with large established foreign firms.

Malaysia also convened a special conference of developing countries in July 1996 to explore a common 'south' stand on a number of issues that industrial country governments were expected to raise at the First WTO Ministerial Conference in Singapore in December 1996. It successfully obtained a consensus position amongst those participating at the conference against the investment issue.

Indonesia formally outlined its objections to the inclusion of investment in the WTO by jointly submitting a petition together with Malaysia and six other developing countries on the matter. Thailand initially rejected the idea of a global investment agreement. After the financial crisis, however, the Thai Cabinet agreed to support the adoption of a broad trade and investment agreement at the WTO Ministerial Meeting in Seattle, provided issues like investment incentives, dispute settlement between governments and private business, and national treatment principles were excluded. Although Thai support was for a more limited agreement compared to the more comprehensive MAI, the government was, no doubt, responding to the country's need to remain attractive to FDI in the face of loss of investor confidence in Thailand. Singapore was more sympathetic to the idea of a global investment regime.

Although practically all the core ASEAN countries rejected the idea of a global investment regime that would include the principle of national treatment, the concerns were strongest in Indonesia and especially Malaysia as already noted, and were centred on the future of domestic firms. These concerns were reflected in alternative interpretations of globalisation that deviated somewhat from the dominant competitiveness discourse although the notion of competitiveness was not totally rejected.

Alternative Interpretations of Globalisation

Although for the most part globalisation was interpreted in a positive manner in ASEAN, as a process through which national economies could participate in global wealth creating activities that would benefit national society, other interpretations and discourses were also evident. The primary discourse, emphasising competitiveness, continued to focus on the importance of adopting

neoliberal economic reforms in order to adjust to globalisation. This was discussed, which also pointed out that in Malaysia and Indonesia, alternative readings of globalisation were also present that deviated from the neoliberal competitiveness discourse. These competing discourses essentially emphasised the possible demise of domestic firms, particularly emerging firms, as a result of having to compete with well-established foreign corporations. These sentiments became especially pronounced during the time of the debates and moves in the OECD, the EU and the WTO to inscribe global investment rules.

While the competing discourses on globalisation in Malaysia and Indonesia did not reject the idea of competitiveness *per se,* they stressed other dimensions of competitiveness that were marginalised in the neoliberal discourse. Notably, these alternate discourses emphasised the importance of nurturing the competitiveness of *domestic-owned* firms and the key role of governments in that process, the aim being to enable their development into firms capable of competing with the TNCs in the global market. These discourses thus reflected developmental ideas.

In Malaysia, Dr Mahathir, the Prime Minister, had largely shaped discourses on globalisation, which by the mid-1990s had become a common part of the Malaysian political and economic scene. The centralisation of power in the office of the Prime Minister coupled with the personal authority that he largely enjoyed, at least until the financial crisis, meant that his ideas and interpretations generally prevailed and were translated into official policy. What was most notable about Malaysian discourses on globalisation was the embrace of only parts of the globalisation message associated with the Washington Consensus. Other aspects were redefined or re-interpreted, again largely by the Prime Minister.

In the Vision 2020 document of 1990, which laid the foundation for the Prime Minister's attitudes and responses to globalisation and his strategies to achieve developed country status for Malaysia, the neoliberal message of markets, competition and competitiveness was explicit. Mahathir's aim was to 'secure the establishment of a competitive economy that is subjected to the full discipline and rigour of market forces'. The Prime Minister also appeared to accept the nature of global market competition when he commented that 'entry into the world market pits our companies against all comers and

subjects them to the full force of international competition a challenge we must accept'. As already noted in the previous chapter, the adoption of policies of deregulation, privatisation and liberalisation in Malaysia was consistent with these ideas.

Despite the emphasis on competitiveness, other concerns were never ignored, only de-emphasised. By 1996, however, the Prime Minister's longheld concerns about the inequalities in the global economy re-surfaced in the discourses associated with globalisation. The timing of his re-interpretation of globalisation, even before the financial crisis hit Malaysia, was linked to the flurry of activity at the OECD on the MAI, the move to embrace new issues in the WTO, and the pressure on Malaysia to make better market opening offers in the GATS financial services negotiations. At the Sixth G-15 Summit in Harare in November 1996, the Prime Minister pointed out that 'in the name of globalisation, developing countries have been called upon to account for many things, be it the environment, labour standards, investment laws, financial services, or other development issues'. Mahathir also began enunciating the view that globalisation was a threat to developing countries in general, and their firms in particular. This interpretation became increasingly pronounced since the 1997 financial crisis. The competing discourse also drew attention to the emergence of huge corporations and banks that dominated economies everywhere through having acquired or absorbed small companies and banks, particularly in the developing world. The emphasis on growth through embracing neoliberal policies was also confronted by concern with building up domestic firms.

In Indonesia, three competing discourses were evident during the 1990s. All three shared the same perception of globalisation as an inevitable economic force, which Indonesia needed to cope with to 'survive'. These three discourses, nevertheless, viewed competitiveness and the means to achieve it through different lenses. Although neoliberal ideas about competitiveness appeared to be dominant, seemingly reflected in the trade and investment liberalisation undertaken during the mid-1990s, neoliberal policies were essentially limited to the external sector. This was pointed out in the previous chapter. Reforms to deregulate the domestic economy, increase market competition and privatise state enterprises were far more limited, however, reflecting not only the particularistic interests

of the politically well-connected but also competing concerns in Indonesia with nurturing domestic capital.

The discourse of the economic nationalists emphasised the importance of economic reform to meet the competitive challenges of globalisation, but advocated state intervention to protect strategic industries and sectors from foreign domination and for governments to help leapfrog technological development. Minister of Research and Technology, B. J. Habibie, later Suharto's Vice-President in 1998 and subsequently Indonesian President for a year until late 1999, was the most prominent proponent of these ideas. These ideas resonated with many Indonesians, who regarded a state-controlled economic system to be sacrosanct under the country's Constitution. Moreover, the nationalists were also concerned about the dominance of the Indonesian economy by ethnic Chinese Indonesian business.

The discourse of the economic populists, like that of the liberals and the nationalists also emphasised economic restructuring, but the populists saw a crucial role for the state in nurturing small- and medium-scale, indigenous businesses and the rural economy, rather than large, strategic industries. Like the nationalists, the populists, the most notable of whom was Adi Sasono of the Muslim Intellectuals Association, were also concerned by the dominant position of ethnic Chinese Indonesian capital, which the populists believed had thrived under the liberal economic policies of the government. Thus, the populists were in favour of an affirmative action programme similar to that in Malaysia to upgrade the economic position of the majority indigenous population.

The once dominant position of the liberal technocrats in the Indonesian bureaucracy and government who had pushed through neoliberal policies since the mid-1980s declined considerably as the 1990s wore on. By 1994, President Suharto had appointed many economic nationalists to his cabinet, until then dominated by liberal technocrats. These policymakers increasingly embraced the idea that deregulation and liberalisation could be strategically integrated with state-driven industrial policy to help develop domestic industrial and commercial capabilities. The concern with nurturing domestic capital was clearly reflected in these discourses in Indonesia, and ultimately in policy preferences.

Although alternative interpretations of globalisation challenging its purported beneficial effects were present in Thailand

and the Philippines, constructed largely by non-governmental organisations, the powerful liberal technocrats in these respective governments continued to emphasise a conventional neoliberal policy agenda of growth and international competitiveness. In both countries, the technocrats were supported by outward-oriented big businesses, especially in Thailand. In the Philippines, the neoliberal economic agenda found support in the significant constituency that had emerged by the 1990s advocating economic reform in order to challenge the power of the old-landed oligarchy. Nevertheless, departures from neoliberal policies, including in AFTA, were not uncommon in the Philippines, driven by particularistic business interests with substantial political influence. Departures from liberal economic policies and from AFTA were less evident in Thailand due to the powerful coalition of interests technocrats and urban-based big business in favour of the neoliberal agenda.

Using the AIA as a Developmental Tool

In response to concerns about the future of emerging domestic capital, the Malaysian side advocated a developmental role for the AIA that would help nurture *domestic* capital through the privileging of ASEAN investors in the AFTA market. Thus, Article 3 of the AIA lists as one of its objectives, 'increasing the flow of investments into ASEAN from *both* ASEAN and non-ASEAN sources'. A senior Malaysian trade official acknowledged that the AIA was designed not only to increase the inflow of FDI into the region but also aimed at 'developing and helping ASEAN investors'. Preferential market access and national treatment privileges for ASEAN investors were aimed at providing domestic (ASEAN) firms space to grow and become internationally competitive before TNCs were allowed full investment privileges in the regional market. With these privileges, the single regional market under AFTA would provide the necessary scale and learning economies for domestic firms, at least theoretically.

The Lure of Large Domestic Firms and ASEAN Multinationals

The AIA was not only aimed at stimulating the growth of large domestic firms, a crucial part of the project was also to encourage the development of ASEAN conglomerates through joint ventures or other forms of alliances among ASEAN domestic investors as a means of competing with the global corporate giants. A senior official

from the ASEAN Secretariat explained, 'the ASEAN countries saw the need to develop regional MNCs using the grace period before foreign investors would be accorded the same privileges'. There was clearly a move to nurture domestic capital, especially emerging capital, through the AIA as well as use the latter to catalyse the formation of ASEAN multinationals.

The AIA essentially introduced a developmental agenda into AFTA without necessarily jeopardising the role of the CEPT component in attracting FDI. The ASEAN governments were sufficiently realistic not to adopt inward-looking policies that restricted or rejected FDI, with governments remaining committed to foreign investment and open regionalism in the CEPT. Whether the idea of using the AIA as a developmental tool was workable is a separate issue that falls beyond the scope of this book. Why such a project was adopted is the more interesting question, to be addressed below.

Although it was the Malaysian government that initiated the idea of using the AIA as a developmental tool, which Indonesia supported, all the respective investment agencies in the core ASEAN countries accepted the need to initially accord investment privileges to ASEAN investors in the AIA and only later to extend these to non-ASEAN investors. This point had, in fact, been extensively debated during the three years of consultations that led up to the formal signing of the AIA Agreement in October 1998. It had been noted at these consultations that privileging ASEAN investors would be difficult to justify on economic grounds, since foreign TNCs possessed the wealth-creating assets that the ASEAN countries required in order to participate in increasingly sophisticated global production. Nevertheless, it was also acknowledged that preferential treatment of ASEAN investors could potentially stimulate intra-ASEAN investments and facilitate the emergence and growth of indigenous ASEAN multinationals, which was a necessary vehicle 'to compete in a world economy increasingly characterised by globalisation and competition'.

ASEAN leaders and policymakers were broadly united on the importance of domestic firms becoming large and/or multinational as a means of meeting global market competition. The Singapore government's 'Local Enterprises 2000' strategy, first enunciated in the country's 1991 Strategic Economic Plan, proposed to groom a

group of promising local enterprises over the next ten years to become the MNCs of the future. President Suharto advocated large and medium-sized firms for Indonesia as a means to face competition from TNCs. On the one hand, this may well reflect Suharto's need to justify the regime's preferential treatment of the conglomerates of his ethnic Chinese allies and family members. On the other hand, Suharto was supportive of his Research and Technology Minister, B. J. Habibie's plans to develop large, technologically advanced firms as a means for Indonesia to leapfrog technology development and join the ranks of the advanced industrial economies. The private sector also echoed these sentiments. The President of the ASEAN Business Forum agreed that 'we are too small to go out and fight with the Fortune 500 companies', while the Thai private sector urged its government to support the creation of regional Thai firms.

While investment officials were broadly united on the need to accord investment privileges to ASEAN investors ahead of foreign investors, they differed on how to define an 'ASEAN' investor in terms of its minimum ASEAN equity share (or maximum foreign equity share). This was a critical point in the AIA negotiations, since many domestic investors in the ASEAN countries were also involved in joint ventures with foreign capital. In any case, FDI was an important player in ASEAN and the ASEAN governments were not advocating keeping out FDI; they were only interested in nurturing domestic capital through temporary privileges accorded to the latter, and particularly in non-manufacturing sectors. As already noted, developmental regionalism was to be achieved through the AIA without jeopardising the role of the CEPT in attracting manufacturing sector FDI.

Thus, it was not surprising that a very open economy like Singapore advocated a liberal definition of an ASEAN investor that stipulated only a minimum 30 per cent ASEAN equity share. This meant that any venture up to a maximum foreign equity share of 70 per cent could qualify for national treatment and market access privileges. The Thai Board of Investment, in contrast, advocated a minimum ASEAN equity share of at least 51 per cent in keeping with prevailing Thai investment policy, at least during the initial negotiations on this matter. On the other hand, the Thai Commerce Ministry that has overall charge of AFTA policy and negotiations was more concerned about emphasising the AIA as a tool to attract

FDI rather than its developmental role. It was able to pressure the Board to lower the minimum ASEAN equity figure to 30 per cent. The other countries, all with varying degrees of restrictions on foreign participation, preferred a more conservative definition, however. In the end, the ASEAN governments agreed to define an ASEAN investor as a domestic investor according to each prospective host country's local investment laws and policies. Flexibility prevailed for two reasons. First, it allowed individual governments the independence to adopt mixes of domestic/ASEAN and foreign investment that met national needs. Second, it continued to facilitate joint ventures between foreign and domestic firms as a way of building up the domestic partner through technology transfer and learning from the foreign partner.

Malaysia: The Main Proponent

Malaysia was especially vocal in advocating large enterprises as a means effacing global competition, emphasising in particular the idea that ASEAN multinationals or conglomerates would be best able to weather global market competition rather than smaller firms. It was Prime Minister Mahathir's belief that only products from large firms would be able to penetrate the world market. Thus, he advocated using the state to assist 'small and medium industries to grow bigger', for all Malaysian firms to become 'sturdy and strong' and be able to 'take on the world'.

Since the early 1990s, senior officials of the Economic Planning Unit, the foremost economic policymaking agency in the country, had begun emphasising, often with great urgency, the need to nurture domestic capital, revealing the extent of official discomfort with the country's over-whelming reliance on FDI. A senior official from the Unit noted that 'FDI cannot be relied upon to build up an indigenous base, which is required for long-term sustainable industrialisation...building up indigenous industries, owned and controlled by Malaysians is more complex but is more important in the long run'. The head of the Unit in 1992 explained that the thrust of economic policy over the next few decades would be 'the creation of Malaysia's own multinationals and global companies'. Thus, it was not surprising to find that Malaysia was the main advocate of a developmental approach to the AIA.

The Malaysian government saw the AIA as an opportunity for national companies to grow and develop their industrial and

commercial capabilities by exploiting the investment privileges that the investment agreement would accord them in the regional market compared to foreign investors. Trade minister, Rafidah Aziz advocated regional level mergers and acknowledged that discussions had been held among ASEAN policymakers on how to encourage national firms to form large ASEAN conglomerates to exploit regional market opportunities as well as to compete effectively in the global market, including in service sectors. Rafidah also suggested the possibility of an ASEAN financing mechanism, such as a Pan-ASEAN Export-Import (EXIM) Bank to provide financial backing for ASEAN conglomerates in their regional operations.

Of the other core ASEAN countries, only the Indonesian government explicitly supported the Malaysian position. In October 1998, Coordinating Minister for the Economy, Ginandjar Kartasasmita endorsed the Malaysian suggestion of using the AIA to develop ASEAN multinationals and conglomerates that would be globally competitive. Although officials from the Commerce Ministry in Thailand found the privileging of ASEAN investors in the AIA to be contradictory to AFTA's role as an instrument to attract FDI to ASEAN, neither Thailand nor Singapore rejected the Malaysian suggestion. There were no disputes in ASEAN over the AIA, unlike the very vocal and public disputes over petrochemicals, agriculture and automobiles.

The regional financial crisis, however, drew attention to the contradictions inherent in AFTA between privileging ASEAN investors and attracting foreign investors from outside the ASEAN region. It was noted in the previous chapter that the ASEAN Secretary General was somewhat critical of the distinction the AIA made between ASEAN and non-ASEAN investors in view of the urgent need to boost FDI flows to the region as a result of the financial crisis. A senior Thai investment official also expected the crisis to force the ASEAN governments to play down the intra-ASEAN investment emphasis and focus on strategies to attract FDI from outside the ASEAN region. Although the discriminatory clause in the AIA was finally removed in September 2001, the fact that this form of developmental regionalism was contemplated and maintained for three years requires explanation.

Political Importance of Domestic Capital in ASEAN

The different positions of the ASEAN governments on the AIA reflect the political importance of domestic-owned capital in these societies and the coalitions formed by the latter with the political/ ruling elite. Malaysian and Indonesian approaches to the AIA, specifically the privileging of domestic/ASEAN investors, lay in the key role played by domestic capital in these societies, particularly their political role. Although Thailand and Singapore did not actively champion a developmental clause in the AIA, the absence of a challenge from these governments on the issue needs to be explained. As the following discussion shows, the Malaysian move to privilege domestic/ASEAN investors through the AIA was actually helpful to domestic-owned capital in Singapore and Thailand undertaking expansion in the regional market.

Singapore: Economic Restructuring, Domestic Capital and Regionalisation

The mid-1980s recession led the Singapore government to recognise the vulnerability of the island economy to global economic upheavals as a result of its over-reliance on FDI, manufacturing production, and exports to developed markets as well as the lack of indigenous entrepreneurs. This led to the adoption of a new growth strategy that emphasised services as a vital growth sector, the expansion of domestic capital and regionalisation. While FDI remained important, the expansion of domestic capital was regarded as crucial for Singapore's competitiveness and as a way to reduce the over-reliance of the economy on external capital. Regionalisation was aimed at 'geographically expand[ing] the Singapore economy itself. The regionalisation strategy not only emphasised Singapore's role as a springboard for global TNCs locating in Singapore to operate in the region, it was also regarded as a means of enabling domestic capital to expand beyond the confines of the limited domestic market.

The novel feature about the new growth strategy was the commitment to facilitate the expansion of domestic private capital, which was a turn-around for the PAP government that had governed Singapore since the early 1960s. Singapore's development strategy in the past had relied heavily on FDI, driven by the PAP government's historical distrust of the predominantly ethnic Chinese domestic capital. The animosity between the PAP and Chinese business

stemmed from the latter's perceived support for 'Chinese chauvinism' and left-wing/communist political elements within the PAP during the party's factional struggle during the turbulent 1960s. The bias towards foreign capital in development was compounded by the government's belief that domestic private capital lacked the capability to engage in efficient production. Moreover, state capital had taken on the role of domestic private capital, engaging in a range of activities in services, heavy industry and high technology activities through government-linked corporations (GLCs).

The nurturing of domestic private capital, including the building up of large domestic corporations became a priority for the government, although these goals were not to be achieved through protectionism. Instead, the government's approach was to supply the necessary public goods like human resources, research and development facilities, information, as well as fiscal and financial incentives to support domestic capital in market competition. The regionalisation drive Regionalisation 2000 was a key element in creating the conditions to enable the expansion of domestic capital. Domestic firms were seen as natural suppliers and joint venture partners to the GLCs, which had already begun diversifying their operations to the ASEAN region. The concentration of domestic private firms in the now critical services sector, particularly in finance and commerce, reinforced the role of domestic capital in Singapore's future growth.

Although domestic private capital in finance and manufacturing was already investing abroad since the late 1980s, largely in the ASEAN region, 'Regionalisation 2000' was an effort to actively encourage and hasten the process. Singapore Prime Minister Goh Chok Tong emphasised that 'going regional is part of our long-term strategy to stay ahead. It is to make our national economy bigger, our companies stronger and some of them multinationals'.

