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New Challenges Facing the Global Economy

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Introduction

This publication was written for a Global Political Economy course taught in business schools offering undergraduate or graduate levels of education. The textbook focuses on select countries and regions which, in our opinion, will be the most important consumer and export markets in the next two decades. Writing a short textbook intended to be relevant in any region of the world, we had two priorities. First, the authors were careful to give full respect to any national identity, religion, ethnicity, gender or individual political views. We avoid value judgments ethnic prejudice, and acknowledge fundamental rights of all people. We desire to see the world less polarized and its citizens living in peace. Second, the book strikes a balance between being practical, concise, and marginally theoretical. Considering the above intentions of the authors and the complexity of the science of Political Economy, we adopted a formula: write about what business students *must know from the start of their studies to then deepen their understanding about global political economy.* For example, significant facts from economic history, geography, politics, cultural distinctions, and demographics—these are all crucial components for conducting business in a given country or region. With this textbook, students will learn the '*must know*' factors quickly, which is essential in their careers as professionals who need to have this knowledge at hand.

Keeping global political economy content current in a textbook is a daunting task. The political and economic environment changes rapidly. Vast amounts of information pour in daily from all over the world, instantly available from many media sources. A textbook can be outdated as soon as it is published. That is why this textbook is an informational launching pad to guide business students how to synthesize information for conducting successful business.

Each country/region chapter has a "short view" and a "long view," summaries of the macrotrends as seen by the authors. This lattice is filled with more detailed explanations of connections and correlations that are then made more apparent in the text. The most important value added of this textbook is to offer explanations of the stakeholders, opportunities, constraints, and "rules of the road" in society and politics. The textbook also addresses core values, which are important to students and professionals who believe in the superiority of democracy over authoritarianism and populism, freedom of expression over censorship, the right to choose the sovereign over the rule of enlightened dictators, rights of minorities over terror of the majority, rights of the poor to break through poverty, rights of law breakers to defend themselves in independent courts.

Both authors are researchers, educators and global travelers. Ryszard Piasecki Ph.D., is Professor of Development Studies at both Polish and French schools of higher education (University of Lodz; CIFE Nice) and a former Ambassador of Poland to Chile (2008–2012) and Consul General in Brazil (1993–1998). Miron Wolnicki has received two Fulbright Awards, a German Marshall Fund award, and draws much from his experiences as a Polish émigré and a Professor at the Villanova University Business School in the United States. During many joint academic travels, we discussed writing a book for business students and are very pleased to bring this project to fruition. In this book we will take our readers on the tour with us.

The Authors would like to express their deep gratitude to the people who helped in editing of this book, especially Mrs. Marcia Geary, Prof. Wanda Dugiel, Mrs. Jolanta Hrdina-Rzezniczak, Mr. Jan Szlenkier, Mr. Michał Zaremba, Mr. Jan Woroniecki and others. Their comments were invaluable. We are also grateful for the financial help provided by the Dean of the Faculty of Economics and Sociology of the University of Lodz.

Chapter 1
The evolution of development economics and globalization

Kindleberger wrote that a theory of economic development could not be compared to a theory of economic growth, as the latter is simple, elegant and easy to explain. In contrast, theories of economic development are general, vague and chaotic – much like the mass poverty with which they attempt to come to terms (Herrick and Kindleberger, 1988, p. 48).

The legacy of the last 50 years of development economics is not very inspiring. Twentieth-century development theories focused on the choice between the market and the state as well as individualism versus collectivism but did not take into account the socio-cultural complexities of the world they were trying to model. Today's conflict of Western individualistic capitalism and liberal democracy with radical Islamic unifiers may symbolize a gap between economists wishful thinking that goals and methods to achieve it are universally accepted and understood (Kiriyenko, 2002). Undoubtedly, modern development economics must do better in understanding the different objectives and paths of growth. Additionally, it needs to tune in its paradigms and objectives to a world that is struggling to reconcile globalization with regionalism, as well as uniformization with national identity. For the first time since its inception, development economics is on the verge of becoming a valid social science, in which the analysis of traditional institutions, community life, religious and ethnic factors is not only important, but also decisive in developing new social and economic growth objectives and economic models. (Piasecki, Wolnicki, 2004).

1.1. The birth of "development economics" as a discipline

After the Second World War, there was widespread interest among economists in finding solutions to the poverty and underdevelopment left behind by the disintegrating colonial system. Despite controversial legacy of Stalin's economic model in Russia, faith in the benefits of planning and nationalization became common even among "Western" economists. Works on economic planning by two Polish economists, Michal Kalecki and Oskar Lange, and one Russian, Vladimir Kantorovitch, served as standard readings for many students of economic development. In the 1950s and 1960s, development economics was a breeding ground for alternative theories "to wasteful, exploitative capitalism." While it was categorized as a sub-discipline of economic science, development theory was reminiscent of "political economy" with a very distinct shift to the left. Gradually, the discipline produced more literature concerning economic development in areas outside the Western and Soviet camps. Sauvy is generally credited with coining the term "Third World," which he first used in 1952 on analogy with the so-called "third state" of the pre-Revolutionary France – that is, social groups other than clergy and aristocracy. The term fit well for developing countries that either did not want to associate with either camp or preferred to play East-West confrontation to their advantage (Roy, 1999, p. 3).

Generally, theories of development in this period originate in two theoretical and philosophical schools of eighteenth- and nineteenth-century European thought. Though both concern the wealth of nations, they differ fundamentally on how growth should be achieved and how its benefits should be distributed within a society. For classicists and neo-liberals, the interests of nations and social classes are compatible and harmonious, while for Marxists, dependists and radicals; a definite conflict of classes and interests exists, requiring either radical social engineering or revolutionary change (Black, 1999).

Thus the literature on economic development is generally categorized by different degrees of attachment to the "market" and mechanisms for creating "just prices," different approaches to the international economy, and, above all, different evaluations of the role of state in the economic life (Herrick and Kindleberger, 1988, pp. 48–61). The main groups of theories were:

- Neo-classical theories of economic development (including the work of such economists as: Peter Bauer, Theodore Schultz, James Meade, Gerald Meier, and Henry Bruton).
- Theories of structural imbalance (Hollis Chenery, Jeffrey Nugent, and others).
- Radical and Marxist theories of economic development (Paul Baran, Gunder Frank, Vladimir Lenin, Samir Amin, Gabriel Palma, and others).

Until the 1980s, a score of developing nations experimented with non-market theories and concepts, but with rather limited success. Brazil, India experienced a few years of non-sustainable growth in the 1960s. Unfortunately, none of these countries could match the successes of those that chose the mixed economy and the market system in 1990s. (Piasecki, Wolnicki, 2004)

1.2. The crisis of "development economics" in the 1980s

By the 1980s, against many prominent economists' expectations, development had not materialized in the Third World – with the exception of the Gulf nations. Even in countries such as Qatar, Kuwait, and Saudi Arabia, where significant growth was observed, employment gains were generally unsatisfactory. Everywhere else in the developing world inequality and poverty grew. In addition, inflow of capital and Western consumption standards challenged traditional sectors and the existing power structures. As a result, tensions between modernizers and Islamic traditionalists heightened. According to various estimates only 10–25 percent of windfall revenue following the oil crises was used for development purposes. This was one of the problems that "development economics" was not prepared to solve (Bruton, 1985). Hirschman (1981) wrote that the hopes for Third World growth cherished by economists in the 1950s and 1960s had been lost. Streeten (1984, p. 121) was equally pessimistic when he wrote: "at the end of the day we must admit that we do not know what causes underdevelopment, and, what is worse, we lack a clear plan and timetable for further scientific research."

The disappointments of the mid-1980s spurred a debate between adherents of neo-classical model, such as Ian Little, Anne Krueger, Deepak Lall and others, known as "the World Bank group," and the Brandt Commission group, which included structuralists, dependists, neo-institutionalists and others. According to the World Bank group, stagnation in the Third World had to be blamed on a bad price system, misallocated investments, and wrong choices in production technology (Stewart, 1987). While the Brandt Commission group did not fully reject this neo-classical critique, they attributed the stagnation more to failure of the state's industrial and price intervention policies than to the incompleteness of the neo-liberal economic model. According to the Brandt Commission group, there was no proof that a free price system could lead to better welfare than a system based on price intervention. As Streeten (1984, p. 143) wrote, "a good price system does not mean the end of the economic development process, although it is obvious that a bad price system can totally hinder economic development." Finally, the Brandt Commission group was convinced that it was impossible to trigger development processes without state intervention. The Asian pro-export growth strategy of the late 1980s lent strong support to their claim.

A common characteristic of development theories before the 1990s was a conviction about the advantages of industrial policy and state trade strategy. Economists and politicians praised the effects of subsidies and state-business cooperation in establishing export industries, price intervention, and protectionism. In a way, this opinion was consistent with the prevailing economic notion of the post-war era – that the nation-state was to be strong and active in promoting economic growth. The concepts of the indispensability of a powerful government and interventionism originated in the legacy of post-colonialism and the critique of the developed countries. Political and intellectual elites presented the opinion that gaining independence in early 1960s did not mean gaining economic independence, after all. The "First World" capitalist countries would not open markets to agricultural imports or provide enough capital to modernize the "Third World" struggling economies. Thus, Latin American economists, worried about the declining terms of trade, advised minimal reliance on world markets, the creation of government monopolies in banking, transport and other key industries, and import substitution. South East Asian countries, on the other hand, saw a chance to develop the export sector and open their economies to foreign investments. The theory of development focused on describing the benefits of state control over key sectors of national economy. A pro-active nation-state became the focus in India, Mexico, Chile, Argentina, Brazil, Indonesia, Malaysia, and South Korea.

A big shift in development economics started in the mid-1980s, and the Latin American debt crisis had no small role in the re-evaluation of the old developmental paradigms. After the failures of economic policies in Mexico, Brazil, and Bolivia, it was obvious that massive borrowing alone would not solve their problems; a new approach was required. In addition, development economists became more skeptical, and even cynical, in their evaluation of the motivations of politicians and the competence of bureaucrats. The politicians were criticized for being mostly concerned with their own political survival, and the governments for mainly representing the interests of small but influential pressure groups (Balasubramanyam and Lall, 1991, p. 12). Governments became a problem, rather than a solution. At the same time, more and more development economists argued for free, deregulated markets and limited interventionism (Lall, 1983, p. 109).

What caused the growing dissatisfaction with the role of once omnipotent governments in the development process? The answers are many:

- In many poor countries, the governments failed to address even the most fundamental social-economic problems, such as education, illiteracy, health, water supply, and transportation. These governments came to be mistrusted as their administrations turned out to be parasitic and corrupted – that is, run by "cleptocracies."
- Foreign aid mainly benefited the ruling elite, not the poor and needy. The fragile political/ethnic consensus in many African countries collapsed as the governments revealed their inability to cope with national emergencies such as drought, disease control, and ethnic strife.
- National and religious identities were revived in the poorest Asian nations in the face of governmental failure to cope with poverty, drug trade, health catastrophes, and famines. (Piasecki, Wolnicki, 2004)

1.3. The rise and decline of neo-liberals

The shortcomings of traditional development models were particularly obvious during Latin America's "lost decade" of the 1980s. Mounting debt, inflation, and negative growth in all but one of the region's economies sounded the final death knell for "import substitution" and the "independencia theorem." On the other side of the Pacific, export-driven growth, inflow of technological foreign direct investments, and fast industrialization in Malaysia, Indonesia, and Singapore armed the liberal lobby of Washington's think-tanks and the World Bank group with new convincing arguments, and a list of liberal reform guidelines known as the "Washington consensus" was born. The "consensus" carried the unequivocal message that a free market and open economy supported development far better than any form of protectionism and state interventionism. However, not all development economists agreed, and an ideological rift ensued. While the majority seemed to accept a neo-classical model, a sizable group of "leftist" structuralists disagreed.

During most of 1990s the Washington consensus dominated the theory and practice of economic development. This entailed tough fiscal and monetary policy, deregulation, foreign trade and capital flow liberalization, elimination of government subsidies, moderate taxation, liberalization of interest rates, maintenance of low inflation, and so forth. The proponents of these comprehensive liberal reforms strongly believed that the "miracle of the market" would eventually solve the problems endemic to underdevelopment. A special role in this process was attributed to global corporations and the inflow of foreign direct investments to low-cost developing economies.

In the 1990s, the theory and practice of development economics turned to the analysis of export promotion, trade-related industrial policies and models of optimal state-business relations (Piasecki, 1998, pp. 39–51). According to the representatives of a new school of thought, economic development depended on the following conditions:

- the opening of national economies to the outside world;
- synergy with the world market in order to obtain optimal allocation of resources;
- international competition; and
- the social acceptance of the objectives and methods for the economic growth.

The policy implications for developing countries in the area of foreign trade were truly fundamental. Governments shifted from either neutral or negative assessment of interaction with the world markets (for example, in the dependency school of the 1970s) to acceptance of free trade and unrestricted flow of capital as the most important means of overcoming structural underdevelopment (Piasecki, Wolnicki, 2004).

The classic comparative advantage trade theory by David Ricardo (Ricardo, 1911) was rejuvenated as a new development paradigm. While classical trade theory advocated specialization and gainful trade between the developed and developing countries, foreign trade became, in the new paradigm, both the means to assure optimal use of land and labor resources and the source of technologically advanced industrialization. The post-Ricardian trade theories predicted that specialization in labor- and capital-intensive goods would bridge enormous wage gaps between the poor and rich countries, sparing the latter from massive labor immigration. The theories developed by Hecksher, Ohlin, Stopler, and Samuelson offered, among other things, theoretical explanation of welfare effects for displaced workers in developed countries, as well as the benefits of factor price-equalization on a global scale. At the same time, the international trade literature made strong arguments denouncing the effects of state protectionism (Gerber, 2002).

