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Whither Income Inequalities?

Jomo Kwame Sundaram and Vladimir Popov

Abstract

Some major trends in world income inequalities and relevant economic trends are reviewed here. In recent decades, there have been indications of a reversal of the growing income divergence between North and South after over half a millennium, especially in the last two centuries. Meanwhile, income inequalities within most countries have been growing again, increasing social tensions, which may jeopardize growth in some countries and reshape global economic competition. In the 1960s, when the profit rate and capital's share of national income in Western countries were highest, income inequality within countries was at a historical low. Since the 1980s, the increasing share of profits in national income and rising inequality within countries have gone hand in hand.

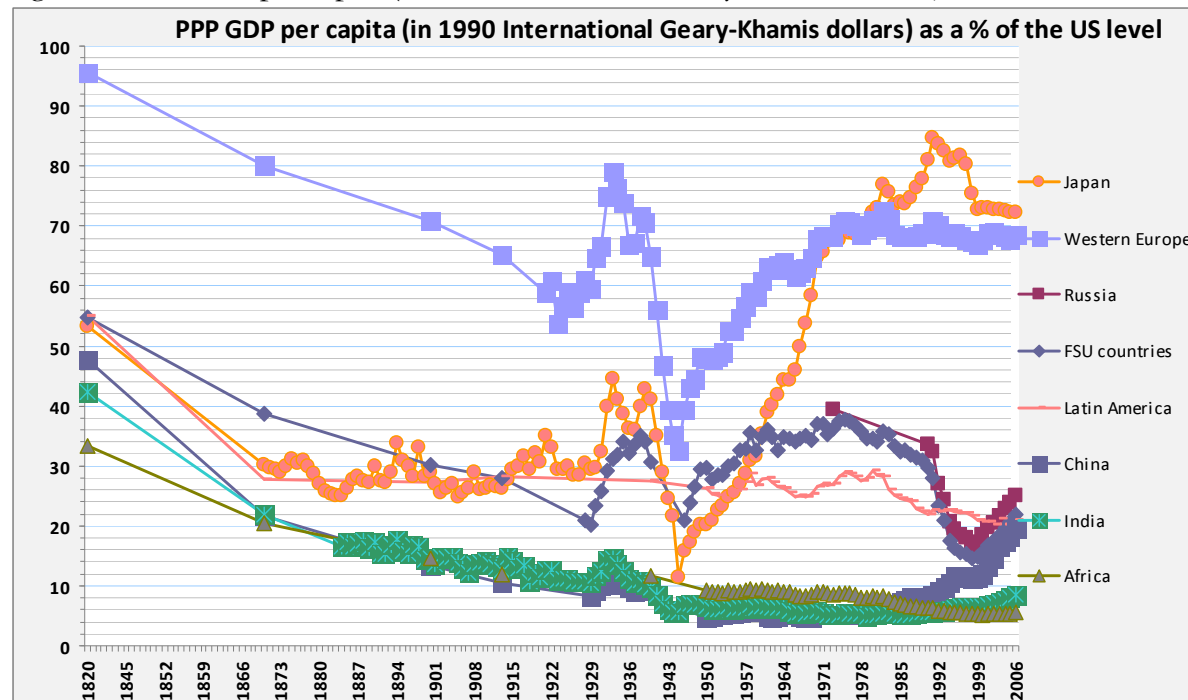
Convergence?

According to Angus Maddison and others, all countries had roughly the same GDP per capita (about \$500 in 1990 prices) before 1500. By 1900, the per capita income ratio between developed and developing countries had increased to 6:1 (Maddison, 2010). In 2000, it was at roughly the same level. But in the second half of the twentieth century, while sub-Saharan Africa, Eastern Europe, the former Soviet Union and Latin America failed to close the gap with the West, and even fell behind. Japan, South Korea, Taiwan, Singapore, Hong Kong, and a few other developing countries have managed to close the gap while much of Southeast Asia, China and India have succeeded in reducing the gap with the more developed countries (Figure 1).

If convergence and divergence are epiphenomena, the key question then is: What are the underlying phenomena? Today, consumption is not directly related to production, especially with global economic integration; some countries can invest more than they save, import more than they export, and consume more than they produce for a considerable period of time by going into debt. However, at the end of the day, differential investment rates are the major determinant of productive capacities and achievements in long term performance. Econometricians running regressions to explain economic growth know that the most robust predictor of long term growth rates is the share of investment in GDP. For instance, East Asian countries were able to catch up with the West due to higher investment/GDP ratios. And in the decade before the current crisis, Greece had the highest rates of investment and productivity increases in the OECD (Organization for Economic Cooperation and Development). Its PPP GDP per capita increased from 42 per cent of the average Western European level (29 countries) in 1950 to 74 per cent in 2006 (Maddison, 2010). Greek workers' productivity and wage levels did not deter private investors from investing for at least a decade before the crisis. Of course, increased productivity makes higher wage remuneration possible, but there is no guarantee that wages will rise with productivity. Nevertheless, none of this has been able to dispel the currently popular urban legends about Greek stagnation being due to lazy but militant Greek workers.

The sources and sustainability of growth as well as related resource and demographic potential and constraints also matter. There is considerable historical evidence that the national source of direct investments is consequential. Investments due to domestic resource mobilization will have different implications compared to foreign direct investments. Investment decisions of foreign direct investors tend to consider the relative medium-term profitability of investments. Compared to private investments, public investments are more likely to be national in orientation. All these factors shape and sustain the accumulation process, and hence, the likelihood of sustained output increases.

Figure 1. PPP GDP per capita (in 1990 international Geary-Khamis dollars) as % of the US level



Source: Angus Maddison. Statistics on World Population, GDP and Per Capita GDP, 1–2008 AD. OECD, Paris. <http://www.ggdc.net/MADDISON/oriindex.htm>.

The sustainability of growth is also influenced by whether it is dependent on the extraction of exhaustible, non-renewable natural resources, especially mineral resources. Despite the recent popularity of the ‘resource curse’ thesis, much recent growth of many developing countries, as well as quite a few developed countries, has benefited greatly from such resource extraction. In recent decades, some (such as the oil and gas producers of West Asia) have experienced substantial increases in income due to elevated commodity prices without strong output growth. But such income increases will be difficult to sustain. The recently popular analytical framework promoting the conversion of ‘natural capital’ into other supposed forms of capital, such as ‘financial capital’, is also misleading and problematic. Different demographic transitions have ramifications that may also bear on the sustainability of economic growth.

During the 1950s and 1960s, some convergence took place as much of the developed world recovered from the devastation of war, while the postcolonial economies were able to grow rapidly as they implemented policies more conducive to development. The 1970s were a mixed decade, but after that, much of Latin America and Africa saw slow growth if not stagnation. Japan has not experienced much growth since the 1990s, while the growth records of Southeast Asian nations have been mixed since the 1997-1998 Asian crisis. Hence, it is not clear that the recent growth in East Asia will be sustained throughout the region. For convergence to take place, sustained and rapid per capita growth in developing countries is necessary.

Moreover, many factors influence living standards. There is mixed evidence that productivity increases raise the incomes of producers. Significant increases in agricultural productivity have often lowered commodity prices rather than raised net incomes of producers, especially after deducting the additional input and other costs to secure the productivity increases.

Primary commodity prices declined relative to prices for manufactured goods as Hans Singer

and Raul Prebisch found for the first half of the 20th century. Similarly, the prices of tropical agricultural products declined compared to those for temperate agriculture over the same period as argued by Arthur Lewis. More recently, the prices of manufactured goods from developing countries have declined compared to those from developed countries.

Prices for some important mineral commodities, like oil, actually increased in the twentieth century, and are now at very high levels. Resource abundance may therefore be a blessing, not a curse. The oil exporting nations of West Asia (Saudi Arabia, the Gulf states) are the second sub-region of the South (after East Asia) catching up with the West in terms of income and perhaps welfare, but it is doubtful their economic model is sustainable in the longer term. Unlike in East Asia, labour productivity in these countries has not increased as much. Rather, their terms of trade improved considerably, so consumption and living standards have grown faster than labour productivity. Insofar as oil rents are used not only for consumption, but also for investment in human resources and infrastructure, high natural resource prices may contribute to catch-up development.

There are many kinds of resource rents, and incomes from resource rents can be deployed for many purposes – for consumption or investments of different types, current or delayed. What one does with the economic surplus, whether profits or rents, determines the sustainability of growth. Norway and Holland, for instance, have been quite innovative with their oil revenues, using them to diversify their economies and to enhance other productive capacities. In some other countries, living standards rose, and the countries fared well on some human development indicators. Libya utilized its oil rents to become the top scorer on the Human Development Index in Africa and the Arab world.

Contrast this with most other oil-producing countries. Whether oil rents are successfully used for developmental purposes often depends on how well they are invested for productive purposes, rather than to enhance welfare or consumption, and whether this for a few or for many. However, it is unlikely that the new economic capacities and capabilities can be sustained without oil rents. A national oil company may be well-managed, but even then, it does not follow that national oil wealth will be well invested or deployed developmentally or to raise living standards.

Where does growth come from more generally? It typically comes primarily from investments, which, in turn, comes from the economic surplus and, of course, from innovation. Mainstream economics typically presumes perfect competition in which many small producers produce the same product consumed by many different consumers. In the real world, this is the exception, not the rule. In the real world, the surplus includes not just what mainstream economics calls profits, but also rents – in this case, resource rents – typically associated with monopolies, oligopolies or what is termed *imperfect competition*.