Moreover, the service sector, emphasised as the new growth sector for the economy, was heavily reliant on the regional market, which made services inextricably linked to the regionalisation strategy. The competitive advantage of Singapore service firms also lay in the regional market. Lacking the necessary ownership-specific advantages to compete with global TNCs in global markets, local service firms were not keen to venture further afield. This explains

why Singapore was keenest among the ASEAN countries to negotiate services liberalisation within AFTA. The government's recognition of the trend towards the unbundling and outsourcing of previously in-house services such as logistics and information technology services for manufacturing industry also explains its desire to include services 'incidental' to manufacturing and other economic sectors in the AIA. The regionalisation drive required an active regional diplomacy to negotiate the institutional framework necessary to facilitate the expansion of domestic capital. The Singapore government's support and championing of AFTA, thus, needs also to be seen in this light, and not solely in terms of AFTA's role in attracting FDI.

Economic growth was a key component of political legitimacy for the PAP government. The regionalisation strategy allowed the PAP government to regenerate the bases of its domestic legitimacy by incorporating domestic capital as a source of growth. Not only was this move aimed at diversifying the sources of economic growth for Singapore, it allowed the PAP government to co-opt domestic Chinese business as part of the ruling elite, albeit as the junior partner in the ruling coalition of political/bureaucratic elites and state capital.

The discussion suggests that the privileging of ASEAN investors in the AIA did not contradict the interests of the Singapore government. In fact, it benefited Singapore's economic restructuring strategy based on the expansion of domestic capital through regionalisation. The regional financial crisis prompted a re-think of the regionalisation strategy, however, with Singapore opting for a more global strategy to diversify risk and avoid 'putting all its eggs into the regional basket'. Regionalisation, nevertheless, remains a key plank in Singapore's growth strategy for the future, although it is unlikely to be premised solely on ASEAN alone but will extend to other regional configurations.

Thailand: DomesticCapital and Overseas Expansion

Domestic capital has played a key role in the Thai economy from the 1950s. Although Thailand experienced an FDI boom since 1985, foreign capital did not overwhelm domestic capital, which also expanded considerably after 1985, often in joint ventures with FDI. Most importantly, domestic capital, particularly urban

(Bangkok-based) big businesses had also begun to expand overseas. Unlike Singapore, Thailand did not have a formal policy to develop domestic capital or a formal regionalisation policy to support the overseas expansion of Thai private capital. Nevertheless, the government's commitment to AFTA served the interests of the Bangkok-based business elite, which was in close alliance during the 1990s with both elected politicians and liberal technocrats in the bureaucracy who advocated open economic policies for Thailand, including regional trade liberalisation.

Overseas expansion in the 1990s by outward-focussed elements of Thai domestic capital was especially evident outside manufacturing industry where large family-based Thai conglomerates dominated. The Shinawatra group, the Samart group, the Charoen Pokphand group and the Ucom group, for instance, ventured overseas to Southeast Asian markets in a variety of activities related to their core domestic business in telecommunications and information technology. As in the case of Singapore, the decision to privilege ASEAN investors in the AIA did not necessarily contradict the interests of the political and state elites nor that of its business allies since it clearly benefited internationally oriented Thai domestic businesses seeking to venture abroad.

That was, however, the state-of-play in 1998 when the AIA was initially adopted and the effects of the 1997-98 financial crisis were still unfolding in the country. Since then, the collapse of significant elements of Thai big businesses lent new emphasis to the role of FDI in spearheading growth in Thailand as the Democrat Party under then Prime Minister Chuan Leekpai sought to restructure the Thai economy towards greater market openness and competitiveness. Hence, there was an attempt by Thailand to de-emphasise the foreign-ASEAN distinction in the AIA through attempts to bring forward the deadline for full foreign equity ownership in investment. The Deputy Secretary General of the Thai Board of Investment, Chakramon Phasukvanich, in fact, suggested that the crisis might force ASEAN to play down its intra-ASEAN investment area in favour of attracting FDI from outside ASEAN. In the end, ASEAN member governments chose to maintain the foreign-ASEAN distinction in the AIA.

For the Thai government, the most important reason for establishing AFTA was to attract FDI. Despite this, the privileging

of ASEAN investors in the AIA did not necessarily contradict the interests of the political and bureaucratic elite and their business allies since the AIA did not jeopardise the workings of the CEPT, which was the primary instrument used to attract FDI to the region. More importantly, the AIA benefited Thai capital seeking to venture abroad. The importance of AFTA to Thailand should, therefore, also be seen in this light, as a mechanism that also benefited the growth of domestic, especially the Bangkok-based, business elite.

Indonesia: Domestic Capital, Patronage Networks and Economic Nationalism

The support given by Ginandjar Kartasasmita, Coordinating Minister for the Economy in the Habibie government, for the Malaysian proposal to use the AIA to nurture ASEAN firms and to develop ASEAN multinationals needs to be seen in the light of Ginandjar's credentials as an economic nationalist. It was earlier pointed out that the economic nationalists envisaged a key role for the state in directing markets to achieve particular national goals, particularly technological development and the nurturing of indigenous Indonesian capital. Dr Habibie and Ginandjar were both in favour of reducing Indonesian dependence on foreign technology. Habibie also justified his state-driven high-technology strategy in terms of enabling Indonesia to quickly move to higher value-added production in the face of competition from cheap-labour economies like China and Vietnam. Despite his broad commitment to neoliberal reforms, former President Suharto during his tenure had also been attracted to and generally supported Habibie's vision. This was unsurprising, as Suharto was rather ambivalent about the value of free markets, seeing them only in instrumental terms as a means to deliver regime-legitimating growth.

Economic nationalist policies thus encompassed an economic imperative, emphasising growth though with a strong infant industry or strategic trade flavour, as well as a political agenda, namely the redistribution of economic wealth from non-indigenous to indigenous hands. Ginandjar's response to the Malaysian proposal to employ the AIA to develop domestic capital, and President Habibie's support of it, need to be seen in this context.

Indonesian domestic capital may be divided into ethnic Chinese capital, indigenous or *pribumi* capital and state capital, all of which

were politically significant but for different reasons. The ethnic Chinese entrepreneurs dominated big business in Indonesia, having gained their economic fortunes and pre-eminent position in Indonesian business through connections with politically influential persons, including military elites and especially President Suharto. Because of their Chinese ethnicity, they occupied a very vulnerable position in Indonesian society. In return for political protection and economic benefits, the ethnic Chinese conglomerates provided funds to the President, which he disbursed to selected organisations and individuals in return for political support. The Chinese were, therefore, a crucial link in Indonesian patronage politics although they were strongly resented by indigenous Indonesian business interests and the indigenous Indonesian public. The President and government were generally sensitive to anti-Chinese sentiment, which indigenous business exploited. The government's support to both state and indigenous private capital needs to be seen against this background of resentment against Chinese businesses, particularly the conglomerates.

State-owned enterprises, some of which were part of the strategic industries programme initiated by Habibie, constituted a large part of the Indonesian economy during Suharto's rule, which were only partially reformed through privatisation during the 1980s and 1990s, and continue to remain salient in the post-Suharto era. The role of public enterprises as agents of development is legitimised by Article 33 of the Indonesian Constitution, which accords a primary role to state control of 'branches of production essential to the state and governing the life and living of the public'. Moreover, public enterprises were considered to be the 'fortress for the indigenous', a bulwark against ethnic Chinese and foreign domination of the economy. State enterprises were found in virtually all sectors, particularly infrastructure, finance, telecommunications and the high-technology industries within the purview of Habibie. Although strongly criticised by the technocrats, and even by indigenous business interests who feared their potential crowding out by state capital, Suharto generally supported the strategic industries programme as it reflected his vision of a developed Indonesia.

As for private indigenous capital, Suharto also used economic favours like preferential credit and import licenses to encourage the growth of an indigenous business class during much of the 1970s

and 1980s. These preferential policies enabled the President to ensure the political support of the indigenous elites who were ultimately beholden to the President as a result of their special treatment. Nevertheless, these preferential policies led to the creation of a second corporate elite group indigenous big businesses. These policies supporting indigenous businesses continued into the 1990s despite the broad neoliberal reforms undertaken during this period. In fact, the appointment of the economic nationalists to influential positions in the 1993 cabinet reshuffle appeared to herald the further rise of the fortunes of indigenous big businesses, particularly since economic nationalist policy-makers advocated a more interventionist approach to economic policy, one that emphasised the development of domestic, especially indigenous business capabilities. Indigenous capital soon became concentrated in sectors like power, roads, cement, telecommunications and broadcasting, banking and finance, and retail trade. Interestingly, many of the indigenous business elites participated in politics but they did not confine their participation and support to the state party, Golkar and at times worked with opposition parties as well. Indigenous business was, therefore, a politically salient group that the President and government could not afford to ignore.

The political salience of indigenous and state capital did not, however, end with the fall of Suharto and the financial crisis. Many Indonesians, including economic nationalist policymakers, regarded further neoliberal reforms sanctioned by the IMF as attempts by western interests to impose a form of capitalism on Indonesia that would, once again, 'prevent *pribumi* Indonesians from taking their rightful place at the economic table'. The redistribution imperative to achieve economic parity between the ethnic Chinese and foreign investors on the one hand and indigenous groups, particularly in business, on the other, remained strong. Both Habibie, Indonesian president in 1998 when the AIA was adopted, and Ginandjar had long been in favour of reducing Indonesian dependence on foreign investors and in weakening the dominant position of the ethnic Chinese business elite by building up state and indigenous businesses. While Habibie championed state capital, Ginandjar championed indigenous business interests. It is not clear, however, that developmental regionalism through the AIA would have been feasible as a means to help develop indigenous Indonesian capital.

It was more likely that the larger, more advanced ethnic Chinese businesses would have been the project's main beneficiaries. Nonetheless, the point to note is that Ginandjar's open support of Malaysia's developmental approach to the AIA emerged out of such ideas and the ascendance of indigenous business interests. AFTA could fulfil twin purposes as an exercise in open regionalism to attract FDI and as an exercise in developmental regionalism. The financial and political crisis in Indonesia meant, however, that the growth imperative, particularly to attract FDI to the country, became vital while IMF reforms made it difficult to translate economic nationalist ideas to firm policies.

Malaysia: Ethnic Politics, Economic Nationalism and Domestic Capital

The political salience of domestic capital in Malaysia is tied up with the country's ethnic politics and with the broader economic nationalism of Prime Minister Mahathir. The original 'ethnic Malay capitalist project' of the 1970s and 1980s soon became bound up during the late 1980s and 1990s with a broader Malaysian economic nationalism that sought to develop a more encompassing Malaysian capitalist class that would lead towards parity with the developed countries, although the ethnic project was by no means dismantled. The Malaysian government's approach to the AIA, as a means to develop domestic capital through stimulating their regional expansion on preferential terms, needs to be viewed against these dynamics in the domestic political economy.

Between 1970 and 1990, a state-directed development programme the New Economic Policy (NEP) drove the Malaysian political economy. The NEP was the outcome of ethnic riots following the May 1969 elections. It reflected Malay concerns at the community's economic marginalisation and fears that they would lose their political dominance to the relatively better off ethnic Chinese community as a result. Among the policy's objectives were the creation of a Malay business (and middle) class and the achievement of a target of 30 per cent Malay equity in the corporate sector. The NEP was vital to the legitimacy and security of the UMNO-dominated regime, since it enabled both a more equitable distribution of wealth for the Malays as well as Malay political dominance through the control of economic resources. The United Malays

National Organisation (UMNO) has long been the leading Malay party in Malaysia, regarded as the champion of Malay political rights in multiethnic Malaysia.

Although the NEP was replaced by the National Development Policy in 1991 that scaled back ethnic preferences, the goal of creating a Malay business community continued to be emphasised in the 1990s. Even the privatisation programme undertaken as part of the economic restructuring package adopted in response to the mid-1980s recession was actively used to create a Malay business class to fulfil the NEP goal. Privatisation largely benefited UMNO-linked Malay businesspersons, although a number of ethnic Chinese and Indian businesses gained as well. This group, in turn, became a valuable source of political and material support for UMNO. By the late 1990s, therefore, this politically influential rentier domestic business community had become part of the governing elite.

The new Malaysian conglomerates that emerged out of privatisation and other preferential policies were also a key component of the wider economic nationalism of the Malaysian Prime Minister. Especially after the mid-1980s recession, policy had moved beyond the NEP's narrow focus on building a *Malay* capitalist class to advocate the growth of large, *Malaysian* firms as a means of meeting the competitive challenges of the global economy, although NEP goals remained salient. The policy shift reflected the strategic vision of the Prime Minister, who was no longer content with Malaysia remaining a Third World producer of industrial commodities. Thus, he stressed the building up of Malaysian corporations and conglomerates able to compete with foreign TNCs in what was perceived to be an intensely competitive world economy.

Since foreign firms were dominant in the far more efficient, export-oriented manufacturing sector, it was in the non-manufacturing sectors that emerging domestic capital, including ethnic Malay capital found its niche, using market restrictions as well as access to preferential treatment through political connections as a means to profits. As already noted in a previous section, the expectation among policy-makers was that global rules would eventually allow foreign corporations unrestricted access to the domestic market. It was clear that Malaysian firms, including the politically privileged ones, would eventually have to compete with

global firms, not only in international markets but in the domestic market as well.

A former coordinator of Malaysian participation in OECD workshops, Ong Hong Cheong, notes that foreign interest in 'national treatment [of investment] was seen by both the Malaysian government and the private sector to pose the biggest threat to domestic companies'. Ong further points out that an alarming aspect of the MAI was the open-ended definition of investment, because it meant that the MAI would be binding on the host country to allow foreign multinational companies the full right to both establish a new presence and to expand their existing presence in the manufacturing, services and other sectors of the economy in addition to the right to take part in new privatisation exercises the MAI could also lead to eventual foreign domination of the banking and financial sector, a totally unacceptable political proposition.

The writing on the wall was clear. The expectation that global rules would eventually allow foreign corporations unrestricted access to the domestic market was very strong indeed among policy makers. They expected Malaysian firms, including the politically privileged ones, to eventually have to compete with global firms both in international markets and in the domestic market as well. If politically important domestic firms were not ready for global market competition, their demise would have significant political repercussions for the NEP goal of advancing a Malay business class, for Mahathir's personal authority, and ultimately for the stability of Mahathir's ruling coalition as well as the security of the UMNO-dominated political system. The new business elite nurtured through the state by Mahathir were also important players in Malaysian patronage politics. The developmental role envisaged for the AIA by the Malaysian side was, therefore, intimately related to ensuring the survival of these politically important domestic firms that were key players in the Malaysian political economy.

Growth Imperative Overwhelms: Reviewing the AIA

The ASEAN governments agreed to remove the disparity in the AIA between foreign and domestic/ASEAN investors in the non-manufacturing sectors, thus offering foreign investors full market access and national treatment privileges by 2010 rather than in 2020.

Although the AIA had been adopted in October 1998, right in the throes of the financial crisis, it was at that time not expected to adversely affect manufacturing sector FDI since its discriminatory effects were largely, though not solely, confined to the non-manufacturing sectors. It was the flow of FDI to the manufacturing sector that was considered to be crucial during this period, since it had been the main engine of growth and exports in ASEAN from the mid-1980s, and was believed by political leaders to be the main means of recovery from the crisis. Some member country officials as well as the ASEAN Secretary General believed that the AIA as it was then designed would jeopardise the inflow of FDI during such difficult times when the liberal reformist credentials of member governments were at stake. Nevertheless, the latter continued to maintain the AIA in its original form. Instead, member governments accelerated CEPT tariff liberalisation in 1998 as a means of reassuring foreign investors that they were committed to realising the single regional market, the main 'carrot' used to attract FDI flows to ASEAN. Member governments also temporarily relaxed investment restrictions for a one-to two-year period in selected manufacturing sectors in their respective countries as a way of maintaining investor interest in the region, as already noted.

Nevertheless, member governments agreed in August 2000 to a one-year study on the AIA in view of the report presented by the ASEAN Secretary General the previous month that revealed a fall in investment into ASEAN from US$28 billion in 1997 to US$13 billion in 1999. Moreover, the report also showed that the ASEAN economies received only 17 per cent of FDI flows to Asian developing countries in 1999, compared to about 60 per cent in the early 1990s. China, on the other hand, received about 60 per cent in 1999, up from 18 per cent during the early years of the decade. The negative correlation was not lost on ASEAN officials and leaders. China's potential accession to the WTO and the anticipated diversion of FDI to China as a result added to the sense of urgency among the ASEAN leaders with regard to the FDI situation.

Concern about the future of FDI flows to ASEAN became especially pronounced by the middle of 2001, and it was this that finally prompted member governments including Malaysia to review the AIA in September 2001. By this time, it seemed clear that growth in ASEAN was in serious jeopardy as all the main engines of growth

in the global economy the US, Western Europe and Japan seemed headed into recession. In fact, it had become clear by early 2001 that a global economic slow-down was imminent, threatening the recovery that most member economies had experienced over 1999-2000. Falling demand in the US during 2001, still the region's main export market, meant that the ASEAN region appeared to be facing a more severe downturn than the 1997-98 regional financial crisis. Not only were export markets threatened, but foreign investment too was expected to slow further as a result.

In short, growth and FDI had, by the middle of 2001, emerged as the overwhelming priority for the ASEAN governments, including Indonesia and Malaysia. In addition, foreign investors, notably American investors pressed the ASEAN governments to accelerate national treatment under the AIA by citing the need to counter the diversion of FDI to China. It must be emphasised, however, that the relative decline of FDI inflows to ASEAN throughout the 1990s, and especially since the financial crisis, was not the result of the ASEAN-foreign distinction in the AIA. Nevertheless, there was concern in ASEAN that this particular clause could send the wrong signals to foreign investors at a time when ASEAN was under severe scrutiny by foreign investors and was facing a rather precarious foreign investment/growth situation. The ASEAN decision of 14 September 2001 to allow full market access and national treatment for *all* investors by 2010 in the non-manufacturing sectors was, therefore, directed at re-affirming ASEAN's openness to FDI. The attempt at developmental regionalism was halted, and open regionalism (at least, the FDI variant) has re-emerged as the main feature of ASEAN economic regionalism in the quest for growth.

Yet, it is also important to bear in mind that member governments have not agreed to implement complete regional investment liberalisation in non-manufacturing sectors anytime soon. This is targeted for 2010, suggesting that at the national level, full investment liberalisation will proceed cautiously. Domestic capital, in short, remains a key focus in the individual ASEAN economies, but support for it will likely be addressed through national instruments where possible and available rather than concerted regional ones. The regional instrument has been reserved once again to realise the FDI/growth imperative, but this is not to suggest that domestic distributive priorities have been marginalised across ASEAN. In fact, the AFTA

experience confirms that the tussle between growth and domestic distribution is a key dynamic driving regional cooperation. The delays in negotiating services liberalisation and Malaysia's temporary withdrawal of automobiles from AFTA disciplines reveal that there are sectors where regional liberalisation will proceed cautiously, driven by domestic distributive priorities despite the overall concern with growth. Thus, the AFTA story shows that while governments in Southeast Asia turned to regionalism as a collective policy response to the pressures associated with globalisation, the tussle between growth and domestic distributive imperatives ultimately shaped the manner in which cooperation unfolded and the forms that regionalism took.

Conclusion

The interaction between globalisation and domestic political economy dynamics, this chapter shows that policymakers and leaders in the ASEAN countries were also concerned with ensuring the growth and viability of domestic firms as with their anxiety over FDI inflows. While both forms of regionalism associated with AFTA open and developmental regionalism were driven by the growth imperative, distributive concerns were weaved into the concern with growth in the case of developmental regionalism. The latter paid special attention to nurturing domestic capital in anticipation of new global rules that were seen to be potentially damaging to emerging firms. The developmental dimension to the AFTA story is one that has so far been missed in the literature.

While all the core ASEAN governments used regionalism to facilitate the expansion of domestic capital, governments in Malaysia especially and Indonesia advocated preferential investment treatment of domestic firms in the ASEAN market through the AIA, the idea being to nurture domestic capital to enable them to meet global competition eventually. Governments and leaders of these countries were most concerned about the survival of those segments of domestic capital that were valued for their perceived role in sustaining incumbent elite rule and in helping to underpin the legitimacy and security of the prevailing regime.