1.4. The limits of the "Washington consensus"

The second half of the 1990s, beset with financial and currency crises, proved that the openness strategy advocated by the Washington consensus had its limitations. The South East Asian currency crises of 1997–1998 showed that the combination of fixed exchange rate regimes and a large inflow of foreign investment could be very risky for macroeconomic stability. Indonesia, Malaysia, Singapore, and Thailand seemed to have gone through similar cycles of economic overheating. It started with demand-driven inflation, real currency overvaluation, current account deficit, and outflow of currency reserves, and finally ended with nominal currency devaluations and a recession. These crises might have been averted by timely currency refloating and tighter fiscal and monetary policies. Many of the liberal reformers chose to blame external causes, such as currency speculation, globalization, the IMF, and the World Bank, for their own mistakes.

The Washington consensus was critiqued in the post-communist countries of East Central Europe as well. After the market reforms and four to five years of rapid growth in early 1990s, Poland, the Czech Republic, Hungary, and Slovakia experienced an unexpectedly hard landing in the second half of the decade. Rising unemployment, currency devaluation in the Czech Republic, and growing budgetary and current account deficits encouraged criticism of "foreign capital" in the banking, financial services, retail and power generation sectors. Notably, however, none of the ruling post-communist coalitions had ever advocated deconstruction of their market economies, and instead they all continued with privatization and vigorous pursuit of membership in the European Union.

Several authors who evaluated the relevance of the Washington consensus to the realities of economic development in Asia, Central Europe, and Latin America in the 1990s were convinced that it had some significant omissions. One of the fundamental lessons learned by the countries pursuing large-scale privatizations in 1990s was the issue of competition. In countries where liberal reforms were limited to the exchange of state monopolies for private monopolies, market reforms failed. This was because many small- and medium-sized businesses either disappeared or were not given a chance to grow during the large-scale privatizations. Decontrolled prices quickly rose and popular support for the reformers waned. Before any positive effects of reforms were felt, the reformers had to step down. In Argentina, Chile, and Bolivia, new private monopolies in trade, transportation, and banking first eliminated competition, then raised prices, then reduced their tax payments to the government. Stiglitz (1998) observed that the neo-classical concentration on creating "just prices" is not sufficient to support a functionally sound market economy. The insufficient emphasis on competition in the Washington consensus may be one of its main weaknesses.

Another significant criticism of the Washington consensus concerned its lack of attention to effective legal-institutional infrastructures. The problems encountered in Poland, Russia, and the Czech Republic proved that, in addition to political will, large scale privatization requires a clear and transparent body of laws: land deeds registry, stock registry, tenant-owner laws, consistent contract laws, a valuation system of loan collaterals, and so forth. These laws and institutions make the true difference between successes and failures of market economies and influence broad popular support for liberal reform-minded governments.

For example, Hernando de Soto argued that the root cause of Latin American underdevelopment is the absence of land deeds and legal titles to property. Since the squatters of poor Latin American favelas could not collateralize their houses and businesses, they could not take advantage of the banking system, which requires proof of ownership. Consequently, the poorest of the poor were unable to obtain bank loans to expand their businesses and raise their income no matter how hard-working they might be. Billions of *reals*' worth of potential value was not created in Brazil and millions of houses were not mortgaged or built because the most fundamental bank service was not available to the poor. Moreover, poverty became endemic because family members inherited undocumented property (de Soto, 1991).

Less-than-perfect information represents even a bigger problem in applying a market system in developing countries than in developed ones. Since access to information in poor countries is limited by cost considerations and communication technology, price transparency and rationality cannot be assumed as given (Piasecki, Wolnicki, 2004). Not surprisingly, some neo-liberal economists outside these countries could not agree on many aspects of micro- and macro-management in developing countries, such as:

- the use of capital controls;
- the need to target the current account;
- anti-inflationary measures in the fast-developing market;

- the use of income policies and indexation;
- the level of the tax burden and the degree to which governments should be involved in the redistribution of income;
- the use of industrial policies;
- the priority of population control; and
- the priority of environmental conservation.

1.5. Globalization and economic development

By the mid-1990s, the advances in international trade and investment looked like undisputable proof of the validity of neo-liberal model. It seemed no wonder that the concepts of "openness" and development through "globalization" and "regional integration" became new development paradigms. Economists studied the opportunities offered by "outsourcing," "special economic zones," free trade agreements, and regional integration. NAFTA was intended to become a model solution for the Americas. Emblematic of that period was the ministerial session of UNCTAD in Midrand, South Africa in 1996. Globalization was equated with "democratization" of world economic growth, a historic opportunity, which converged the interests of the poor and the rich nations. This new optimism contrasted with the pessimism of the 1980s, when only one-eighth of the developing countries could report some economic and social growth.

The shift in development economists' opinion on "globalization" came around the time of the currency crises in South East Asia in 1997 and 1998. These crises particularly influenced opinion because countries that were rather well integrated into the world economy, such as Indonesia, Malaysia, Singapore, and Thailand, suffered most. Devaluations, interest rate hikes, and stock price crashes turned the average 6–7 percent annual GDP growth of the early 1990s into a deep social and economic crisis. In Indonesia, for example, unemployment and poverty grew to levels not experienced in two decades, health conditions worsened, and the natural environment degraded.

According to the Secretary General of UNCTAD, the two causes of the South East Asian crises were: "excessive openness to the world economy" and "inability to manage this openness" on the part of the South East Asian governments. Rucipero recounts that, after the liberalization the 1990s, the trade deficit of those countries was three percentage points of GNP higher than it was in the 1970s, while their average economic development growth rate was lower by two percentage points. In his opinion, globalization failed to assure sustainable economic growth in the developing countries (Rucipero, UNCTAD, 1999). Others simply blamed globalization for deepening vertical and horizontal income inequalities. Special criticism was reserved for those neo-classical economists who talked about wealth "trickle down" effects.

From the beginning, the term "globalization" meant quite different things to different people (Streeten, 2001). The 1998 winner of the Nobel Prize in Economics, Amartya Sen, defined it as the "intensification of the process of interaction involving trade, migration and dissemination of knowledge that has shaped the progress of the world over millennia" (Gerber, 2002, p. 33). Globalization, understood as international economic integration, did not give rise to much emotional reaction among development anti-internationalists. However, the "collateral dependency" that this process has brought has definitely become an issue for "globalization." First, the number of nations dependent on trade, foreign capital, and the world financial markets increased greatly. Second, multinational corporations increased their bargaining power vis-a`-vis nation-states. Third, global and intercultural communication resulted in challenges to tribal, theocratic, and non-democratic systems to provide more individual and economic freedoms. Fourth, the World Trade Organization emerged as a powerful multilateral organization capable of effectively influencing individual governments to follow international trade rules, copyrights, policies on subsidies, taxes, and tariffs. Nation-states could not break the rules without facing economic consequences. Fifth, widespread use of computers, faxes and mobile phones, introduction of the internet and e-commerce, and quicker and cheaper means of transportation in some cases offered opportunities to developing countries, but in many cases deepened the gap between global firms and traditional industries (UNCTAD, 1999, p. 30).

The opinion on globalization among the development lobby shifted from euphoria to ardent criticism. Violent anti-globalist protests during the December 1999 Seattle World Trade Organization meeting and again in April 2000 in Washington provided evidence of a growing and vocal international lobby demanding the reform of the International Monetary Fund and the World Bank.

The facts were hard to dispute. The world economic system, which 80 percent of countries regarded as failing to give them a fair chance to improve living standards, was no longer viable. It is estimated that only 20–25 percent of the world population directly benefits from globalization, and for the rest the benefits are marginal or nonexistent. Only 1.8 billion people out of six billion can afford the goods and services available on the world market. Only half of those lucky ones are within the reach of the banking system (de Rivero, 2001, p. 82).

The real issue is how to ensure jobs and a better quality of life for the almost three billion people today earning less than two dollars per day and for the two to three billion people to be added to the world's population over the next 30 to 50 years. Reaching this goal, while taking better care of our environmental and social assets, requires a different global development strategy than the one followed in the past (World Development Report, 2003). Is globalization, as we know it, offering a chance to achieve these developmental goals? (Piasecki, Wolnicki, 2004).

1.6. Critique of globalization theories

The relations between globalization and development are neither straightforward nor palpable. A good illustration of its complex make-up is the relation of a nation-state and a global corporation:

- In theory, developing countries can use general or specific industrial and trade policies to be more or less "welcoming" to foreign direct investments, capital, foreign tourist services, and so forth. They can directly and indirectly shape their participation in the global economic system. In practice, however, with few notable exceptions, developing countries were passive in structuring their own participation in international trade and finance. In practice, the end decision and the net economic effect of their "openness" to globalization was beyond their control. During the negotiation of costs and benefits between the nation-state and a global corporation, the first was often in a weaker bargaining position.
- In theory, the nation-state and a global corporation should cooperate in addressing social and environmental challenges that directly affect their foreign direct investments. In some cases, the divergent goals of multinationals and local governments were successfully brought together to solve the educational, housing, environmental and health problems of a local community. In practice, however, the recent experience in Latin America has been that many such open-handed multinationals moved their operations to, for example, China or South East Asia because of cost and market considerations.
- In theory, globalization opened up new opportunities for developing countries to create jobs and expand exports. In practice, many developing countries competing for foreign investors offered longer tax holidays, costly subsidies, and various incentives for multinationals. The competition among developing nations reduced positive net effects of globalization or, at best, delayed them.

According to critics such as de Rivero, the key problem for the global economy is, on the one hand, the deepening of the gap between the more dynamic and complex world of international finance and investment, and, on the other hand, the absence of a relevant institutional system capable of management and effective control over those processes.

What was the role of international organizations in solving developmental problems? Most of the critics are quite unforgiving. The development experts, they claim, have wrongly assumed that it was enough to put a correct program into practice and poor countries would, not now but "eventually," catch up with industrialized countries. Many of the worlds' most influential economists reinforced this rather simplistic approach. As a result, many poor countries espoused unrealistic expectations and demands only to end up deeply disillusioned. This type of wishful thinking is evident in numerous UN resolutions on "the right to development," interpreted as the right of poor countries to obtain the standards and models of consumption of the industrialized countries. These resolutions, which were also important for political propaganda, were not just divorced from reality, but unfeasible. If all developing countries reached today's level of consumption in the industrialized world, global environmental catastrophe would be imminent (de Rivero, 2001, pp. 110–114). For example, since 1982, the UN tried to implement 162 adaptation programs in Africa and 126 programs in other developing countries. After twenty years of subsequent developmental experiments, Africa entered the new millennium as the continent with the most highly dysfunctional and marginal national economies lingering outside the global economy (UNCTAD, 1993, pp. 163–167).

Severine Rugumamu concludes that in the twenty-first century the position of the African continent in the world economic system will probably continue to worsen in the short- and middle-range perspectives. (Piasecki, Wolnicki, 2004). Its economic growth will be slow and sometimes even negative; terms of trade and debt crisis will worsen; areas of poverty will increase. Simultaneously, the population will grow, and deadly diseases will spread (Rugumamu, 2001, p. 77).

1.7. The "misery" of a traditional development economics and the opportunities for a modern development economics

What caused the "misery" of traditional development economics? We think that the main reasons are as follows.

First, "development economics" limited the scope of its research mainly or exclusively to economic factors. It is accepted nowadays that development economics, in particular, should cover the whole range of both economic and non-economic developmental factors.

Second, many economists applied economic concepts that were totally inadequate to the realities of developing countries, such as industrial unemployment, skill levels measured by years of formal education, or naively adopted biased or inaccurate statistical data in their research.

Third, "development economics" did not do enough to grasp country-specific developmental factors. Instead, it excelled in advocating sweeping replacements of a traditional sectors with the modern, more efficient ones. The process of sector replacement was supported by propagating foreign cultural models in media, educating the elite abroad and yielding to demonstration effects. Development strategies recommended costly, modern solutions, abandoning long-established less costly production methods and market structures. Thus, lack of domestic and foreign capital was considered to be the main obstacle to growth and the "capital shortage" hypothesis dominated development economics for many years (Piasecki, Wolnicki, 2004).

Fourth, in recent decades, development economics held a simplistic view of the fundamentals that govern the theory and practice of development. This view holds that growth requires two things: foreign technology and good institutions. Failure to grow can be attributed to either (or both) of two pathologies: the "protection" pathology, in which governments stymied progress by reducing access to foreign investment and technology, and the "corruption" pathology, where political leaders failed to respect property rights and the rule of law (Rodrik, 2002).

Traditional development economics failed to resolve a number of important issues for developing countries. For example, what effects does specialization have on economic growth in the long run? The resolution of this issue is vital in discussions of globalization effects on developing countries. Advocates of deep specialization argue that it does not matter whether a given country specializes in raw materials, agriculture, or electronic production. The developmental impact would be equally positive in all cases. However, the empirical evidence has been that the spillover effects may vary significantly depending on the type of specialization. Generally, the levels of technology used make all the difference. What is more, the world demands different types of exports; for example, raw material, agricultural and electronic production grow at different rates. Thus, overly narrow specialization in some developing nations (for example, mono-cultural ones) can lead to high levels of dependence on weather cycles or demand in major import markets. The issue of specialization risks requires particularly careful analysis in the context of recommending an export-driven growth model for developing countries.

Modern development economics needs to address the issue of rational decision-making process and human psychology. Explaining underdevelopment as the absence of rational market behavior, as some development theories did, was simply incorrect. What seemed irrational to some economists could have been explained by lack of information, high costs of entry into a given market (transaction costs), problems with obtaining loans, insurance costs, new technologies acquisition, lack of marketing skills, lack of access to markets, and so on. A comprehensive analysis of human behavior, underlying religious beliefs, ethical standards, and ethnic traditions in developing countries may prove to be very significant for putting the theory of development to a new, higher level than it is at today.

Another key point for development economics is that all development models are, by necessity, country-specific and nation-specific. Discovering what works and what does not in any one country requires experimentation. After all, what may succeed in one setting may perform poorly or fail completely in others. It seems that this simple truth took decades for development economists to acknowledge. Such specificity helps explain why successful countries – China, India, South Korea and Taiwan, among others – usually combined unorthodox elements with orthodox policies. It also accounts for why important institutional differences persist among the advanced countries of North America, Western Europe, and Japan in areas such as the role of the public sector, the legal system, corporate governance, financial markets, labor markets, and social insurance (Piasecki, Wolnicki, 2004).