Socialism and convergence

Wassily Leontieff (1974) once noted that an economy using the profit motive, but without planning, is like a ship with a sail, but no rudder. It may move quickly, but cannot be steered and would soon crash. A purely planned economy that has eliminated the profit motive is like a ship with a rudder, but no sail. It can be steered well, but may not move quickly. To move forward while avoiding dangerous pitfalls, an economy needs both material incentives, such as the profit motive, and planning – both a sail and a rudder.

There are many different understandings of what socialism means. For the political right, almost anything associated with the public sector or state intervention is socialist. By such a definition, Singapore, Israel and some oil welfare states would be the most socialist in the world owing to the size of the public sector in these economies, even after the modest privatizations of recent decades some of them have undergone. For others, however, government intervention is

what defines an economy as socialist. Crudely put, the greater the degree of regulation and/or government intervention, the more socialist the economy. By this yardstick, most European economies would be considered quite socialist by American standards owing to the pervasive role of the state.

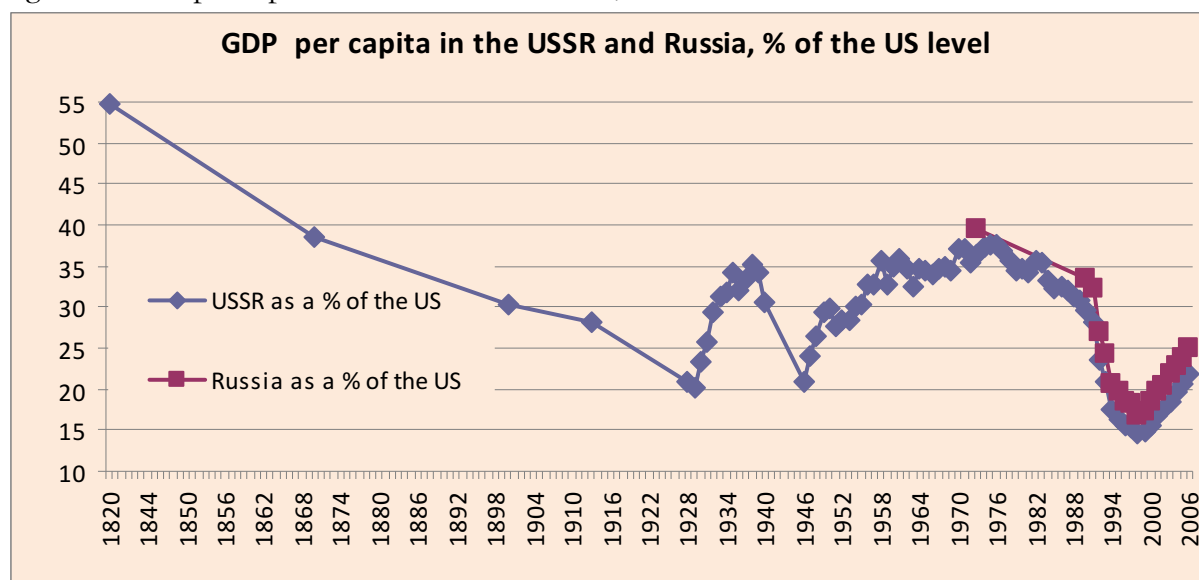
The degree of income inequality is another criterion – in all former ‘socialist’ countries, Gini coefficients for income distribution were between 25 to 30 per cent. Outside the ‘communist’ world before the 1990s, such low levels were only observed in the Scandinavian countries, often described as ‘socialist’. Of course, there are many other understandings of socialism. Soon after the collapse of the Soviet Union, for example, Joseph Stiglitz argued in favour of the continued relevance of his version of the socialist project.

The collapse of the Soviet Union was not economically pre-determined. On the contrary, the economic collapse of Russia and most other Soviet republics did not precede, but rather followed the political collapse of the Soviet Union. Only over two decades later, in 2012, did the Russian economy reach its 1989 output level (Popov, 2010). Nevertheless, most people are not aware of the actual sequence of events, and wrongly believe that Boris Yeltsin saved Russia from economic collapse caused either by Mikhail Gorbachev, his predecessors, or those who sought to oust him.

Soviet economic development was very impressive for many different reasons, with much of their progress achieved in the face of great hostility. The USSR successfully embarked on catch up development from the 1930s. Up to the 1960s, Russia was closing the gap with the West, although the Soviet economic model started to experience problems and failed to continue catching up from the 1960s. Before the Soviet period, from the 16th to the 19th centuries, Russia continued falling behind the West; neither the reforms of Peter the Great in the early 18th century, nor the elimination of serfdom in 1861 (with the Emancipation Act), nor even Witte’s and Stolypin’s reforms in the early 20th century could change this trend (Figure 2).

Centrally planned economies continue to exist, but rarely at the state level. By definition, a large corporation may be diverse and variegated, but there is invariably centralized planning for the corporation as a whole. When things go wrong, adversely affecting a corporation’s performance, action is likely to be taken early to address mistakes and inadequacies. Although centrally planned national economies are not monolithic and unchanging, the presumption is that they are generally slower to change and correct course. There are competing views of why this is the case, but this must surely give pause to advocates of central planning for national economies.

Figure 2. GDP per capita in the USSR and Russia, % of the US level



Source: Angus Maddison. Statistics on World Population, GDP and Per Capita GDP, 1–2008 AD. OECD, Paris.
<http://www.ggd.net/MADDISON/oriindex.htm>

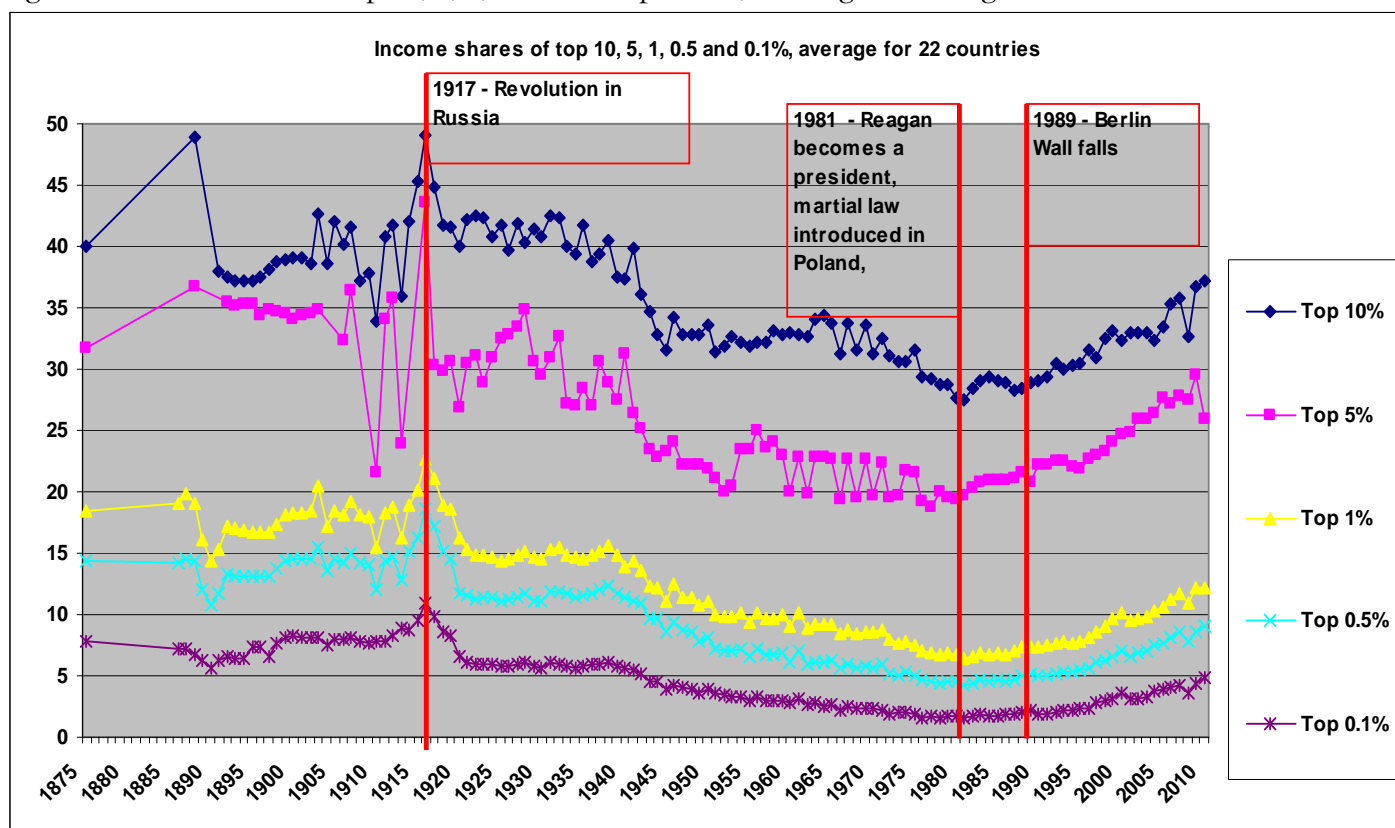
Growing inequalities within countries

In recent decades, there has been a general decline in social provisioning in many societies. This is not only true of many so-called welfare states, but also of postcolonial societies featuring some tax-financed social provisioning. Such social provisioning has declined in China, Russia and many other ‘economies in transition’. As a consequence, the welfare of individuals and families depends much more on what they can afford based on their wealth and incomes. Similarly, the recent period has seen greater income inequality in most, though not all societies. The era of economic liberalization has witnessed not only increasing income inequality at the national level (Figure 3), but also growing concentration of income and wealth at the world level (Figure 4).