Nevertheless, the AIA Agreement was designed in a rather flexible manner since it did not prevent any member from according

market access and national treatment privileges to *all* investors at any point before 2020. It was effectively a compromise between those advocating a developmental approach in AFTA through the AIA and those wishing to maintain the project's original interest in attracting foreign investors by using the carrot of the single regional market. As such, it is unclear whether the idea to use the AIA to build up domestic firms would have been workable. That, in any case, is not the main concern of the analysis, which is to account for the anomaly the AIA presents to prevailing FDI-centred explanations of AFTA.

Despite the broad commitment to nurture competitive domestic firms through developmental regionalism, implementation proved to be rather more difficult. As the next chapter illustrates in its discussion of departures from AFTA commitments, the imperative of distribution was so over-whelming in certain instances that governments found it difficult to immediately implement their AFTA commitments, including the AIA. Despite the latter's perceived potential to stimulate the development of larger, more capable domestic/ASEAN firms, some governments feared that immediate regional investment liberalisation and the privileging of ASEAN investors would challenge the dominant position of favoured domestic firms in the domestic market.

9

Markets Route to Full Employment

Introduction

Full employment of labour, capital and other 'factors of production' emerges from the formal competitive general equilibrium (CGE) model through the same market-clearing mechanism that efficiently allocates their output. Factor-owners decide how much they should rationally offer at different prices; factor-users decide how much they should rationally employ; and market adjustment simultaneously decides the equilibrium factor prices (wages and interest rates), the factor quantities employed at these prices, the output arising from this employment, and the product prices that will clear the markets for these products given the incomes paid out to factor-owners and the way they choose to spend them.

The price of a product or factor would lie above its social opportunity cost (the loss of utility or product value in one use when it is redeployed to another), implying that its production or employment is too low for social welfare to be maximised. Without full employment, too, owners of factors and products surplus to their requirements would be unable to realise the income needed for their equilibrium expenditure plans. In any situation where factors

are unemployed or products unsold at their market-clearing prices, a Pareto-improving trade is possible, from which buyer and seller would both gain.

The market system drives an economy towards full employment by constantly reducing the prices of products in oversupply and raising the prices of products in undersupply, until the vector of prices is established which allows all markets (including labour markets) to clear. Throughout, the adjustment process conforms to Walras's Law. Any excess demands in some markets are matched by excess supplies in others, so that the appropriate price adjustment will eliminate both. Since this establishes continuous full employment, the CGE also conforms to Say's Law. Any firm which sets out to raise its production will, through the equilibrium wages, interest and input costs it pays, inject into the economy exactly enough new demand to absorb the new production. Some of the income paid will be saved rather than spent, but since the interest rate adjusts to match this saving with investment, markets still clear, an overall rise in rates of saving simply shifting the production structure from consumption towards investment goods.

A Tactical Redefinition: 'Natural Rate' unemployment

In the short run, some labour may be unemployable in the sense of its subsistence needs exceeding its marginal product in any use. Some labour may be 'voluntarily' unemployed, not immediately willing to take a job at its market-clearing wage rate, perhaps because it does not regard this as matching the disutility of the work, or expects better-paid jobs to become available. Some unemployment will be frictional, involving people moving between jobs, or seasonal, where jobs provide work for only part of the year. There will also be some unemployment due to mismatches between labour demand and supply which slow down the matching of excess demands and excess supplies. This is mostly structural, with workers having the wrong skills until they retrain, and/or regional, with workers being in the wrong place until they move.

The CGE's full employment means, in practice, a 'natural' rate of unemployment, being the residue of labour which does not want to work, is not socially worthwhile employing given its current productivity, or is undergoing reallocation as part of the system's adjustment towards better allocation. The natural rate leads on to

the concept of a non-accelerating rate of unemployment (Nairu), being the rate of unemployment at which prices are stable. Workers who are 'naturally' unemployed can be brought back into employment only by deceiving them (and their employers) about real wages, through an inflation which they temporarily interpret as relative price change. Under standard CGE conditions inflation caused by money-supply growth will raise all absolute prices equally, leaving relative prices unchanged, and once they realise this agents who were voluntarily unemployed will return to being so. The Nairu also includes a component of people who would like to work at the current real wage, but whose unemployment is socially efficient because its disciplining effect on the productivity and wage bargaining of those in work outweighs the sacrifice of output.

Acceptance of a 'natural' unemployment rate may also avoid a possible objection to neoclassical marginal-productivity income distribution theory when all resources are fully employed. To measure a factor's marginal physical product by withdrawing one unit of it from its current production task would require, if full employment is to be preserved, redeploying that unit in another production task. The marginal physical product is then not the amount of production lost by withdrawal, but the difference between that amount and the additional product resulting from redeployment in an alternative use. Establishing the value of the marginal product requires multiplication by a relative price which will itself have been changed by the alteration to the composition of production. If marginal productivity is to be anything more than a thought-experiment, then under completely full employment, 'The value of the marginal product has no unambiguous meaning, since the pattern of prices, of factors and commodities, is altered by the change in productive capacity'.

The natural rate of unemployment and Nairu represent market imperfections. The natural rate could be brought down if faster response to price signals accelerated workers' move to the right place with the right skills and reduced the length of their 'search' for a better wage. The Nairu could be brought down if greater competition in the labour market (especially through better information to strengthen unemployed workers' 'potential entry' threat) prevented upward pressure on nominal wages as the economy moves close to literal full employment. Both approaches regard unemployment,

whether voluntary or involuntary, as a result of slow or stalled price adjustment in the CGE system.

Involuntary Unemployment as Imperfection

A competitive factor market should allow labour and capital providers to sell as much as they wish, driving income up to the point where work's disutility (exhaus-tion, depreciation, etc.) starts to outweigh it. One of economists' oldest challenges has been to explain why most market-based societies, most of the time, have some labour unemployed and some capacity idle even though their owners could expect a positive return if they were put back to work.

Once trading in the labour and capital markets has been identified as a complement to profit- and utility-maximising trade in product markets, an obvious explanation for unemployment is that factor prices have failed to find their market-clearing levels. Labour is unemployed because the wage it seeks is above what employers will pay, given its quality (marginal productivity) and their derived demand. Capital stock is idle because the interest rate on funds needed to work it is above the profit rate it is expected to deliver. Too high an interest rate can also prevent saving from being converted to investment, and so give rise to unemployment and spare capacity though a downturn on the demand side.

This price rigidity explanation of unemployment predates one formal CGE model, arising from a partial-equilibrium perspective which treats the market for labour as functionally equivalent to that for apples or ice cream. Unemployed workers can always find jobs if they are willing to offer their services for less. Their plight arises from an unwillingness to lower their wage offer, or some factor which prevents them from doing so. Prime suspects are union-negotiated pay agreements, statutory minimum wages, inappropriate skills or location, high food or housing costs which make it impossible to survive on the market wage, or an over-generous social security system (perhaps reinforced by the 'poverty trap' of tapering benefits and income-graded taxes) which give a more comfortable existence out of work than in.

The downward rigidity of real wages, and their tendency to move upwards at a faster rate than is 'justified' by labour productivity, both appear to gain strength as aggregate demand

rises and labour markets tighten. Strong product demand also makes it easier for employers to finance a nominal wage rise through a rise in prices, especially when they know that rivals are under the same labour-cost pressure, and when their industry's annual wage rounds are temporally clustered. The cost of lost product demand through a higher price must be weighed against the cost of lost product supply through a strike, which also rises as the firm runs down its inventories and moves closer to full capacity working. 'Wage-push' from a buoy-ant labour market is the standard explanation for the remarkably durable empirical finding of a 'Phillips curve' trade-off between price inflation and unemployment, with wages and prices spiralling upwards once unemployment falls below its 'natural rate'.

Reasons why falling unemployment should add to real wage pressures are less clear. While Anglo-American theorists have tended to blame over-powerful unions for restricting labour supply, the limited change in cyclical pay patterns after extensive curtailment of bargaining rights suggests that employers' battle to recruit and retain increasingly scarce skilled labour may produce the same effect from the demand side. Union resistance to productivity-enhancing technology also tends to be anecdotal, and often provoked by lack of consultation over (and training for) its introduction rather than inherent Luddite inclinations. The relatively benign inflationary experience of some industry- or economy-centralised bargaining systems, notably in western Europe, suggests that labour unions with enough coverage for the general price implications of their demands to become visible alongside the specific wage implications, enough disciplinary power to force a 'socially responsible' settlement onto sectionally militant members, and enough bargaining power to trade non-wage benefits against wage moderation, may be more conducive to real-wage moderation (and the occasional downward adjustment) than weaker and more dispersed union systems.

Whatever its causes, however, the persistence of an inverse relation between wage inflation and unemployment reinforces the neoclassical message that the successes of aggregate demand management are likely to be transitory. A fall in unemployment, at least once the 'natural rate' is undercut, creates labour-market conditions which will subsequently reverse it. Generous welfare provision appears to compound the trade-off by weakening

employees' incentive to avoid inflationary wage settlements which may price some of them out of work.

A general equilibrium perspective alters this picture only by widening the range of markets whose imperfection might lead to unemployment. The prices firms pay for factors are also the incomes from which factor-owners buy the products of the firms, so that optimum allocation also determines income distribution. Recalling the 'second fundamental theorem' of welfare economics, any change in initial distribution means a different pattern of Pareto-efficient trades. Cutting the wage to labour or the interest rate on financial capital to its 'market-clearing rate' may therefore cause that rate to change. Adjustment to full-employment equilibrium now becomes more of an iterative process, spread across all product and factor markets as well as the one that is initially in disequilibrium.

Imperfection in the capital market may cause real interest rates to stick above the level that allows investment (an addition to aggregate demand) to match savings (a withdrawal from it). Unemployment follows as a result of deficient demand.

Keynes traces this rigidity to the money market, where interest the compensation for parting with liquidity should adjust to bring private demand for money into balance with an exogenous money supply. Since money demand takes the normal form, varying inversely with the opportunity cost of not investing, a rise in real money supply must thus cause interest rates to fall (and hence bond prices to rise) to induce investors to hold their wealth as money rather than bonds. However, a floor is placed under the interest rate by slow-changing perceptions of the long-term rate. If short (money-market) rates fall much below this investors believe that the next move will be upwards, and so are persuaded to hold any amount of additional money, for a 'speculative' move into bonds once their price had fallen. If this lower limit to the interest rate is above that needed for full-employment investment, the 'equilibrium' is one of constrained output and unemployment.

Keynes's closest followers have, however, downplayed this 'liquidity trap' as a component of his equilibrium-unemployment theory. On one interpretation, investment volatility is due less to changes in the interest rate than to changes in the volume of fixed investment undertaken at any particular rate, as long-term expectations shift. On another, there is no reliable connection

between investment undertakings and interest rates because the concept of a well-behaved demand for fixed capital is logically flawed.

Meanwhile, economists more concerned to square Keynes's results with CGE have shown that capital-market influence can be as much benign as malign, adjusting to compensate for rigidities in other markets. If the real wage cannot be reduced, because nominal wage cuts are matched by (cost-based) price cuts, full employment is restored by automatic monetary expansion. The price cut means a higher real money supply and (assuming no liquidity trap) a fall in interest rates which (assuming a well-behaved capital demand function) boosts investment. Even if the real interest rate does not fall (because price cuts are assumed to be ongoing, or because of the liquidity trap), aggregate demand is restored by the rise in the real value of 'outside' money holdings.

Real monetary expansion is, however, a second-best solution, with real wage flexibility restoring full employment at less economic cost. The danger with manip-ulating money supply is that governments may start to use this to drive unemployment below the 'natural' rate for short-term political purposes, by introducing inflation which fools private agents into offering more factor services and products until they recognise that relative prices have not changed. This is made worse if marginal workers have their wage expectations raised while they are temporarily in employment, so that their next spell out of work is voluntarily prolonged as they search for work at a wage above what the market can offer given their productivity.

Product-market imperfection has also been held responsible for unemployment, since monopolies reduce output compared with the same industry under perfect competition, and oligopolies tend to respond to a downturn by reducing output rather than adjusting prices. A shift from perfect competition to monopoly and oligopoly may therefore, *ceteris paribus*, cause a fall in output and employment and a tendency for future demand changes to impact directly on output and employment. Some oligopoly models predict a tantalising coexistence of unemployed labour and unused capital stock. From a simple welfare viewpoint there would clearly be a Pareto gain in bringing the two together to raise production. But if the unemployment is intended as a device for disciplining the effort

and wage demands of those in work, and the excess capacity is intended as a credible retaliation threat should new entrants make a grab for the oligopolist's profits, firms' own economic interests are served by keeping the two apart.

Keynesian theory has sometimes veered towards an imperfect-competition explanation for unemployment, although the General Theory assumption that real wages equal labour's marginal product implies that firms are setting price equal to marginal cost, thus facing perfect competition at least in the product market. Even if firms are allowed a monopolistic mark-up of prices over costs, the resultant labour-market situation with lower real wage and lower employment still represents full employment in the 'natural rate' sense, marginal workers having voluntarily withdrawn because they are paid less. Imperfect competition may even assist the return to full employment after a labour market disturbance, since releasing firms from the obligation to cut prices in line with costs makes it more likely that workers can convert a money wage cut into a lower real wage.

The general equilibrium perspective thus widens the range of disturbances that could result in unemployment, while also increasing the number of ways in which unemployed agents can be 'priced back into work'. Unemployment may be a result of personal work-leisure choice, unemployability, or an institutional (labour-union) blockage to wage adjustment, but money wage rigidity is no longer the only mechanism. Interdependence between markets redirects attention from the theoretical existence of general equilibrium to the ways in which a competitive economy can actually achieve it.

Market System Exonerated

Ascribing involuntary unemployment to price or wage rigidity essentially denies the main assertion of Keynesian theory, which is that the economy can reach a situation in which no amount of price or wage adjustment will clear the labour market essentially an unemployment equilibrium. Keynes had argued that equilibrium merely meant stability in the circular flow of income. For a closed and fully privatised economy this required that savings, households' withdrawal from the circulation, equalled investment, firms' injection into it. Whereas households' saving was a fixed

proportion of their income, firms' investment was based on their perception of likely future investment returns, based on a view of the long-term future which rested heavily on experience of the recent past. This made investment the active component in the flow, too low a rate causing a matching shrinkage in savings by reducting aggregate income. As income fell, unemployment and spare capacity would appear which, far from restoring full employment by price adjustment, was likely to dampen investment expectations and so compound the downturn. Previous theory had argued that savings automatically concerted to investment, so that only the composition of aggregate demand could change and not its level.

To market theorists, even if the reversed investment-savings relation is accepted, Keynes's argument is still underlain by price rigidity. People could get back to work if they reduced their real wages. If they cannot, because prices fall as fast as wages, the rising value of real assets will restore aggregate demand. To the 'Keynesian' prescription that government spending above its income can restore the imbalance caused by private agents spending below theirs is counterposed the view that what government adds to demand through its deficit will be offset by an equivalent private-sector surplus, households saving or the tax they know they must eventually pay to service and repay the government's debt. State intervention would impede rather than assist the adjustment of markets, and the 'automatic' return to full employment.

The defeat of Keynesian policy was more a result of its own difficulty in correcting the market's deficiencies than of the market rediscovering self-correction. After two decades during which aggregate demand management appeared to keep the economy at full employment, a firm link between unemployment and wage growth explaining the accompanying rate of inflation, interventions began to draw only the inflation. Defenders of the 'neoclassical' theory, of which Keynes had tried to dispose, saw vindication for the view that past interventions had been tricking agents into abandoning (temporarily) their voluntary unemployment rather than curing involuntary unempoyment. However, the price rigidity arguments drawn from partial equilibrium analysis to support this view do not convert easily to the general equilibrium context in which neoclassical macroeconomic arguments proceed. Keynes's intuition, that unemployment can still occur when all prices are flexible, will

return, in two distinct guises, once the problems of moving from existence to attainment of general equilibrium have been addressed.

Getting into Equilibrium: The Too-invisible Hand

Price adjustment in one market involves separate decisions by each of the producers and consumers there, co-ordinated by what the market tells them about other agents' behaviour. Agents take market prices as given when forming their utility or profit expectations, but the actions they take as a result alters industry output and raises price. Provided demand and supply are well behaved, excess supply pulls prices down and excess demand lifts them up. Using Boland's terminology, excess supply can be given a Walrasian interpretation (supply exceeds demand at the non-equilibrium price initially offered in the market) or a Marshallian interpretation (supply price exceeds demand price at the non-equilibrium quantity initially brought to the market). Under Walrasian adjustment, competing suppliers will battle to undercut one another until market price has fallen to the equilibrium, with some supply withdrawn and some additional demand attracted until quantity is consistent with this price. Under Marshallian adjustment, marginal suppliers unwilling to sell their output at the market price will start to withdraw, others start reducing their supply price, while demand price rises in response to the falling supply until quantity has adjusted to the equilibrium price.

These conclusions are drawn on the assumption that conditions in other markets stay the same. This implies a sequential determination of equilibrium prices, however, whereas under CGE these are determined simultaneously. The step from proving the existence of an equilibrium price vector to showing how the economy attains it has not proved an easy one to take.

Even if full employment does not depend on it, perfect competition enters the CGE's optimum allocation properties by ensuring that the 'representative' firm's price just covers marginal costs at the point of minimum average cost. The firm must accept whatever price results from industry supply and demand. All agents under CGE are 'price takers', too small to influence market price through a unilateral change in output.

In the models of the theorists such as Arrow, Debreu and Hahn, which are the focal influences in general equilibrium theory, not just households but firms are assumed to act as price taker. These models are exactly applicable only to agriculture, forestry, fishing and part of the mining sector, industries whose outputs account at the very most for 20% of GDP in most modern economies.

The partial-equilibrium intuition is that any price disequilibrium will cause all firms and consumers to adjust supply and demand in a consistent direction, re-establishing equilibrium through continuous feedback between prices and quantities, achieving an adjustment for which all are responsible though not consciously planned. Any agent who could affect market price through their own quantity adjustment would possess monopoly power, and could not be expected to follow optimal pricing rules.

In general equilibrium the feedback gets more complicated because of spillovers into other markets. Increased output of one product necessarily raises that of its joint products. A change in one product's price affects demand for any complementary or substitute products. Changes in product-market conditions affect factor markets, whose adjustments cause generalised change to the composition (and possibly level) of aggregate demand. Changes in factor-market income distribution would also alter the composition of aggregate demand, if neoclassical theory did not adopt abstract from consumption externalities and adopt wholly autonomous perspective on consumption.

It is assumed that utility is acquired in a very specific manner, which does not allow for any influences arising from consumption of others in society a view of the consumer which is no more than a special case. Yet the special case is presented as a general case.

With all decision-makers waiting for an aggregate outcome which is not established until they decide, an indeterminacy sets in, and arrival at the equilibrium price vector is usually ascribed to a mechanism outside the system. For Adam Smith this was the 'invisible hand', which metaphorically steered agents' self-interested actions towards the socially beneficial outcome. For early CGE formalisers it was an 'auctioneer', who assesses agents' trading plans and announces the set of equilibrium prices before any trading takes place. The Walrasian auctioneer is, in effect, charged with

solving the simultaneous equations which comprise the CGE system, having first obtained a reliable record of the production functions, utility functions and initial endowments that underlie it. No trading is permitted until the auctioneer has announced the equilibrium prices.

The Walrasian auction involves a *tatonnement* process, the successive announcement of an (initially arbitrary) set of prices to which agents state their demand and supply responses, allowing the price vector to be revised and reannounced. The process continues until 'convergence', where the prices announced are the same as those that result when agents design their transactions using these prices. This process is similar to that now used to solve large econometric equation systems, though these can generally rely on cheap computing power not available to the classical auctioneer. CGE theory guarantees that prices will eventually converge to equilibrium by this method, from any starting-point, provided its conditions are met in full and provided an auctioneer, or its invisible-hand equivalent, is present at the start.