1.8. Conclusions

Development economics is trying to take a broader and longer-term view of development processes – happily, no one is proposing quick fixes. Remarkably, "globalization," which in the past was regarded as a universal panacea for the poor nations, is not even once mentioned in the World Bank's World Development Report (2003). Contemporary development studies more often include interaction between economic, social and environmental problems to identify that could be handled locally, internationally or globally. This is because the solutions to specific problems are in inclusive societies and institutions that promote growth by encouraging creativity, initiative, and learning. These initiatives may come from the public sector, the private sector, or the civil society. The objective of fighting poverty is not to wait for the creation of a brand-new sector, but to modify the traditional sector so that it becomes naturally viable, dynamic, and flexible, suited to the needs and ambitions of the traditional environment.

Quite often the past failures of "development economics" were attributed to the blind imposition of "Western" modernization schemes on the societies, whose traditions, values, habits, social strata, and concepts of economic activity were fundamentally different. This type of mismatched modernization scheme proved to be costly, unsustainable, or both. Unsuitable economic models rekindled ethnic and political conflicts and contributed to regional destabilization. "Western" institutions replicated in developing countries were ineffective and the resources used to create them often wasted. Theories on import substitution, nationalization, collective farming, subsistence production, and central planning were revealed to be divorced from the realities of developing countries – culturally alien and economically unviable. Many of these theories reigned too long only because of bureaucratic and corruptive manipulation. In the final analysis, the development theories that either totally abandoned neo-liberal paradigms or tried to transplant them fully to developing countries contributed little or nothing to the development of poor countries.

Is then the neo-classic "development model" proposed by the developed countries moribund? We believe that the neo-classical hopes for the poor countries have not been fulfilled yet. The limited success of the Washington consensus showed the failure of "one size fits all quick fixes" for developing and emerging economies countries (Fine et al., 2001). How, then, should the Washington consensus be modified and restated? We propose following amendments:

- A more sustainable development path is possible only in a socially inclusive society. It enables the society to transform and solve collective action problems. The neoclassical dimension of this process is the formulation of policies to stimulate local initiatives and local responsibility for job creation, environment, and education.
- The civic society and the local institutions should be very sensitive to removing impediments to the creation of markets and supporting legal and financial institutions.
- The approach should focus on the issues and processes that underpin human life and the nation's wellbeing, improve the quality of the environment, strengthen the social fabric, and improve educational standards. In particular, the investments in human capital have fundamental importance to successful development in the long term.
- The development will be sustainable only if there is a flow information and mechanisms assuring absorption of such information. The market system requires informed participants.
- Wherever there are market imperfections, state intervention should be market- and competition-friendly.

Finally, we believe that the neo-liberal economic model of global market openness, if not distorted to serve selected interest groups, is basically culturally and politically neutral: it is not Western or Eastern, American or European. Even though globalization is often presented as the source of inequality, alienation and interference in the traditional social fabric, it is, de facto, the most inclusive system there is. Any type of internationalization of production, distribution, and consumption will affect the way in which people live or strive today in the poor countries of the world. The debate about the globalization pros and cons and different growth models will continue among development economists, but a true verification of any policy choices they offer will be whether or not the lives of three billion people improve in the future (Piasecki, Wolnicki, 2004).

Chapter 2

Review of international economics

2.1. The balance of payments

There are no closed economies in the world today. All countries have trade and financial exchanges with the outside world. **The Balance of Payments (BOP) is the accounting record of all monetary transactions between a country and the rest of the world. Theoretically, the BOP is always zero at the end of the fiscal year** (Krugman, Obstfeld 2018) International Economics: Theory and Policy. The BOP has three components: the current account (CA), the real estate capital account (KA), and the financial capital account (FA). In an algebraic format:

$$BOP = CA + KA + FA$$

The current account has four components: export (X), import (M), interest income, and the unilateral transfers.

CA = (X – M) + balance on interest income + balance on unilateral transfers

Export of goods and services(X) shows in the CA as **credit** because it earns foreign currency for the home country. The revenue from export defines the supply of foreign exchange or foreign currency (FC) in the Foreign Exchange Market (FOREX). For example, the USD in Shanghai FOREX is a commodity, as is any other currency, and the yuan (RMB) in New York is also a commodity, as is any other currency.

Import of goods and services (M) shows in the CA as **debit** because it costs money to buy them from foreign countries. The cost of import defines the demand for FC in the FOREX.

Interest income is the third component of the CA. For example, if GE builds a turbine factory in India and sells the turbine made in India to Thailand, it will generate profit from the sale. It is interest income on capital investment in India.

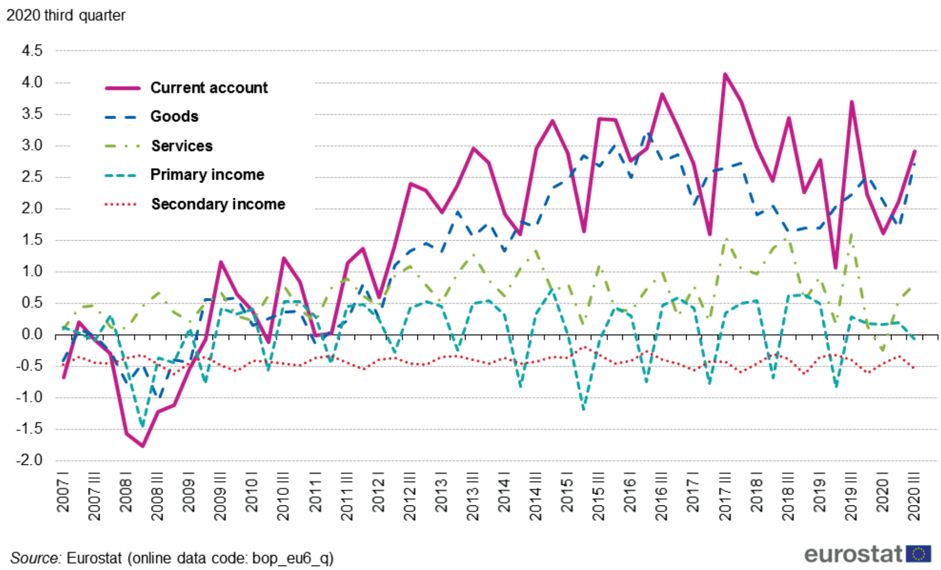


Chart 1. Balances of EU-27 current account main items as share of GDP(%).

Source: https://ec.europa.eu/eurostat/statistics-explained/index.php?title=File:Balances_of_EU-27_current_account_main_items_as_share_of_GDP_(%25)_2020_third_quarter.png [accessed August 1, 2020].

If the profit is transferred back to the United States, it will be recorded as interest income or credit in the US CA.

If Honda Motor Corp. sells more cars from its factory in the United States and decides to transfer profits back to Japan, it will be recorded as a debit in the US interest income on capital invested by the Japanese in the United States. But if Honda Motor Corp. reinvests profits in the United States, nothing will happen in the US CA because there was no financial transfer across borders.

Now, the reality check. Because the corporate income tax in the United States is higher than in Ireland, Apple, Inc., keeps some $90 billion from their global sales and profits in Ireland, and the US CA is lower by $90 billion than it should be. Like Apple, Inc., hundreds of US global companies keep their profits (interest income on capital) abroad. Also, thousands of foreign companies owned by China, Saudi Arabia, Russian oligarchs, and others keep their profits in the United States. Many foreign citizens, businesses, and governments keep their investment income in the United States, so US investment income is not debited.

The fourth component is **unilateral transfers**. These are, for example, US government payments to the International Monetary Fund (IMF) or the World Bank (WB), or simply Social Security checks sent to US citizens who retired to Costa Rica, Mexico, or the Caribbean.

The real estate capital account (KA) is a balance of the migrant money, the forgiven debt, and the real estate transactions of the government. Real estate is regarded as fixed capital. KA records the money that migrants (noncitizens) send to their home countries. Debt forgiveness or buying and selling embassies or military bases must also have a record in the BOP. KA is insignificant for the BOP if we assume in our future analysis that KA = 0.

The financial capital account (FA) is a record of the government, corporate, and private financial transfers to and from foreign countries. We present the FA as:

$$\mathbf{FA = Mk - Xk}$$

Mk is the import of financial capital, and Xk is the export of financial capital. Mk is a credit, and Xk is a debit. When there is a net outflow of capital, we can assume that the country has less capital at home to go around.

Now, let's analyze all possible cases. The BOP must be 0 at the end of the accounting period, and two possible cases can fulfill this condition:

- Because BOP = 0, when X > M, Xk > Mk or CA > 0 and F < 0,
- we say that a country is a net exporter of goods and a net exporter of capital.
- Because BOP = 0, when M > X, Mk > Xk or CA < 0 and F > 0, we say that a country is a net importer of goods and a net importer of capital.

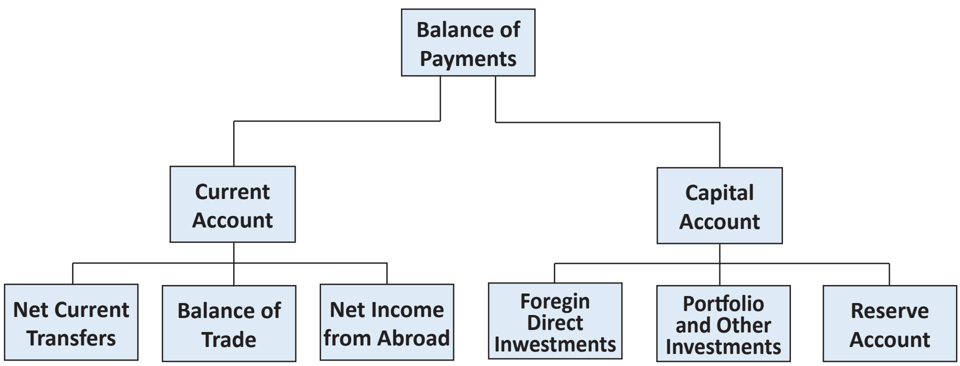


Chart 2. Balance of Payments.

Source: Own elaboration.

For example, the United States' current account deficit (CA < 0) in 2006 was equal to 6 percent of GDP, or \$600 billion (easy to remember!). That tells us that the financial account surplus of USA (FA > 0) had to be, barring some statistical error, plus \$600 billion. Moreover, it tells us more about the financial reality of the USA position in the world. The United States had to import \$600 billion of foreign savings or foreign financial capital from the world. This conclusion is fundamental to understanding that the United States is not only a net importer of goods but also a net importer of capital.

In 2018, we had a net import of some \$500 billion in foreign capital, based on the projected current account deficit being around CA = –\$500 billion. The average CA deficit of the United States between 1968 and 2018 has been CA = –\$49 billion.

Between 1980 and 2010, we imported a total of $8.1 trillion of foreign savings, or about 60 percent of the 2010 GDP.

You may think it's not too bad of a deal. We can import cheap foreign goods from other countries instead of making them at home at higher cost and import financial capital from the world to pay for them! The problem is that we must pay interest on the capital we borrow from other countries.

The BOP of the USA

The United States has a surplus on the financial capital account FA > 0 because the Mk >Xk. The United States is a net importer of foreign capital (foreign savings) for three important reasons (Roberts, 1995):

First, the United States must offset the current account deficit. We will use the analogy of a credit card. If you had dinner in a restaurant and spent $50 on your credit card, your bank paid for your dinner. You owe the bank $50, which you will pay back with interest. If the United States had a $500 billion net import bill in 2018, foreign banks paid the bill. The United States owes the amount of the bill along with the interest.

Second, in a macroeconomic sense, US private savings (Sp) are zero. Americans do not save, so the American economy must borrow savings from other countries to have enough investments, which are always financed by savings, not consumption.

Third, the United States government is running a budget deficit and a large public debt. The public debt is financed by IOUs or Treasury Bonds. Foreign countries central banks, pension funds, and individuals buy US Treasury Bonds. If they did not buy them, interest rates and taxes would rise at home.

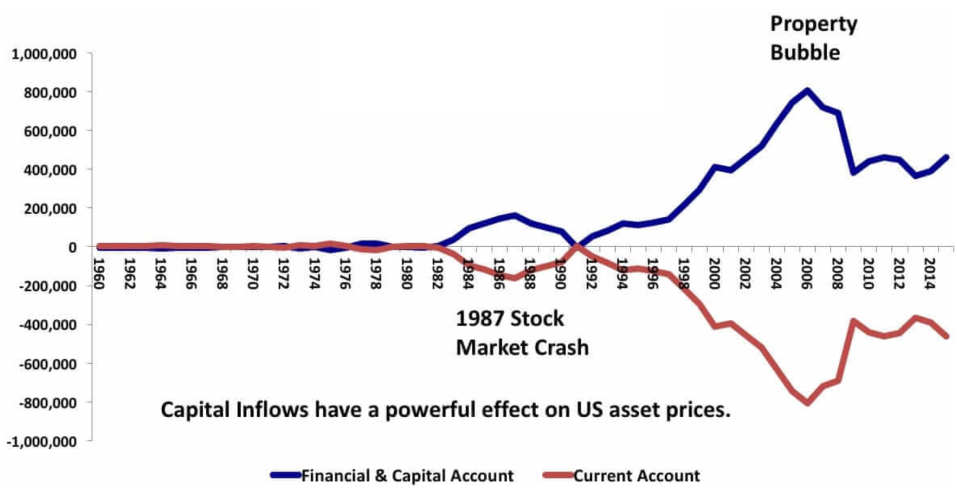


Chart 3. US Balance of Payments The current Account =The Financial and Capital Account US$ millions, 1960 to 2015.

Source: https://www.bea.gov/ [accessed September 1, 2020].

The BOP of the PRC (China)

The People's Republic of China (PRC) is a mercantilist country to the extreme. The PRC ran a CA surplus averaging + $360 billion from 1998 until 2014, reaching an all-time high of almost $1.0 trillion in 2008. However, China's current account surplus has slipped from 10.3 percent of its GDP in the third quarter of 2017, to just 0.4 percent in the third quarter of 2018. In 2019, the current account deficit could be only 0.3 percent of its GDP and widen to 0.6 percent in 2020 (IMF 2019).

