One

The Next Great Globalization: A Force for Good?

In 1960 South Korea was one of the poorest countries in the world, with an average income per person less than that in many countries in sub-Saharan Africa. It was only minimally engaged in trading goods and services with the rest of the world,[1] and the flow of capital from abroad into South Korea was minuscule, amounting to less than $400 million per year. Today South Korea is a member of the rich-countries club, the Organisation for Economic Co-operation and Development (OECD), and the booming metropolis of Seoul looks like any prosperous, world-class city. International trade is a key feature of the Korean economy, with over a third of the economy engaged in exporting, and the annual net flow of foreign capital into South Korea has increased over twentyfold to more than $10 billion.[2]

What has happened to South Korea to allow it to grow like this? *Globalization,* the increasing involvement of its economy in world markets.[3]

What Is Globalization?

Globalization is a term that is often used imprecisely and can mean many things. This book focuses on *economic globalization,* the opening up of economies to flows of goods, services, capital, and businesses from other nations that integrate their markets with those abroad.

Economic globalization takes many forms. When a New Yorker orders a Mercedes that is made in Germany, rather than a Cadillac built in America, she is taking advantage of the globalization process. When MGM sells a DVD of one

of its hit movies to a teenager in Singapore, this also is a result of globalization. When a company based in London makes use of an Indian computer programmer in Bangalore, globalization is again at work. All of these examples of globalization involve international trade, the flow of goods (Mercedes cars and DVDs) and services (computer programming). Globalization of trade in goods and services has expanded at an extremely rapid pace in the past forty to fifty years, growing from a little over $1 trillion (at current prices) in 1960 to over $15 trillion today.[4]

Economic globalization can take another form: the movement of capital and financial firms across borders, a process called *financial globalization.* When a Japanese investor buys a U.S. Treasury bill or a share of IBM stock, capital has moved from Japan to the United States, and the purchase is an example of financial globalization. Citibank's loan to a Malaysian shoe manufacturer is also financial globalization. The opening of a Spanish bank office in Santiago, Chile, is a further move toward financial globalization. Financial globalization has also expanded dramatically. Since 1975, when the data were first collected, international capital flows have increased more than eightfold to over $1.4 trillion per year today.[5]

The globalization process has given a new name to a class of countries that have only recently opened up their markets to the flows of goods, services, and capital from other nations: *emerging market economies.* The advent of emerging market economies and the huge increases in international trade and international capital flows suggest that we have entered a new Age of Globalization.

The First Age of Globalization, 1870–1914

The current Age of Globalization is the second great wave of globalization of international trade and capital flows. The first occurred from 1870 to 1914,[6] when international trade grew at 4% annually, rising from 10% of global output (measured as *gross domestic product* or GDP) in 1870 to over 20% in 1914, while international flows of capital grew annually at 4.8% and increased from 7% of GDP in 1870 to close to 20% in 1914.[7] John Maynard Keynes captured the feel of this era with the following famous passage from his *The Economic Consequences of the Peace,* which was published in 1919:

> What an extraordinary episode in the economic progress of man that age was which came to an end in August 1914! The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their delivery upon his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble, in their prospective fruits and advantages; or he could decide to couple the security of his fortunes with the good

> faith of the townspeople of any substantial municipality in any continent that fancy or information might recommend.[8]

This first wave of globalization was accompanied by unprecedented prosperity. Economic growth was high: from 1870 to 1914, world GDP per person grew at an annual rate of 1.3%, while from 1820 to 1870 it grew at the much smaller rate of 0.53%.[9]