Staying in Equilibrium: The Intertemporal Dimension

Although tatonnement has remained a dominant metaphor for equlibrium price-setting, it sets stringent demands on the auctioneer, who must set prices to structure trades that keep supply and demand in balance not just across space but also through time for as long as the competitive economy lasts. This would be straightforward if agents' preferences and technologies were set for all time, and if their trades exactly reproduced the initial equilibrium prices, resource allocation and income distribution. But preferences change over time as people incur new needs or discover new pains and pleasures, technologies change as a result of innovation, and income distribution changes as a result of trading, modifying the choices made out of consumption and technology sets.

The basic (Arrow-Debreu) general equilibrium model does its best to minimise such changes, principally by keeping firms' profits down to 'normal' levels or, if they do more than break even, distributing any supernormal profit to consumers. This rules out investment, so ensuring that there is no change in the capital-labour ratio (or consequent change in market-clearing relative factor prices),

no installation of new process technologies or introduction of new products (which would change relative product prices), and no growth in income that could alter existing consumer preferences or reveal new ones. The assumption of no investment impact on capacity makes basic CGE a short-run model, a status confirmed by the equilibrium price vector's failure to equalise profit rates across firms in different sectors.

In the long run, competition causes migration of firms and their fixed capital from lower-profit to higher-profit sectors, until sectoral profit rates are equalised. (Since wage rates also differ across sectors, labour might also migrate to those with higher wages if mobility and training were allowed.) Investment is the process by which firms alter their capital stock and introduce new technology, so a long-run CGE model must allow for change in the capital stock, relative prices and incomes. Unless the auctioneer is to stay on the scene and re-run the tatonnement process every time any determinant of the equilibrium price vector changes, it must offer agents a means of incorporating new price information through time to retain a Pareto optimal allocation, without departing from market-clearing and full employment. This involves supplementing the existing product and factor markets with a complete set of forward markets, allowing agents to set up their supply and demand plans (and hence know their incomes) at every future period. For intertemporal general equilibrium, the set of equilibrium prices with which trade begins must include forward prices for all resources to be traded now or in the future.

The absence of public goods or an assumption that the private sector will eventually find ways to supply them avoids a steady rise in unemployment and allocative distortion as demand grows for products which only government can offer. Rising income is entirely spent on products which satisfy the basic CGE requirements, sidelining government as producer or employer.

On these heroic assumptions, the auctioneer gets to the general market-clearing result more quickly than price adjustment in individual markets, since it can adopt price adjustment rules which take account of imbalances all across the economy, not just in one particular market. As a device to establish the viability of competitive markets this must remain a metaphor, since the auctioneer taken

literally resembles nothing so much as an omniscient central planner. Indeed, Lange turns the CGE model into a blueprint for the socialist economy. Reclaiming CGE for the market system requires a more decentralised adjustment process, with each market price responding to its own demand-supply balance. Yet without the device of the auctioneer, agents' powerlessness to affect market price unilaterally makes it hard to see how such unassisted adjustment can take place, unless some departure from perfect competition is allowed.

Unemployment as a Consequence of Disequilibrium Trading

Simply launching into trade, and relying on price adjustments in individual markets to sort out the initial disequilibria, does not ensure that decentralised agents will duplicate the auctioneer's price-adjusting work. False trading, the exchange of products at non-equilibrium prices, pushes agents away from their equilibrium incomes. So, by displacing demand and supply schedules, it may cause prices to converge to an 'equilibrium' lacking optimum allocation and full-employment properties, or perhaps even fail to converge at all.

Disequilibrium trading can cause a downward spiral in output and employment if current income is a binding constraint on current expenditure. If an agent sells products or labour services for less than their general equilibrium price, or is unable to sell all they want to at that price, their income is less than would have been received in general equilibrium. Unless the agent can draw on savings, or a capital market willing to lend on the security of higher future income (an unlikely move given that equilibrium prices and incomes are not yet known) it must cut down on current spending plans to keep within the tighter budget constraint. Other agents who had planned to sell to them will now also receive less than they expected, and so reduce own spending. A downward multiplier sets in, forcing the economy into an equilibrium with less than full employment.

Orthodox analysis does not provide a general theory of disequilibrium states: first, because it yields no direct information about the magnitude of realised as distinct from planned transations

under disequilibrium conditions; second, because it tacitly assumes that the forces tending at any instant to change prevailing market prices are independent of realised transactions at the same moment.

Walras's Law is violated, because an actual excess supply of labour coincides with an excess demand for products which is only notional, given that consumers cannot match it with ability to pay. Say's Law holds, but is stood on its head: firms cut back production because demand is falling, and this cuts income and expenditure to match the lower level of output.

Clower's analysis confirms Keynes's intuition that with aggregate expenditure a fixed fraction of aggregate income (the consumption function), the circular flow of income is likely to be brought into balance by changes in aggregate output rather than changes in relative prices. A fall in expenditure, caused either by lower income (due to false trading) or a rise in the savings rate, leads to a fall in aggregate output, and workers become unemployed without any necessity for their wage to be above their marginal productivity. Subsequent analyses of trading at non-equilibrium prices have confirmed that constraints on the quantities that agents can sell may lead to a settled pattern of trading activity in which aggregate demand falls short of aggregate supply. 'Disequilibrium analysis generalises the traditional theories of demand, supply and price formation to cases where, in the absence of an auctioneer, markets do not automatically clear'.

Such aggregate demand failure can be prevented by detaching current consumption from current income and linking it instead to 'permanent' income, the agent's assessment of its long-run budget constraint which is assumed to be that which emerges from continuously maintained general equilibrium. Any short-run demand constraint is recognised as temporary, and prevented from transmitting through the system because agents maintain their previous level of consumption, even if this temporarily moves above their current income. The tendency for outputs to adjust instead of relative prices now looks once again like price rigidity, resulting from labour or capital market imperfection. But this again presupposes that agents' perception of permanent income is consistent with the income they receive in intertemporal equilibrium, and that they have the resources to override a current income constraint.

The whole of traditional price theory rests on the tacit assumption that market excess demands are independent of current market transactions the Keynesian consumption function and other market relations involving income as an independent variable cannot be derived explicitly from any existing theory of general equilibrium.

Equilibrium without Intention 1: Evolutionary Selection

If the equilibrium price vector can be neither announced beforehand by an auctioneer nor arrived at by trade among competing agents, it might still arise through some form of evolutionary selection process. Those who fail to alight on an optimum trading pattern might be squeezed out of business or induced to adopt a better pattern by imitating those who are observed to be getting better results (the Lamarckian mechanism, rejected by biologists but more appropriate to social science in which agents are assumed able to learn and adapt). One or both mechanisms could lead agents to an optimising result without their consciously optimising, hence without their being inhibited with lack of the price information needed to optimise. Non-optimising agents must adapt or die, so that optimum behaviour spreads even if initially based on ill-informed conjecture. 'Conjectures may be such that if an agent acts on any conjecture other than the perfectly competitive one, his profits will be lower'.

The evolutionary explanation has obvious affinities to a model founded on competition, but strong conditions are needed if selection is to guarantee convergence to a general equilibrium.

This may be true in a static world with perfect foresight, in which profits can be made only through the relentless pursuit of the principle of substitution. But in a world of imperfect foresight and changing technology, the Darwinian process may favour the successful innovator who operates on hunches rather than the homo oeconomicus of the more pedestrian type, the careful equator of marginal substitution ratios.

But such 'exogeneity' of the selection rule is rare in interdependent situations. If a person is selling something too cheaply because he doesn't know the true value of the product, it

often pays to buy from him; even if the buyer has no use for the product, she can gain from re-selling it at a more realistic price. If everyone else is running for the exit, it may be less injurious to run with them, even if the building is not on fire. Optimising agents must be able to condition their action on correct anticipation of what actions others are taking, a computational requirement which defeats the 'as if optimal' outcome which evolution was meant to achieve.

Since agents generate their own competition, which intensifies as the weaker ones leave the scene, selection rules are likely to get tougher over time. This makes it unclear whether evolution will lead to more optimal performance, even if the optimisers survive the earlier rounds. Intensified competition might actually eliminate the best performances as well as the worst, narrowing the dispersion of performances but leaving the average unchanged. 'As play improves and bell curves march towards the right wall, variation must shrink at the right tail'. Even worse for the assumption of evolutionary progress, intensified competition might eliminate 'strategic' actions which sacrifice immediate optimisation so as to make more lucrative actions available later. If selection requires efficiency at all times, strategic optimisers might be eliminated before the merits of their choice become apparent.

Equilibrium Without Intention 2: Game Theory Solutions

Equilibrium can be reached even if one agent incorrectly guesses the other's price or quantity setting behaviour. In duopoly, for example, the Cournot model shows both firms adjusting to equilibrium output (from which neither has an incentive to depart) even though each had assumed that the other would keep output fixed. Whereas in small-numbers games of this type the resultant (Nash) equilibrium may differ substantially from the optimising (Pareto-efficient) equilibrium, increasing the number of agents can bring the two closer. 'When there are a large number of agents of each type, the Nash equilibria of the Shapley-Shubik game give nearly identical allocations to the the competitive allocations of Arrow-Debreu'.

However, agents still require full information on other agents' demand and supply plans for the relevant product before knowing

the payoffs from such a game. Even then, there is no guarantee that the equilibrium reached will be the one that could be attained if agents had perfect information. In general, game-theory treatments of CGE weaken the traditional definition of equilibrium, retaining the property that agents in equilibrium no longer wish to change their plans, but losing the property that transactions at these self-fulfilling price expectations are necessarily those that ensure utility/ profit optimisation for the agent and Pareto optimisation for the system as a whole.

Disequilibrium as a Consequence of Uncertainty

In the absence of an auctioneer, to trade without knowing equilibrium (current and forward) prices, do so under conditions of uncertainty. Across space, they do not know what other agents plan to demand or supply this period, and thus cannot be sure whether their own current sale and purchase plans are based on correct expectations of this period's market-clearing prices. Across time, they do not know how aggregate supply and demand for products and factors will develop, and so are equally unsure whether their own forward purchase and sale plans are based on correct expectations of future market-clearing prices.

Current-period uncertainty is a problem of communication. In the case of involuntary unemployment resulting from the current income constraints observed by Clower, unemployed workers cannot persuade firms to recruit them even at the current market wage because they cannot persuade employers that the extra wage-bill they incur will be justified by market-clearing sales of the extra product. Workers in excess supply cannot express its excess demand until firms actually re-employ them, which they will not do unless the excess demand is signalled in advance. Communicating a credible commitment to spend the extra income would still not be enough, since firms could not be sure that the spending would go on their particular product.

Decentralised agents are held back by the interdependence of their decisions. In the current period, interdependence means that an agent's information is incomplete, relying on beliefs about the plans of other agents which are in turn conditioned on the plans of other agents, including the first. Tracking the dependence of each

agent's expectations on all others' may well produce an infinite regress. Even if it does not, it is likely to produce a calculation so complicated as to run up against computational limits. Bounded rationality then replaces the normal optimising process, as agents are forced to simplify their decision so as to arrive at an answer within the time available.

Even if agents do manage to arrive at conjectures of one another's intentions that are mutually consistent, the resultant conjectural equilibrium need not have the efficiency properties of a full-information CGE. Under some conditions of less-than-perfect competition it may not even exist. A weak definition of equilibrium conjecture, as one motivating an action which the agent has no reason to change when its results are observed, can result in an equilibrium in both perfect and imperfect competitive conditions, and may even induce 'as if' perfectly competitive actions in an economy whose structure is imperfectly competitive. But such arbitrary conjectures still give no guarantee that an equilibrium exists or is unique.

An intermediate definition, under which a 'reasonable' conjecture maximises profit given other agents' conjectures, also fails to overcome these problems, because those other conjectures may not be rational. Investors in Russia's stock-market in 1996–7 profited greatly from their shared conjecture that post-privatisation prices were grossly undervalued. Those who stayed in the market as it crashed in 1998 discovered their conjectures, though temporarily consistent, were built on expectational sand. A stronger definition, requiring the conjecture to be 'correct' (i.e. fulfilled in practice), leads to general equilibrium only in perfectly competitive conditions. Once more, the price-adjustment problem means that mere existence of a unique equilibrium does not ensure that decentralised trading can bring agents to it.

Future-period uncertainty begins with the consequences of current decisions taken under incomplete information, but takes on another dimension in the absence of a complete set of forward markets. In forming future price expectations, agents must also grapple with imperfect information about their own and others' future preferences and technologies, and the supply and demand conditions for products and factors that result. Changes to these can arise endogenously from the collective results of agents' actions (e.g.

capital accumulation changing factor prices and causing preferences to change as income grows) or exogenously (e.g. preferences changing spontaneously, new inventions being made, new material sources suddenly being unearthed).

Without an auctioneer or a forward transaction structure to dispel these spatial and temporal uncertainties, the demands on agents' information-processing or markets' information-transmitting power become even steeper if optimum allocation and full employment are to be preserved through time. Instead of setting out a definite purchase and sale plan for all future periods at the start of trading, each agent must now devise a trading strategy which 'determines inputs and outputs at each date as a function of incoming information'.

Waiting for information to become available before taking firm decisions in later periods gets round the problems of computing endogenous changes and anticipating exogenous changes. But it adds another dimension to the CGE price vector. 'Commodities are to be distinguished, not only by their physical characteristis and by the locations and dates of their availability, but also by the environmental event in which they are made available and/or used'. Unless blessed with a complete set of forward markets, or the power to think through any number of decisions based on incomplete and endogenously imperfect information (and correctly anticipate any exogenously imperfect information), agents must literally set out a separate set of transaction plans for each future period under each possible 'state of nature', delaying the choice of plan until the prevailing state can be observed. The state of nature reflects the combined result of all transaction plans chosen by other agents in previous periods, plus the impact of any exogenous changes.

Price Rigidity as a Consequence of Uncertainty

Even if complete forward markets were to eliminate future-period uncertainty, by assuring agents of the prices and quantities they could expect to buy and sell at later dates, present-period uncertainty would still arise through competing agents' problems of communication. Traders are left with imperfect information about the quality of the products on offer, and incomplete information about the intentions of those who are offering them. This raises the

possibility of price rigidity which has nothing to do with any institutional barriers or perverse expectations, but merely reflects agents' caution when trading in products of which they lack full knowledge. Failing to trade can do as much damage to the CGE's optimum allocation and full employment properties as trading at disequilibrium prices. But without full information about the resources they are dealing with, consumers and firms may fail miss out on transactions which it would have been mutually beneficial (and Pareto optimal) to conduct.

In an influential example of information asymmetries in the product market, Akerlof shows that certain welfare-enhancing transactions (in this case of second-hand cars) may not take place in the market, because the seller cannot persuade the buyer that the vehicle has no hidden defects making it worth less than the advertised price. The price that would permit a transaction under perfect information is too high for the buyer who, knowing less about it than the seller, assumes that a vehicle for sale is more likely to be a substandard than a well-performing one. While the quality of 'identical' items will always vary, that of new cars can be expected to be symmetrically distributed around the average for that model, whereas that of used cars (whose owners have got to know them and are more likely to sell those they do not like) is expected to be skewed in the below-average direction. Transaction is likely to go ahead only if the seller accepts a discounted price to take account of the missing information, or if one or both parties incurs extra costs to fill the information gap (e.g. getting the vehicle independently checked and certified), or if the two agree to an extended relationship allowing redress if new information shows one party to have been misled.

Employers' special problems in judging the quality of labour before hiring it give rise to several cases of likely disequilibrium trade or missed equilibrium trade. In the efficiency wage case, employment demand becomes an increasing (or at least non-declining) function of employees' wage demands, because employers see a positive link between the wage they pay and the productiviy they receive. This may arise from *ex-ante* signalling (higher-quality employees demand higher wages), or *ex-post* incentive effects (higher-paid employees work harder and are more concerned to be flexible to retain their jobs). It means that unemployed workers may

not be able to price themselves into work, even if they offer their services below the market wage, because it is assumed that their productivity will be lower by at least the same proportion. Indeed, some employers may deliberately pay above the market wage, to make quitting a less tempting option and dismissal a more damaging threat.

'Insider' workers may also command a wage premium because employers know more about them, and have invested them with skills which make for a higher unrecoverable cost if they quit. Employing 'outsiders' will entail extra costs of pre-recruitment selection, post-recruitment probation and productivity loss before unsuccessful recruits can be discharged. So outsiders' offers to do the job for less may well be rejected, even if there were no labour-law restricting their doing so. Wage flexibility is unimpeded but, as with efficiency wages, it cannot clear the labour market because of the adverse signals that it gives. Price adjustment works only if quality information is fed into the demand function from other sources; it breaks down if price and price movement become a proxy for quality.

In the capital market, lenders encounter two well-known problems when they contemplate setting a high interest rate to compensate for lack of information about a prospective borrower. Before the loan is given, there is an *adverse selection* danger that the expectation of high interest rates will restrict applications to those borrowers who are highest on risk (chasing high but volatile returns) or lowest on honesty (with little or no intention of paying back). After the loan is given, there is a *moral hazard* danger that the borrower will take avoidable or excessive risks in the hope of getting a higher return. There is anecdotal and experimental evidence to suggest that, if the probabilities are not too adverse, agents will prefer gambling for a gain with the risk of a large loss rather than settle for a certain small loss.

Since few lenders can exhaustively establish their clients' credentials before lending, and since this still does not insulate them from moral hazard dangers after it, lenders may deliberately keep their interest rates below the market level, and deal with the excess demand by rationing credit via queuing (as a test of applicants' commitment) or merit assessment. (In these days of banking-sector fragility, partly based on their difficulty in selecting reliable clients, it should perhaps be noted that long-term borrowers may have the

same informational difficulties about the quality of their banks.) Once more, prices are rigid and the market fails to clear because of one agent's attempts to infer quality from the price demanded by the other.

Market for Uncertainty

The absence of a complete set of forward markets, and of full information about present product characteristics and intentions, does not automatically condemn agents to live with uncertainty or computation-straining contingent trading plans. Markets exist through which agents can reduce or transfer their uncertainty, swapping a variable prospect for a fixed one of lower mean but lower variance, or paying a fixed price to limit the consequences of an adverse future event. Thus an agent can hedge against unpredictable movements in relative prices, insure against future loss of earnings through unemployment or the collapse of planned trades, or purchase options to buy or sell a product conditional on certain future conditions prevailing.

Such trade in uncertainty is made possible by agents who find it profitable to purchase risk from others, or (equivalently) to sell them insurance cover for a pre-determined fee. Specialist risktakers aim to profit from the transaction by assembling risks into a balanced portfolio, whose pooled variance is less than that of the outcomes taken separately. Risk-spreading may work because of complementarity (one risk's negative outcome being another risk's positive outcome), or lack of correlation under given future states of the world (the same low-covariance outcome that investors use to reduce portfolio variance). Alternatively, specialist risktakers may simply believe that they know more about the likely outcomes than the risk-seller, or may derive utility from taking risks.

Whatever their motive, the existence of these 'marketmakers' allows others to sell risks (or buy relief from risks) that they do not wish to run. Although the trade in 'exotic' risks (disasters, currency movements, buyer bankruptcy) tends to get attention, any act of production 'for stock', without a specific buyer lined up at an agreed price, entails a risk which the producer will try to pass on. 'Competitive markets are inconceivable without intermediaries merchants or "dealers" who are both buyers and sellers at the same

time (at different prices) and who carry stocks so as to make "a market" that enables producers to sell and consumers to buy'.