The PRC has been the world's largest exporter of capital so far. China is still a poor developing country and is exporting capital. Some will ask, why, with 1.34 billion people waiting to raise their standard of living, has China put more than half of its estimated reserves of $3.8 trillion in US Treasury Bonds funding the US public debt and the government deficit of the richest country in the world? Shouldn't they put all the earnings from their exports into their own economy?

Here's the answer why that's impossible, in the short run at least (Jacques, 2012):

First, monetizing or converting such gigantic dollar trade surpluses into RMB (renminbi is abbreviated **RMB** or indicated by the yuan sign **¥**) would create havoc in the PRC's macroeconomics. An out-of-control increase in the money supply would lead to inflation. Inflation would be followed by demands for higher wages and would become hyperinflation.

Second, wage and resource hikes would increase the costs of production and end China as a low-cost producer, leaving millions of unemployed. China would be in a situation similar to Africa, where there are no jobs in manufacturing.

Third, the price of the dollar in RMB would drop. The RMB would appreciate, making Chinese exports expensive and its export surplus disappear. China must turn its dollar export surpluses into reserves of the People's Bank of China (PBOC). The PBOC must buy US Treasury Bonds and underwrite Chinese government projects in Africa and Latin America. It must act in the best interests of China's state-owned economy. The Chinese communist leaders may not like American capitalism, but they must cooperate with the United States at least for now.

Fourth, the appreciation of the RMB against the dollar means a loss of reserves. For example, for every $1,000 of reserves they had in 2018, that meant 6,950 RMB in reserves at the exchange rate of Rn = 6.95 per dollar. If the RMB appreciated, for example to Rn = 4.95 RMB, the $1,000 reserve would be only 4,950 RMB. That's why the PBOC is charged with the task of reducing the appreciation of the RMB against the dollar.

In 2018, the PBOC conducted a massive repurchase of dollars from exporters in FOREX, paying a higher price per dollar in RMB than the market was willing to pay—6.95 RMB per dollar. This is called currency intervention in China and currency manipulation in the United States.

Chart 4. Current Account and Trade Balance (as a Percent of GDP).

Source: State Administration of Foreign Exchange (SAFE) of the People's Republic of China, World Bank and author's calculation [accessed September 1, 2020].

We criticize Beijing's policy, but from its national economic policy perspective, currency manipulation serves the country's best interests, even if it's not the best policy for maintaining global equilibrium.

World trade is a zero-sum game. For every country with a trade surplus, there has to be a country with a trade deficit. China works against global equilibrium, but that's how the Chinese government operates. The PBOC sold $25 billion from its reserves to prop up the dollar and weaken the RMB to stop it from hitting the mostly psychological barrier of Rn = 7.0 RMB per dollar.

The recent RMB devaluation caused tensions for China, as the United States is against strict currency control and the other Asian nations are having trouble competing against China's artificially devalued RMB. The tariffs imposed on Chinese exports have added incentive for China to devalue the RMB even more. It's obvious that in the long run the Chinese government will try to reduce its dependence on the dollar. What is China doing to achieve this goal (Harris, 2018)?:

- China is seeking oil trading arrangements with its major suppliers, including Russia, Saudi Arabia, Iran, and Venezuela, which will involve the exchange of national currencies.
- China uses barter arrangements; that is, its offsets select countries debts with which have strategic interests by getting paid in national currencies assets like ports and maritime transport facilities, land leases, and agricultural goods (Greece, Sri Lanka, Bangladesh)
- The government says it has been relying more on domestic consumption than exports, but so far there's no evidence of this. China's consumption represents only 32 percent of the GDP and is lower than in India and Brazil. The depreciation of the RMB suggests China is still aiming to rely on competitive exports overseas more than domestic demand for growth.

In the fall of 2015, the International Monetary Fund (IMF) added the RMB to the list of world reserve currencies, though RMB transactions are still 3–5 percent of world trade, compared to the dollar, which still accounts for about 75 percent. China still has a long way to go to be less dependent on the dollar, the US market, and exports.

2.2. The future of the US current account deficit

How did the US current account look in the past?

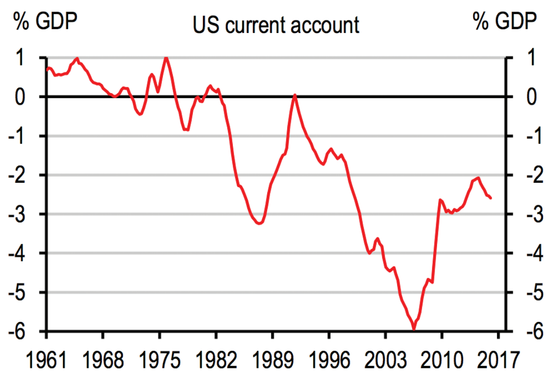


Chart 5. US current account.

Source: US current account deficit likely to resume widening [in:] Bussinesinsider.com<https://www.businessinsider.com/current-account-global-imbalances-financial-crisis-growing-again-2016-9?IR=T>. [accessed August 1, 2020].

How does the CA deficit create capital import (FA > 0)?

Imagine that a buyer is importing a car from Germany that's shown in a BMW dealership. It's not the most expensive model, costing about $40,000, but because Americans don't save cash to buy cars, we usually take out a car loan. The buyer will apply for a car loan from his bank or any other bank or financial institution that offers car loans. The loan is to be paid off in four years, and the payments include the principal plus interest. The financial institution that approved the loan issues a check to the BMW dealer, and the happy new owner drives off the lot.

The dealer asks the BMW head office in Germany if it should wire the check for the car to Germany. The answer is no. BMW asks the dealer to deposit the check into BMW Financial, which is a US-incorporated financial institution, or any US financial institution of its choice. It is German money, German financial capital that will finance the purchase of the next BMW in the United States.

At this moment, the United States has imported $40,000 in financial capital from Germany, and Germany has exported $40,000 in financial capital. This transaction will be recorded in the US FA as Mk = +$40,000 and in the German FA as Xk = –$40,000. Now multiply this by the number of BMWs, Mercedes Benzes, and Porsches imported annually from Germany, and all the foreign cars imported to the United States. It really doesn't make much difference if the cars are assembled in US plants from foreign parts; however, it makes a difference in terms of jobs and wages created in the United States. Foreign capital invested in the United States is always good, but we need to remember that it generates profits for foreign owners of capital. That's why we should save more money rather than always using loans to buy everything (Chart 6).

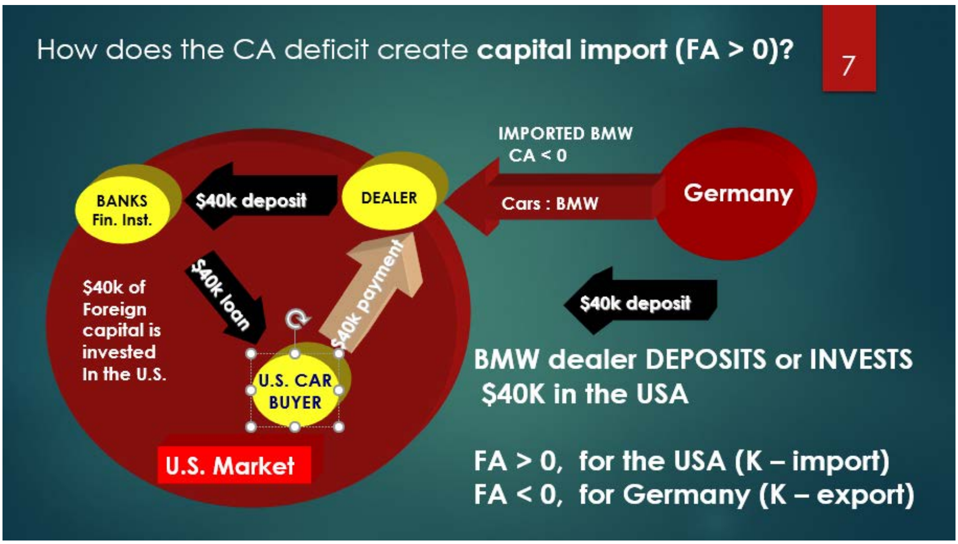


Chart 6. How does the CA deficit create capital import (FA>0)?

Source: Own elaboration.

Well, some of you will say at this point that it's not such a bad deal. If we can import cheap foreign goods from other countries instead of making them at home at higher cost and import financial capital from the world to pay for them, it shows that we have a pretty good business sense as a nation! Also, one must admit that we're getting a pretty good deal. The United States is supplying 75 percent of the liquidity to the world's payments.

But let's be more precise. The dollar is the world trading currency, and there's a difference between financial capital and dollars used to pay for imports (Further: Krugman, Obstfeld, 2018).

The dollar is a medium of global payments. Any other nation, except for the United States, must earn dollars to buy a barrel of oil from Saudi Arabia or Iran.

China must assemble iPhones or make Nikes, Brazil must export orange juice, and Italians must rent out hotel rooms in Venice and sell Maserati's. Only the United States can roll the printing presses with greenbacks or see the Fed reduce the discount rate and watch the dollars start rolling in. We get an interest-free loan from the world when we pay with a supply of new dollars. It's called seigniorage (Neumann, 2014).

Let's go back to the financial capital, which is "imported" foreign savings or, more precisely, money invested by foreigners in the United States (FA > 0). When we import financial capital, it earns an interest rate that's not ours but foreign. In the long run, this can amount to a lot of money.

Foreign financial capital invested in the United States generates profits for the Saudi family and the Chinese communist government. They are the big investors in US Treasury Bonds. When the interest or profits are reinvested here, they create even more profits for China or Saudi Arabia. Having foreign capital in the United States is not bad, but if we don't reduce CA deficit and stop using other countries' savings to feed financial system with foreign profits, it's not going to look pretty for us at all. The United States will become a place where profits are generated for other countries, not for US citizens. We need to make this simple statement to make it easier to understand more complicated problems later in this chapter.

How are other industrial countries different from the United States?

We will use the United States and Japan to illustrate the difference. We'll use the following standard notation (see Charts 7 and 8):

Tx – Taxes paid on income
Yd – Disposable income, money left after paying taxes
Sp – Private savings, money that is not spent on consumption (Yd = Sp + C)
C – Consumption, money spent on consumption, if Yd = C then Sp = 0
M – Imports, money that people spend on imported goods
CA – Current account
FA – Financial capital account
I – Investments, money spent by corporations on job creation, new plants, and new technologies
G – Government spending, budget spending (G > Tx) – Government budget deficit (Tx – G) – Net government saving

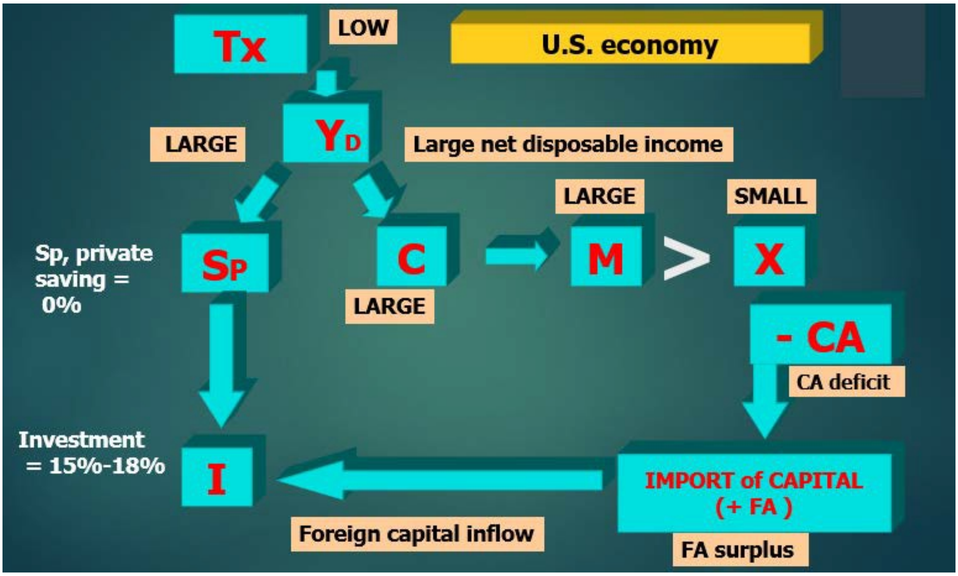


Chart 7. US economy.

Source: Own elaboration.

The United States has a low personal income tax (PIT) compared to other industrialized countries: the maximum tax rate is 32 percent in the United States, whereas the average maximum tax rate in EU countries is 50 percent or more. American after-tax disposable income is large, but we have very small savings—zero most of the time. The US disposable income is spent on consumption: Yd = C.

US import costs include resources, for example, Canadian and Mexican parts for the cars we assemble, but mostly consumer goods. US imports are greater than US exports, but also US import of capital is greater than US export of capital. In macroeconomics terms, we pay for our home capital investments using imported capital. To fully understand the scale of US dependence on foreign capital, we have to say that US government needs an inflow of foreign money to balance the government budget (G > Tx). In terms of the macroeconomic equation it is: (Tx – G) + I + Sp = (X – M).

How are we different from Japan? Japan will serve here as an example of an export-driven economy. Compare charts 7 and 8.

The most important distinction is the source of business investments (I). In the United States, business investment is financed mostly by imported capital, whereas in Japan, it's financed by private savings (Sp). In the United States, Sp is close to 0. In Japan, Sp is about 20 percent of Yd.