The increase of income inequalities within countries since the 1980s was especially pronounced. The income shares of the richest one, five or ten per cent of the population have been growing for over thirty years. In many countries, inequality has been approaching levels before the Second World War, which led to the emergence of the socialist bloc and the dramatic decline in inequalities in most countries. To give one example, in the United States, the share of the nation’s total income held by the top (richest) ten per cent of the population was 40–45 per cent in the 1920s and 1930s, fell to 30–35 per cent from the 1940s to the 1970s, and started to increase again from the early 1980s, reaching 45 per cent in 2005.

The recent rise in inequality has paralleled an increasing rate of profit. During the post-war Golden Age, typically, when profits were high, capital’s success was shared with other social groups. In the 1950s and 1960s, for instance, wages, salaries and welfare programs grew together with rising profit margins. But since the early 1980s, profit margins have increased hand in hand with the rise in inequalities.

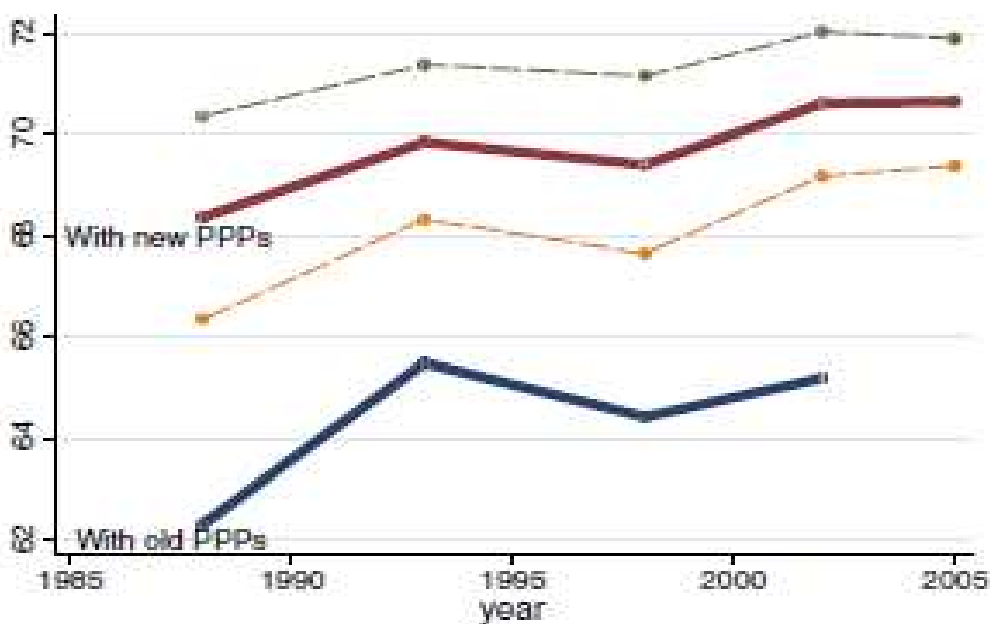
Figure 3. Income shares of top 10, 5, 1, 0.5 and 0.1 per cent, un-weighted average for 22 countries



Note: European countries: Denmark, France, Germany, Netherlands, Switzerland, UK, Ireland, Norway, Sweden, Finland, Portugal, Spain, Italy; North America: United States and Canada; Australia and New Zealand; Latin America: Argentina; Asia: Japan, India, China, Singapore, Indonesia; Sub-Saharan Africa: South Africa, Mauritius, Tanzania. Overall: about half the population of the world.

Source: Alvaredo, Facundo, Anthony B. Atkinson, Thomas Piketty and Emmanuel Saez (2012). The World Top Incomes Database. 25 April. <http://g-mond.parisschoolofeconomics.eu/topincomes>.

Figure 4. Global Gini coefficients for income inequality, 1988–2005, calculated with new and old PPPs



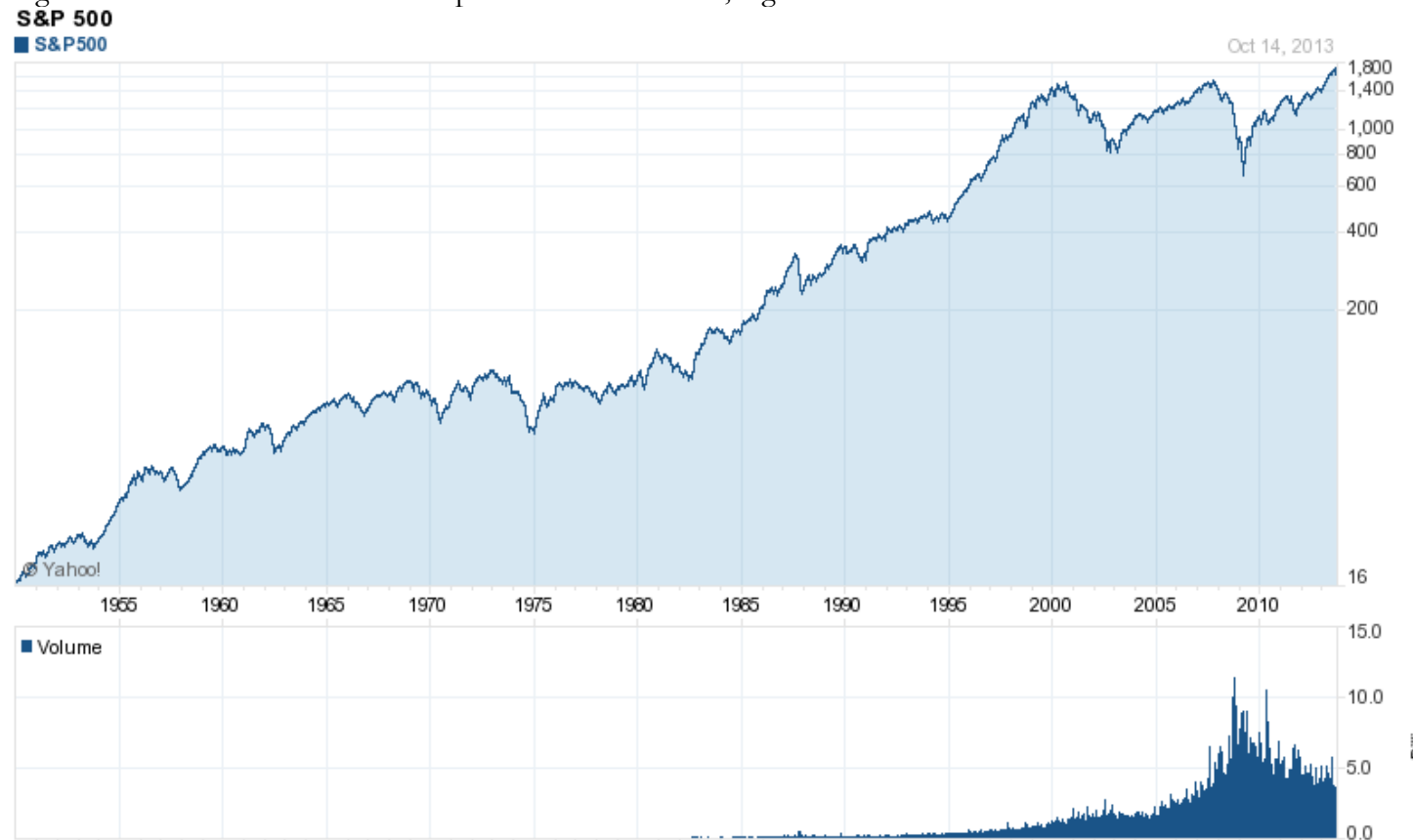
Source: Milanovic, Branko (2009). [Global inequality recalculated: The effect of new 2005 PPP estimates on global inequality](#). MPRA Paper No. 16538, University Library of Munich.

If the producers are mainly wage earners, a lot depends on the nature of wage determination and wage contracts. Arthur Lewis noted different types of labour markets. Where unemployment is high and incomes low, workers are willing to accept wages close to subsistence. But where labour is organized for collective bargaining and working conditions are regulated, wages are more likely to rise with productivity increases. For instance, for several decades, living standards in China did not rise as fast as productivity, but in recent years, living standards have risen as employers experience labour shortages and expect greater skills and productivity from their workers. With greater social protection and provisioning (public health, education, housing), the ‘social wage’ may increase much more than suggested by the money or real wages workers receive. But in many developing countries, the “social wage” has not risen faster than profits since the 1980s.

To put the issue in historical perspective, the 2008-2009 crisis does not yet seem to be a turning point in the long run, comparable to the Great Depression of the 1930s (Eichengreen, O’Rourke, 2009). The 2008-2009 crisis was not unique in terms of recent collapses of stock indices; between October 1929 and July 1932, and again between January 2000 and July 2002, the S&P index fell by almost half – as between October 2007 and March 2009 (Figure 5). But the collapse of world output (by 3.4 per cent in 2009) was the largest decline in 60 years – much greater than the 1.4 per cent reduction in 1982, the 0.4 per cent reduction in 1974, and the 0.8 per cent reduction in 1975 (Figure 6). US profit margins and the rate of profit reached their lowest levels in the post-war period in 1974, 1980 and 2002 (Figure 7). The US unemployment rate reached its post-war peak of 9.7 per

cent in 1982, compared to 9.6 per cent in 2009 (Figure 8). Meanwhile, real wages in the US are well below their early 1970s' level, while profits remain high¹.