There is, however, an uneasy coexistence between those marketmakers who target income from stockholding, by charging a fixed mark-up of selling over buying price (as the charge for production-smoothing, storage, presentation, buyer-supplier matchmaking, etc.) regardless of which way the buying price moves, and those who seek capital gain from stockholding by taking a definite view on whether buying price will move up or down. Both activities have the potential to stabilise prices and reduce risk for other agents, since they generally involve the marketmaker buying when others are keenest to sell (with prices below the equilibrium) and selling when others are keenest to buy (with prices above). But both can also introduce inefficiencies. The income-oriented stockholder, whose income is proportional to the frequency of trades, has an incentive to 'churn' the market with regular upward and downward price movements which allow stocks to be accumulated and decumulated, generating charges whenever they change. The gain-oriented, 'speculative' stockholder, whose income is proportional to the magnitude of correctly anticipated market price movements, has an incentive to exaggerate these swings. Where speculators outnumber underlying traders and reach the same view about future price movements, their activity becomes destabilising, as they cluster on either the buying or selling sides of the market and destroy the profitability of trades planned to run the other way.

Further limits to this 'market' solution to future uncertainty are revealed by the tactical substitution of the term 'risk'. This implies that future transaction outcomes and states of the world, although not knowable, can be subjected to some kind of probability analysis, so that actuarial valuations can be made on the basis of expected values and risk preference. Probabilities, or related quantitative measures of relative likelihood, are essential for risk-absorption to be a reliable trade. But many future contingencies have no past precedents from which to derive probability/utility valuations and frequency-based probabilities, and give no firm foundation for forecasting outcomes or their probabilities by any other method. As with forward markets, insurance markets are likely to exist for only a small subset of the future contingencies and timescales with which

agents have to deal. There is a market for risk, but not for the uncertainty of which it is only a small component.

Like the labour and capital markets, insurance markets also suffer a pricing difficulty arising from uncertainty about client characteristics. If premiums are raised too far to provide cover for large risks, the insurer risks adverse selection (of clients who are more than likely to suffer the contingency insured against) and moral hazard (as insured clients are drawn towards behaviour which makes the contingency more likely). So even where it is available, insurance may be underpriced and subject to quantity rationing. The market economy's limited ability to compensate for risks (already a second-best solution, given that many of those risks arise within the market from inadequate communication and co-ordination) and the transaction costs of transferring risks, still leaves open many cases of disequilibrium trading and of failure to conduct equilibrium trades.

Money as a Defence against Uncertainty

The basic CGE model establishes equilibrium prices relative to a numeraire, one of the products within the system against which other products' value can be valued. There is no obvious role in the model for money, a medium of exchange with no intrinsic value which earns no interest. The numeraire makes money unnecessary as a unit of account. Agents' success at structuring market-clearing deals, across space and through time (assuming full forward markets), makes money unnecessary as a store of value, since the mutual coincidence of wants is prede-termined and there is no need to bridge the gap between purchase and sale.

Money does make an appearance in overlapping generations models of intertemporal CGE, which imagine that agents live for two market periods, supplying labour to earn income in the first and then spending it after retirement in the second. Agents now need money as a store of value to transfer consumption from the first period to the second. But it is still not required as a medium of exchange unless there are appreciable transaction costs in exchanging spatially separated physical products, or a requirement on consumers to balance their budget at the end of each period so that they have a precautionary motive for holding money balances.

'Incorporation of monetary exchange tests the limits of general equilibrium theory, exposing its implicitly centralised conception of trade and calling for more decentralised models of exchange'.

Demand for money as a store of value arises in the overlapping generations model if there is uncertainty over ability to liquidate capital assets in retirement, or being able to stay within the budget constraint at each period in a lifetime consumption plan. It arises in CGE models more generally once the assumption of complete forward markets is dropped, and agents must form trading plans on the basis of uncertain future prices. Money acquires utility as a form of postponed decision, the medium in which income is stored until information arrives showing which state-contingent trades will prove profitable in this particular market period. But while the appearance of a role for money may add realism to the CGE perspective, it does further damage to the prospects for getting into equilibrium.

Money and Inflation: 'Neoclassical' Disturbances

The basic general equilibrium model maintains a strict separation between the 'real' and 'money' economies. Relative (real) prices reflect only tastes, technologies, initial endowments and the pattern of trades which follow from them. Absolute (monetary) prices depend on the amount of money in circulation, and monetary changes have purely monetary effects. In the traditional 'quantity equation', MV=PQ, the supply of money (M) multiplied by its velocity of circulation (V) equals the physical output (Q) multiplied by its absolute price level (P). That is, the volume of expenditure equals the monetary value of output in each market period. Output Q is assumed fixed by full employment, and velocity V by banks' and businesses' institutional payment systems. Therefore changes in the money stock M are automatically and directly matched by changes in absolute prices P.

Although monetary disturbances have no effect on the real economy in the long run, they can distort it in the short run, because of dispersed, competing agents' difficulty in distinguishing relative price changes, caused by altered supply and demand conditions in a particular market, and absolute price changes caused by a change in money supply. Confronted with an unexpected drop in money

supply (or its failure to grow in line with real output), firms may mistakenly believe that the fall in their product price is unique, and so reduce their output, conse-quently raising unemployment. Not until they realise that wages have fallen by the same proportion will they re-employ the sacked workers and return to equilibrium output. Likewise, unanticipated inflation caused by a monetary expansion can induce unemployed workers to take jobs believing that their real wage has risen (and employers to take them on because they believe real product price has risen), causing unemployment to dip below its 'natural' rate until agents realise their mistake and reverse the transaction.

To stop money, introduced to help agents cope with uncertainty and so stay on their full-employment equilibrium path, dislodging them from it, holders of this 'monetarist' view advocate transparent and fixed rules for monetary management. Monetary authorities are advised to set a growth target for money supply, prefer-ably in line with, or just above, the real output growth rate, so that aggregate prices stay stable or grow at a regular low rate. At too low a monetary growth rate, unless the velocity of circulation can speed up, prices must fall to accommodate the rising real output, unemployment resulting if wages or any other price are down-wardly inflexible. If money grows too fast there is inflation which, if it gets out of hand, can have equally serious real impacts. Unindexed savings are wiped out, fixed-rate borrowers gain at the expense of lenders, idle workers are tricked back into employment, and investment decisions become more error-prone as future profits and real interest rates become still more difficult to forecast.

Money and Inflation: 'Keynesian' Disturbances

There is an alternative (again attributed to Keynes, especially by the 'post-Keynesians') which sees money demand changes as a much more intrinsic source of real disturbance. Unemployment is traced to the effect of money in breaking the automatic link between saving and investment. In the pre-Keynesian model of circular income flow, saving converts to investment automatically, either because the same agents (firms) are responsible for both, or because the interest rate adjusts to keep the two in balance. A rise in the rate of saving shifts the structure of aggregate demand (and hence the

long-run structure of production) from consumer goods to investment goods, but does not reduce the level of aggregate demand because investment always rises to fill the gap.

Keynes identifies a circularity in the concept of a 'market for loanable funds'. The demand for saving (to use in investment) is set by the marginal productivity of capital, which depends on a monetary measure of the present value of capital. This requires its expected future profits to be discounted, using the market rate of interest the same rate that savings demand is supposed to help determine. Keynes's suggested alternative traces the interest rate to the money market, where it equates money demand (liquidity preference) with an exogenous money supply. This externally determined interest rate then sets the level of investment via the 'marginal efficiency of capital', the schedule of rates of return on successive increments in investment, down which a fixed investor moves until the next project promises to yield no more than could be gained by putting the money into banks or bonds instead.

The Keynesian derivation is equally circular, since money demand depends in part on the level of income, of which interest rates (via their effect on investment) are one main determinant. This pitfall in the move to general equilibrium was resolved by the General Theory restatement by Hicks in which interest rate and output/ income are determined simultaneously where the loci of money-market (LM) and capital-market equilibria (IS) cross.

It identified consumption and investment as the components of aggregate demand in a closed economy, and observed consumption to be a stable proportion of income, Keynes (on this interpretation) traces unemployment to the effect of uncertainty on the marginal efficiency of capital. This depends on entrepreneurs' perceptions of long-term profit rates, which are highly unstable because of changes in expectation of future market conditions and in the 'animal spirits' that accompany new investment ideas. It may thus be only by chance that, on occasions, the volume of investment chosen at market interest rates matches the volume of saving chosen by households at full-employment income. If investment falls below this, there is a multiplied fall in income, which restores the savings-investment equality at the lower rate of investment. Although this 'equilibrium' is below full employment, the fact that the money and capital markets

still clear prevents any tendency for a fall in the interest rate to rebuild the level of investment, even if the investment demand schedule has the necessary interest-sensitivity.

Money compounds the destabilising effects of the uncertainty already observed in barter-based intertemporal equilibrium, by giving agents the option of holding their income as cash 'generalised purchasing power' instead of committing it immediately to current or forward purchases. 'In the Keynesian view, the organisation of a private enterprise economy incorporates a tension between the public good secured by accumulation of capital and the reason private individuals hold their wealth in liquid form'. Money is an instrument for postponing decision until further information becomes available. With it, sales can be made without equivalent purchases, violating Say's Law, and savings can be made which do not immediately convert into investment, violating Walras's Law. A rise in liquidity preference caused by increased uncertainty is one possible catalyst for the downward multiplier already identifed, in which falling aggregate demand shrinks income and saving to the level consistent with lower investment. Lapse from full employment is made possible without any monetary disturbance, and, since the expenditure constraint is now psychological, it cannot be prevented by appeal to the permanent income hypothesis.

Optimal Imperfection

The importance of perfect competition to optimum allocation and full employment, general equilibrium analysis has shifted the focus to perfect information. Without full knowledge of others' intents and future events, and the necessary computing power to process it, agents are left guessing about their future income and frustrated in their efforts to sell to finance new purchases. The resultant preference for money-holding and constraint on consumption out of current income can both push the system away from equilibrium output and full employment.

There is a tendency, especially when assessing pure exchange economies in the current period only, to assume that the two problems can be solved together: full information leading automatically to perfect competition.

The information highway will extend the electronic marketplace and make it the ultimate go-between... this will carry us into a new world of low-friction, low-overhead capitalism, in which market information will be plentiful and transaction costs low. It will be a shopper's heaven.

Markets simultaneously maximise the speed at which relevant information reaches decentralised agents and, by summarising it in relative prices, minimise the amount of information they must process to reach optimising decisions.

But while perfect competition may produce perfect information about existing price and purchase decisions, it only adds to the problem of incomplete information when it comes to repeating or revising those decisions. If the perfectly competitive firm really faces a perfectly price-elastic demand curve that is tangential to its average costs, any fall in price will bankrupt it because costs are no longer covered and any rise in price will bankrupt it because all customers will switch to rival (identical) firms. Any rise in price will also bankrupt it because all consumers will immediately switch to a lower-cost supplier. Even if they survive an initial disturbance in market demand or supply, perfectly competitive firms can make no rational response to a change in price or the announcement of a new discovery, because they cannot know how fast and how far other firms will respond with investment in new capacity, products or processes.

The vision of a globally wired, instantly updated network supplying perfect information to consumers highlights the information-incompleteness problem for firms, and for consumers planning future purposes. In enhancing the ability of agents on the demand side to act on current prices, it compounds the inability of price-taking agents on the supply side to initiate the price changes that would lead the system into competitive general equilibrium. The interdependence of competitive decision-making means that information may never be complete across space, and this inherent lack of certainty over what other agents are doing makes it equally unlikely to become perfect across time. Alerted to the possibility of better networking and information-sharing among customers, and unification of segregated markets, driving down their profit margins by generalising the lowest price (or best price-quality combination),

suppliers are also finding ways to keep the picture confusing. Where products and product qualities cannot be differentiated (e.g. through proliferation of brands, leaving buyers to guess which are generically identical), prices themselves can be differentiated. Two-part rental/ user charges, different weight and volume units, different levels of follow-up service and various discount and loyalty bonuses are among techniques of 'confusion' or 'chaos' pricing now identifiable in markets where products have become too homogeneous and customers too well-informed to preserve past margins.

Information incompleteness can be reduced if agents cease to compete and start communicating information by means other than price, and because such cooperation becomes easier the smaller the number of agents. Imperfect competition, far from causing unemployment and suboptimal allocation, may now become a solution to the adjustment problem, allowing firms with limited price-setting power to substitute for the Walrasian auctioneer. 'They adjust price to eliminate any excess demand and they do not trade out of equilibrium'. As noted in the discussion of prisoners' dilemmas and related games, smaller groups of agents generally find it easier to attain and sustain mutually beneficial strategies, to identify any opportunistic defection from them, and to punish such opportunism (or make a credible threat to do so). As the number of competing agents falls, or co-operation and collusion among them increases, the system moves away from perfect competition but improves its flow of strategy and payoff information.

A Financial Test

The limitations of perfect competition are perhaps best illustrated by those markets which at the present time are widely regarded as our closest approaches to it: the large, liquid stock and bond markets of financial centres such as London and New York. These enable continuous trade among many competing buyers and sellers, each able to buy or sell as much as they want without individually affecting prices (perfect competition), each well informed about the (homogeneous) instruments traded, the quality of the assets (companies and credit risks) that underlie them, and the economic conditions affecting those assets' performance. Agents are instantly informed of new developments through movements in market price

(perfect information), and can execute trades cheaply and near-instantaneously (minimal transaction cost). Markets clear continuously, or after very short order-matching intervals. There is an expanding range of forward markets to structure transactions through time, and derivatives markets to offset some of the risk of future trades.

Empirical proof of these markets' perfection is offered by the apparently unsys-tematic movement of their prices. This implies that agents have already, through their transaction behaviour, priced in all the relevant information already known, so that prices change only in response to randomly arriving bits of new information. A stock's 'spot' price measures the market's current assessment of its present value (total discounted future profit), while movements in the price result from the arrival of new information, or changes in traders' assessment of existing information, which alter the aggregate balance between buying, holding and selling. Although some 'rules of thumb' based on past regularities (the 'January effect', 'Sell in May and go away') seem to persist, the normally random movement of individual prices should mean that no investor can hope to make money simply by projecting from past price trends. They will have to seek new information ahead of other profit-maximising agents, or be faster or more ingenious in the way they interpret it. But if it were literally true that an instrument's current price conveys all relevant information about it, and that 'news' is immediately incorporated into it, such research activity would cease to be worthwhile. Market prices would always be the best available valuation of an instrument's discounted lifetime earnings, and those who merely act on these prices could free-ride on those who incurred the research and transaction costs which discounted the information into them. Trade on a perfectly competitive market brings external benefits, implying an undersupply which will undermine the perfect competitiveness.

The enduring success of 'chartists', who forecast future stock price movements through extrapolating past patterns, could be seen as a case of free-riding on those who do more systematic (e.g. econometric) calculations about fundamental values. But it also casts doubt on the hypothesis that there is nothing to learn from past price movements, as do the more recent successes of chaos theoreticians in forecasting short-run stock index movements.

Program trading, under which computers are instructed to buy or sell certain stocks solely on the basis of their price levels, is a clearer instance of free-riding on the information human traders have brought to the price.

A free-riding strategy might be imitative or contrarian; there are often short-run gains from following the crowd, even without questioning its choice of direction, but longer-term rewards from going against the market. Observed success for either strategy will tend to turn more traders into imitators rather than calculators, and the change in price patterns resulting from this rise in free-riding may well be part of the reason why such techniques as chartism focused on one way markets respond to information flow rather than the actual information and decision that shape those responses predict at least as well as more 'fundamental' analysis, and enjoy enduring success. The possibility of simplified decision being rational, the savings on 'fundamental' calculation outweighing any losses from not using it, are reinforced by the relative measures usually adopted to assess investors who choose to calculate. Professional fund managers tend to be judged by whether they beat a market index whose movement is itself heavily influenced by their decisions. If performance is normally distributed, half the class can be expected to fall below an average standard even if all perform well against some fixed external standard. None the less, the regular failure of experts in the market to 'beat the market' gives an enduring appeal to lower-cost methods of stock selection, of which the (by now very rich) monkey throwing darts at the *Wall Street Journal* is a much celebrated example.

Even the willingness to trade can, in certain circumstances, cause an information spillover which may prevent the transaction going ahead. Normally, investors with apparently identical preference functions can still be expected to reach mutually beneficial trades because stocks still have different values to them, either because they assess its future earnings prospects differently or because it has different covariances with the stocks already in their portfolios. But with a non-portfolio investment, such as ownership of a single firm, an outside agent's willingness to bid for more than the market price will suggest to the existing owner that their stock is undervalued. The bid is likely to be turned down; or, because (few hostile bids staying secret) the stock has now been identified as a

takeover target, its owner may wait for a takeover battle to bring higher offers.

With information transmitted so quickly, and with agents so tempted to imitate others rather than do their own calculations, financial markets have the potential to become highly unstable. Agents can become clustered on the 'buy' or 'sell' sides of a transaction, leaving those who wish to trade against the run of play confronting an improbably high or low price, or at the limit having no one to trade with. The number of contrarians, willing to bargain-hunt on the basis of rosier growth and yield predictions or merely a sense of undervaluation, can be critical in arresting sudden slides in the price of an asset, which in a highly imitative market can otherwise snowball from one attitude-changing event or report.

The possibility that market prices are incorrect (i.e. not an accurate measure of net present value of future returns), as a result of agents concentrating on information about other agents' action to the exclusion of information relevant to actual valuation of the stock, is the main motive for refraining from free-riding and continuing to process information other than current prices and the behaviour that has led to them. Often praised for summarising all transaction-relevant information in the market price, markets actually risk undermining themselves if they do so. Some scope must be left for further profit-enhancing information gathering or processing by each agent, if they are to continue to behave in ways which steer the price towards its equilibrium level. The paradox is that it can never reach that level, or be known to have reached it, if rational action is to continue to push it towards that level.

The interdependence of decision calculation means that full information about future supplies, demands and prices may be impossible to achieve, however good the dissemination of those already announced. One or more agents are left with an information set which includes details of other agents' present or future actions, which cannot be known or even accorded a probability distribution. By preventing mutually beneficial trades, and permitting trades from which one or both parties lose, such interdependence can block the path to optimum market adjustment. General equilibrium prices can remain elusive even if they exist.

Market for Information

Information, like money, occupies an uneasy ground between being 'subject' and 'object', enabler and participant, in the market process. As a prerequisite for optimising decision by competing private agents, it belongs with other public and merit goods (defence, law and order, judiciary) among the framework elements that must be kept outside the market system if this is to work. But as a tradable resource, for whose production agents incur costs which they expect to recoup through intellectual property rights, it must be admitted within the framework like any other private product. Costless transmission of information through the price mechanism is appropriate to its role as a public good, but inimical to its role as a private product, where the inability to keep it secret or charge for its revelation threatens underinvestment in its generation and dissemination.

Information's dual role led first to an interventionist response, then when the counterproductive and second-best aspects of this became clear to the search for a self-generated cure. In the early stages of market development, governments were heavily involved in generating and disseminating transaction-relevant information through state-funded research facilities, libraries and communication networks, regulation to standardise quality (and sometimes prices) across markets, patent and copyright systems which made innovations freely available once the private monopoly phase ended, and the public-good provision of products requiring specially informed decision (e.g. through state-run health and education purchasing operations).

More recently, through deregulation propelled by technical changes in the form and transmission of information, production and dissemination of information has moved predominantly into the private sector. Some producers of information have learnt to internalise its benefits and so charge for it directly: consultants bill for their time, academics find industrial sponsors (with first-refusal rights) for their research, documentaries decamp to subscription-only television. Some have managed to link it to a physical product with portability, durability and excludability characteristics, as when newsagencies make their coverage available only to those who have installed the appropriate electronic equipment, and musicians and

database compilers put their performances on disk. Sometimes information is provided free as a 'loss leader' designed to generate follow-up purchases, as with advisory services offered by financial product or household equipment suppliers. And sometimes the spread of information has been assisted by non-market motivations on the part of its producers, with scientists putting the acclaim of being first-to-publish above the financial rewards of being first-to-patent, and new celebrities preferring to tell the world than sell their story for a fraction of the coverage.