But did this greater economic growth translate into a better deal for the poor of the world? If economic growth during this Age of Globalization had been associated with growing income inequality, then the poor might not have benefited. However, this is not what happened for countries involved in the globalization process. The income gap narrowed between wealthy and poor nations that actively participated in global markets (although there was little effect on income distribution within these countries).[10] Japan provides an extraordinary example. Starting in the seventeenth century, Japan completely cut itself off from the rest of the world, allowing only one Dutch ship per year to land in Nagasaki to engage in a small amount of trading. When Commodore Matthew Perry and his black ships arrived on Japanese shores in 1853 to force Japan to trade with the United States, Japan began to open up to the rest of the world. The resulting shake-up of Japanese society eventually led to the Meiji restoration in 1868, as a result of which Japan became fully engaged in the global economic system. In 1870, at the start of this period, Japan was a backward country with an average income per person that was less than a quarter of that in the United Kingdom. From 1870 to 1913, its income was able to grow at 1.5% in comparison to a growth rate of 1.0% for the United Kingdom, thereby narrowing the gap. Argentina's growth experience during this period was even more extraordinary. From 1870, when its income per person was a little over 40% of that in the United Kingdom, its income grew at 2.5% through 1913, raising its income per person to over 75% of that in the United Kingdom. The Japanese and Argentine examples illustrate how poverty was reduced in the countries that were active in the globalization process.

However, not all countries engaged in that process. Globalizers did well, but, as critics of globalization point out, some countries were unable to take advantage of globalization. For example, countries like India and China actually deindustrialized during this period,[11] with China's income per person falling from 24% of the United Kingdom's in 1870 to 13% in 1914.[12] However, this increase in income inequality between globalizers and non-globalizers occurred because non-globalizers did so badly relative to globalizers. For countries that were able to take advantage of the globalization process, income inequality actually fell because globalizers that were initially so poor did so well relative to globalizers that started out rich. Increasing income inequality between countries during the period was clearly not the fault of globalization. It was

rather a consequence of the inability or unwillingness of some countries to enter the global economic system.

The End of the First Age of Globalization: The Great Reversal, 1914–1939

The first Age of Globalization came to an end with the advent of World War I. The war caused a disruption of capital flows and trade between nations that continued even after the conflict ended. From 1914 to 1929, the average level of international trade fell from 22% of world GDP to 16%, and capital flows dried up, falling from close to 20% to 8% of world GDP.[13] And worse was yet to come. In 1929 the Great Depression started in the United States, and it quickly spread to the rest of the world. The economic devastation was immense. Unemployment reached a peak of 25% in the United States, and the income of the average person had fallen by 30% by 1933 and was only slightly above 1929 levels by 1939. However, the consequences of the Depression were far worse elsewhere. The economic collapse in Germany and Italy helped bring the fascists and Nazis into power. The world then entered the worst nightmare imaginable: a second world war. From 1939 to 1945, over fifty million people died, over half of whom were innocent civilians. The inhumanity of the Holocaust resulted in the slaughter of six million Jews and five million people of other religious and ethnic backgrounds in concentration camps.[14]

The collapse of this first Age of Globalization, which has been given the name the "Great Reversal" by Raghuram Rajan and Luigi Zingales,[15] provides two important lessons: (1) Globalization is not an immutable economic force; it can be reversed. (2) The economic and political nightmares of the interwar period should warn us that a backlash against globalization can be disastrous.

The Second Age of Globalization, 1960 to the Present

The aftermath of World War II has been an extraordinary period. Even before the war ended, the soon-to-be victorious allies realized that the mistakes of the interwar period should not be repeated. They met in Bretton Woods, New Hampshire, in 1944 to develop a new international system to promote world trade and prosperity after the war. They created two new international financial institutions (IFIs) both of which were headquartered in Washington, D.C., just across the street from each other: the International Monetary Fund (IMF), whose job was to oversee the international financial system and ensure that it would facilitate trade between countries, and the International Bank for Reconstruction and Development, which became known as the World Bank, whose job was to provide long-term loans to war-torn Europe and to developing countries to aid in their economic development. An additional organization arising out of the Bretton Woods meeting, but not established until 1947, was

the General Agreement on Tariffs and Trade (GATT), headquartered in Geneva. Created to regulate the conduct of trade between countries, this organization evolved into the World Trade Organization (WTO).

These new institutions were created to promote globalization, and in this they were extremely successful. Once the world economy had returned to normal by the end of the 1950s, globalization advanced at a rapid pace. From 1973 until today, world trade grew at 11% annually, rising from just over 22% of world GDP to 42%.[16] Since 1973 the flows of capital between countries have also exploded, rising from 5% to 21% of world GDP.[17] We are clearly in the second wave of globalization.