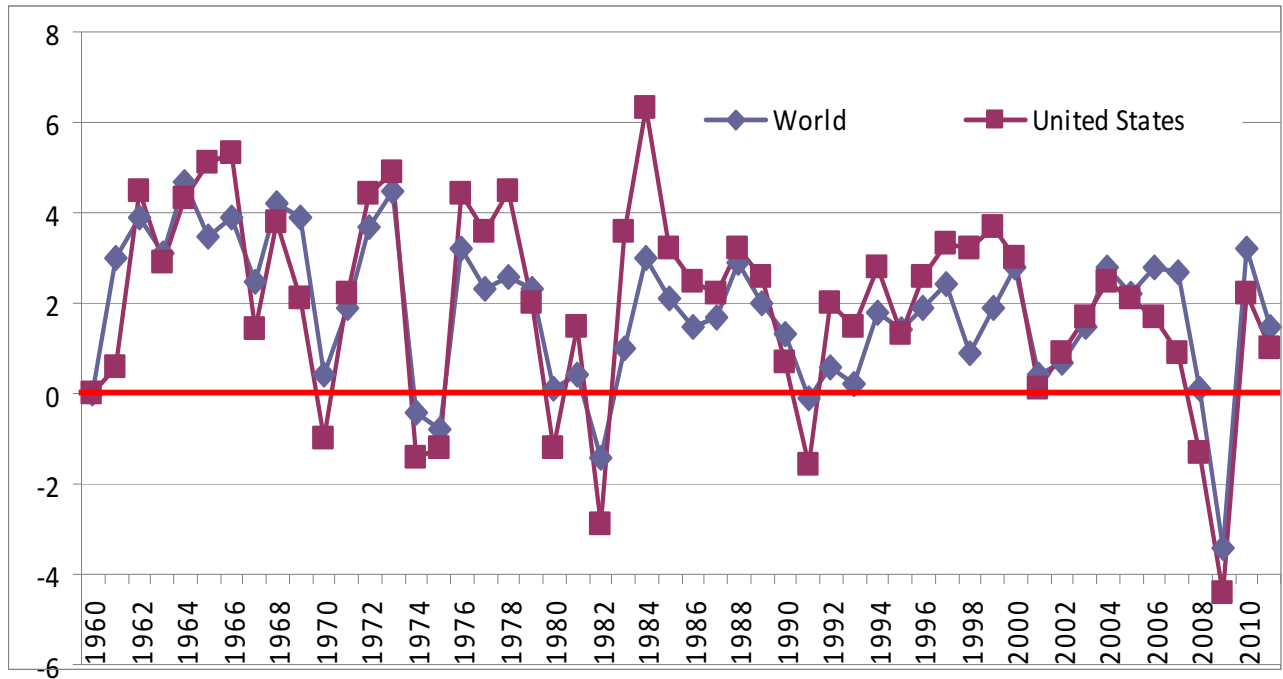
Figure 5. US Standard & Poor stock price index since 1950, log scale



Source: Yahoo finance.

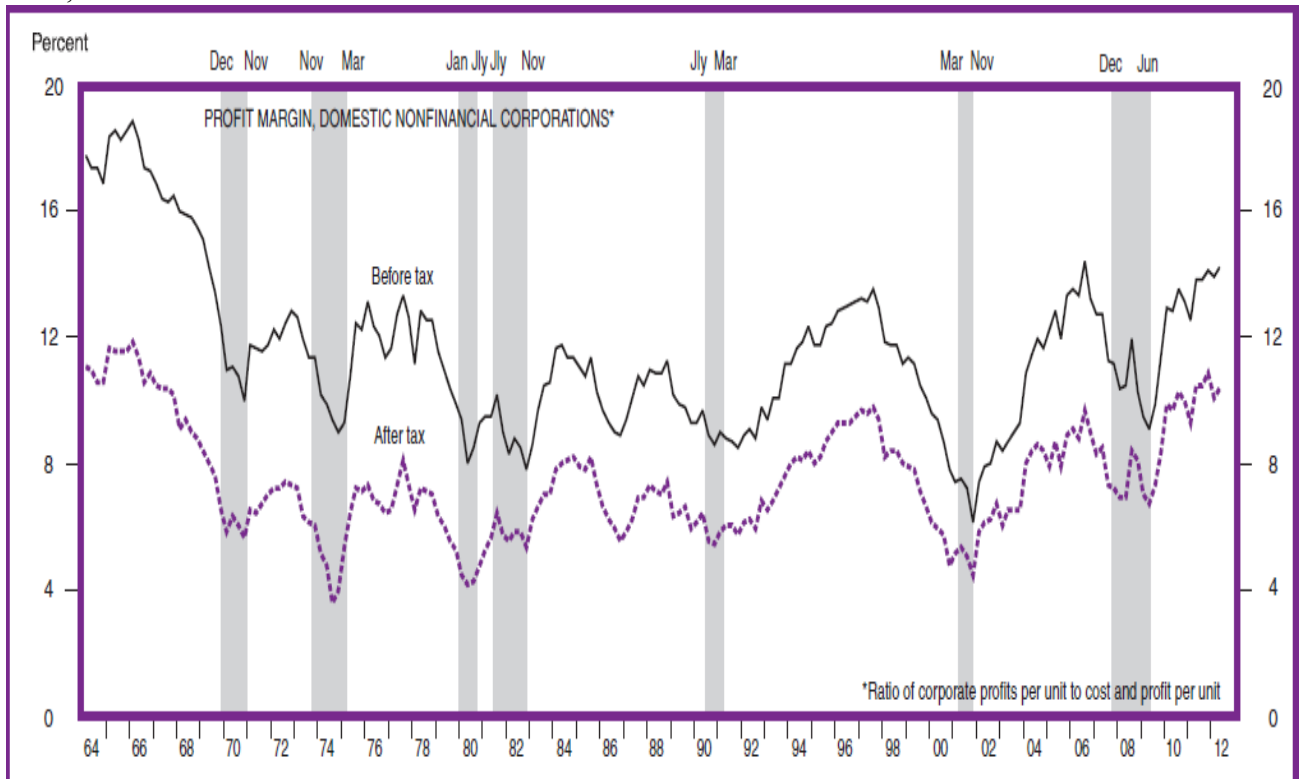
¹ If Kondratieff long waves exist, the lowest point of the long cycle should come in the 2020s or 2030s, not now; the previous troughs were in the 1870s, 1930s, and 1970s-1980s.

Figure 6. World, US GDP per capita growth rates, 1960-2011, %



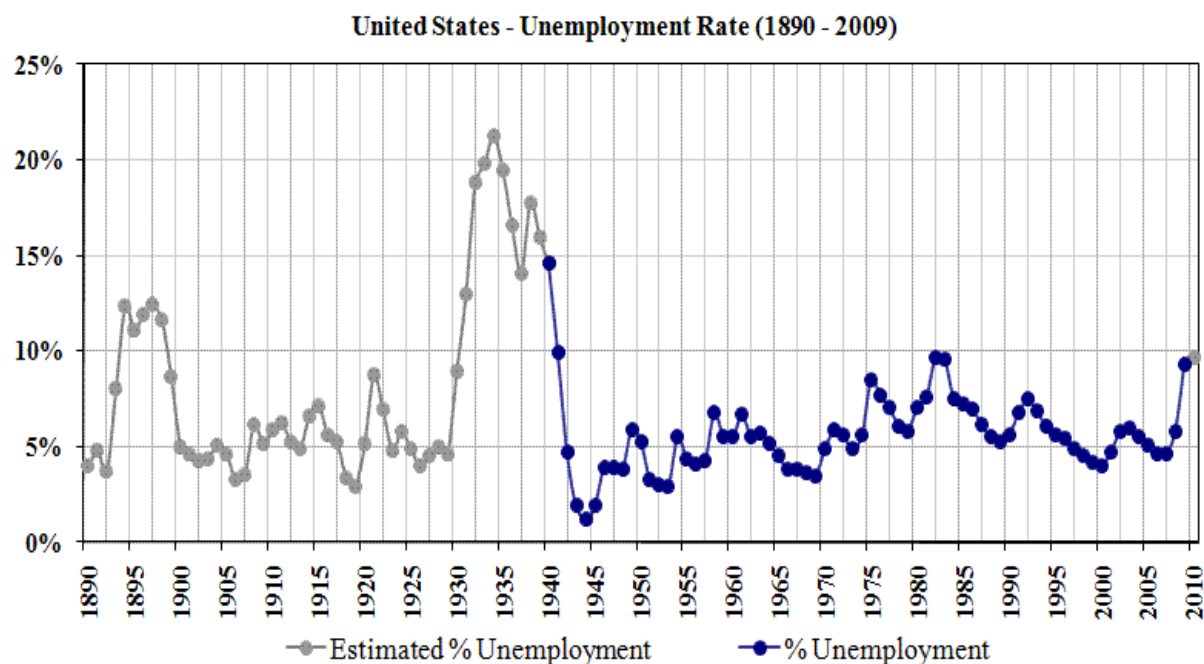
Source: World Development Indicators database, World Bank.