While this 'marketisation' of information has swollen and quickened its flow, there is room to doubt the information technologists' promise that this will lead the economy out of its information problems. As already seen, the conquest of imperfect information (about present and future 'exogenous' states of the world) does not necessarily solve the problem of incomplete information (about other agents' knowledge and motives and the 'endogenous' consequences of their action). By increasing the amount of second-guessing that agents can bring to their interdependent calculation processes, the speed with which they can react to new information and the amount of new information they react to, greater perfection may even lead to less completeness as old expectation-stabilising behavioural conventions break down. Much of the recent growth in information technology has consisted of new messages being swollen and stretched to fill new media: there is much repetition, mild differentiation, over-elaborate presentation and sheer invention in the escalating flow, as well as genuinely authentic and authenticated ideas. And there is room to doubt whether agents' ability to process information will ever grow as rapidly as the amount they receive, even though microelectronics offers stimulus to both. The ratio between information, the stream of detail that washes around us, and knowledge, the part of that flow that we have actually processed and assimilated, seems set to rise inexorably for as long as random access memory-power keeps to its exponential curve.

Just as perfect competition is a condition for the existence of a general equilibrium price vector which may ultimately stand in the way of its attainment, perfect information provides a means of attaining general equilibrium which may in the process destroy

the conditions for its existence. This possibility is perhaps best seen in a trend already under way, towards the assembly by manufacturers and retailers of ever more detailed information about present and potential clients. At stake are two major steps towards further maximisation of profit: the presentation of the product to all those whose income or preferences might dispose them to buy it, and the determination of a price that more closely reflects their willingness to pay. The (competitive) seller's desired outcome is something akin to generalised monopoly price discrimination, buyers' demand functions being separately identified so that each can be treated as a separate market, and consumers' 'surplus' being captured by the producer as they lose the chance to buy at a generalised market price below what they would willingly have settled for.

It may appear a completion of the market process, information-based 'consumer differentiation' may in practice be as much a recipe for imperfect competition as is product differentiation. Personalised dealing has the potential to destroy or greatly downsize markets which depend on cross-subsidy of some buyers by others, like insurance, and to stifle investment and innovation-related transactions by allowing the provider (of capital or R&D support) to capture all the potential proceeds from the buyer. By eroding the anonymity of the marketplace, data-based 'relational marketing' in fact gives rise to a new form of transaction with very different characteristics.

One other aspect of new information systems whose 'perfection' of the market may be counterproductive is the much-discussed 'disintermediation', as consumers bypass wholesalers, retailers, advisers and financiers and go straight to producers to conclude and enact their exchanges. Where intermediaries simply act as match-makers trading on consumers' and producers' lack of communication and information, there is a clear transaction-cost saving in bringing them together by cheaper electronic means. But where the intermediary is a marketmaker, actually buying and re-selling the product, disintermediation also forgoes the bulk discounts they might have won by aggregating purchases, and the market price stabilisation that can be achieved by intermediate stocking and destocking in opposition to the final demand cycle. The new world of dealing direct may be one in which high streets regain their

non-commercialised glory, but it could also bring higher and more volatile prices or items where continuous production meets discontinuous consumption.

The full-employment properties of general equilibrium might still not be assured. So far in this presentation, and in the basic CGE model, prices have been given the sole function of clearing particular markets. But factor prices in general equilibrium have two distinct roles. As well as clearing the market for factors, they generate the income which furnishes market-clearing demand for all other products. The introduction of uncertainty, across space or through time, gives factor prices a third function: signalling the quality of the services offered and the expectations shaping other agents' present and future plans to trade them. Product prices, similarly, now take on two functions in the presence of uncertainty: equating the present demand and supply brought about by past decisions, and conveying information relevant to the present decisions that will shape future demand and supply.

The public/private nature of information has already been shown to give prices ambiguities or incentive effects which can impede or prevent trading in the markets they are intended to clear. If these arguments are correct, prices may be adjustable to their 'equilibrium' levels only through violation of the very conditions of perfect information and perfect competition that is supposed to characterise that equilibrium.

A sympathetic criticism, but one that does not depend on any information problems, argues that economic co-ordination can break down because price takes two distinct forms which are falsely run together in the orthodox (CGE) analysis. Reverting to the previous ('classical') tradition, associated with Adam Smith among others, it is argued that CGE is inherently unstable because it deals only in short-run prices, those that adjust in each market period to match demand and supply. The system's centres of gravity are actually long-run prices of production, derived from income distribution and the technical conditions of supply. These indicate where market prices would settle down if released from the temporary disturbances of day-to-day trading, and it is these that the 'classical' theory of value sets out to explain.

An Alternative 'General Equilibrium' Model

The derivation of prices of production begins in a similar way to that of neoclassical general equilibrium prices, with consideration of n sectors, each of which delivers a final product using inputs of itself and all other products. (Some of these inputs can be zero.) Inverting this input-output matrix solves the system for the vector of gross outputs, and the vector of prices is derived by constraining profits to be uniform, at a rate linked to the subsistence wage of labour. By using uniform profit and wage rates to close the equation system, no reference is made to market demand, whose movement simply causes period-by-period fluctuations around these 'centre of gravitation' prices. 'Prices capable of reproducing the economy exist, so long as the technological and subsistence data render the augmented technology capable of producing a surplus'.

Prices of production represent a long-run equilibrium, but on a very different definition from the equilibrium market prices whose existence CGE theory atempts to prove. This 'neoclassical' equilibrium price vector clears all markets, but leaves profit rates to vary across sectors. The 'classical' equilibrium price vector equalises profit rates, with no particular implications for the balance of supply and demand in particular markets. Neoclassical equilibrium prices are set period-by-period, changing whenever agents find their last-period actions inconsistent or their preferences or technologies changing. Classical equilibrium prices are set for the long period, changing only as a result of changed technical production coefficients or a shift in income distribution between wages and profits. Since prices are determined separately from quantities, on the basis of the wage-profit distribution and with no reference to demand conditions, the economy on this interpretation has no natural tendency to full-employment output even under conditions of perfect competition and perfect information.

The price-of-production concept was refined by Ricardo, redesigned by Marx and finally rescued from its labour-theory-of-value confusions by Sraffa, who showed how a composite numeraire could be constructed whose valuations of other products is invariant to the wage-profit distribution. Whereas the CGE model shares the price-setting task between supply and demand, with demand tending to be interpreted as the active component ('consumer sovereignty'),

the classical model (long-run) traces prices to technical conditions on the supply side, demand being little more than a validating flow set in motion by investment in fixed and working capital. The CGE is a short-run model which, as noted above, has considerable difficulty moving into the long run. In contrast, 'classical' equilibrium is a perspective on the long run, far more adapted to the analysis of growth and capital accumulation than of present-period allocation.

The tendency of any distributional change (between wages and profits) to alter the equilibrium price vector makes it impossible to show capital demand as a smoothly declining function of interest rates, so that the capital market (and by implication the labour market) cannot be expected to clear as a result of price adjustment. To its proponents, this view raises the possibility of unemployment persisting at equilibrium, even in the absence of any price rigidity and any uncertainty. 'The level of employment is determined by the level of effective demand; a magnitude which is not susceptible to systematic variation in the face of changes in relative prices, the wage rate or the rate of profit'.

In the Marxian development of Smith's and Ricardo's work, persistent involuntary unemployment is a deliberate device in the hands of capitalists to keep the remaining workforce disciplined and prevent wages moving above subsistence. In its neo-Ricardian development it is the accidental consequence of the flaw in neoclassical CGE, which Keynes proposed solving through the variation of government spending or the socialisation of investment. Price rigidity, uncertainty and liquidity traps are seen as conceptual detours used to sideline the General Theory as an imperfection in the CGE framework, when it actually points to a fundamental flaw in the belief that a stable and unique short-run market clearing price vector can even exist. If the argument over 'logical priority' of distribution over allocation is accepted, classical theory shows that unemployment can appear at equilibrium with no 'disequilibrium' trading due either to price inflexibility or informational imperfection.

Conclusion

Adjusting prices to clear all markets presents an additional set of problems for the decentralised economy, on top of those encountered in establishing a unique set of equilibrium prices to

adjust to. Lack of information and co-ordination can cause aggregate demand to lapse from the rate needed to validate agents' supply choices, with the introduction of money as an uncertainty-reducing device only compounding the problem as spending and saving decisions are postponed. Even in the absence of uncertainty, and of any wage or price rigidity, unemployment can arise because of the unclear link between lower wages and higher employment demand. The dependence of equilibrium relative prices on the initial distribution of income reverses the normally perceived link between distribution and employment levels.

However, any unemployment that results will still tend to appear to follow from the real wage being stuck above its equilibrium level. With prices acting to determine income and signal quality as well as to balance demand and supply, adjustment to equilibrium across a set of interdependent markets may be delayed or prevented indefinitely. Getting into equilibrium may require an imposed price-setting mechanism not available under perfect competition, and a consistency of expectations not attainable with less than perfect information. Expanding the number of markets to ensure the general equilibrium's existence may even add to the problems of attaining and retaining it. Destabilisation seems inherent in a market system which allows for changes in capacity through investment and tastes and technology through innovation. The need is revealed for a more dynamic perspective on adjustment, in which the market's ability to improve allocational possibilities with a minimum of information for decision eclipses its ability to optimise current allocation when provided with the maximum.

10

Administered and Informed Transaction in Free Economy

Introduction

Most employees remain in organisations which insulate them from direct demand and supply, turning external market forces into internalised managerial orders. Many self-employed or small business operators are almost equally in thrall to corporate command despite being formally outside it. For those excluded from the workforce by retirement or redundancy, the constraints simply come from a more distant and unapproachable (state) agency, or from financial limitations which seem to stem in part from the fragmentation of shared interests when not organised and led as a single group.

There are two main reasons for submitting to authority: because we have to, or because we want to. In economic terms, these shade into one. Accepting the commands of a hostile ruler brings us less pain than defying them, and accepting the commands of a sympathetic ruler brings more benefit than ignoring them. How the second, consensual type of order-taking grows out of the first, coercive type has been a major theme of political study since large-scale societies and politics became observable. Economists have

staged much the same debate in confronting one of the most obvious, and problematic, questions arising from market theory. If independent pursuit of self-interest is the best way to collective harmony and prosperity, why do most of us continue to sacrifice much of our economic independence to groups whose collective interest imperfectly matches our own?

Haggling Together to Avoid Haggling Separately

Relational transaction (RT) departs from market transaction (MT) by introducing non-price information about the product being traded and the agent being traded with. But RT retains the individual focus of MT, and still views the path of the economy as beaten by the footing of many individual bills. In contrast, two further types of transactions can be identified in which the exchange of information, and the exchange of products that results, is conducted by clusters of individuals. Trades are entrusted to 'legal' persons, acting in the name of groups of natural persons, and previously autonomous individuals now subordinate their aims and actions to the group.

Relation-building and mutual learning allow agents to overcome many of the information problems that arise from pure market transaction. Conventions and institutions, developed actively as an extension of relationships or passively as an outcome of learning through market transaction, can overcome many of the coordination problems that arise when individual maximising actions have contradictory collective consequences. But there remains a large number of transactions which if done, not done or done differently could deliver better results to the economy as a whole, and so potentially to all the agents who comprise it.

Believing that these cannot be reliably attained through acting individually, or under the guidance of purely voluntary institutions, agents turn to external authority for help. Perhaps more accurately, certain agents acquire power over the economic and political activities of the majority, whose exertion is accepted because it can bind or guide the others to better outcomes than they might have expected if continuing to act alone. Two types of third-party intervention in transactions can be identified. Under *administered transaction* (AT), agents agree to let the outside authority rewrite their objectives, alter their action sets and circumscribe their choices, on

condition that this results in new actions becoming available, their outcomes being more useful and more predictable, and perhaps their implementation being made easier or better protection being provided should evaluations still prove misguided.

Under *informed transaction* (IT), the organisation's role is to improve individual decisions by making available new information, new actions or new assurances over the likely outcome of those actions. IT tends to preserve the individual's original aims, but gives them better means to attain these. Under AT, the individual accepts altered aims and restricted action possibilities in expectation of greater rewards than if they went their own way in the marketplace. The organisation becomes the decision-maker, turning individual decisions into a co-ordinated means to a collective end. The organisation's task is to study the transactions that occur when agents work individually, identify its inconsistencies and aggregate failures, and modify individuals' choice processes (or at the extreme, impose a choice pattern on them) so as to ensure a better result for the group reflecting improvements for all those within it. Under IT, the outside authority does not alter agents' objective-set-ting, choice or implementation directly, but uses its overview of the collective transaction pattern to offer help at the search, evaluation and assessment stages. AT aims to achieve better results through instruction, IT through fuller information.

AT takes two significantly different forms, distinguished by the nature of their outside authority. Exercised by central political forces over the whole economy, AT as 'central planning' is generally regarded as an experiment which failed to improve on the market in terms of allocation, employment level or growth, mainly because it involved the planners in information problems every bit as bad as those produced by a pure market economy. But exercised by the management of larger companies, AT as 'corporate planning' is generally recognised as having significantly improved the effectiveness of transaction for creating new resources and moving them to more effective uses. By producing a large increase in action effectiveness for a small sacrifice in the freedom to act, corporate AT may indeed be the closest agents can come to the transaction results they would obtain if allowed to operate in a market with no information availability, information processing or coordination failures.

Imposed Alternative

Wartime mobilisation has often shown the power of a common enemy to make competing agents work in harmony. Efforts to establish the same unity or compatibility of purpose in peacetime (and so incidentally reduce the risk of war returning) appeal to a more constructive external authority: experts obeyed because they know more than those they instruct, a boss obeyed because this will bring greater financial rewards than disobedience, or a referee obeyed because this upholds the rules within which personal ambitions can be better fulfilled. Adam Smith's proclamation that decentralised agents could interact to produce order and mutual benefit was an economist's dissent against prevailing political opinion, summarised more than a century before by Thomas Hobbes:

> *Being distracted in opinion concerning the best use and application of their strength, they do not help, but hinder one another; and reduce their strength by mutual opposition there be somewhat else required (besides Covenant) to make their Agreement constant and lasting; which is a Common Power, to keep them in awe, and to direct their actions to the Common benefit.*

Administered transaction dispenses with much of the freedom of choice which market transaction provides through the right of switching to alternative options, and relational transaction provides through the right to negotiate or bargain over contract terms. Under AT agents do what they are told, or select sometimes mechanically from a limited range of actions which prescribe what to do in different situations. Action is largely separated from choice, and agents carry out explicit instructions (orders) or contingent instructions (programmes) on behalf of an external authority. This authority, the principal, has the power to change the agent's orders or programme unilaterally, and to punish them for any breaches of instruction.

At the level of the firm or organisation, AT is regarded as obvious and essential. To put its resources to their optimal use and ensure that all its people pursue the same profit-maximising objective, the firm must limit one decisions its employees have to take and set down guidelines as to how they are to take them. Few firms begin life without a business plan, and few sustain it without strategies and timeta-bles for action. When translated into job descriptions and procedural codes, these take agents well away from the

marketplace, usually selling labour services for non-specific lengths of time for variable rewards conditioned on future tasks that are only broadly delimited, and on terms designed for flexibility if the employer's internal or external conditions change. Employees accept such conditions because the resultant transactions are expected to be simpler and more rewarding for themselves, because of the efficiency they bring to the organisation. If widely enough observed, such firm-based AT can also benefit agents in their transactions outside work, by improving performance of the economy as a whole. Practised at economy level, however, AT has come to be seen as a command structure too far. What works as a solution to information and co-ordination problems among competing firms founders when applied to whole industries, and fails when applied to whole nations. But a completely centralised planned-transaction system recreates these problems at the centre, overloading the planning agency, depriving agents of the means and incentive to use localised information in their own decisions, and failing to supply them with satisfactory substitute instructions (or the means or incentive to carry them out).

Motives for Administered Transaction

Submission to AT may be a deliberate choice, for any of the following reasons:

- The agent is following a strategy, and needs external discipline to follow the correct intermediate steps (making present sacrifices for future gain), rather than lapsing back into moment-by-moment maximisation.
- The agent is participating in the co-operative solution to a prisoners' dilemma-type collective action problem, and needs external discipline to resist the temptation for myopic maximisation. Submission to such discipline also per-suades other agents that this agent will co-operate, so that they do too. This externally imposed avoidance of the 'war of all against all' comes closest to Hobbes's explanation.
- The agent believes that a principal is better informed about the information needed for a successful transaction, or better able to process this information, and so defers to the principal's instruction. The principal's advantage may lie in superior

knowledge about the agent's private situation (e.g. a patient consulting a doctor), or about the state of knowledge, belief and intention among a group of agents (e.g. mountaineers deferring to their team leader).

- The agent wishes to enter a transaction for which he or she lacks the necessary resources, or credibility to keep the necessary promises, so the agent looks to external authority to supply these. As a reward for lending additional power in implementation, the principal claims one right to prescribe or circumscribe the transaction.
- The agent wishes to limit or avoid the penalties of a failed transaction, by passing on responsibility for its design. The principal in this case is a specialist risk-taker, whose reward is usually the excess profit from a successful transaction once the agent has been paid a results-invariant retainer.
- The agent wishes to avoid the information-processing costs of transaction, by passing them on to a specialist. The principal is assumed to have natural or
- situational 'comparative advantages' in taking transaction decisions, or economies of scale through taking large numbers of this type.
- The agent wishes a transaction to continue, knows that it would normally have to be periodically renegotiated or else made highly contingent on future events to take account of uncertainty, and so gives the counterparty the right (within limits) to set or vary its terms. In this case the principal is usually also the person (legal or natural) with which the agent makes the transaction.

The final case, of letting the other transactor set and vary the terms, may reflect the motivations in the previous cases, but more usually a power imbalance. Typical instances are an employee who gives their employer the right to set their pay and conditions of work, and the small supplier who lets a large manufacturer specify product, price and delivery schedule. Continued employment and continued contracts are so important to the weaker agent that they are willing to accept wide imposed variations in contract terms, which the stronger agent can impose because their market power (of inflicting damage by switching) is greater. Although contract continuity is mainly prized by the agent because alternative income

sources are uncertain, one further hope is that the arrangement will help to rebalance the power relations over time (by making the principal more dependent on the agent for its proven reliability, flexibility, etc., or causing them to share sensitive information), thus more willing to accommodate their needs and preferences. Administered transaction may then evolve into something close to relational transaction.

Efficiency Case for Administered Transaction

Where applied effectively, AT can allow agents to carry out a transaction they know to be worthwhile, but cannot attain or sustain through either market transaction (MT) or relational transaction (RT). These advantages arise from the 'market failures', and their imperfect resolution by 'relational' alternatives, already examined. Those arising at organisational level apply mainly to allocative and productive efficiency. They form the main 'neoclassical' explanation for the existence of firms. Those arising at economy level apply mainly to full employment and growth, and formed the once equally respected 'neo-Marxian' argument for the treatment of the economy as one giant firm, through the device of central planning.

Localised Administration: The Transaction Cost Case

The model of optimal resource allocation through competitive general equilibrium assumes that agents pay for what they get and get what they pay for. No cost is incurred in the actual process of transaction. Costs of computing the correct product prices, and the investigation of product qualities, preferences and technologies that underlie this, are absorbed outside the market by the Walrasian auctioneer, or as an external benefit of agents' private maximising efforts (the 'invisible hand'). Costs of enforcing transactions agreed at the equilibrium price are absorbed outside the market by costlessly developed institutions, or police and judicial systems assumed to be financed by a non-distorting tax. Costs of storing and transporting products, and processing money payments, relate to separate products which, because they are supplied and priced through the market, are assumed to be supplied in optimal quantities.

In practice, computing and enacting transactions is not a costless process, and the existence of transaction costs can obstruct, or scale

down, transactions which would promote allocative efficiency. To the extent that it reduces transaction costs, AT can then move the system closer towards allocative efficiency. In some of the following main cases, the terms of the AT may be set out by an actual person in authority. In others, authority is exercised indirectly by a set of instructions. Instructions consist of orders, or of a limited set of actions with strict guidance as to which should be adopted in which set of conditions.