Have the participants in this new Age of Globalization experienced the good economic outcomes and the reduction of poverty associated with the previous Age of Globalization? Data suggest that they have. World economic growth from 1960 to today has been at the highest pace in the history of the world: world income per person has been rising at a 2% annual rate.[18] Critics of globalization point out that income inequality across countries has grown and argue that for this reason globalization has not been good for the poor. But they have not looked carefully enough at the data. Income inequality across countries has risen only because, as in the period before World War I, those countries that have been active in global markets have grown very rapidly. Meanwhile those who have not (such as most countries in sub-Saharan Africa) have not only seen their position relative to globalizers fall but also experienced absolute drops in income per person. As before, the globalizers have won and the non-globalizers have lost. In 1960 the income of the average person in Somalia was 10% higher than that of his South Korean counterpart. Over the next forty-five years, Somalians experienced a drop in their income, so that Somalia's income per person is now less than one-tenth that of South Korea's: Somalia's income per person decreased by 33% while South Korea's increased by more than 1000%.[19]

What we have seen in this new Age of Globalization is a convergence of income per person among countries that have been able to take advantage of globalization by becoming export oriented. For this set of countries, income inequality has decreased; for the non-globalizers, it hasn't.[20] Furthermore, there is little evidence that globalization has increased income inequality within developing countries.[21] (There has, however, been an increase in income inequality within rich countries in recent years that might be related to globalization.)[22] Thus we are led to the same conclusion that we reached for the pre–World War I era: this new Age of Globalization has seen a reduction of poverty in developing countries that have been willing and able to globalize.

Another way of looking at the data also suggests that globalization has been associated with reductions in poverty. If, instead of looking at inequality across countries, where all *countries* are weighted equally, we instead look at

inequality across the world population, where each *person* is weighted equally, we get a very different picture. The great success stories in recent years have been in Asia, which has two of the most populous countries in the world, India and China. Both countries came to globalization late and have sometimes used unorthodox methods to develop their economies, but their embrace of globalization has had high payoffs. Rapid growth in India and China has removed over a billion people from extreme poverty. When we realize that these billion make up a sixth of the world's population, it becomes obvious why research that weights every human being equally in computing inequality finds that income inequality has actually fallen, not risen, in recent years.[23] The great success stories of India and China in reducing poverty are reflected not just in economic data but also in life expectancy. In 1955 life expectancies in India and China were thirty-nine and forty-one years, respectively; today they have risen to sixty-two years in India and seventy years in China.[24]

These success stories are not meant to minimize the terrible plight of certain parts of the world, such as sub-Saharan Africa, where poverty has increased and life expectancy has actually fallen to disastrously low levels in recent years because of the AIDS epidemic. (Those in poverty, defined as having income of less than $2 per day, rose from 73% of the population to over 76% today, while life expectancy has dropped from fifty years in 1990 to less than forty-six years currently.)[25] The plight of these countries, however, is due not to globalization but rather to the failure to globalize. This observation has been cogently expressed by economists Peter Lindert and Jeffrey Williamson: "As far as we can tell, there are no anti-global victories to report for the postwar Third World."[26]

A word of caution: The association of the reduction in poverty with countries that have globalized could be the result of reverse causality. That is, countries that had the capability to grow fast were also the ones that could take advantage of globalization. Evidence and analysis presented later in this book, however, suggest that causality *is* likely to run from globalization to high economic growth and reductions in poverty.

Financial Globalization in Emerging Market Economies: The Next Great Globalization?

Although economic globalization has come a long way, in one particular dimension it is far from complete. As is documented in Maurice Obstfeld and Alan Taylor's book, *Global Capital Markets,* financial globalization is primarily confined to rich countries.[27] Despite the huge increase in international capital flows in recent years, they primarily flow from North to North, that is, from rich countries to other rich countries that are mostly in the Northern Hemisphere, rather than from North to South, from rich to poor countries.[28] Most

international capital flows are exchanges of assets between rich countries and are undertaken primarily for diversification. These flows enable people in rich countries to put their eggs into different baskets by holding assets from other rich countries. International capital does not generally flow to poor countries to enhance their development.