Figure 7. US domestic non-financial corporations' profit margins (share of profits in sales), 1960-2012, %



Source: Bureau of Economic Affairs.

Figure 8. US unemployment rate long term trends, %



Source: 1890-1930 data from: Christina Romer (1986). Spurious Volatility in Historical Unemployment Data. *The Journal of Political Economy*, 94 (1): 1-37. 1930-1940 data from: Robert M. Coen (1973). Labor Force and Unemployment in the 1920s and 1930s: A Re-Examination Based on Postwar Experience. *The Review of Economics and Statistics*, 55 (1): 46-55; 1940-2011 data from the US Bureau of Labor Statistics (http://en.wikipedia.org/wiki/File:US_Unemployment_1890-2009.gif).

There were high, even double-digit inflation rates and economic slowdowns in major Western countries in the 1970s following the two oil price shocks of 1973-1974 and 1978-1979. This unexpected combination was dubbed a period of 'stagflation' and seemed unresponsive to traditional Keynesian fiscal and monetary policies. The first oil price shock followed the Arab-Israeli War of 1973, while the 1979 Iranian Revolution accompanied the second one. The 1974 Portuguese Red Carnation revolution, the subsequent collapse of the last colonial empire, the US military defeat and withdrawal from Indochina in 1975 and other contemporary developments seemed to promise the prospect of major transformations.

By the 1970s, the hegemony of Western capitalism seemed under threat from within and without. The conservative reaction in the Anglophone West soon followed, led by Thatcher and Reagan in the 1980s. The collapse of the Berlin Wall (1989) and the USSR (1991) were among the high points of this resurgence, reflected in the counter revolution against Keynesian and development economics. The income share accruing to capital increased, at the expense of labour, with the rentier share (accruing to finance, intellectual property rights) of the former growing more than the real economy. Generally higher unemployment and real wage stagnation, if not contraction, despite productivity increases, ensured rising profit margins and income inequalities. Meanwhile, trade union and worker movements in Western countries have been experiencing decline since the 1980s. Thus, the Thatcher-Reagan counterrevolution was successful in its own right on a global scale. Today, capitalism is the only 'show in town', and the main debate is among varieties of capitalism, rather than between capitalism and some systemic alternative.

Financial versus real sector

The current economic crisis has some characteristics that distinguish it from earlier crises. It is widely seen as not only due to the hegemony of finance in recent decades, but also the specificities of uneven financial liberalization and globalization due to political settlements, institutional reforms and corporate responses. Hence, while the circumstances of a particular conjuncture shape developments, letting Lehman Brothers collapse or saving AIG, and their consequences, were not all predetermined. Many developments all over the world have also shaped the subsequent course of events. For example, there was strong and widespread support for fiscal and other stimuli to overcome the economic downturn in late 2008 and early 2009. But by the end of 2009, proponents of fiscal austerity were successfully invoking financial market responses to the sudden increase of sovereign debt to bail out financial institutions, in order to reverse such countercyclical policies. The expansion of new financial sector derivatives in recent decades has been quite unique and probably responsible for the nature of the 2008-2009 recession. The ratio of total debt – corporate, household, financial and government – to GDP by 2008 was higher than ever before (360%), even higher than the previous peak of the early 1930s (Figure 9). It is noteworthy that the bulk of the debt increase occurred in the financial, insurance and real estate (FIRE) sector, not in the real sector (Figure 10). Whereas the real sector debt as a share of GDP remained largely unchanged in 1962-2007 (around annual GDP), the debt of the FIRE sector quadrupled to over 400% of GDP (Figure 10). Relative remuneration in the financial sector (after controlling for education, experience and the other usual ‘determinants’) in recent years was also unusually high – as high as in the 1930s (Figure 11).

The market in derivatives, which hardly existed before the 1970s, has expanded greatly. As Mario Nuti puts it, the current crisis is unprecedented due to “the unregulated degeneration of financial institutions, banks and non-bank intermediaries, the result of twenty years of hyper-liberalism. According to the Basel-based Bank of International Settlements, the global outstanding derivatives – bets on the value of assets, and bets on those bets – have been growing exponentially and reached 1.14 quadrillion dollars... By comparison, the gross domestic product of all the countries in the world is only 60 trillion dollars” (Nuti, 2009). Ironically, derivative financial instruments, designed to hedge risk, became the source of volatility themselves.

In major Western countries, and especially in the US, some financial institutions went bankrupt, while others on the verge of bankruptcy were saved by the government. As credit dried up with the financial crisis, outflows of private capital from developing and transition countries followed, adversely affecting and causing economic slowdowns in many of them. However, US ‘quantitative easing’ and other similar policies restored short-term capital inflows into many so-called emerging market economies, but the prospect of ending these policies has reversed such flows, with adverse consequences for these very same recipient economies, as in mid-2013.

Figure 9. US corporate, household, financial and government debt as % of GDP

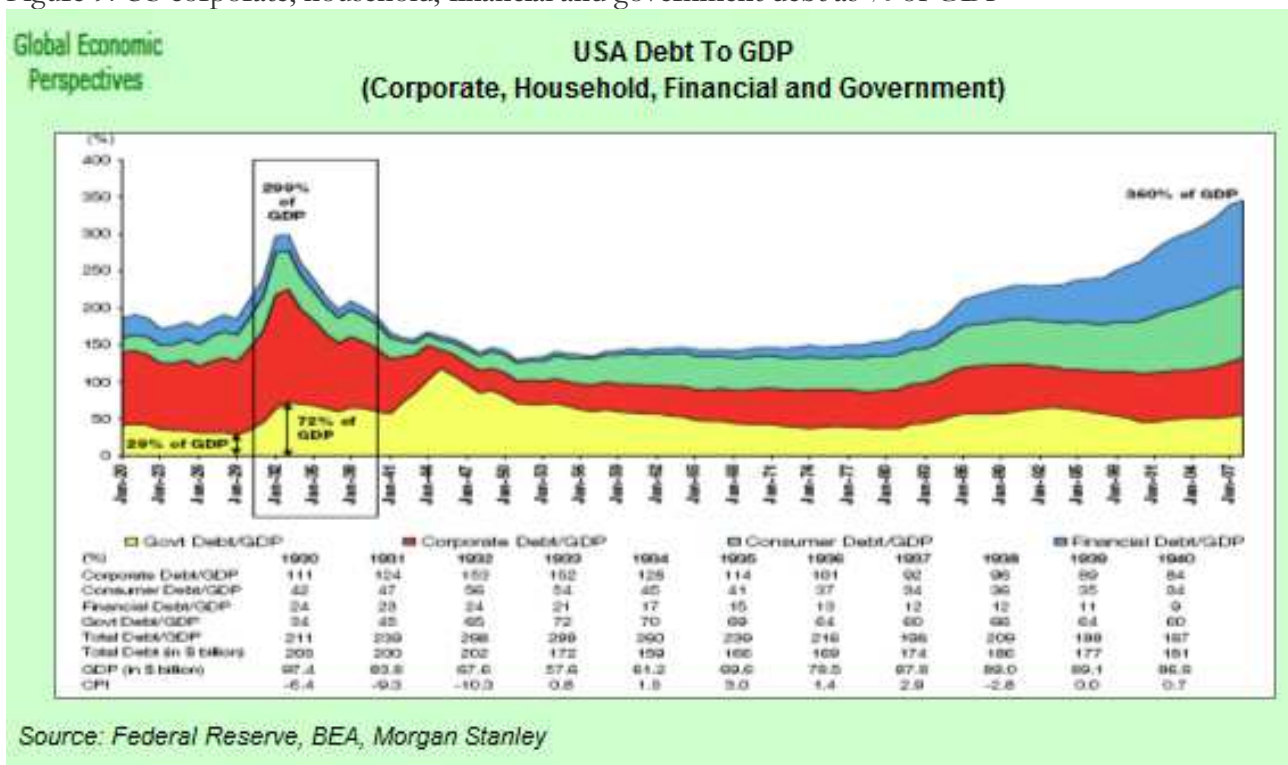
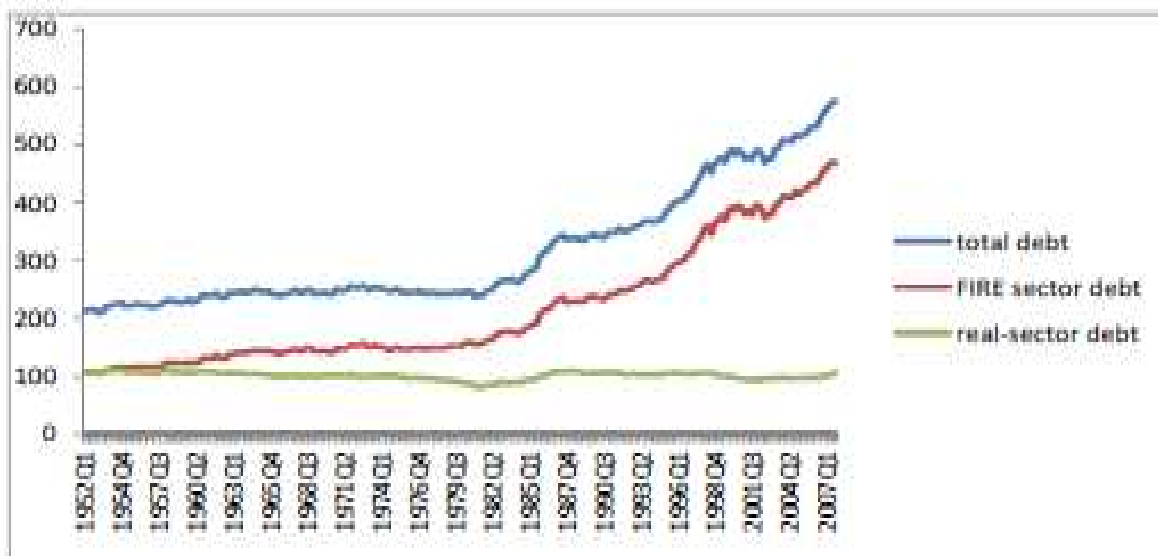
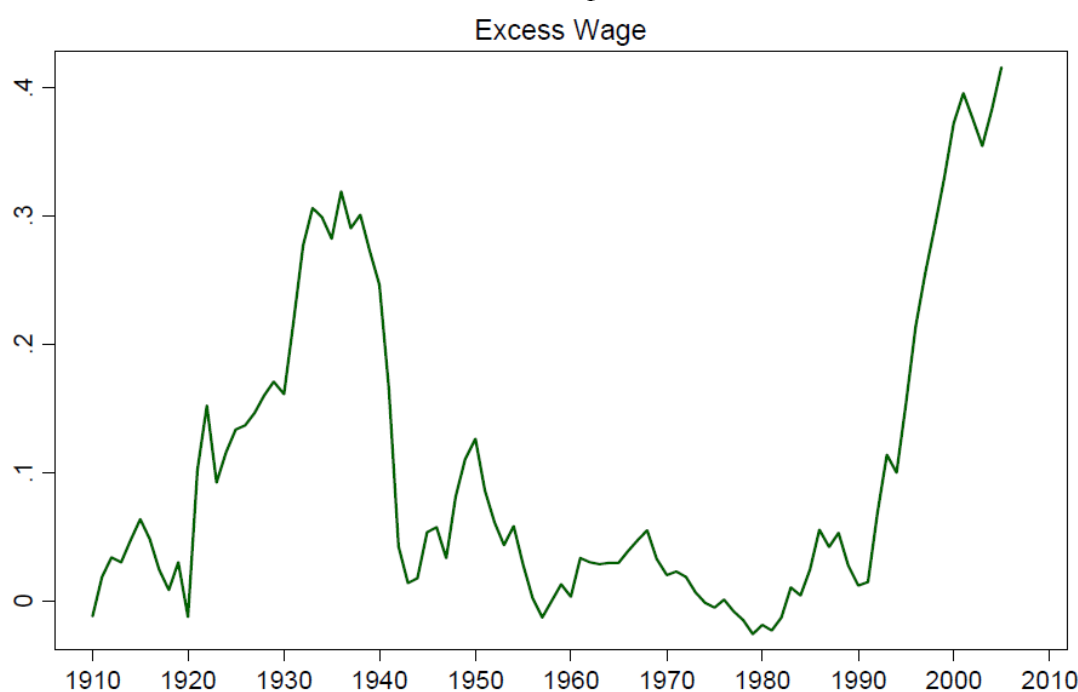