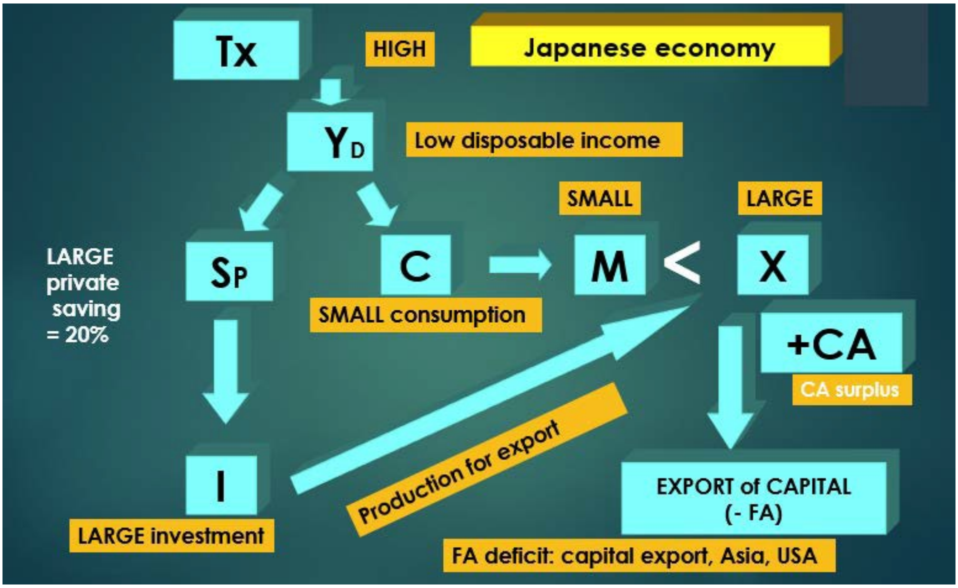


Chart 8. Japanese economy.

Source: Own elaboration.

Why does the United States need to import capital?

First, capital import is necessary to balance US international position as a net importer (CA < 0 and FA > 0). We are net importers of goods and capital. That means we depend on the willingness of other countries to use their savings in the form of buying US assets and stocks and bonds. Foreign central banks create their reserves by holding US Treasury Bonds and US Treasury Bills among other assets.

Second, private savings (Sp) in the United States are too small. US households do not generate an adequate pool of savings to pay for business investments (I).

Third, the US government runs a budget deficit (G > TX). The US Department of the Treasury issues bonds to cover the deficit. Bonds are purchased by foreign banks and individual investors.

What would happen if foreign countries and banks did not buy US Treasury Bonds?

- The Treasury Department would have to raise the return on bonds to sell them at home. That would mean higher interest rates, more expensive mortgages, etc.
- The US Congress would need to introduce higher taxes on corporate and household income.
- Corporate investment would be lower, and fewer jobs would be created.
- Generally, the living standard and growth in the United States would both be lower.

Who owns US debt?

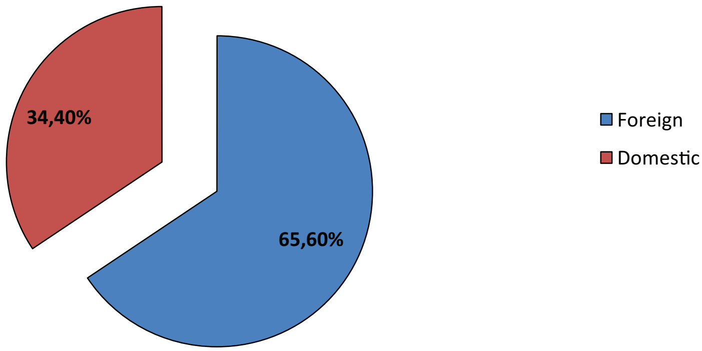


Chart 9. Allocation of US Debt.

Source: Own elaboration based on Financial Report on the United States United States Government FY 2016 <https://www.fiscal.treasury.gov/files/reports-statements/financial-report/01112017FR-(Final).pdf>[accessed August 1, 2020].

- For example, in 2016, US government (public) debt reached $19 trillion. Of that total, 34.4 percent was held by foreign countries. These are the largest holders: China, Japan, Belgium, the Caribbean banking centers, and oil exporters (Chart 9).In the fourth quarter of 2018, close to 41 percent of US government spending was financed by foreign savings ($71 billion).

What are the potential problems with having a large foreign- owned debt?

- We pay interest to the foreign debt owners from the current government budget. We have less money to spend at home on job creation and new technology industries. A large portion of US tax revenues go to foreign countries and markets.
- We are running the risk of a hostile "fire sale" of US Treasury holdings and a dollar devaluation. If this happened, the dollar would lose its role as a world reserve currency and payment currency, and we would lose the ability to borrow more money.

Why do foreign countries want to spend their savings in the USA?

- The United States has a strong strategic (military) position in the world.
- US GDP represents 22 percent of the world GDP.
- We supply 70 percent of the liquidity (dollars) for world trade and about 63 percent of world reserve money (government reserves).
- We have low inflation.
- We enjoy the rule of law (a judiciary independent from the Executive Branch and free elections).

Is a large CA deficit bad for the economy?

- It is undermining the value of the US currency.
- It makes the United States dependent on foreign capital.
- The government and Congress don't feel the pressure to balance the budget and increase tax revenues.

Expenditure-reducing policies: The situation suggests reducing demand in the economy, that is, G, I, and C. For example, have higher taxes and higher interest rates to decrease the government deficit. In practice, this would not be a good idea because consumption demand generates 70 to 73 percent of US GDP.

Expenditure-switching policies, for example dollar devaluation, as well as increased trade protection that renders imports more expensive, would be another option. We do not want to manipulate currency like China, and the rise of protectionism will also reduce US exports.

Supply-side policies, for example, increasing labor market flexibility, and improving education, is a preferable option. This is good advice, but it takes a long time and money to accomplish.

What would be the best policy to reduce the CA deficit?

All of the following suggested solutions can be accomplished through the tax system, government incentives, and legislative incentives, not government subsidies or protectionism:

- Promote high-tech and energy-saving technology to developed countries.
- Promote export of consumer technologies and US brands to countries with an emerging middle class.
- Promote service export. The United States is a net exporter of financial, managerial, medical, construction, computer, research, and education services.
- Increase savings at home and reduce the government deficit.
- Develop robust trade diplomacy.
- Increase productivity through education and R&D support. We have a $4 trillion college debt and very few loans offered to attend vocational schools.
- Create incentives for US corporations to bring profits back to the United States and invest in the US economy.

According to a study by the Fed Bank of St. Louis, the United States has been on the right track since 2009 (Chart 10).

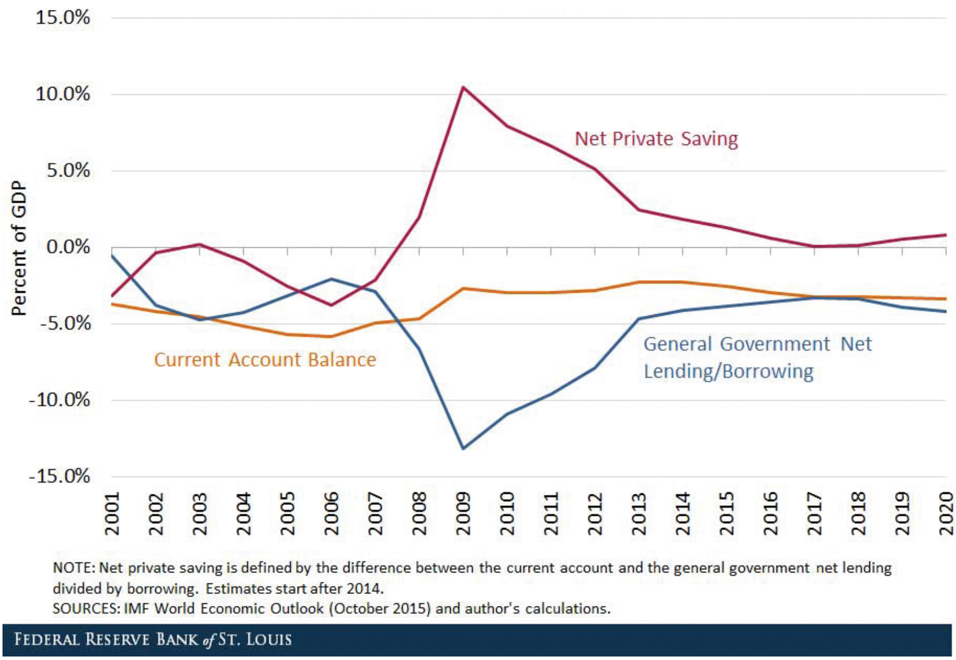


Chart 10. US Current Account.

Source: US current Account https://www.stlouisfed.org/on-the-economy/2016/march/how-has-current-account-us-changed [accessed August 12, 2020].

2.3. Exchange rates

In finance, a nominal exchange rate Rn (also known as a foreign-exchange rate or forex rate), between two currencies is the rate at which one currency is exchanged for another (Salvatore, 2013). The notation for nominal exchange rate is Rn.

$$Rn = HC / 1\ FC$$

HC – home currency
FC – foreign currency

The Rn is a price paid in home currency (HC) for one unit of a foreign currency (FC). If we pay less for a unit of foreign currency, Rn is decreasing, and the HC is appreciating. When we pay more HC for a unit of foreign currency, Rn rises, and the HC is depreciating. That is why the charts that show Rn on negative slope show HC appreciation, and Rn on a positive slope show HC depreciation. That is why we say that Rn slopes are counterintuitive.

The quotes in the US are always in US currency, for example, Rn = \$0.9433, and the same quote made in Paris would be Rn = €1.06. It is because 1/Rn (US quote) = €1.06).

Today, currencies are valued against each other. This means that when the dollar appreciates, it does so against all other traded currencies. In the earlier **"gold standard"** which dominated from mid-nineteenth century until the 1920s, the currency's value was set by the **gold parity or the weight of gold per unit of currency**. Under the "gold standard," countries could change individually the price of gold, and their currency could appreciate or depreciate without an automatic adjustment of exchange rate to other currencies. That's why many countries were tempted to manipulate the gold price to promote their exports.

Spot currency rates (R) and forward currency rates (F)

Rn is the quotation for the currency retail price. In the foreign currency market (FOREX) transactions are usually for more than \$1 million dollars. In such case the currency value quoted as either the **spot rate (R)** or a **forward rate** (F). **The spot rate** is a daily rate and the forward is for a specific day in the future; for example, 60, 90, or 180 days from now or practically on any day in the future.

A **forward rate** is particularly useful in foreign trade. If a company knows the future due day of a payment in foreign currency it has two options. One, it can purchase foreign currency spot on the due date and take transaction risk or, two, it can buy foreign currency in the forward market and avoid transaction risk. Most of companies chose the second option (Krugman, 2018).

The spot and forward rates are also important for commercial banks to decide how much money they should put into **currency trading** as opposed to **foreign bond markets.**

Notation:
ih – return on home bond
if – return on foreign bond
R – spot rate
F – forward rate

International commercial banks invest their money at the capital and currency markets. The arbitrage between the two markets, is described by the <u>interest parity equation</u>: ih – if = (F – R)/R. The left side of the equation, ih – if, shows the return in international bond trading and the right side, (F – R)/R, the return in the currency trading for the same period, so called SWAP transaction. We will use the interest parity equation later on to explain the relation between the interest rate differentials between two countries and the exchange rates.

Appreciation, depreciation, and the current account

When HC depreciates (Rn rises):

- Export prices decrease. The home price is unchanged, but goods are less expensive for foreign buyers.
- The quantity of exports rises.
- Export revenues (X) rise.
- Import prices rise.
- The quantity of imports decreases.
- Import cost (M) decreases.
- The Current Account rises or the deficit decreases (CA > 0).

When HC appreciates (Rn decreases):

- Export prices increase. The home price is unchanged, but goods are more expensive for foreign buyers.
- The quantity of exports decreases.
- Export revenues (X) decrease.
- Import prices decrease.
- The quantity of imports increases
- Import cost (M) rises.
- The Current Account decreases or the deficit increases (CA < 0).

Most countries would like to increase their revenue from exports and decrease the cost of imports. That's why governments are tempted to depreciate or devalue their currency. This race to competitive devaluations was one of the causes of the Great Depression. Today, countries with large exports try to reduce their currency appreciation.

Open markets (economies) behave according to the laws of economics. The currencies in countries with a current account deficit want to depreciate, and countries with a current account surplus want to appreciate, their currencies. Market forces show up in foreign exchange markets (FOREXs). For example, because the United States has a large CA deficit with China, according to the laws of economics, the FOREXs in Shanghai and New York should show dollar depreciation against the RMB or RMB appreciation against the dollar.

Let's assume that the People's Bank of China does nothing to manipulate the market (intervene). Does that mean that China and the United States would reach a balanced trade? This is only a very theoretical assumption. Many other factors would not make US CA = 0 or X = M. The most important are cost of labor, trade barriers, cost of transportation, subsidies to export firms, and availability of resources, among many other factors.

Would the US CA deficit disappear if the United States decided to depreciate (devalue the dollar) against all currencies, including the RMB? The answer is no. When the home currency is depreciated (devalued), the CA gets worse in the first three to six months then temporarily improves, and in 12 to 24 months, the CA deficit returns. Price elasticity of demand for imports and exports is low in three to six months, then it improves, but competition in foreign markets wipes out the price advantage in 12 to 24 months. This was described by the Marshall-Learner condition known as a J curve. From both the theoretical and practical point of view, the currency manipulation critique is fully justified.

Determinants of Exchange Rates (Krugman, 2018)

- The Current Account
- Inflation
- Interest rates
- Central bank intervention at FOREX
- Current events
- The international position of the country

The current account

When the current account is in deficit (CA < 0), the home currency wants to depreciate. When we say "wants," we mean the underlying economic market forces are present in the FOREX, but it is not necessarily taking place because other factors are involved.

When the current account is in surplus (CA > 0), the home currency wants to depreciate. When we say "wants," we mean the underlying economic market forces are present in the FOREX, but it is not necessarily taking place because other factors are involved.

Inflation

Exchange rates are determined by home and foreign inflation. Here's an example under the conditions of the floating exchange (no currency control):

Rn* – expected Rn

Rn* = Rn x (Ph/Pf) (Note: The Pf is the denominator.)

Rn – current nominal exchange rate

Ph – home country inflation

Pf – foreign country inflation

Ph > Pf – home currency depreciates, Rn* > Rn

Rh < Pf – home currency appreciates, Rn* < Rn

The expected nominal exchange rate Rn* over time will respond to the relative prices of comparable goods in HC and FC, which is captured by published national price inflation rates. *The Economist* has its own rule of the thumb measure called a Big Mac currency index. *The Economist* compares prices of Big Macs in two countries. If the price of a Big Mac rises faster in country A than B, currency A is expected to depreciate against currency B. There is some truth to this measure because Big Macs are very comparable goods across countries, and the official inflation rates often are not very accurate or are calculated for different periods.