As Nobel laureate Robert Lucas has pointed out, this feature of international capital flows is a paradox: Why doesn't capital flow from rich to poor countries?[29] We know that labor is incredibly cheap in poor countries, and so we might think that capital would be especially productive there. Just think of how hugely profitable a factory might be in a poor country where wages are one-tenth of what they are in the United States. We should expect massive flows of capital from rich countries (where the returns on capital should be far lower) to poor countries (where they should be higher). While there has been a big increase in the amount of capital moving to emerging market countries in recent years, capital still flows primarily from one rich country to another, where the returns on capital are similar.[30]

The amount of private capital flowing to emerging market countries increased dramatically in the 1990s, and its annual rate is now over $300 billion. That may sound like a lot, but it is only one-fifth of total international capital flows from private sources.[31] When governments are added into the picture, recent developments are even more surprising. Emerging market countries have actually been sending capital *back* to rich countries. The United States is currently running enormous trade and current account deficits of over $600 billion because Americans are buying more goods and services from other countries than they are selling to other countries. These deficits are being financed by loans from foreigners, with emerging market countries providing the United States with about $200 billion per year. The Chinese government, for example, has accumulated almost $800 billion of foreign assets, and it is now one of the largest holders of U.S. Treasury securities in the world.

Also remarkable is the finding that capital flows from North to South relative to total capital flows are far smaller than they were in the first Age of Globalization in the late nineteenth and early twentieth centuries. By 1914 around half of the capital in Argentina was supplied by rich foreign countries, particularly Great Britain.[32] Today less than one-tenth of Argentine capital is being supplied by foreigners.[33] This change in the pattern of capital flows has not been confined to Argentina. In 1913 over 25% of the world stock of foreign capital went to countries with income per person less than one-fifth that of the United States; by 1997 this figure had fallen to around 5%.[34]

As these numbers show, financial globalization is far from complete. Will financial systems in emerging market economies become more integrated with those in the rest of the world? Will the next great globalization be financial? If it is, will further financial globalization benefit poorer countries?

Is Financial Globalization Always Beneficial?

The benefits of globalization of trade in goods and services are not a controversial subject among economists. Polls of economists indicate that one of the few things they agree on is that the globalization of international trade, in which markets are opened to flows of foreign goods and services, is desirable.[35] (Globalization of trade is, however, controversial among the general public and more will be said about it in Chapters 8 and 12.) *Financial* globalization, opening markets to flows of foreign capital, is, however, highly controversial even among economists.

The important role of its financial system in a nation's economy is not well understood by the average person. Even many economists are shocked by the high salaries paid to investment bankers and other financial professionals.[36] After all, what do these financial professionals produce? Nothing concrete comes from their highly paid work.

Even high-level government officials underestimate the importance of the financial system. George Bush's first treasury secretary, Paul O'Neill, whose job involved designing policies to deal with financial markets, displayed this ignorance in an interview shortly after he took office. He belittled the value of participants in currency markets: "The people who benefit from roiling the world currency markets are speculators, and as far as I'm concerned, they provide not much useful value."[37] O'Neill couldn't have been more wrong.

Getting the financial system to work well is critical to the success of an economy. To understand why, we need to recognize that the financial system is like the brain of the economy: it is a coordinating mechanism that allocates capital to building factories, houses, and roads. If capital goes to the wrong uses or does not flow at all, the economy will operate inefficiently and economic growth will be low. Even the strongest work ethic cannot compensate for a misallocation of capital. Working hard will not by itself make a country rich, because hard-working workers will not be productive unless they work with the right amount and kinds of capital. Brain is more important than brawn, and similarly an efficient financial system is more important than hard work to an economy's success.

Financial globalization has several important benefits in emerging market economies. First, by bringing in new capital, it lowers the cost of capital, thereby encouraging investment; this in turn promotes growth. Second, when foreign capital and financial institutions are allowed to enter a country, they improve the allocation of capital. Third, globalization of the financial system helps promote the development of better property rights and institutions, both of which make the domestic financial sector work better in putting capital to productive uses. To reap these benefits, financial globalization must be extensive enough that the entry of foreign capital and foreign institutions increases competition in domestic financial markets. (More about this in Chapters 2 and 3.)