Figure 10. US private debt in the FIRE and real sectors, 1952-2007, % of GDP



Source: Dirk Bezemer and Michael Hudson (2012). Incorporating the *Rentier* Sectors into a Financial Model. *World Economic Review* 1: 1-12.

Figure 11. US financial sector ‘excess’ incomes, multiples



Source: Thomas Philippon and Ariell Reshef (2008). Wages and Human Capital in the U.S. Financial Industry: 1909-2006. December. http://pages.stern.nyu.edu/~tphilipp/papers/pr_rev15.pdf

Constraints to development

The major international constraints limiting policy space for developing countries are of two types. First, the legal commitments to rule-making and enforcement made by governments, e.g. by joining multilateral organizations such as the World Trade Organization; by signing international treaties, whether bilateral or plurilateral; and by implementing policy conditionalities associated with loan and other such agreements. Second, governments often conform to the constraining and disciplining expectations of markets, the business media, opinion-makers and others. The education, training, socialization and cultural formation of economists, lawyers and other market professionals serve to shape and define what is considered appropriate and acceptable behaviour.

The international media can also serve to discipline the behaviour of decision makers such as central bank, finance ministry or trade ministry officials. Policies or decisions can be applauded or disapproved of, inducing officials to conform or risk their reputations. Challenging the orthodoxy or “conventional wisdom” can be very difficult. For example, when Malaysia imposed capital controls in early 1998, the international financial media promised nothing but gloom and doom. Although the controls were late, they certainly did not have the adverse consequences predicted by such critics. Thus, the masters of the media, the interests they represent, and their ideological and policy preferences can effectively discipline governments, officials and policymakers.

Given the *de facto* constraints on policy space in particular, besides *de jure* prohibition of or constraints on trade protection and export subsidies, many countries have resorted to deliberate exchange rate undervaluation to achieve export competitiveness and export-led growth – a policy approach belatedly gaining some support in the academic literature (Dollar, 1992; Easterly, 1999; Polterovich and Popov, 2004; Rodrik, 2008). This is a long term effect operating through export externalities (strengthened by FDI inflows – Polterovich, Popov, 2004). In developed countries,

trade/GDP ratios are generally already at optimal levels, but this ratio is typically sub-optimal in developing countries, requiring special policy interventions to gain the benefits of externalities from exports.

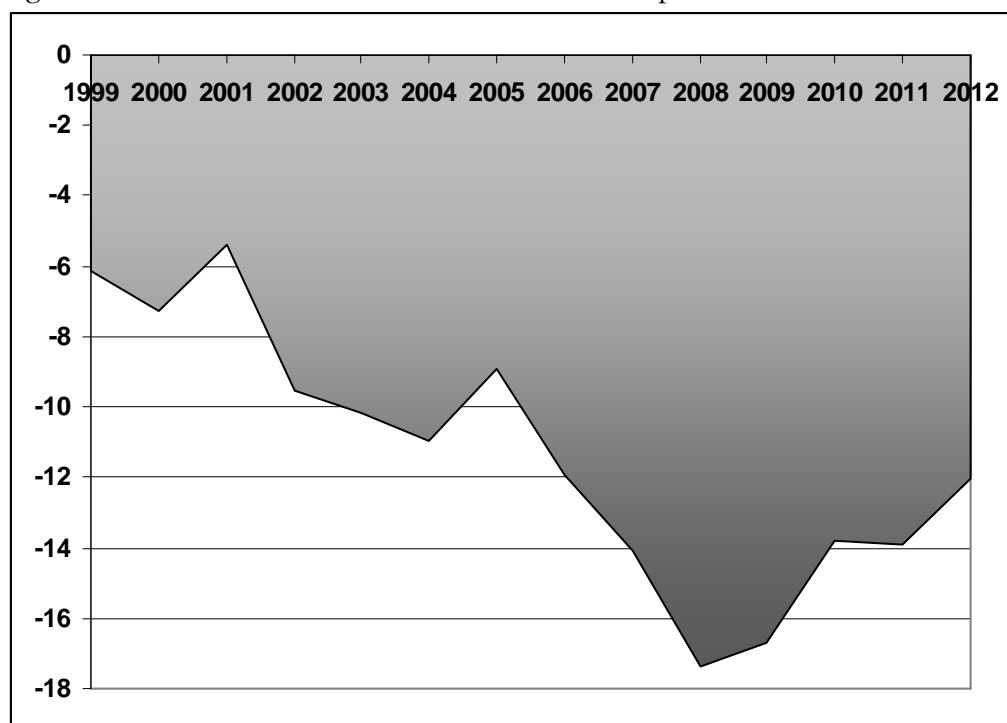
While all externalities are supposedly better managed via taxes and subsidies, selective industrial policy tools typically require a relatively clean and effective bureaucracy to successfully use these growth promoting tools. In one sense, currency undervaluation is equivalent to imposing import duties on all tradeables and providing subsidies to exporters, thus enhancing the price-competitiveness of exports. As a non-selective industrial policy instrument, it can be successfully used even in highly corrupt environments.

Accumulation of reserves means that the country saves more than it invests, produces more than it consumes, thus providing its savings to finance investment and consumption in other countries. This appears to slow down development by allowing savings to be invested abroad. According to conventional economic theory, capital should flow from rich to poor countries because K/L ratios are lower in developing countries, and hence, returns to capital are greater. However, this is only one effect which may well be more than offset by others.

Another effect is dynamic, working in the opposite direction: if a country somehow manages to become competitive in world markets (via higher productivity, lower wages or a competitive exchange rate), it exports more than it imports, developing a trade surplus. If this surplus is stored as foreign exchange reserves, the exchange rate remains undervalued and the trade surplus persists. That is why countries that develop faster than others usually have a trade surplus (the United States in the 20th century before the 1970s, Japan and Germany after the Second World War, the East Asian newly industrializing economies and China in recent decades). Accumulation of reserves (invested in reliable government short-term securities, typically yielding low interest rates) implies losses to the national economy (Rodrik, 2006), but this is seen as the price to pay for promoting export-oriented growth. Thus, reserve accumulation can be seen as a 'second-best' development tool.