Example:
We are calculating Rn* for the Mexican peso based on the relative inflation rate between the United States and Mexico. (The peso floats against the dollar.)
Rn = 5 pesos (quotation in Mexico, in pesos). Mexican inflation is 12 percent (index 112). US inflation is 2 percent (index 102).
Rn* = 5 x (112/102) = 5.4901
Rn* (5. 49) > Rn (5.00)

The peso will depreciate because Mexico has a higher inflation rate than the United States.

Example:
Although most countries float their currencies, a few countries create pegs to dollars, the euro, or a basket of currencies. These pegs are intended to increase stability between trading partners and may remain in place for decades. For example, the Hong Kong **dollar** has been pegged to the **US dollar** since 1983, and Denmark's **krone** has been pegged to the **euro** since 1982. In 1997, the Thai baht was fixed to the dollar. We refer to countries with a peg as having a **fixed exchange rate regime**. In the early 2000s, Argentina also had a peg to the dollar.

In countries with fixed exchange rate regimes, different inflation rates across countries may lead to **currency appreciation or depreciation in real terms**. To be more precise, there will be a difference between the nominal official value of the currency as defined by the government peg and the real purchasing power in the foreign market. In such cases, economists calculate the **real exchange rate or Rr** (only in the case of a currency peg).
Rr = Rn x (Pf/Ph) (Note: The Ph is in the denominator.)
Rn – pegged, official exchange rate
Ph – home country inflation
Pf – foreign country inflation
Rr > Rn – home currency is depreciated in real terms
Rr < Pf – home currency appreciated in real terms

Let's assume that the Argentine government has fixed the dollar at Rn = 36.0 pesos/$. There's an identical shirt that costs 360 pesos in Buenos Aires and $10 in New York. Argentinean inflation is 40 percent, and US inflation is 0 percent. Now the shirt costs 504 pesos (360 x 1.4 = 504 peso) in Buenos Aires. Instead of buying the shirt at home, Argentineans will convert 504 pesos at the official peg and get $14 (504/36 = $14). This is enough to buy the same shirt in NYC and have a bonus of a small burger for $4! The peso has appreciated in real terms against the dollar (Rr < Rn) because it has higher purchasing power in NYC than in Buenos Aires.
Rr = Rn x Pf/Ph
Rr = 36.0 x (100/140) = 25.7
Rr (25.7) < Rn (36.0)

This happened in 2001 in Argentina. Many Argentineans attempted to convert the peso to dollars and bought foreign goods with the dollars. The Argentine Central Bank reserves of dollars were depleted, and Argentine government defaulted on some $90 billion foreign debts.

The similar situation happened in Thailand. In 1998 it sparked the Asian Currency Crisis which affected many countries of the region. Countries which can't control their inflation should never peg their currency to another currency; rather, they should keep it free floating.

Interest rates

Exchange rates also depend on government interest rate policy. For example, central banks must adjust interest rates relative to their forecasts about the economic business cycle, inflation, or deflation. Changes to interest rates in one country are not coordinated with other countries unless they are bound by a monetary union. For example, all members of the eurozone follow the directions of the European Central Bank (ECB). Differences in the interest rates or bond rates between countries will change their spot and forward trading rates and generally the nominal exchange rates, Rn.

Let's look back at the earlier described interest rate parity equation: ih – if = (F – R)/R. We will analyze how rising interest rates (bond rates) affect the spot rate R (the predictor of short-term Rn) and the forward rate F (a predictor of Rn on a date in the future).

i $ – interest rate in the United States, bond rate in the United States
i € – interest rate in the eurozone, bond rate in the ECB
R – spot rate, the wholesale exchange rate on large transactions quoted daily
F – forward rate, the wholesale exchange rate quoted daily with the delivery at a specified future date

When i $ > i €, then F > R (The R in the denominator is removed to simplify the equation.)

The capital will move from the eurozone to the United States. This will appreciate the dollar against the euro in the short run (R decreases) and depreciate the dollar against the euro in the long run (F increases).

When i $ < i €, then F < R

The capital will move from the United States to eurozone. This will depreciate the dollar against the euro in the short run (R increases) and appreciate the dollar against the euro in the long run (F decreases).

The Central Bank Intervention in the Forex

Exchange rates are determined by government foreign exchange policies. Countries have the choice of having **free float, fixed exchange, or managed float rates.** Under any system the governments can try to influence the value of the currency:

- If the governments want to prop up the value of the home currency, they can raise the interest rates or sell foreign currency from reserves.
- If they want to weaken the currency, they can lower the interest rates or buy foreign currency from their exporters and commercial banks at a higher value than the market would offer

Fixing the currency to a peg (another currency or a composite of selected currencies) has many advantages such as stability, predictability of costs, and profits for foreign investors and resource-exporting countries. However, it has even more disadvantages. To maintain the exchange rate, the central bank must have large reserves of major world currencies, which involves opportunity costs of investing its reserves. The biggest risk is that there's a threat of currency overvaluation in real terms if the country is not able to control inflation.

Floating of home currency increases the risk for traders and investors but also has many advantages, such as no need for keeping large reserves of foreign currencies and adjustment to the market. Also, a floating currency will never be overvalued in real terms because it will depreciate before it would cause the capital flight and loss of reserves.

Current events

Alongside headlines of controversial elections, international conflicts or events, and referendum upsets, the values of various currencies have risen and plummeted. Brexit has caused depreciation of the pound, which has softened the blow to the UK export economy, similar to how the dollar value declined temporarily after President Trump's victory. The FARC vote caused the Colombian peso to collapse, and OPEC's spat had member states tightening controls on their currency.

The relationship between politics and currency values is hard to trace. The influence is often personality-driven and goes beyond study by economists. What causes shifts in currency after a political event is, essentially, human expectations. Luckily, any damages done to currency values following political events are temporary, and the currency value returns to being determined by underlying economic forces.

Currency values, like human skin, ultimately reflect the health or otherwise of a country's underlying economy. Larger economic factors include job creation, employment rates, trading, debt, and the state of small businesses in a nation. In the case of the United States, we have observed that the US dollar seems to appreciate when the world economy is in a recession, implying that the United States is still treated as a safe harbor by the outside world.

2.4. Trading systems and global governance institutions

Trading systems

The trade systems have gone through many phases since the advent of the industrial age. When industrial goods became a staple of international trade in the mid-nineteenth century, they were freely traded—no tariffs, quotas, or nontariff barriers impeded the flow of Atlantic and European trade. Starting in the 1880s, among industrialized countries there was a steady rise of protectionism, "beggar thy neighbor policies," and competitive devaluations that culminated in 1930 with the Smoot-Hawley Tariff Act. The United States introduced the highest tariffs in history on 20,000 agricultural and manufactured imports. That act may have contributed to the spread of international economic depression.

After WWII, the United States became the champion of free trade. To understand better the US-led rules-based international system, global governance institutions, and the fundamental canon that we cherished that trading nations do not fight wars, we need to look at the theory and practice behind free trade.

Comparative advantage

Free trade is a theoretical abstract, a goal we'd like to achieve. The proponents of free trade came from the classics of economic science: Adam Smith and David Ricardo. Today, we still teach the theory of comparative advantage to prove that free trade is profitable for all, even though thousands of factors decide who makes money in modern trade (Krugman, Obstfeld, 2018).

In 1776, David Ricardo presented a simple model to show that trade between a rich and a poor country would benefit both and doesn't require colonial exploitation of one by the other. He did not use the prices of the goods or wages, but the relative opportunity costs. We will recreate his example for the United States and Mexico.

Each country has the same number of workers, say 100. The United States has an absolute productivity advantage over Mexico because 100 US workers can produce either more corn or more computers (Chart 11).

Country (100 workers)	Output Corn	Output of Computers	Opportunity Cost	Spec	Consumption/ Export	Import/ Consumption
USA.	100cr	50ct	2:1	?	/	/
Mexico	80cr	20ct	4:1	?	/	/

Chart 11. US and Mexico productivity.

Source: Own elaboration base on the US Labor Statistic https://www.bls.gov/fls/tables/fls-table-21.htm [accessed September 12, 2020].

The opportunity costs show that Mexico has a comparative advantage in corn. If Mexico gives up 1 computer and moves workers to corn, they will make 4 units and the United States only 2. On the other hand, Mexico must sacrifice 4 units of corn to make 1 computer, and the United States only 2, so the United States has a comparative productive advantage in computers (Chart 12).

Country (100 workers)	Output Corn	Output of Computers	Opportunity Cost	Spec	Consumption/ Export	Import/ Consumption
USA.	100cr	50ct	2:1		/	/
Mexico	80cr	20ct	4:1		/	/

Chart 12. US and Mexico productivity.

Source: Own elaboration base on the base of US Labor Statistic https://www.bls.gov/fls/tables/fls-table-21.htm [accessed September 12, 2020].

The United States will specialize in computers, Mexico in corn. Then they trade. The rest of the analysis is simple arithmetic, but, before we do that, we must find the autarky consumption in each country. We need to know how many units of corn and computers each country would have if they never specialized and traded (Chart 13).

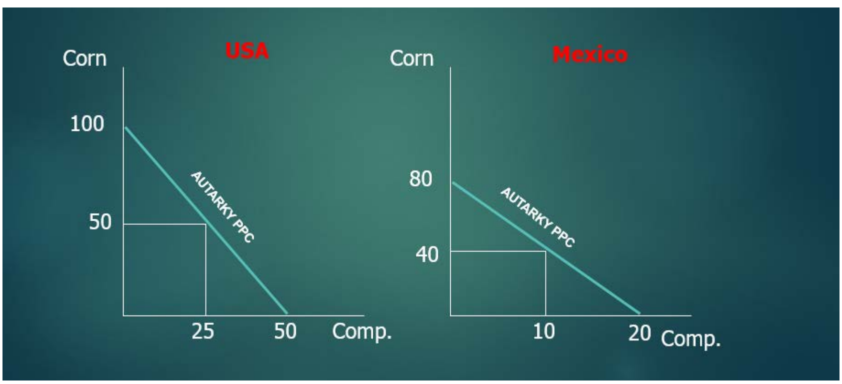


Chart 13.

Source: Own elaboration.

Country (100 workers)	Output Corn	Output Computers	Opportunity Cost	Spec	Consumption/ Export	Import/ Consumption
USA	100cr	50ct	2:1	?	/	+40corn/ 50cr
Mexico	80corn	20ct	4:1	80cr	40cr/ -40corn	/

Chart 14. U.S and Mexico productivity.

Source: Own elaboration base on the US Labor Statistic https://www.bls.gov/fls/tables/fls-table-21.htm [accessed September 12, 2020].

The US consumption of corn is 50 and importing 40 does not satisfy American appetite for corn. Even if the US specialization must be in computers, we need to make 10 units of corn not to be hungry! The United States will make 10 units of corn at the cost of 5 computers (the opportunity cost is 2:1). The maximum production of computers is only 45 (Chart 15).

Country (100 workers)	Output Corn	Output Computers	Opportunity Cost	Spec	Consumption/ Export	Import/ Consumption
USA.	100cr	50ct	2:1	10cr +45ct	30ct/ -15ct	+40cr/ 50cr
Mexico	80cr	20ct	4:1	80cr	40cr/ -40cr	+15ct/ 15ct

Chart 15. US and Mexico Productivity.

Source: Own elaboration base on the US Labor Statistic https://www.bls.gov/fls/tables/fls-table-21.htm [accessed September 12, 2020].

Now compare the autarky joint production of corn. It was 90 before and is still 90. No change here. Mexico made 80 and the United States made 10. What about computers? Autarky joint production of computers was 35 and now is 45. That means 10 more computers were made in this world consisting of two countries. Imagine adding hundreds of countries, hundreds of specializations, and hundreds of millions of different products—the world will be richer, and people will be happier!

Let's stop here with the overpowering enthusiasm. How will those 10 extra computers be divided between the United States and Mexico according to NAFTA? Will Mexico take it all, or will we take it all? What determines the outcome is called the terms of trade? They define the relation of prices between exporters and importers, which translates to the proportions of who gets what. The price negotiations must be fair to make sure that the 10 computers are divided, at best equally, with 5 more for Mexico and 5 more for the United States. In our example, it was easy, because we didn't deal with prices but instead just used algebra and a lot of good will. The new PPC shifted to the right (!), and the red rectangle shows the benefits to the United States and Mexico (Chart 16).

Here, I usually ask students why the United States with higher productivity in both goods benefits from trading with less productive Mexican workers. (The United States has an absolute productivity advantage). Students come up with short answers that are correct: Mexican workers are cheaper than American workers, and they have a comparative advantage over the United States in corn. My response is: First, the example never used the cost of labor! Second, I understand that the opportunity cost ratios worked here look like magic, but what's behind the opportunity costs?

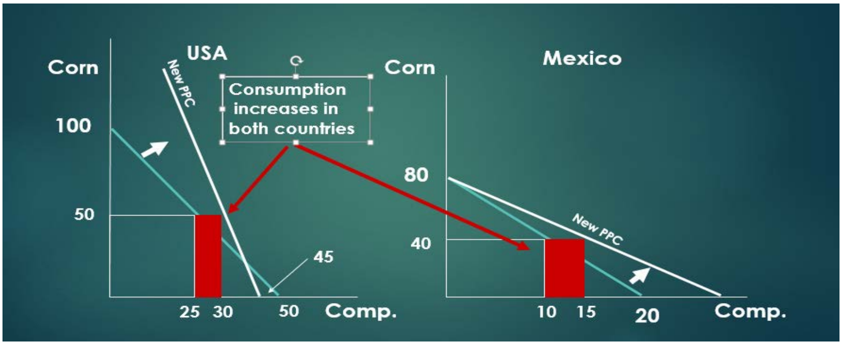


Chart 16.

Source: Own elaboration.

The opportunity cost differentials show individual productivity per worker and the productivity of the group of workers. Let me explain this. It takes 5 workers to make one computer in Mexico (100/20) and only 2 in the United States (100/50). When Mexico sacrifices of one computer it can put 5 workers in corn production and US only 2 workers. The total output of 5 workers is larger than of 2 workers in corn making in either of the countries.