Even with all these powerful benefits, financial globalization is not necessarily always a force for good: it can go very wrong.[38] As we will see in Chapters 4–7, opening up the financial system to foreign capital flows can lead, and has led, to disastrous financial crises, which have resulted in great pain, suffering, and even violence. (There was widespread ethnic violence in Indonesia after its crisis in 1997, and in the wake of Albania's financial crisis in 1996–97 there were some 2500 casualties.)[39] This is why financial globalization is so controversial. Joseph Stiglitz, a Nobel Prize–winning economist, is critical of globalization in his book *Globalization and Its Discontents;* he believes that the opening of financial markets in emerging market economies to foreign capital leads to economic collapse.[40] Even Jagdish Bhagwati, one of the most prominent economists defending globalization (his book is titled *In Defense of Globalization*)[41] is highly skeptical of *financial* globalization: "the claims of enormous benefits from free capital mobility are not persuasive."[42] George Soros, one of the world's most prominent financiers, opens his book *On Globalization* with an introductory chapter entitled "The Deficiencies of Global Capitalism."[43]

The case studies of financial crises in Latin America and East Asia presented in Part Two show that financial globalization is likely to produce financial crises in emerging market countries when bad policies in those countries encourage excessive risk taking by financial institutions. Unfortunately such policies are often promoted by political and business elites in these countries for their own aggrandizement. Thus the issue is not whether financial globalization is inherently good or bad; I argue that, when it is done right, financial globalization has substantial benefits. But when financial globalization is perverted by policies that lead to an explosion of the financial system, it can go very badly.

Another Great Reversal?

As we have seen, the second Age of Globalization, in which we currently find ourselves, has many similarities with the first age, which occurred in the late nineteenth and early twentieth centuries. Could there be another Great Reversal, in which globalization again retreats and the world suffers great political, social, and economic upheaval and destruction? Could we experience déja vu all over again?[44]

Unfortunately the answer is yes. The backlash against globalization in Latin America is currently very strong. Much of the public in Latin America has turned against globalization because they have been disappointed in the amount of economic growth since 1990, when they opened up their economies, particularly to foreign capital flows. Some countries (such as Mexico, Ecuador, and Argentina) have also experienced disastrous crises that have led to depressions. In the immediate aftermath of its economic crisis in 2001–02, for example, Argentina experienced an unemployment rate of nearly 20% and an income per person that was 18% below the level it had reached in 1998.[45]

Given its depression, Argentina has been pursuing policies that make it harder for it to participate in the global system. This is exactly what happened in the aftermath of the Great Depression of the 1930s. Before this period Argentina was a full-fledged participant in globalization and was one of the richest countries in the world, with income per person that was actually higher than the average for countries in Europe.[46] Indeed, Argentina was one of the most desirable destinations for immigrants. At the turn of the century, when poor Italians were choosing whether to get on a boat for Buenos Aires or New York, it was a coin toss as to which destination was better. The success of Argentina before the Great Depression is reflected in the fact that, of twenty-seven countries for which data are available, it had the highest growth rate from 1870 to 1930.[47] In the aftermath of the Depression and World War II, however, the country turned its back on globalization and closed off its economy to the rest of the world. Over the next fifty years, Argentina had low economic growth, and it has since fallen into genteel poverty, with its income per person falling to only one-half that of the average for European countries. The same study of twenty-seven countries that found that Argentina had the highest growth rate from 1870 to 1930 ranked it last in terms of growth for the period 1930–92.

Argentina seems to be going down the same path again. The 2001–02 crisis discredited the policy in the 1990s of opening up the Argentinean economy. Given the backlash against globalization, it is not surprising that the Peronist government of Nestor Kirschner, harking back to the disastrous policies after World War II of the founder of its political party, Juan Perón, has been pursuing anti–free market policies that increase the likelihood that Argentina will turn its back on the global economic system. One of the most egregious examples is a measure implemented by the Argentine government in March 2006 to restrict exports of beef for six months in order to increase the domestic supply and lower the price, thereby halting most beef shipments abroad for the world's fifth largest beef producer.[48] The country is poised to lose another fifty years of economic growth.

The backlash against globalization has also manifested itself in countries such as Bolivia and Venezuela. Demonstrations against further opening up of the economy led to the ouster of the Bolivian president in 2003 and again in 2005, while Venezuela's president, Hugo Chavez, has advocated policies that turn it away from global markets (as well as democracy).