The firm is the principal unit of administered transaction and, at least since Coase, economists have tended to ascribe its very existence to the 'internalisation' of transactions where this reduces their costs. The transfer and processing of information and the exercise of power also emerge as possible reasons for the firm's existence. However, the main transaction types open to administration, listed below, show close similarities to those open to relational transaction. AT and RT are different ways to approach the operational problems of market transaction, and cast doubt on the firm separation of 'firm' from 'market' that a straight MT-AT dichotomy would suggest.

Repeated Transactions

Rather than going through the full transaction process every time, agents who make the same trade regularly can agree to repeat it by invoking a pre-established routine. This avoids the costs of 'reinventing the wheel' by repeating a calculation process which is likely to lead to the same conclusion (e.g. restaurant regulars request 'the usual', shoppers frequent the same store, doctors write repeat prescriptions). It also allows the transactors to invest in arrangements which bring down future transaction costs (e.g. dedicated accounts and specialist handling facilities).

Repeated transactions are most likely to become administered where requisite quantity, quality and market price are relatively stable through time, or fluctuate round a known average. Those who design the transaction then have a high degree of certainty as to the conditions likely to prevail, the actions appropriate to them and the selection rule to set. Agents who submit to this design can fairly safely assume either that the cost saving from abbreviating the decision process will outweigh any losses in not getting the terms

exactly right, or that anything lost by the fixed terms being unfavourable at some times will be offset by gains from their being favourable at other times. By demonstrating a willingness to make the occasional suboptimal trade for the sake of mutual transaction cost saving, agents may be able to signal mutual trust, and so reduce the cost of monitoring compliance with the terms.

Where fluctuation around the average widens, AT may give way to MT as agents realise that it would pay to re-run the calculations and change the transaction terms each time. Where fluctuations are small but the average is actually following a trend, the terms of the AT may be subject to periodic step-change revisions as agents realise that benefits from changing to a new fixed formula will outweigh the costs of working it out. But there are occasions when rapidly changing conditions encourage the transition from MT to AT, because of an overriding objective for whose pursuit agents are willing to submit to highly variable demands with few tolerance limits. At national level, war and natural disaster are the most common instances. For the firm, bankruptcy or downsizing pressure are the equivalent survival threats, prompting workers to take wage cuts and managers to take company doctors' orders in ways which might threaten the mutual acceptance of AT under less extreme conditions.

Spatially or Temporally Connected Transactions

Where the value of a transaction is time-sensitive, it may have disappeared by the time its terms are calculated or its market exchange carried out. AT is introduced as a way of speeding up the transaction so that some value is extracted, even if it is not the full value that instantaneous market transaction would have achieved. stream die-caster is haggling over purchase terms, and computer-systems failure, for which in-house generalist engineers are called in even though an outside specialist might have done a better job if their arrival and terms could have been instantly arranged. Labour-based services encounter similar externality, since the producer must supply his or her time as well as the service performed during that time. Suppliers of capital-based services can usually separate the two, and so are more likely to trade through the market. For actors, teachers, shop assistants and production workers, for whom such

separation is impossible (unless they commodify the service e.g. by recording a past appearance), the more rewarding alternative is often to enter an employment relationship in the hope of being paid for presence as well as performance. (Those in shorter supply, such as consultants, senior lawyers and software engineers, may find their market power sufficient to claim compensation for the inseparability through their fees, while remaining self-employed.) Integration is not always direct. The first response to spatially or temporally connected transactions is often to locate close together while continuing to trade through the market. However, this tends to set up the repeated transactions and unilateral-monopoly relations which make for relational transaction, and may then make internalisation worthwhile. Similarly, specialist labour may start under an outsourcing (market) contract, which turns to an internal contract once shared information (about the firm's needs and the worker's skills) has locked them into a repeated transaction. This stepwise process, and the possibility of relational repeated transaction. This stepwise process, and the possibility of relational transaction as an intemediate stage, is a reminder that 'market' and 'hierarchy' may not be the stark alternatives sometimes suggested.

Transaction-specific Investments

While sunk-cost investments to enable or improve a transaction can be protected by relational transaction, this still leaves the investing agent vulnerable to unrecoverable loss if the other party suddenly leaves. Submission to AT can be a means of strengthening the relationship to the point where such defection is impossible, or carries severe penalties, thus creating the security with which to make the investment. The external authority administering the transaction may also be induced to contribute to the investment, since a reward from a share of its returns strengthens their incentive to discipline the transactors.

Joint-product and Team-product Transactions

Where two or more saleable outputs arise from the same process, it may be impossible accurately to assign marginal costs between them in order to compute optimum prices; or the process of doing so may be judged more expensive than any losses from assigning costs

in a more arbitrary fashion. Similarly, when two or more people are responsible for a single output, it may be impossible or too costly to apportion effforts and rewards among them. Agents may then submit to AT as a neutral way to solve disagreements over price and wage setting, either by using simplified rules, or by handing authority to an administrator who tries to judge the maximising transaction terms in return for pocketing any residual excess profits.

Resolving Bilateral Monopoly Disputes

Where small numbers of agents confront each other, either as buyers and sellers or as competing sellers, there is generally a range of transaction terms over which profits are maximised for one of the agents, or for all agents jointly. Bargaining can lead to a variety of outcomes, depending on relative power and strategies adopted, and the breakdown of bargaining can lead to inferior results all round. An external authority may then be brought in to impose a solution and, where this is a joint-maximising solution involving a cartel of producers or consumers, to defend it against attemps to profit by breaking the rules.

Collective-action Co-ordination

Not knowing what others intend to do in the current period, or what collective results their actions will have in future periods, may complicate competing agents' transaction planning to the point where the costs of computing a maximising decision may well exceed its benefits over a more arbitrary decision. To get closer to optimality, transaction design may then be handed over to an external authority who is regarded either as better able to process the information available to the agent, or in possession of superior information because they have a better insight into the intentions of other agents. This second situation is especially likely where all the most heavily interdependent agents submit to the same external authority, who can then lay down an administratively coherent set of transactions.

Even where full information is available, agents may discover they face a coordination problem, under which they will maximise their rewards from taking the collectively optimal action only if everyone else does so. AT may then be established to enforce the arrangement and prevent it breaking down. Either each agent

submits to a separate authority who will force them to follow the co-operative strategy; or, perhaps more economically, each submits to the same external authority, whose incentive for enforcing the optimal solution may again be a share of the additional profits that result. Concerned to achieve maximum performance for the wages they provide, a firm's owners can discipline or dismiss employees who try to earn the average pay for less than average effort. Employment within the firm changes agents' payoffs in a prisoners' dilemma-type situation so that they are no longer tempted to be opportunistic, and so transaction-specific investments can be made more safely. It should be noted, however, that whereas such monitoring and sanctions can work both ways under relational transaction, AT tends to make them one way only. The firm in this case could use its knowledge advantage in relation to its own financial accounts, or external market conditions (from which agents have been removed), to blame wage reductions or added work demands on a challenge to profits or competitiveness that does not actually exist.

Transactions Involving Sensitive Information

Market transactions can sometimes be blocked because one or other party cannot trade their product without also giving away commercially sensitive information either contained in the product offered or demand expressed, or necessarily supplied to the other party before they can agree the transaction terms. The information is effectively an unpriced joint product, supplied as external benefit when the original product is traded. By conducting the trade through an external authority, it may be possible to separate the 'public' product from the 'private' information. But in return for performing the service and as an incentive not to seek profit by divulging the information the authority must be given the right to set the transaction terms.

Risk Sharing and Risk Transfer

Where a maximising transaction design requires guesswork about future states of the world which leave open the possibility of grave miscalculation, an agent may prefer to give responsibility for it to someone else. In effect, costs are attached to the possibility of miscalculating which detract from the benefits anticipated from

correctly calculating, and the agent is willing to reduce the potential benefit in order to escape these costs. An external authority now sets the transaction terms to ensure a fixed reward for the agent and a contingent reward for themselves, taking the bonus for overperformance and any punishment for underperformance.

The firm that internalises its factor supplies, and makes specific (training or machinery) investments in them, adds to its risk of high redundancy costs if it has to sack employees in a downturn and of high sunk costs if its fixed capital becomes obsolete or inoperative. Service providers have effectively locked-in the firm to long contracts so as to avoid the risks of selling their services on an open market. In return, the firm designs these contracts to minimise the risk of having to write-off its specific investments. Employees are given 'fuzzy' job specifications allowing them to be administratively reassigned between tasks and locations in accordance with demand. Reassignment of capital is assisted by the introduction of reprogrammable equipment, or selection of product lines among which equipment is interchangeable (for scope economies). Where more specific capital stick is needed, firms may still step outside the AT framework and enter relational transaction with a specialist provider, who can keep it more fully employed and so pass on scale economies in its charging.

Centralised Administration

Externally devised and enforced solutions to interdependence are effective only if they cover most or all the agents whose individual actions significantly affect the collective outcome. Increasing group size makes for more effective solutions, and solutions for a wider range of problems, provided the appropriate set of administered transactions can still be devised and enforced. While obstacles to worthwhile trade arising from transaction costs can mostly be eliminated by bringing together just those immediately involved in the transaction, obstacles arising from incomplete information or lack of co-ordination usually require much wider involvement.

In particular, firms need assurance about aggregate-demand effects across the whole economy if they are to invest enough to ensure full employment, and about the future composition of demand and factor prices if they are to maintain the rate and composition of

capital formation that maximises growth. Workers need assurance that additional profits will be spent on productivity- and employment-increasing investment if they are to moderate their wage claims, and that additional revenue will go towards the hard- and soft-infrastructure 'social wage' if they are to accept higher income taxes. It was to macroeconomic challenges of this sort, ironing out demand cycles and speeding up supply-side development, that the grander vision of centrally administered transaction was originally addressed.

A Rational-control Vision

Biology had helped control disease through systematic immunisation and public health improvement; physics and chemistry had tamed water and fire for industrial use, and were beginning to do the same with electricity; civil engineering had reshaped the landscape. Social theorists were keen to apply the same scientific principles to political and economic organisation, establishing control over forces previously regarded as naturally immutable or theologically ordained.

Biology provided a popular early template, with 'functionalism' drawing a direct parallel between the division of labour in industrial society and the division of organic function in multicelled organisms. Evolutionary theory provided a second powerful analogy, 'Social Darwinism' identifying a natural way in which free market competition would improve the performance of surviving agents, though one that could be accelerated and improved on by eugenics. These approaches were still inadequate, however, for deriving policy proposals, accounting for what existed but giving little indication of how it would develop. They were also too fatalistic for the growing group of social researchers who regarded present economic and social conditions as materially and spiritually denuded, and believed a political redirection of the system could bring greatly improved results.

Revolutionary socialism made the boldest proposals for central direction of the economic system, summarised in the claim that communism 'overturns the basis of all earlier relations of production and intercourse, and for the first time consciously treats all natural premises as the creatures of men, strips them of their natural character

and subjugates them to the power of individuals united'. The aim of this subjugation was to overcome the inefficiencies and artificial scarcities of capitalism and so eventually raise productivity to such an extent that the detailed division of labour could be abolished and the state 'wither away' along with the class divisions it was assumed to uphold. But the working class that was to bring about this transformation 'knows that replacing the economic conditions of class labour by the conditions of free and co-operative labour can only be the progressive work of time, that this economic transformation requires not only a change in distribution, but also a new organisation of production'. So the state, under new management, would initially expand its role to supervise that new organisation.

Marx's followers outside western Europe identified an earlier role for the state, speeding up the processes of accumulation and technology acquisition until it was feasible to refocus from growth onto redistribution, replacing income with need as the basis for allocation. Central planners would be able to fix the rate of capital accumulation at whatever was needed for full employment, given the current productivity of capital and labour. They would raise those productivities by expanding education and systematically applying science to commercial ends, without the uncertainties, financial restraints and monopoly profits on current technologies which held back innovation under capitalist arrangements. Financing for the higher rate of investment would come from recapturing the wealth and luxury-consumption expenditure into which capitalists had diverted industrial workers' surplus, and from transferring agricultural surplus (and labour) to industry far more rapidly than market signals would have done. The state would assist the import of 'best-practice' technology, and upgrade human capital and infrastructure to support the new industrial demands. Dynamic efficiency was stressed, and possible incompatibility with static efficiency was readily accepted, with early Soviet growth theorists (notably Feldman) adding to the range of models showing that 'unbalanced' concentration of investment on heavy industry could contribute more in faster growth and higher resource utilisation than it sacrificed in temporarily inefficient allocation of the resources. This argument allowed early evidence of basic supply-demand

mismatches to be excused by sympathisers as a necessary sacrifice for future gain.

Central planning also appealed to many who flatly rejected Marx's vision of communism but, for this reason, sought a way to rescue capitalism from its more extreme tendencies towards boom-bust cycles, unemployment, alienation and inequality. Intellectual support for state direction of the economy probably reached its height during and immediately after the Second World War. The Soviet Union, its most complete practitioner, appeared (with a little help from its propagandists) to have transformed an agrarian into a war-winning industrial economy within 30 years, after sidestepping the Great Depression that had afflicted most capitalist economies. The United States and other 'market' economies had adopted extensive forms of central direction for their successful war efforts, which many now hoped to turn with equal effect to the domestic war against poverty and ill-health (their mass unemployment having been largely solved by wartime mobilisation).

The contribution of natural science to winning the war, through such breakthroughs as code-breaking, radar and nuclear weapons, had reinforced confidence in the power of scientific investigation to solve social problems. While few accepted Marxist claims to have produced a 'scientific' socialism, natural scientists were often as drawn to this view as social scientists, especially those who had been part of the state-sponsored efforts that led to radar, code-breaking, the nuclear bomb and other war-winning technologies.

In general the whole of evolution is concerned with the gradual increase in conscious rational control over ever more complex fields of behaviour. It seems inevitable that at some time the economic forces in society will have to be organised by human thought instead of by the automatic 'laws' of supply and demand.

Markets were chaotic and wasteful because they left agents battling to outperform and second-guess one another when they could all have done better by cooperation and co-ordination. The prisoners' dilemma-type zero sum game had replaced Adam Smith's equation of private self-interest with public gain, and it was the task of those who had noticed the conflict to give agents a co-ordinated means of escaping it.

Inherent Collapse Explanations

Central planning's appeal was not sustained, and by the end of the century its application had been almost universally abandoned. China hit the 'capitalist road' in 1978, eastern Europe's 'democratic centralism' was swept aside by the revolutions of 1989, Russia had taken its first dose of market 'shock therapy' by 1992, and even those governments still professing loyalty to Marx, Lenin or Mao have allowed large segments of agriculture, trade and natural resource exploitation to move outside the plan. While central planning experiments can claim to have accelerated growth, equalised income distribution and eliminated unemployment in their early stages, their promises to overtake the capitalist economies never materialised. 'Communist' economies were matched by their market-based rivals in the unprecedented northern hemisphere growth surge of the 1950s and 1960s, and joined them in the output- and productivity-growth slowdown after 1973. Thereafter growth was sustained only by heavy foreign borrowing, intensification of employment with corresponding real wage restrictions, and the limited reintro-duction of market forces (already tolerated in the form of large 'grey' economies) to overcome rigidities in the plan.

Planners' problems were little different from those of the neoclassical competitive general equilibrium (CGE) and growth models already reviewed. Some CGE theorists, such as Walras and Lange, had readily admitted that what they were describing could just as well be the aim of a socialist system as the outcome of a market system. A centralised transaction plan, designed on the basis of the best technology and a 'fair' initial distribution, could in principle achieve Pareto optimality and overcome the various problems arising from increasing returns, externalities, public goods, monopolies and investment-decision uncertainties. But CGE stopped at an existence proof showing the equilibrium price-quantity matrix as a piece of abstract algebra. Turning this into actual arithmetic gave the central planning agency at least as great an information-processing problem as the Walrasian auctioneer.

To map out a consistent set of transactions that will fully employ resources, optimise their current use and maximise their rate of expansion, central planners must gather together all the relevant supply-capability and demand-intention information held by

competing agents. Even if those agents are honest enough to reveal their true knowledge and intentions without coercion, and to follow their instructions faithfully once received, the planners are still left with an intractable calculation problem. A plan set out in advance, even for four or five years, was overwhelmingly large and error-prone, being prey to exogenous disturbances (such as wars, science-based innovations and slowdowns in other economies) even if it correctly forecast endogenous disturbances. A plan continuously adjusted to incorporate new information would forever lag the actual situation, and reproduce the informational uncertainties, time-inconsistencies and destruction of useful strategy it was seeking to escape.

Yet administrative planning, like the market, had to be all-embracing if it were to be effective and sustainable. It was not enough to co-ordinate the investment plans of the larger corporations, if major players in related sectors, smaller players in their own sector, or final demand (consumers) were not given similar guidance. Market forces left to play freely at either end of the production process, or in any of the tributaries feeding into it, would eventually frustrate the plan and 're-infect' the activities that were supposed to have been brought within it. Unless fully empowered to assert the priority of full employment, distribuional fairness and growth, planners would see their grand design dragged down in the pursuit of short-run efficiency.

Much as the 'Austrian' critics had predicted, any inefficiencies from entrusting the economy to markets were overshadowed by the problems of taking them away. Shortages and surpluses became routine as the plan failed to anticipate the pattern of final demand, and as intermediate producers worked to meet quantitative targets without regard to the quality of what they produced, or its consistency with downstream needs. Official (accounting) prices failed to adjust to acknowledge the mismatch, which thus worsened as underpriced supplies were diverted onto illegal private markets. With no direct measurement of capital productivity through the interest on loans or the profits on investment, capital continued to flow into areas of overcapacity. Labour was similarly retained in core industries where political ease of organisation was no longer matched by economic justification, so that even where its physical productivity kept rising, monetary productivity was dragged down by declining demand for the product.

These resource allocation problems might have been worse had planning not switched from accelerator to brake over structural and technical change. Strikingly successful at rapidly adopting the leading technologies at the time of its inception (coal, steel, mass-production machine tools, railways, electricity), central planning was consistently late in recognising the importance of subsequent productivity-raising technologies (microelectronics, telecommunications, microcomputers, auto transport, aerospace, robotics, household electricals, financial and business services, biotechnology, new crop varieties), continuing to concentrate its investment in areas of known strength but (by the early 1970s) global overcapacity resulting from rapid growth in low-wage competition. Planned economies similarly lagged in the adoption of the new organisational forms called into play by new technology (smaller firms, larger retail units, decentralisation, subcontracting) and the development of the new sectors which, where allowed to develop, absorbed a growing proportion of rising income. Ironically, economies dedicated to fairer treatment of industrial labour were led to impose greater discipline, pay restriction and spending curbs (especially those needing foreign exchange) on its workforce to avoid import dependence that would threaten the plan's extension to trade. Workers' efforts to meet their needs by transacting outside the system were similarly curtailed.

Explanations of the command economy's collapse 'from within' ascribe the inability to allocate and slowness to innovate to the removal of market incentives from individuals by the lack of reward (either from higher pay within the firm to profit from leaving it to set up in business), and from firms by the insulation from demand and customer pressures that generally stimulate product and process change. Origination of new techniques was further slowed by the strong concentration of R&D effort on (usually secret) military applications, the lack of incentives for (or existence of) rival firms to be first to innovate, and political direction of basic scientific research. Adoption of techniques developed elsewhere was impeded by lack of interchange among technologists, and lack of foreign exchange with which to import new technology.

Central planning's effectiveness at organising for a single national aim (supplying the war effort) translated badly to the much more varied production objectives of a peacetime economy, especially as rising income stimulated demand for consumer products and as

the flexibility of small production units began to grow in importance relative to the scale economies of the large. Soviet communism's major success had lain in mobilising agricultural savings for investment in a narrow range of complementary heavy industries, whose expansion could be planned through simple quantitative targets and supported by the (often forcible) movement of rural labour and capital into industry. Reallocation, reorganisation and technical change, the main contributors to growth once labour surplus has been absorbed according to most econometric estimates, were less easily handled, resulting in stagnation of older industries and the non-appearance of new ones.