We can expand the Ricardian model and add wages to make it more realistic. The expensive worker must be more productive, and the less productive worker paid less. The key is production per dollar of wage cost.

Here's the connection to US–China trade. Assume that we pay the US steel worker in Pennsylvania or Ohio $25 an hour and the Chinese worker at a state-owned plant in Chengdu $5 an hour. They both make on average a ton of steel an hour. The Chinese steel will be cheaper even when we add four weeks' transportation cost from the Chinese port to New Jersey. The ratio of wages is 1:5, and after adding transportation cost, say 1:3 per ton.

The tariff standoff with China was coming. Chinese steel is still too cheap to keep US mills open with industry acceptable wage levels.

If the last round of steel tariffs imposed in 2002 by President George W. Bush the long-term impact of tariffs are higher prices and smaller quantities for US businesses and consumers that result in lost business, reduced employment, and slower economic growth.

Here is one example. In March 2002 tariff lasted for three years and one day. The rates ranged from 8 percent to 30 percent on certain steel product imports from all countries except Canada, Israel, Jordan, and Mexico. These tariffs affected products used by US steel-consuming manufacturers, including producers of fabricated metal, machinery, equipment, transportation equipment, and parts; chemical manufacturers; petroleum refiners and contractors; tire manufacturers; and nonresidential construction companies. This definition of steel consumers is conservative, as many other industries are also consumers of steel.

Most of the manufacturers that use steel in their business processes are small businesses. Ninety-eight percent of the 193,000 US firms in steel-consuming sectors, at the time of the Bush steel tariffs, employed less than 500 workers. The economic implication of such small firm size meant that these businesses were "price takers." In other words, the firms were too small to have the market power to influence prices and instead had to accept the higher input costs caused by tariffs.

The effects of higher steel prices, largely a result of the steel tariffs, led to a loss of nearly 200,000 jobs in the steel-consuming sector, a loss larger than the total employment of 187,500 in the steel-producing sector at the time (https://taxfoundation.org/lessons-2002-bush-steel-tariffs/).

The tariffs not only led to domestic pressure characterized by supply shortages and higher prices, but also international pressure. US steel market prices were generally higher than steel prices paid by competitors abroad. This gave foreign producers of steel-containing products a cost advantage over US producers of steel-containing products. In response, customers began shifting orders from US manufacturers to foreign manufacturers.

In total, the benefit of using protectionist policies to save very few steel-making jobs in the short run was significantly outweighed by the unintended consequences of higher prices and job losses in other industries. The outcome of the 2002 Bush steel tariffs is not unique, and we should expect to see similar effects from the new tariffs on steel and aluminum products under President Trump.

The LTV steel conglomerate which asked for temporary tariff relief (protection) under President Bush invested some of its new profits in new technology, and some in the bonuses for outgoing CEOs. A few steel plants survived as producers of specialized steel, while others closed.

The real lesson here is that the United States uses tariffs to implement a broader set of strategic foreign economic policy goals, for example:

- **The security of the domestic supply for steel**
- **Narrow the labor cost differentials**
- **Pressure on Chinese government to eliminate state subsidies, remove protectionism of financial services market, remove the requirement for a Chinese partner for American investors and many other restrictions to free trade and capital relations**
- **Create opportunity for US high value-added industries to sell in China**

There are never easy answers, and tariffs are the least desirable options when they are imposed bilaterally rather than within the WTO framework. To be more precise, in case of the steel and aluminum tariffs they would be more effective if they were imposed by the US, the EU and Canada on China at the same time rather than the US on all countries above.

Other trade theories

The Heckscher–Ohlin (HO) and Stolper–Samuelson (SS) trade theorems may also be useful to explain US–China trade. The HO and SS theorems state that countries should specialize in making and trading goods that utilize a relatively more abundant factor at home, either capital (K), or labor (L) (Salvatore, 2013). The United States has an abundance of capital. Let's assume that the US ratio is: K/L = 1000/100 = 10. Every worker in the United States has 10 units of capital to work with. Capital in this theory is understood not as financial capital but constant capital, i.e., machines that make workers more productive.

In China, for example: K/L = 400/400 = 1. China has more people than the United States but less capital per worker. Since the United States has K/L = 10 and China has K/L = 1, capital (K) is a relatively more abundant factor of production in the United States, and labor is relatively more abundant in China. The United States will specialize in production and export of capital-intensive goods, i.e., heavy machinery, ships, etc. China will specialize in labor-intensive goods, i.e., textiles, manually assembled electronics, etc.

What happens next? In the United States, the owners of capital will see higher demand for capital. The profits of owners of capital will rise – higher demand means higher profits. The profits of owners' labor (wages of workers) will drop relative to the profits of the capital owners. Since China has a relative abundance of labor, it will produce and export labor-intensive goods. The owners of labor (workers) will see their wages rise relative to the profits of the owners of capital.

Conclusions from the HO and SS theorems: Over a longer period, American wages will stagnate, and the capital owners will be relatively better off. American workers will be better off if they buy cheap imported labor-intensive goods. Chinese workers will be better off than the owners of capital, and they will be able to buy more cheap imported capital goods. Economists pore over the data and discuss whether they confirm the hypothesis or not in the real world. Trade economists make efforts to confirm or dismiss these hypotheses. In the paper "The China shock: Learning from labor market adjustment to large changes in trade", David Autor, David Dorn and Gordon Hanson (NBER Working Paper 21906, 2016) the authors have confirmed that it was true in 61 percent of analyzed countries. These are important studies, however they come with many assumptions and no definite answers. There is statistical evidence that Chinese wages have been rising faster than US wages in the last 20 years in relative terms. Economists call this a global factor price equalization. Over a long period of time, wage differentials of open economies will tend toward equilibrium. However, it will still be a long time before we see the average wages of 1.34 billion Chinese being close to the average wages of 340 million Americans.

In addition, extensive statistical evidence provided by Thomas Piketty indicates that capital worldwide is concentrating and that the return from capital is about 2 percent higher than from labor. We all prefer to live off capital, but as John Paul II said in his 1981 encyclical "Laborem exercens": "work is a fundamental dimension of human existence on earth." Think about that next time you play Powerball or Mega Millions.

Rules-Based International System (Krugman, Obstfeld, 2018)

After WWII, the United States became a superpower, with 65 percent of the world GDP produced in a single country. We felt an obligation to offer a design for a better post-war world. The answer was the rules-based international order. The United States set the rules. The rules-based trade system worked and should stay in place. It is a shared commitment by all countries to conduct their activities in accordance with agreed rules that evolve over time, such as international law, regional security arrangements, trade agreements, immigration protocols, and cultural arrangements.

The United States founded the United Nations, developed the new Bretton Woods monetary system with the dollar at its center as "paper gold," and created the International Monetary Fund (IMF) and the World Bank (WB). We made sure to have the majority vote in both the IMF and the WB. In 1948, after two years of unresolved negotiations with the British and the French over the voting power in the proposed International Trade Organization, the United States gave up majority vote in the General Agreement on Tariffs and Trade (GATT) as a temporary solution. The GATT was the most successful international organization in the world's economic history. It contributed not only to the expansion of trade but also to rising living standards for about 6 billion people in the developed world and developing countries among its 130 members. In 1995, the GATT changed its name to the World Trade Organization or WTO.

The objective of the **GATT** was to promote international trade by reducing or eliminating trade barriers, such as tariffs, quotas, or nontariff barriers. The rules of the **GATT** are only for trade in goods; the rules of the **WTO** include services and aspects of intellectual property along with the goods. Its agreements are multilateral. Five principles are particularly important:

- **Nondiscrimination:** This has two major components: the **most favored nation** (MFN) rule, and the **national treatment policy**. MFN means that bilateral tariff reductions must be extended to all other country members of the WTO. **National treatment** assumes that foreign firms must be treated the same way that domestic laws and tax regulations treat domestic firms.
- **Reciprocity:** This is about bilateral trade. A country is expected to grant mutual concessions in tariff rates, quotas, or relief from other **commercial restrictions**. Reciprocity is not expected to be generalized to other countries.
- **Binding and enforceable commitments:** A country can change its **commitments** but only after negotiating with its trading partners, which could mean compensating them for loss of trade. Think about US trade relations with China.

- **Transparency obligation:** This means requiring member governments to report trade measures to the relevant WTO body if the measures might influence other members. As important as they are, WTO notifications of such measures are notoriously incomplete, late, or nonexistent.
- **Product safety, food sanitation regulations, and protection of intellectual property under Trade-Related Aspects of Intellectual Property Rights (TRIPS):** The TRIPS Agreement plays a critical role in facilitating trade in knowledge and creativity and in resolving trade disputes over **intellectual property**. For those more interested in the subject, the TRIPS Agreement is Annex 1C of the Marrakesh Agreement Establishing the World Trade Organization, signed in Marrakesh, Morocco, on April 15, 1994.

The International Monetary Fund and the World Bank

The International Monetary Fund (IMF) is an international organization consisting of 189 countries working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world. The IMF established the international payment system and plays a central role in the management of balance of payments difficulties and international financial crises. Countries contribute funds to a pool through a quota system, from which countries experiencing balance of payments problems can borrow money. The IMF has a total fund of about $1 billion as of 2018 (Pease, 2018).

President: Christine Lagarde (French, European)

Headquarters: Washington, D.C.

The World Bank (WB) is an international financial institution that provides loans to countries for capital projects. It comprises two institutions: The International Bank for Reconstruction and Development and the International Development Association. The WB is a component of the World Bank Group.

President: David Malpas (American) Headquarters: Washington, D.C.

The IMF and the WB are known collectively as the Bretton Woods Institutions, after the remote village in New Hampshire, United States, where they were founded by the delegates of 44 nations in July 1944. The WB and the IMF are twin intergovernmental pillars supporting the structure of the world's economic and financial order.

- The United States, together with the French and the British, built the international order, which worked for almost 80 years. But since 1944, many things have changed. For example, the EU formed and includes 500 million people, and the US GDP is no longer providing 65 percent but about 22 percent of the world GDP. The IMF and the WB have been subject of a mounting criticism from both right and left of the global spectrum. Criticisms of the

World Bank and the IMF generally center around their pro-market policies, and the way they are governed. Here are some of them:

- Lack of accountability for the money spent in many developing countries.
- Conditionalities follow the 'Washington Consensus', that is: liberalization—of trade, investment and the financial sector—, deregulation and privatization of nationalized industries.
- Disregard of borrower countries' individual circumstances.
- Loss of state's authority to govern its own economy because governments must follow predetermined IMF rescue packages.
- Displacement of indigenous peoples by the projects.
- Promoting private sector and reduced investment in public health and education.
- Undemocratic governance structure.
- Privileging of the private sector.
- Supporting projects in the carbon-intensive industry and heavily polluting industries.
- Undermining the role of the state as the primary provider of essential goods and services, such as healthcare and education.
- Promoting business to increase the use of financial intermediaries such as private equity funds and funding of companies associated with tax havens.
- Domination by the G7 because they represent the largest donors without much consultation with poor and developing countries.

The above criticisms represent a mix of the real problems of development, debate about the role of the state and market and clearly anti-capitalist, populist narratives. In a sense, they represent the fault lines between orthodox and heterodox economic models as well as a tendency to blame the "rich countries" for home-made corruption and mismanagement.

Here are some of the proposals how to reform these two international governance institutions:

First, give larger voting power the PRC, Russia, and Brazil in exchange for a larger financial contribution. So far, these countries tried to create their own version of the IMF called BRICS (Brazil, Russia, India, China, South Africa) which has failed to accumulate enough funding. The other initiative which originated in the PRC is the AIIB (Asian International Investment Bank) which the US declined to endorse.

Second, the IMF's funding base must increase. For example, the IMF has committed only 20 percent of the Greek bailout treating it as a regional not global problem. Any size of Asian financial crisis would bankrupt the IMF.

Third, the voting system in both organizations must reflect the proportions of funding. The United States holds the most votes in each organization—more than 17 percent. All the rest of the member countries combined can get a maximum of only 83 percent not 85 percent needed for "super majority."

Fourth, the World Bank must move completely away from 100 percent project funding to private–public funding and finance the interest differentials between the private, commercial funding and the public funding.

Fifth, better supervision of funding is needed. According to independent auditors, the WB has “wasted” $400 billion which was either misappropriated or stolen by corrupt government officials. Also, funding approvals should be cut from average seven years to less than a year which is a standard in commercial lending.

The fundamental canon of the rules-based international order was that trading nations do not go to war. Today, leaders of countries such as PRC and Russia perceive the global governance as a zero-sum game with the US which does not bode well for the cooperation within the IMF and the WB. Readers of this chapter should develop their own opinion how to create a safer and more cooperative world in XXI century and be able to have a rationale to support their arguments.

2.5. Review of concepts and formulas

Notations

- hc – home currency
- fc – foreign currency
- Px – prices of exports
- Pm – prices of imports
- X – exports (revenue from exports)
- M – imports (cost of imports)
- Ph – home inflation
- Pf – foreign inflation
- BOP = balance of payments
- CA – current account (X – M) = (trade transactions)
- FA – financial account (Mk – Xk) = (capital transactions)
- KA – capital account (noncapital transactions!)

Balance of payments

BOP = CA + KA + FA = 0
CA = X – M
FA = Mk – Xk

If CA > 0 then FA < 0 (net goods exporter country is a net exporter of capital)
If CA < 0 then FA > 0 (net goods importer country is a net importer of capital)

Possible cases:
CA > 0, X > M, and Xk > Mk
CA < 0, M > X, and Mk > Xk

Different types of exchange rates

Rn = hc/fc – nominal exchange rate, retail price for foreign currency, official exchange rate
R = hc/fc – spot exchange rate, short-run exchange rate, wholesale exchange rate for large currency transactions
F = hc/fc – forward rate, long-run exchange rate, today's market price for fc delivered in the future
Rr = hc/fc – real exchange rate, the true value of the currency adjusted by inflation (only under a fixed exchange rate system)

Predicting the current account after home currency depreciation or appreciation

Depreciation of hc (Rn = up)
Export prices = Px down
Quantity of export = up
Export revenues (X) up
Import prices = Pm up
Quantity of import = down
Import cost (M) down
Current Account up (CA > 0)

Appreciation of hc (Rn = down)
Export prices = Px up
Quantity of export = down
Export revenues (X) down
Import prices = Pm down
Quantity of import = up
Import cost (M) up
Current Account down (CA < 0)

Inflation and the currency value

Inflation generally decreases the value of the home currency. We can predict the impact of relative inflation with this formula: Rn* = Rn x Ph/Pf where R* is the expected exchange rate.