Only one Latin American country, Chile, has completely embraced globalization. Since 1990 Chile has opened up its economy completely, to both international trade and capital flows, and it has experienced rapid growth. From 1990 to 2003 it has had an average growth rate of 5.6% per year, by far the highest in Latin America. Indeed, Chile has been given the nickname the "Latin Tiger" to compare it to successful Asian countries dubbed the "Asian Tigers."

However, Chile is a small country, with a population of only 16 million, less than one-thirtieth the total population of over 500 million in Latin America.

Which way will the remaining countries of Latin America go? Will they follow Venezuela and Argentina and retreat from globalization, or will they emulate the successes of Chile and embrace it? Recent elections in Latin America have seen a further shift to the left with the success of candidates espousing anti-globalization rhetoric. Evo Morales, a former coca grower and opponent of globalization, was elected president of Bolivia in December 2005, while Ollanta Humala, a left-wing candidate for Peru's presidency who opposes free trade, won the first round of the presidential election in April 2006.

Similarly, the public in many of the *transition countries,* former communist countries that are a subcategory of emerging market economies, also has doubts about the benefits of globalization. This is less of a problem for the transition countries in Eastern Europe that are entering or are likely to enter the European Union soon; by doing so they will automatically become a part of a globalized economy. However, there is a danger that Russia and many of the other countries that were part of the former Soviet Union may turn inward and reject globalization and economic freedom in general.

The Asian public seems to be far more supportive of globalization because they have experienced rapid growth, but the backlash against globalization might reach them too. It would be premature to assume that they will continue down the globalization path.

The backlash against globalization manifests itself in rich countries as well as poor. Protectionist measures to restrict the flow of goods from developing countries, especially China, have been proposed regularly in the U.S. Congress. Protectionist sympathies are also strong in Europe. One French protester described his fears of globalization by saying that he was worried that French workers would get "eaten with a Chinese sauce."[49] Most extraordinary have been recent government efforts in France, Italy, and Spain to block corporate takeovers when the acquiring firm is foreign, even if the acquiring country is a member of the European Union. (Protectionist concerns might also have been behind congressional pressure that blocked the takeover of six U.S. ports by Dubai Ports World in March 2006.)[50]

The possibility of another Great Reversal is very real. This book argues that turning their backs on globalization would be disastrous for both emerging market *and* rich countries. Developing countries, in particular, must embrace globalization so that they can reach their full potential and get rich.

How Can Poor Countries Get Rich?

Most people think that the way for poor countries to get rich is to make sure their citizens get a good education and are healthy, and it is not surprising that so much charitable aid goes into improving health care and education. Public health and education *are* important to economic growth, but increasing pub-

lic spending in these areas does not always produce higher growth.[51] Throughout this book, I argue that the only way for poor countries to get rich is for them to provide incentives for capital (including capital devoted to health care and education) to be supplied to its most productive uses.

If allocating capital to productive uses is necessary to promote economic growth and development, how do you get it to happen? The short answer is, "Develop good institutions that allocate capital efficiently."[52] But what are these institutions?

The most basic set of growth-promoting institutions are those that promote property rights (such as the rule of law, constraints on government expropriation, and the absence of corruption, all of which are discussed in the next chapter). If you live in a country where it is easy for others to take your property away, either at gunpoint or through a corrupt government, you would be crazy to make investments there. Without these investments, workers in your country will be unable to earn high wages because there won't be sufficient capital to provide the machines, buildings, and computers to make them highly productive. Poverty will be severe.

Even if investments are made, if they go to the wrong place they will be useless. Thus the second, related set of institutions are ones that make sure that those offering the best investment opportunities can actually get external funds to make investments. This is the crucial role of the financial system. These institutions promote an efficient financial system through financial regulation and strong enforcement of financial contracts.