The effectiveness of productive investments in all branches of industry except electroenergy and metalworking fell two to three times the list of goods in short supply was very large and continuing to grow, factories flooded the market with huge quantities of unsaleable goods real earnings were rising very slowly and among some sections of the population were even on the decline.

In most centrally planned economies unwanted finished products piled up because consumers did not want them, while those that they did were in perpetually short supply (especially non-staple food products, whose growers often found official prices too low to make them worth bringing to market, and preferred to subsist on them instead). Firms, in turn, were unable to signal their need for new raw materials and intermediate products, or to adopt new technologies without planners' consent. Critics argue that collapse would have come much earlier if authorities had not acquiesced in a large and innovative informal (grey) economy. Since the fall of eastern Europe's communism, the most rapid turnaround (Poland's) has been built on the surge of private business activity based on these previously repressed private activities (which in agriculture had been allowed back into the official economy at a very early stage). The slowest (Bulgaria, Russia) have been those where state companies were 'privatised' but allowed to continue operating with the monopoly powers and political relations acquired under the previous AT system.

Contingent Collapse Explanations

Although communism's demise had long been foretold on the basis of internal information, incentive and democratic deficiencies,

there remains an argument that bad implementation and external threats scuppered a design which might have worked in kinder circumstances. With more participation and decentralisation, plans might have been able to adapt adequately to changing demand patterns. Without foreign technology boycotts, and with fewer scientists down saltmines, new technologies might have been adopted earlier includ-ing the information technologies which sparked a late revival of hope for the attainment of efficient central co-ordination. With less military pressure from a hostile (capitalist) outside world, more resources might have flowed into civilian rather than military production and R&D, inward investment might have relieved the need to squeeze domestic incomes so hard for so long, and foreign trade might have established a more appropriate pattern of specialisation. Circulating accurate information, instead of suppressing what was out of line with the plan and incentivising enterprises to invent results in line with it, would have revealed the problems earlier and improved the chances of resolving them. In this more sympathetic view, central planning appears to have failed because it was never properly tried, or applied too early to economies which as Marx had always acknowledged needed to advance (and suffer) longer under capitalism before socialist transformation could succeed.

The argument mirrors that used to explain the failure of free market/minimum state experiments, which where declared have always retreated onto the safer ground of mixed economy, selective trade protection and some state welfare. It has the same counterfactual limitations. The central plan's optimal-allocation information needs are probably impossible to fulfil, since some consumer preferences are not communicable in advance of the trading situation arising, and producer preferences are likely to change when the results of their aggregation are known (even if they were reliably reported in the first place). Central collection, processing and dissemination of transaction-relevant information thus seems inherently cumbersome, even with honest and efficient communication channels and the best computing power that industrial spies can reverse-engineer. Workers in receipt of the perfect social-welfare-maximising set of instructions may still hesitate to follow them, if the detachment of personal rewards from personal efforts leaves them too dependent on the comparable efforts of ohers.

Stekhanov, Soviet indus-try's one-man productivity miracle, was more persecuted than impersonated by fellow workers when the publicity drive took off.

It could be argued that the choice of testing-grounds prolonged rather than curtailed the system's useful life. Attempts to implement central planning in economies with a more developed industrial (and service) base have in part been frustrated because an enfranchised working population votes heavily against it. 'It is clear that economic planning should go no further than major macroeconomic variables while markets should be allowed to determine detailed output structure and relative prices by the actions of competing firms unencum-bered by central controls'.

The Informed Alternative: Indicative Planning

Dictators perish; their advisers often survive. Even if central authority cannot generally make better decisions than the individuals it surveys, there may well be trends and aggregate oucomes not visible from the ground whose announcement would lead to better decisions being taken there. Even as the planner as comman-der was beginning to take its first casualties, a new vision of the planner as adviser was gaining strength. By sharing information through a neutral central source, it seemed possible for dispersed agents to combine the collective rational control elements of administered transaction with the efficiency and openness of market transaction, and the humanity of relational transaction.

Informed transaction (IT) is based on decisions whose objective-setting, choice and implementation remain with the individual, but whose processes of search, evaluation and assessment are guided from above. External authority is called in to improve the economic background against which transactions are designed, the information flow with which they are designed, the instruments available to carry them out and the statistical documentation of their results. Although their theory (and practice) were closely matched in several non-English-speaking countries, four contributors have won special credit for developing the vision. From Keynes came the view that governments could stabilise the macroeconomy through aggregate demand management without needing to nationalise major industries or intervene in individual markets. From Beveridge

came the view that, once near-full employment was established, income inequality and associated social deprivation could be tackled through tax-financed social insurance and welfare arrangements, again without undermining private enterprise and thrift as the basis for economic growth. From Crosland came the view that steady growth, promoted by demand management, could defuse the potentially disruptive demands for redistribution, protectionism and social exclusion by allowing a generalised rise in living standards, with productivity rising fast enough to offset the upward pressure on wages caused by sustained full employment. From Galbraith came the assurance that, with suitable guidance from the educational and scientific 'technostructure', the private-ownership economy could avoid undermining itself by letting private production outgrow the necessary physical and social infrastructure, overdosing its environment with consumption-related social costs, or inventing enemies that made it overspend on arms.

The state as a democratic and accountable 'facilitator' of better-informed transaction decisions took several guises in the economies that adopted it. Sometimes its intervention was limited to the stabilisation and improvement of investment expectations, encouraging firms to expand on the understanding that real interest rates would stay low, the exchange rate remain competitive and any downturns be offset by cyclical budget deficits. Sometimes the focus was on wage expectations, persuading employees despite the heightened bargaining power that came with full employment to tie their demands to moderate their claims on the promise of rewards through lower inflation or higher social spending if all complied. The most detailed application of IT involved enriching decision information on both the demand and supply sides within particular sectors, partly by feeding firms new technological and economic-forecast information from outside, and partly by pooling information on their own intentions to ensure consistent expectation formation.Indicative planning, variants of which appeared across western Europe and North America from 1950 to 1970, contained some or all of the following elements:

- The submission of natural monopolies, and other strategically important industries, to public ownership or detailed state regulation.

- The use of monetary and fiscal 'demand management' to keep the economy close to full employment, ironing out the previous boom-bust cycles.
- 'Tripartite' consultation among labour organisation, employer association and government representatives to agree sectoral priorities and co-ordinate investment programmes, which formed either a consensus plan setting out (intendedly) harmonious investment and growth targets, or a more prescriptive plan steering resources towards priority projects and sectors.
- The use of labour organisations to impose wage control, to prevent labour-demand pressures at full employment resulting in 'cost push' inflation. Moderation of private wage demands was to be rewarded by the assurance of full employment, and a rising 'social wage' in the form of state-provided social infrastructure, welfare and pensions.
- Promotion of growth through the creation of a stable investment climate, subsidies to 'sunrise' investment, subsidies to R&D for the innovation and rapid diffusion of new technologies (including the formation of clusters for external economies of scale), and promotion of industrial restructuring and merger to achieve internal economies of scale.
- Codetermination, worker-directors, and other forms of workplace democracy, designed to turn an increasingly skilled and educated workforce away from alienation and towards an active input into plant and process management, facilitating productivity growth and adaptation to new technologies.

Mixed Economy Vision

It assumes that giving agents an informed view of where their present plans will lead, and of what else they could aim for, will lead to a pattern of transactions that is better for the industry and society. Initially, when unemployed labour and spare capacity were widespread, the approach was almost entirely demand-sided, trying to boost consumption and investment to bring these back into productive use. Later, as full employment approached, attention turned to the supply side, and the best ways to raise labour and

capital productivity to maintain growth when its 'extensive' phase was over. Often in conjunction with tripartite arrangements for government-business-labour consultation, and usually supported by enhanced efforts to gather sectoral data and forecast the macroeconomy, a central authority seeks to discover private agents' intentions, and help better fulfil them by ensuring more consistency between them.

Individuals' attempts to solve their information and co-ordination problems through relational transaction have been seen to have side-effects, losing other more desirable features of market transaction: the relations become monopolistic, discriminatory and impervious to changes in the external environment. Indicative planning seeks to achieve the same filling-in of information gaps and imposition of co-ordination centrally. Equipped with the information and assurances about others' intentions, and forecasts of future 'exogenous' variables, provided by the plan, agents can more safely go ahead with market transactions untainted by relational aspects, but with its uncertainties and collective irrationalities removed.

Whereas central planning was a testament to early-century faith in the application of natural science to social problems, indicative planning marked the high point of confidence in 'social science' as a distinct project: particularly over measurement, forecasting, linear programming, project appraisal and the ability to notice and dispose of prisoners' dilemmas. West European and North American economies' wartime success in reviving and mobilising under strict guidance from the centre reinforced the belief that centralised information-sharing was the most effective way to overcome the inefficiencies of uncoordinated markets. The fact that this had been achieved by public purchasing and target-setting without wholesale nationalisation suggested that the necessary co-ordination could be achieved by spreading information rather than imposition, so avoiding the bureaucratic overstretch and democratic deficit that had hampered central planning.

Confidence in the setting and implementation of targets was enhanced by the belief that politicians and administrators would be competent and committed enough to achieve them. Post-war governments were extensively composed of distinguished fighters and administrators, supported by a newly meritocratically selected

public service. Increasingly detailed social and economic statistics, new methods of analysis (linear programming, econometrics, input-output analysis, optimal control theory) and the arrival of computers with which to apply them promised an unprecedented wealth of information with which to do so. While social science might not be like natural science, it had already revealed some striking statistical regularities the 'Phillips Curve' trade-off between unemployment and the rate of wage growth, the lagged covariance of monetary growth and inflation with which the economy could be guided to a better future, if enough were known about its present state.

By matching demand to supply in the aggregate, government was now seen as improving the conditions in which markets could successfully guide allocation and expansion at the microeconomic level. The essence of planning was not to supplant markets but to make them work better, by improving the information flow to agents making key investment and innovation decisions, and co-ordinating the actions that resulted.

Confirming the conviction that better understanding the present would allow agents to take control of their future, one leading group of protagonists, the 'New Lausanne' school, chose the term 'enlightenment planning' for their approach.

Contrary to Hayek and the Austrians, prices alone were judged inadequate to spread the necessary information and ensure co-ordination. Even if they adjusted immediately in response to demand and supply changes a questionable assumption when oligopoly and imperfect competition were widespread prices were insufficiently proactive, capturing the results of past decisions rather than the intentions underlying present and future ones. Nor were they sufficiently uniform, visible or stable to be of much help in predicting what rival agents were going to do, or where the sector would end up as a result. The time needed to bring new capacity on stream meant that today's market conditions were an insecure basis for planning tomorrow's output. Firms had to know what other producers intended to do with their resources, labour representatives with their wage claims and government with their macroeconomic control instruments (taxes, public spending, interest rates, exchange rates), to make sure their future output would stay consistent with demand and with factor and input prices on the supply side. Firms planning to adopt new products or processes also needed some

assurance that market demand and new input supplies would make their decision pay off.

History and Technology

The main objective was still faster growth, indicative planning laid simultaneous stress on improving allocation and distribution, and so claimed greater relevance to the high-income economies in which it was mainly devised. Instead of involving government in the cumbersome process of mobilising real resources, under accusations that it was 'crowding-out' private enterprise, it turned bureaucratic paper-pushing into the more laudable information-peddling, with the promise that private enterprise would be drawn into the bigger picture.

It is only by planning that proper account can be taken of the interplay between the various sectors of an expanding economy and between the component elements of economic policy. The basic concept is that business firms, pressure groups or individuals should voluntarily submit to a measure of discipline because, as a result of information issued on the state of the market, they realise that it is in their interest to do so...this coordination is not possible unless there is some degree of centralisation of the power to make basic decisions.

Informed transaction appeared to fit especially well with economies where relational transaction was widespread, where recent political and economic upheaval had weakened the (non-government) institutions that had previously assisted information-sharing and co-ordination, and where there was a tradition of close co-operation and interchange between public bureaucracy and private industry. While France became a paradigm for indicative planning within Europe, post-war Japan was following similar techniques, especially emphasising technological forecasting for 'dynamic' comparative advantage.

The Japanese Economic Planning Agency and Ministry of International Trade and Industry make projections of future product and process developments the opportunities forecast in such projections provide guidelines to both the Japan Development Bank and private banks for evaluating an individual firm's proposals for long-term finance. They allow banks to evaluate investment

proposals not as discrete projects but as parts of an integrated sector anticipated to become internationally competitive.

In the case of electronics, 'The Japanese government (and NTT, an important procurer) have played important roles in economising on the transaction costs involved in establishing research co-operation between competing firms and in increasing diffusion beyond what would otherwise have taken place'. Even if the government's technological forecast were wrong on the basis of present information, the achievement of consensus among private firms on its importance and the resultant race to attain it may well have helped make misguided expectations self-fulfilling.

Wherever individual agents acting alone risked being forced into abbreviated, non-optimising forms of decision by their information and computation constraints, lack of co-ordination or lack of foresight, centrally informed transaction promised a new route to optimal 'collective' choice. Analysis of trends in the economy and its major sectors, and of plans submitted by main producers, promised the information needed to ensure that investment matched the composition of future supply to that of future demand, and that public investment in physical and social infrastructure kept pace with private investment in capacity. Expertly advised, streamlined government departments, working closely with (and sharing staff with) private industry, promised to make best possible use of the information. As controller of the economy's demand side and overseer of its supply side (part of which it might regulate or own directly, though usually with some private-sector competition retained), the state had both the ability and the right incentives to complete its co-ordinating task at the individual sector level. The apparent consensus around Keynesian techniques promised to insulate indicative plans from any changes of government or shifts of opinion within government.

Breakdown of Indicative Planning

Despite its mission to enlighten agents, about the collective consequences of their own plans and new external (market, technological) developments that might affect them, indicative planning involves two sometimes fatal simplifying assumptions. The first is that agents, realising the all-round benefits of the

planning exercise, will put aside their usual rivalries and truthfully report their decision-related information and intentions. Though such details could never be divulged directly to a competitor, they can be entrusted to the neutral indicative planner, whose aggregation of the results will avoid disclosing any of their components. The second assumption is that having received the additional information, about what other agents are doing and how technology is progressing, agents will adapt their plans in ways which bring them closer to a harmonious result.

The second assumption, if correct, would justify the first. Agents would honestly reveal their intentions because they know that everyone will gain if all do so and for this reason, other agents can also be trusted to make a truthful revelation. But the second condition, of 'convergent' revision of informed behaviour, turns out to be deeply problematic. Studying how agents might learn the equilibrium parameters of a transaction system, and so form rational expectations, Frydman begins by confirming the informed-transaction criticism of market exchange. To adjust to equilibrium, agents must estimate the average expectation of equilibrium price (being the price that is fulfilled by output decisions conditioned on that price, given aggregate demand). But expectations of this 'average opinion' are interdependent, aggregate output being predicated on aggregate price expectation assembled from individual expectations of aggregate output.

Although the case for an indicative planner appears to be established, there is no guarantee that they will help agents break through the interdependence. If the planner collects individual plans and announces the 'average opinion', agents will slot this back into their plans and change their behaviour. The output and price that will occur if they now move ahead with transactions will still not be consistent with those that informed their production and consumption decisions. An iterative process is set up, which Frydman shows will necessarily converge only if agents make 'subjectively rational' forecasts, minimising the error in their price predictions. This might be achieved if everyone adopts the same pricing rule, but such a rule must be invariant to changes in the feedback on average opinion, and cannot be arrived at by an optimising procedure on the part of any one agent. Far from resolving the uncertainty, government may compound it if its macroeconomic

policy decisions become a further component of the interdependence, agents trying to guess future levels of interest rates, tax rates and exchange rates which are themselves affected by the actions these guesses lead agents to take. The best the planner can apparently do is to supply an arbitrary rule, for itself and for agents, which will make expectations converge, with no guarantee that convergence will be to an 'optimum' on any allocation, full-employment or growth standard.

The informed transaction perspective had credited agents with the foresight to submit their plans for comparison and analysis, but then demanded a highly simplified response to ensure that consensus was reached.

Indicative planning was supposed to provide a transparent, consistent and consensual picture of future developments, to which all would conform out of self-interest; but the participants in this exercise often cheated; even when they did not cheat, their views about the future could not be well summarised by single-valued and firm expectations, and even if they all agreed on a possible and desirable scenario they could not agree on their own individual part in it.

Like the pre-Heisenberg science whose method it had borrowed, the approach had ignored the tendency of even a neutral observer to change the magnitude they are trying to measure. To arrive at consistent expectations and coherent plans might well require more follow-up meetings than chief executives, union leaders and public servants are willing to attend. But in practice, IT procedures rarely progressed far enough to test this theoretical difficulty. Before indicative plans could run up against such 'endogenous' uncertainties, most were blown off course by more 'exogenous' uncertainties, which also disrupted the macroeconomic policies and tripartite 'social contracts' designed to accompany the plan. Economic and technological forecasts can be deflected by exogenous shocks even if the expectations they depict are completely rational, in the sense of using all relevant information available at the time of the decision. Any link between wage moderation and low inflation, higher taxes and better welfare provision or higher investment and higher profit may be stretched so far in a modern economy that causality hence the credibility of promises built on it ceases to show.

Indicative plans rarely met any growth target significantly higher than those prevailing before they were introduced, and were

equally hardpressed to eliminate old boom-bust cycles around the medium-term rate. During the phase when they performed best, at least in Europe, the 'enlightenment push' may well have been against an open door. Industrial economies, already launched into a phase of historically rapid and stable growth assisted by investment expectations wide enough to be self-fulfilling, were able to subordinate redistribution to growth and to maintain full employment without inflation because wages lagged fast-growing labour productivity. A range of technologies introduced in the 1940s and 1950s were being developed to maturity, along paths which like that of the economy could be forecast with reasonable accuracy simply because of the stable trend. The international diffusion of technologies, though speeding up, was still relatively slow, helped by concentration of patent rights in high-income economies. Where technology did move abroad, barriers to trade and international capital movement were generally enough to defer a serious challenge for market share until the originators had moved on to something else.

The door began to close when rising wage expectations clashed with declining productivity growth rates, unemployment undermined the affordability of tax-based welfare arrangements, and the levers of macroeconomic control began to lose their effect. Without the job creation and growth in the social wage for which it had pledged wage moderation, organised labour became increasingly disaf-fected with tripartite arrangements, and pressures emerged for more prescriptive forms of planning.

'While investment and growth were forthcoming, the increase in union power was of little economic consequence because workers were moderate in their claims. But now that growth has slackened the consequences of this increase in power on economic outcomes are profound'. At the moment when indicative planning was most needed, to avert a downward spiral in expectations, it seemed least able to take effect. What proponents had hailed as a cause of full employment and fast growth showed every sign of being an effect.

Conclusion

The disappearance of government-led planning, of both the administered and informed variety, repeats on the supply side the blow to concepts of controlling the macroeconomy already delivered

on the demand side by the retreat from 'Keynesian' policy. As recently as the mid-1970s, the apparently comparable aims and effectiveness of public- and private-sector planning was encouraging expectations that the two would converge. 'Capitalism is drifting into planning the political apparatus within capitalism is steadily growing, enhancing its power, and usurping functions formerly dedicated to the economic sphere not to undo, but to preserve that sphere'. With this came the confident prediction that 'communist' and 'capitalist' systems would in the end bury their differences rather than each other, as each evolved into mixed economies using markets for their final allocation but a large dose of informed and administered transaction to set their aggregate framework. Pro-marketeers would come to recognise the need for extensive tax-funded social services and public ownership of natural monopolies, but central planners would be forced to return much of their decision-making power to individual enterprises, some of which might even be returned to private ownership.

In contrast to the retreat of centralised administration or informing of transaction, its localised version within the firm appears to have maintained its advance. Firms' success at expanding in size, scope and geographical coverage while retaining co-ordination and responsiveness rests on their success in mixing the four types of transaction. Inability to achieve this in the public sector has been one force behind the recent move towards commercial freedom and privatisation for state industry.

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