The argument against this policy of reserve accumulation and exchange rate undervaluation for developing countries is the following: if all poor countries pursue this policy, developed countries would accumulate unsustainable levels of debt and the inevitable adjustment would be painful. However, even today, the debt levels of most rich countries is not that high. The US has net foreign indebtedness of about 20 per cent of GDP, the Euro zone has net international liabilities of just over 10 per cent of GDP (Figure 12), while Japan remains a net creditor, with net international assets of over 50 per cent of GDP (Figure 13, Table 1).

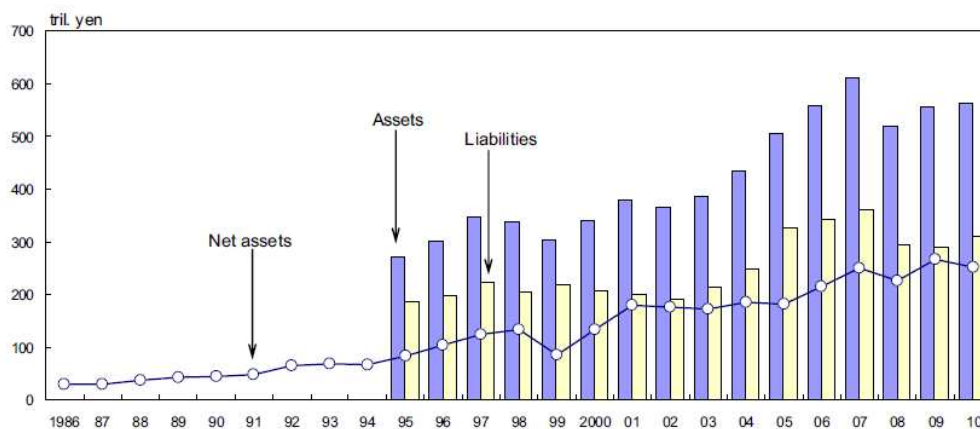
Figure 12. Eurozone 17 net international investment positions as % of GDP



Source: European Central Bank

(http://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=118.DD.Q.I6.BP_IIP_NT.PGDP.4F_N).

Figure 13. Japan: international assets and liabilities, trillion yen (direct investments at market value)



Note: Figures for 1995 and after are calculated in accordance with the fifth edition of the *Balance of Payments Manual* issued by the International Monetary Fund (IMF), while those for years through 1994 are based on the fourth edition.

Source: Japan's International Investment Position at Year-End 2010 International Department, Bank of Japan. BOJ Reports and Research papers, August 2011 (http://www.boj.or.jp/en/research/brp/ron_2011/data/ron110826a.pdf).

Table 1. Net International Assets of Major Countries

<i>Country/year</i>	<i>Net assets as % of nominal GDP</i>
Hong Kong, 2010	308.6
Hong Kong, 2007	233.6
Japan, 2010	53.5
Japan, 2009	56.5
Japan, 2008	44.4
Japan, 2007	48.5
Switzerland, 2010	136.1
Switzerland, 2008	123.2
China, 2009	36.5
China, 2008	34.5
Germany, 2010	42.1
Germany, 2008	26.2
Russia, 2009	9.1
Russia, 2007	-9.4
India, 2007	-6.5
France, 2010	-11.5
France, 2007	13.4
United Kingdom, 2010	-13.2
United Kingdom, 2008	-4.6
Canada, 2010	-16.2
Canada, 2008	0.8
Italy, 2010	-17.1
Italy, 2008	-12.9
United States, 2009	-19.4
United States, 2007	-17.7
Brazil, 2007	-38.8
Australia, 2010	-58.2
Spain, 2010	-87.1

Note: A minus sign indicates net indebtedness

Sources: "International Investment Position" from the central banks of Germany, Switzerland and Italy, as well as the statistical authorities of China, Canada and the United Kingdom. Figures for all other countries are from the *International Financial Statistics* of the IMF. Japan's International Investment Position at Year-End 2008. International Department, Bank of Japan. BOJ reports and research papers, August 2009.

(https://www.boj.or.jp/en/research/brp/ron_2009/data/ron0908c.pdf); Japan's International Investment Position at Year-End 2010. International Department, Bank of Japan. BOJ Reports and Research papers, August 2011.

(http://www.boj.or.jp/en/research/brp/ron_2011/data/ron110826a.pdf).

Of course, some developed countries (including Spain, Greece and Portugal) are heavily indebted, but others are net creditors (Germany and Japan) or modest debtors (US and UK) -- Table 1. Hence, there is still considerable room for much of the West (or North) to go into more debt. As WTO trade liberalization has left little policy space for industrial policy instruments, exchange rate undervaluation is among the few available tools for promoting catch up development. Reserve accumulation in developing countries will not continue forever as it is likely to come to an end, as they catch up. Meanwhile, developed countries get a chance to consume more than they produce and invest more than they save with such access to foreign savings (Popov, 2010).

Maintaining global imbalances could thus help close the major gap of our times – the income gap between developed and developing countries. This gap has widened for five centuries – with geography now counting more than class in explaining overall global inequality (Milanovic, 2012). Only now, in the last half century, there are signs that the gap is starting to decrease, especially with China’s resurgence. The chances of closing this gap sooner, rather than later, would be better if the West would go into debt, allowing developing countries to have trade surpluses that would help them develop faster. Previously, from the 16th to the 20th centuries, the West had developed faster, accumulating trade surpluses with “the rest”, and using these surpluses to buy assets in developing countries, as “the rest” went into debt. The proposed new arrangements can now allow “the rest” to accumulate assets as the West goes into debt.

Exchange rate protectionism is only one of many industrial policy instruments that can be used for spurring growth and promoting catch up development. It is often claimed that in countries using industrial policy for catch-up development, import substitution has led to the creation of “industrial dinosaurs” that could only survive with state support behind protectionist walls, but would go bankrupt once such protection was withdrawn. It is very easy for protected industries to become heavily dependent on and defensive of trade protection as well as other incentives provided by governments to encourage import substitution in particular sectors or industries. Rent-seeking – in responding to incentives and trying to perpetuate or increase them – can thus easily become entrenched and a long-term burden for the rest of the economy. Hence, such protected industries must be encouraged, if not forced, to become internationally competitive within a reasonable timeframe. ‘Effective protection conditional on export promotion’ (EPconEP) recognizes that for industrial latecomers, import substitution is often necessary for industrial promotion, but export competitiveness must be achieved quickly with economies of scale and quality improvements. Exports discipline industries, both quantitatively and qualitatively, as products have to be considered acceptable in terms of quality, and have to be cost and price competitive, especially to break into new markets. It is also important to ensure that ministries or agencies are able to effectively supervise and promote such industries (Sundaram *et al.*, 1997; Sundaram. and Rock, 1998; Sundaram, 2001; Sundaram, 2003).

The secret of “good” industrial policy in East Asia – as opposed to “bad” or poor industrial policy in the former Soviet Union, Latin America and Africa – may be associated with the ability to reap the benefits of export externalities. Exporting to world markets, especially to developed countries, requires upgrading quality and meeting higher technical standards. Achieving technological transformation and accelerating technical progress will yield social returns greater than the income returns to particular exporters. The gap between the actual level of development and the notional level corresponding to the degree of sophistication of a country’s exports is strongly correlated with productivity growth rates (Hausmann, Hwang, Rodrik, 2006). Thus, promoting exports of more sophisticated, high technology goods is valued more than the actual export earnings. Not all countries that try to promote such exports succeed in doing so, but those that do not try, can never hope to accelerate industrial development.

There is a great deal to learn from American history and pre-war American economic thinking. After all, the USA was the first country in the modern period to successfully wage a war of national liberation. Alexander Hamilton was responsible for conceptualizing and designing the major economic institutions for a newly independent nation. Hence, 1776 was very important symbolically, not only for marking the beginning of the Industrial Revolution and the publication of Adam Smith’s *Wealth of Nations*, but also, of course, as the year the American Revolution began.

But the United States did not take off industrially until after the Civil War. If the Southern Confederacy had won and the end of slavery had been postponed, the United States would have remained much more agrarian, perhaps more like Australia, Canada or Argentina. Instead, it rejected

free trade and promoted manufacturing through various institutional developmental measures that would make mainstream economists today cringe.

Development economics for the future?

The economic miracles manufactured in East Asia did not rely on theoretical development thinking, but rather on pragmatic experimentation. Sustained rapid economic growth and transformation in East Asia has never been profoundly influenced by grand economic development theories, orthodox or heterodox. Instead, one finds a deep pragmatism, a willingness to reconsider received ideas, whether domestic or foreign in origin. Cautious experimentation is an expression of such pragmatism, but pragmatism has also meant a focus on constraints and bottlenecks, and a willingness to address and overcome unavoidable obstacles.

One has to be cautious with the idea of powerful leaders or strong politicians being necessary. This can easily become an apologia for despotism justified by development. Rather, what has made the difference is a long-term perspective, especially a long-term commitment to development, perhaps for reasons of national pride, or even if only to preserve the status quo or to ensure regime survival by means other than repression alone. Most electoral systems tend to encourage policy short-termism, as rapid results are needed to ensure re-election, or worse still, to maximize rent capture while the political circumstances allow and the political means are available. So, the institutional reform challenge is to strengthen the incentives for developmental governance. This is precisely how the governance debate should be re-specified and reoriented.