The problem for many poor countries is not that they can't get money for investment but that the investment is counterproductive. In the 1970s, for example, the World Bank provided lending to finance a huge shoe factory in Tanzania that was to produce four million pairs of shoes a year, three-quarters of which were to be exported to Europe. However, the factory, with its aluminum walls and no ventilation system, was ill suited for Tanzania's climate, with the result that it never produced more than 4% of its installed capacity and never exported a single shoe.[53]

Nations are poor because they are disadvantaged in many important areas: their institutions are weak; they are "institutionally challenged." We can classify poor countries into two types. The poorest group includes countries that do not even have basic property rights, either because they are subject to civil strife or because they are run by rapacious governments. Many countries in sub-Saharan Africa, where average income per person is less than one-twentieth of what the average American earns, are in this group.[54] The second group of poor countries has basic property rights and they are far better off and far less poor than countries in the first group. These emerging market countries are opening up their markets to the flows of goods, services, and capital from other nations, but they do not yet have institutions that support a well-functioning financial system.

The terms "less-developed," "developing," "poor," and "emerging market" are often used interchangeably to describe disadvantaged nations, but there are subtle differences. Because this book outlines how disadvantaged nations can improve their financial system, it applies more to emerging market countries. They are the ones at a stage of development where it becomes possible to create a well-functioning financial system. Many of the policy prescriptions offered here, however, also apply to a wider group of countries that includes not only the emerging market countries but also those at the lowest level of development who do not have even basic property rights. When I refer to "less-developed," "developing," or "poor" countries, I am referring to the entire set of disadvantaged countries, including the poorest. When I use the term "emerging market," I am referring to those countries that are ready to develop financial systems that can move them up to rich-country status.

Institutional development (more precisely defined here as measures that promote effective property rights and an efficient financial system) is the key to economic development.[55] Since good institutions exist in rich countries, you might think that these institutions could just be exported to disadvantaged nations to enable them to get rich. Good institutions, however, need to be home grown; institutional frameworks that have been developed in the rich countries frequently do not translate well to poorer countries. This is a lesson that many in the advanced countries of the world have yet to learn. The development of good institutions in the advanced countries took hundreds of years as they grew and adapted to local conditions. Poor countries must ultimately develop their own institutions, and the citizens of these nations must feel they have ownership of those institutions or else the institutions will be ineffective and short-lived.

It is also important to recognize that the impediments to developing good institutions reside in the less-developed countries themselves. Developing good institutions is hard: it takes time and effort for a country to plan, establish, experiment with, evolve, and adapt its institutions to its historical, cultural, and political circumstances. It takes a long time for any nation to achieve strong property rights and an effective financial system.

It is even harder to develop good institutions in less-developed countries because of the political environment. Rich elites and special interests often have considerable political clout; they have much to lose from institutional development that encourages an efficient financial system and promotes competition. Globalization, however, can be an important force in promoting the development of better institutions: it weakens the profits and power of the rich elites and special interests who oppose institutional development, and it can even encourage them to support institutional reforms to restore their profits. Globalization can therefore help generate the political will for institutional reform. We have seen this happen in emerging market economies like Chile, China, India, Singapore, South Korea, and Taiwan that have experienced rapid growth.

Yet globalization, particularly of the financial kind, does not always produce good outcomes. Just as rich elites block needed institutional development to increase their profits, they often pervert the financial globalization process for the same reason, which is why financial globalization often does not work. There are those (including prominent economists Joseph Stiglitz and Jagdish Bhagwati) who put the primary blame for the failures of financial globalization in emerging market countries on outsiders, specifically on the IMF or the Wall Street–Treasury Department complex.[56] The evidence discussed throughout this book has brought me to the conclusion that they are just plain wrong. To be sure, institutions like the IMF or the U.S. Treasury Department are not blameless; public and private financial institutions active in the international capital markets have often aided and abetted poorly designed financial globalization, although this was not necessarily their intention. (More on this in Chapters 5–7 and 11.)

What Can the Rich Countries Do?

How can rich countries help? The key is to provide the right incentives. Currently the IMF and the World Bank often find it hard to deny loans to governments in the less-developed world that misallocate the funds or refuse to develop the institutions that are needed to make a nation's economy successful. The inability to "just say no" creates the wrong incentives for ill-run nations. Money should be used as a carrot to encourage poorer countries to develop good institutions. If a government in one of these countries is unwilling to do this, the IMF and the World Bank must use the stick and cut off the flow of money. This approach sounds harsh, but it is better to engage in tough love than to allow countries to continue down the wrong path.

International financial institutions such as the IMF and World Bank and other governmental organizations in the rich countries (like the Group of Seven or G7) have also had a tendency to impose on less-developed countries institutions patterned too directly after those that have worked well in advanced countries. They have often also pushed standard "one size fits all" prescriptions for less-developed countries, such as flexible over fixed exchange-rate regimes or complete and precipitous abolition of capital controls. The arrogance of these institutions and governments is greatly resented in the less-developed world. The standard prescriptions often don't work, and they also have a strong element of hypocrisy because many of the conditions imposed on the less-developed countries are not met by the rich countries themselves.

The international financial institutions and advanced countries can help in several ways. Although less-developed countries need to develop their own institutional frameworks to make globalization work, there is considerable expertise in institutions like the IMF and the World Bank on which these countries could draw. Technical assistance from these organizations can be of great

value, and indeed it has been in South Korea and Turkey, both of which asked for help after their financial crises. The right incentives from the international financial institutions can also help encourage economic and political elements in the less-developed countries to overcome blocking of institutional development by rich elites.

What about direct financial aid? Wouldn't more aid from rich countries help poor countries to develop? Many people lament the paltry amount of foreign aid that rich countries provide to poor countries: U.S. foreign aid as a percentage of its gross national income is only a meager 0.04%.[57] Although aid in the form of technical assistance has often had important successes, as William Easterly has pointed out in his book *The Elusive Quest for Growth*,[58] aid has generally not worked well in promoting development because it has typically not provided the right incentives.[59] Indeed, Easterly cites the extraordinary example of Zambia: if the $2 billion of aid Zambia has received from the advanced countries and international aid organizations since its independence had gone into productive investments, the nation would now have an income of over $20,000 per person, putting it in the rich-nations club. Instead Zambia has an income of $600 per person, one-third lower than its income at independence.

Just as throwing money at poor countries does not seem to work, simply boosting investment and the amount of capital in a country is also not the key to economic growth, because putting capital in the wrong place does not produce a healthier economy. Only when capital is allocated to its most productive uses does the economy benefit: this is why development of an efficient financial sector is key to economic growth.

What we know does work to promote development is encouraging poorer countries to pursue an external orientation and develop a successful export sector. This approach not only forces the economy to become more efficient, it also creates a demand to improve institutions that encourage financial development. Along with technical assistance and incentives for institutional development, advanced countries can also help to alleviate poverty in the rest of the world by opening up their markets to exports from poorer countries, which they often have not done, particularly in agricultural products. Trade, not aid, will make the world a better, safer, and more economically and politically stable place to be.

Why the Anti-Globalizers Are Wrong

Anti-globalizers have it completely backwards: globalization is not the enemy. Particularly disturbing to me are elements of the left that are against globalization. They say they care about poor people, and I believe they do. They are correct in saying that the globalization process has often been perverted by rich elites and that simplistic solutions like privatization and the establishment of free markets often do not work. They are also right that globalization will not

cure all the ills of poor nations. By itself globalization, in both finance and trade, is not enough to ensure economic development. But to be against globalization is most assuredly to be against poor people in the rest of the world, and this is a morally indefensible position. Less-developed countries cannot get rich unless they globalize, and, in particular, they must globalize their financial sectors. Financial globalization is not a choice: it needs to be the focus of the next great globalization.

Those in rich countries who protest against free trade in the name of helping poor people also misunderstand what it takes to promote economic development. As I have already argued and will argue later in the book, opening up rich-country markets to goods and services from less-developed countries is far more important than financial aid in alleviating world poverty, and such openness also promotes financial stability in emerging market countries. Those who are against opening up our markets—although they often don't realize it—are also against reducing poverty abroad and even at home. True, closing off our markets in rich countries may help *some* workers in the short run (although in the long run it will make the *average* worker worse off because it will lower productivity growth). But this help comes at the expense of the far poorer worker in the less-developed world. Protesting in advanced countries against free trade is the result of ignorance or narrowly defined self-interest.

This book is meant to challenge those who oppose globalization to rethink their objections. As Kofi Annan, the secretary-general of the United Nations, has put it, "The main losers in today's very unequal world are not those who are too much exposed to globalization. They are those who have been left out."[60] Rather than opposing or limiting globalization, we in the rich countries and those in the less-developed countries must, as a moral imperative, work together to make globalization work for the general good of people all over the world.