The emergence of a distinct branch of economics known as “development economics” has had very mixed consequences. For many mainstream economists, development economics is ersatz economics. Development economics has flirted with the other social and historical sciences in ways considered to have corrupted and compromised the elegance, rigour and presumed superiority of abstract economic analysis. The emergence of development economics soon after the rise of Keynesian economics has also encouraged the criticism of the alleged dirigisme of both. The repudiation of Keynesianism from the late 1970s was accompanied by the counterrevolution against development economics. Beginning in the 1980s, many deemed it unwise, if not unnecessary, to teach or study development economics. All that was needed, it was claimed, was to apply the immutable laws of orthodox economics to developing economies.

The counterrevolution against Keynesian economics implied a rejection of parts of Samuelson’s “neoclassical synthesis” embracing “bastard Keynesianism”. But, the result was not a return to Milton Friedman’s monetarism, which had also been deemed irrelevant, but rather, a hodgepodge of new economic fads favouring economic liberalization, deregulation, the end of planning, and the strengthening of private property rights, including so-called intellectual property rights (IPRs). Thus, in the name of promoting competition and eliminating economic rents, its monopolistic antithesis has become the very basis for enhanced rentier accumulation. Hence, for instance, financial rents have become far more significant than when Keynes railed against them, while IPRs have recently become the most important basis for alleged Schumpeterian rent acquisition in the real economy.

So, while it is quite right to reconsider the microeconomic foundations of macroeconomic life, much of this is in a world of make-believe. Similarly, macroeconomic dynamics in the developing world need to be better understood, even if only as caricatures of what is happening in the developed world. After all, abstraction in economic analysis involves caricature, focusing on the most salient aspects of otherwise indistinguishable economic relations and dynamics. The most promising future for development economics lies in critical interaction with both orthodox and heterodox economics. This requires a necessary renewal of development economics, but also greater humility on the part of economists more generally, especially in understanding, informing and

addressing contemporary challenges of economic development in oligopolistic market economies at both national and global levels.

Good policies are appropriate and context dependent, and there is no ‘one size fits for all’ universal set of policy prescriptions for all types of economies at all stages of development. This broad principle may be shared by most development economists, but when it comes to particular policies, there is no consensus. Development economics should thus help explain why, in particular development contexts, some specific policies (e.g. tariff protectionism, accumulation of reserves, control over capital flows, nationalization of particular enterprises – to name a few) are superior to others.

The art of policymaking also includes knowing when to switch policies so as not to get stuck in development traps. Drawing together lessons from different experiences may reveal the interaction, sequencing and hierarchy of growth ingredients. The state can play a strategic role by providing an appropriate institutional framework, e.g. by helping to more effectively mobilize domestic savings for growth and to prevent exchange rate overvaluation. Hence, successful growth strategy – à la the East Asian tigers – seems to include, but is not limited to:

- Building strong state institutions capable of delivering public goods (law and order, education, infrastructure, health care) needed for development
- Mobilization of domestic savings for increased investment
- Gradual reforms to enhance market incentives
- Industrial policy, including tools such as tariff protectionism, export incentives, exchange rate undervaluation
- Appropriate macroeconomic policy: macroeconomic balances should be ensured in the medium to long-term. This implies consistently counter-cyclical macroeconomic policy, rather than the supposedly market-friendly pro-cyclical policies which have become the norm in recent decades. Macroeconomic policy should also be pro-development, e.g. exchange rate undervaluation through rapid accumulation of foreign exchange reserves.

What may be good for developed countries is not necessarily good for countries trying to catch up with the developed nations. In quite a number of areas, e.g. trade policy, industrial organization and exchange rate management, complete deregulation and reliance on market mechanisms has been harmful for developing countries. In other areas, such as the protection of intellectual property rights and migration controls, state intervention desired by OECD countries (TRIPS, limits on unskilled labour flows) are not desired by many developing countries. In our interdependent world, “good policies” for developing countries, whether developmental trade protectionism or controls over short-term capital flows, cannot be pursued unilaterally in most instances, without the co-operation of the OECD countries, or, at least, their acquiescence. Thus, adoption of new rules of the game more favourable to development in the South may finally accelerate growth in the developing world and make globalization “good for the poor”.

But the ability of developing countries to pursue appropriate growth strategies and to negotiate with the North for more growth friendly conditions in the world economy can be jeopardized by domestic developments in the countries involved, particularly growing income inequalities. Such inequalities are associated with various negative social consequences – from increased crime to higher mortality, obesity, psychological disorders and poorer educational attainments (Wilkinson and Pickett, 2010). Inequalities generally undermine social mobility and exacerbate social and cultural divisions: the higher the inequalities, the higher the probability that one’s income will be closer that of one’s parents (the ‘Great Gatsby curve’). Thus, the social and very often, the political structures of society become less flexible as well.

“The frequent claim that inequality promotes accumulation and growth does not get much support from history...On the contrary, great economic inequality has always been correlated with extreme concentration of political power, and that power has always been used to widen the income gaps through rent-seeking and rent-keeping, forces that demonstrably retard economic growth” (Milanovic, Lindert, Williamson, 2007).

As Joseph Stiglitz observes, “widely unequal societies do not function efficiently, and their economies are neither stable, nor sustainable in the long run...When the wealthiest use their political power to benefit excessively the corporations they control, much needed revenues are diverted into the pockets of a few instead of benefiting society at large... That higher inequality is associated with lower growth – controlling for all other relevant factors... The experience of Latin American countries, the region of the world with the highest level of inequality, foreshadows what lies ahead. Many of the countries were mired in civil conflict for decades, suffered high levels of criminality and social instability. Social cohesion simply did not exist” (Stiglitz, 2012).

Societies, both developed and developing countries, with high income inequalities are more likely than others to experience vicious circles – with poor quality institutions, lower growth, lower social mobility and higher social tensions.

In lieu of conclusions

The recent crisis has contributed to the revival of Keynesian economics, triggering a strong response from the right, which depicts Keynesianism as socialist because of its advocacy of countercyclical state intervention. While there may be limited interest in a return to the Soviet status quo ante, the current crisis, as well as growing recognition of the growth of inequality and other social problems, has revived popular interest in economic alternatives, including those sometimes, broadly speaking, deemed socialist. Nevertheless, Western societies do not seem to be clamouring for fundamental changes in economic and social policies. The Great Depression of the 1930s resulted in a significant transformation of capitalism with the New Deal, Keynesianism, the Bretton Woods institutions, and later, the Marshall Plan. But there is little evidence so far that we are going to witness a profound transformation of capitalism this time. Samir Amin famously asked in 2010: “ending the crisis of capitalism or ending capitalism?” (Amin, 2010). The answer to this question today may be ‘neither’.

For example, it still seems unlikely, so far, that finance will be much more effectively regulated following this crisis – not only internationally, but even within most national economies. Needless to say, there is still very little attention to prioritizing the interests of the real economy over those of finance. Despite the great increase in inequality in recent decades, there are no major proposals to reverse this trend. And there has been little serious effort to ensure sustainable development – continued economic development, social progress, and environmental sustainability.

Heavy borrowing to save the financial system greatly increased sovereign debt. This was then invoked to cut government spending, especially for fiscal stimuli, ostensibly to preserve credit ratings and placate bond markets. In the euro-zone and other economies in similar situations, governments could not borrow by ‘printing money’. In these and other ways, policy tools previously available to sovereign governments are no longer available. Instead, governments have had to rely on, and have become hostage to, private financial markets. There is no Roosevelt for our times, and no Cold War to catalyze initiatives such as the Marshall Plan.

Most socialist countries, that once provided alternative models of development with low inequality, have embraced capitalism, with inequality rising rapidly. Many developing countries that previously adopted nationalist or populist developmental policies have initiated market and private sector oriented reforms – economic liberalization, privatization, government down-sizing – with predictable consequences for inequality.

Also, not all dirigisme or state intervention is developmental. It could just as easily be self-serving for the leaders or decision makers concerned. And when they do not expect to survive in power for long, there is even less incentive to plan for the long term, or to be developmental. Meanwhile, checks and balances that previously forced governments to think long term have been weakened.

Some governments do not feel they need to limit unemployment, relying instead on the market mechanism to reduce unemployment by lowering wages; by this logic, lower wages will increase profits and investments that should eventually create new jobs. Keynesian fiscal and monetary expansion policies also seek to promote economic recovery through counter-cycled measures with minimal temporary setbacks in the form of unemployment, output and productive capacities. But this 'soft' Keynesian approach to achieving full employment does not necessarily restore the profit rate. Hence, the preference for putting pressure on labour with unemployment.

Not surprisingly, income and wealth inequalities in most countries – in the West, the former 'communist' economies and in the developing world – have been on the rise in the last three decades with some notable exceptions. Inequalities in the 19th century (Figure 3) were much higher than before the Industrial Revolution (Milanovic, Lindert, Williamson, 2007). Following the rise of workers' movements in the West and the 1917 Bolshevik revolution, the growing inequalities of the previous century were reversed for over half a century until the 1980s as the threat of the spread of communism inspired welfarist, redistributive reforms, giving capitalism a more human face. Such checks and balances have been greatly weakened in recent decades, even though improved economic performance in many developing countries in recent decades, including sub-Saharan Africa in the last decade, has finally contributed to some convergence of incomes between rich and poor countries.

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