- When CA > 0, the supply of fc exceeds the demand for fc and home currency appreciates.

- When CA < 0, the demand for fc exceeds the supply of and home currency depreciates.

For example, considering that the United States had CA deficit with China since 1980's the dollar should have depreciated against the RMB which would have led to more balanced trade between the two countries. However, the value of the dollar vis a vis the RMB was determined by the price at which the Peoples Bank of China bought the dollars from the exporters. This price was higher than the market.

Automatic current account adjustment

Theoretically, if there is no market intervention the CA should adjust to 0. Here is how it could happen:

- **When CA <0,** hc currency depreciates, prices of exports drop, exports rise, prices of imports rise, imports decrease, and the **CA should become 0. (CA balance is restored: X = M)**
- **When CA > 0,** currency appreciates, prices of exports rise, exports decrease, prices of imports decrease, imports rise, the **CA should become 0. (CA balance is restored, X = M)**

However, in real life there are other factors which influence hc exchange rates.

Inflation and exchange rates

a) Floating Exchange Rate System (Rn – nominal exchange rate)

Rn* = Rn x Ph/Pf

From the definition Rn = hc/fc, we know that the Rn must depend on relative prices, then Rn = Ph /Pf. When Ph > Pf, Rn rises and hc depreciates. When Ph < Pf, Rn decreases and hc appreciates.

For example, when Argentinean inflation is 25% (index: 125), US inflation is 2% (index 102), and the current exchange rate in Argentina is Rn = 5 p/$, this will happen: (Rn* = expected Rn)

Rn* = Rn x Ph/Pf = 5 x (125/102) = 6.127

Rn* > Rn = peso depreciates, and the dollar appreciates

b) Fixed or Managed Exchange Rate System (Rr – real exchange rate)

Rr = Rn x (Pf/Ph) (Note: The Pf is the numerator!)

Rr – real exchange rate

Rn – nominal exchange rate

Ph – home inflation

Pf – foreign inflation

- When Ph >Pf, the Rr < Rn. The home currency is appreciating in real terms
- When Ph <Pf, the Rr >Rn. The home currency is depreciating in real terms

For example, in Thailand (1997), the baht was pegged to the dollar and home currency appreciated in real terms. Thai inflation was around 20 percent (index:

120), the US inflation was around 2 percent (index 102), and the exchange was pegged at: Rn = 30 Baht/$. This is what happened:

Rr = Rn x Pf/Ph = 30 x (100/120) =25.5 Baht/$

Rr < Rn = Thai baht appreciated in real terms against the dollar

Remember that that real currency appreciation can be devastating for the economy with fixed or pegged exchange rate regime.

Interest Rates and the Currency Value

The interest rate parity equation:

i (h) – i (f) = (F - R)/R

F – forward exchange rate

R – spot exchange rate

i (h) – home bond return (interest rate)

f (h) – foreign bond return (interest rate)

- When i(h) > i (f) then (F > R)/R. Hc is going to appreciate in the short run (R is down) and depreciate in the long run (F is up)
- When i(h) < i (f) then (F < R)/R. Hc is going to depreciate in the short run (R is up) and appreciate in the long run (F is down)

Here is a possible application of this equation. The rise of interest rates appreciates the home currency in the short run but depreciates it in the long run, so we can predict of what the F* should be to assure equilibrium between capital and currency markets:

US bond return = 1.5% (or 0.15)

Euro bond return = 3.0% (or 0.30)

Current Euro = Rn = 0.72 E/$

Let's look from the EU perspective (home):

ih – if = (F – Rn)/Rn

0.3 – 0.15 = (F – 0.72)/0.72

0.15 x 0.72 = F – 0.72

F = 0.828 (F – forward exchange rate, predictor of future spot rate or nominal rate).

Chapter 3
Asia overview

3.1. The People's Republic of China

The long view

China has 1.345 billion people—more than four times the United States. It has many unique challenges that are not easily understood by those who don't live there or have never visited that country (Garnet, 2002):

First, there is a scarcity of arable land. When you look at the satellite map of China, you will see that 2/3 of the map is either yellow or gray, not green. That's because only 1/10 of the country is arable land. The arable land is mostly in eastern and northeastern China. You can see the very dry Northwestern Plateau, the Gobi Desert in north central China, and the Himalayas in southwestern China. Judging from the percentage of arable land, China has too many people for what is habitable.

Second, there is a shortage of water, which requires very good water management. In the center of the country, two very long, massive rivers flow from the west to the east, and half a dozen smaller ones flow south. Rice needs lots of water. Other grains don't survive heavy monsoon rains, so they are planted in the northeast, which is dryer. Most Chinese people live in some 150 cities that have populations of over one million. They also need a lot of water and regulated waterways transportation. In short, water management requires central decision-making, massive construction projects, and funding.

The Yangtze River is 3,988 miles long—the longest river in Asia—and is meticulously regulated. The Yangtze cuts through three magnificent Gorges, which lead to the Three Gorges Dam, the largest hydropower plant in the world. The dam provides 15 percent of the energy for the East Coast cities. Despite China's large investment, 2/3 of the country must deal with water scarcity.

Third, China cannot allow urban sprawl and must build large urban metropolises and export manufactured goods to pay for energy resources and imported food. Chinese arable land is concentrated in a stretch some 800 miles wide from the coast toward the west. Arable land and agriculture compete with the cities for land. New cities take away arable land, so Chinese apartment buildings must be tall. Cities must have good transportation and use water resources efficiently. China must develop very productive agriculture and provide employment for the people.

Until now, China produced for export, invested money at home and abroad, and reduced internal consumption. The future China will have to produce more for domestic consumption, relying less on exports, and make goods for its own people. However, this cannot happen without a major restructuring of the economy. The leadership of the Party-State prefers techno-utilitarianism and social engineering over free markets. Since 2013, the Party-State bureaucrats have focused on developing high-technology industries and artificial intelligence, which they think will give them the tools to control their society, give China technological leadership in the world, and keep them in power.

Map 1. Warring States of China c.260 BCE Scale not given. Last updated September 2003.

Source: < https://en.wikipedia.org/wiki/Warring_States_period > [accessed December 20, 2020].

Fourth, the anxiety about the future of China is justified. China did not create an alternative socio-economic system. It is a very successful developing country with the ambition to become a leading power in the world, but there is nothing numinous or victorious about the Communist Party-State over a liberal democracy. However, the world has reasonable concerns about the direction China is going to take in the next decade. China is currently the largest polluter in the world, and it will move 100 million people into the middle class, which will produce more CO_2 and add to global warming. In addition, China mixes strategic and economic expansion around the world, which is neither environmentally nor politically neutral. The phenomenal growth of China until 2014 has created a lot of anxiety, which we need to put in a broader perspective of how this society and state operate, what their relation is to the outside world, how they reached the point where they are, and what may happen to China in the next decade. These are the issues we are going to discuss in this chapter.

China and the outside world

First, Chinese society has the characteristics of the "Civilization state" not a "nation state," with its unique culture, language, tradition, ancestral worship, Confucian values, and personal relationships called guanxi. The sociological description of the civilization state is that unity is a more important value than ethnic differences, people are willing to sacrifice individualism for a strong collective, and the paternalistic state mimics the authority of the father in the family. Although all of these characteristics may have been true for centuries, modern society shows a high degree of pragmatism, which weakens the impact of the "civilization state" on the Chinese people today.

Second, the Chinese claim their origin is from a single race, the Han, which is not correct historically but forces a sense of racial identity. The Han expanded the 7,000-mile-long Silk Road, so the choice of this dynasty period was a fitting choice for Chinese world trade ambitions.

Third, China's name in Mandarin is "The Middle Kingdom"—中国—Zhōngguó—with middle meaning the center of the world. They believed themselves to have the highest civilization among the surrounding nations.

Fourth, Chinese people still are said to maintain the very high authority and legitimacy of the state. The state is the guardian of the civilization state, a patriarch. The Chinese state, unlike in the West, was never challenged by merchants, religious leaders, or aristocracy. The rising public awareness of deep corruption in the Chinese Communist Party (CCP) is one of the main concerns of the current leadership because it undermines their legitimacy.

Fifth, the Chinese Party-State had to strike a balance between economic and political control and decentralization. The microeconomic and regional economic decentralization coexists with very strict political centralization, censorship, and data flow and information control. China has a large private sector that must operate within strict boundaries of bureaucratic controls, including travel visas, interest rates, capital control, the exchange rate, and land price control, to mention just a few.

Authority of the state and statecraft

The Chinese people have an important characteristic, one might even say a national DNA, which comes from their long history. They believe in the necessity of a strong central authority but also keep their emperors/kings/leaders accountable in the long run. This also may apply to the contemporary Communist Party-State. The Communist power structure may collapse when the economy slows its expansion.

There is historical proof of this claim. Around 1000 B.C., the Zhou dynasty introduced the **concept of the Mandate of Heaven or a divine approval to rule**. The Mandate of Heaven became central to the Chinese view of government and the authority of the kings. It is a **dynastic cycle**: a pattern of rise, decline, and replacement of dynasties if the spirits do not approve of one king's rule. But the real cause of the cycle was different. The change of power was driven by the rise of corruption of a ruler and his family and ineffectiveness in protecting the people against enemies and natural disasters. The corrupt kings were overthrown by rebels-turned-kings until a new cycle of corruption, greed, and selfishness caused new rebellion and a new cycle of power change. The real test of power was how effectively the new dynasty defended the people against enemies; built walls, dikes, and canals; and helped farmers after frequent typhoons and floods.

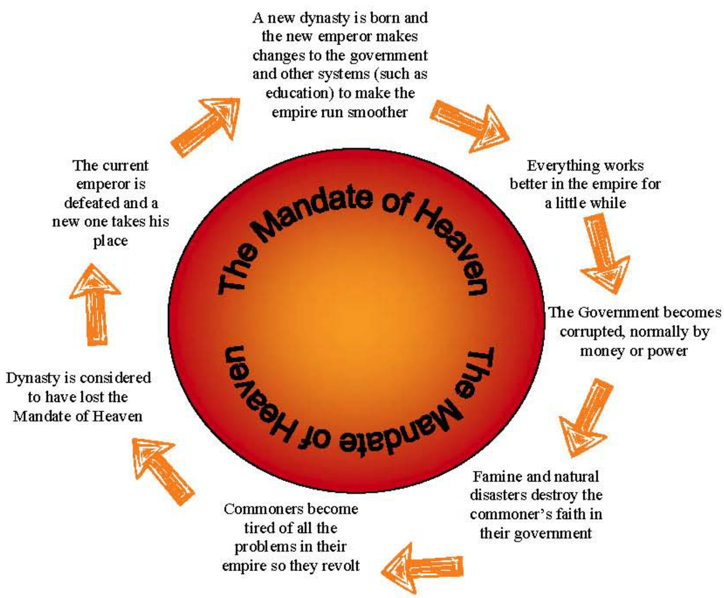


Chart 17. Zhou political System.

Source: https://slideplayer.com/slide/3794809/ [accessed December 20, 2020].

The failure of the king was interpreted as a loss of the Mandate of Heaven (Chart 17). These authors have calculated that over 3600 years of recorded dynastical history, there were 23 dynasties, which brings the average to 156.5 years. Of course, this is a major simplification, but one may think that the Mandate of Heaven was a Chinese version of the social contract described by Jean-Jacques Rousseau in the eighteenth century. The Chinese had the practice of a social contract for a long time. **Bottom Line: The power of the rulers in China does depend on what they deliver to the masses of people.**

Let's fast-forward to modern China. The Chinese economy is slowing down. **The current leaders of the Party-State take precedence in control over what's good for China, which is development of the private sector.** This is the difference between an authoritarian system and liberal democracy.

The Chinese Party-State is stepping back in the privatization of the economy that transformed it into the world's No. 2 economy. For 40 years, China has swung between authoritarian Communist control and a freewheeling capitalism. Subsidized State-controlled companies increasingly account for growth in industrial production and profits, areas where private businesses once led. China has stepped up regulation of online commerce, real estate, and video games. Private companies face higher taxes and employee benefit costs. Some communist intellectuals are calling for private enterprises to be abolished entirely and for revival of the Communist Party organizations in the private sector. China's leaders are making mistakes of historic proportions.

The birth of the PRC (Heilmann, 2016)

The People's Republic of China (PRC) is the product of the Chinese Communist Revolution, which started at the end of WWII. The Communist leader Mao Zedong launched "The Great March" of a ragtag army of peasants in northwestern China. The communists defeated the Chinese Republican government, which was led by the nationalistic Kuomintang Party and General Chiang Kai-shek. The followers of the Kuomintang escaped to Taiwan, where they proclaimed creation of the Republic of China (ROC). From the PRC's point of view, the ROC is an illegitimate state ("One China Policy"). The United States supports the ROC but does not have diplomatic relations with that country and does not sell weapons to them. As of 2018, the ROC has been recognized only by 17 countries, and, for example, the PRC demanded severing diplomatic recognition with the ROC as a condition for loans to El Salvador, Panama, and the Dominican Republic.

The Chinese Communist Party (CCP) nationalized the entire economy in 1950 and set off to build an egalitarian Communist state. When the PRC was born, Communist Russia was rebuilding its industry after the destruction of WWII. China was extremely poor, did not have industry, and couldn't even feed its people. Mao Zedong didn't want to take Moscow's directions for how to build communism in his country, and Moscow did not want to pay for China's industrialization. Moscow and Beijing parted ways. Mao Zedong prompted grassroots industrialization and a low-cost internationalism, a "Global Communist Village." For example, Mao was convinced that producing steel and grains in villages would be the best model for Chinese economic growth.

By the 1960s, Maoism proved to be a complete economic failure; for example, hunger came back to China and steel was produced in village furnaces from melted agricultural machinery to meet state quotas of production. The economy stagnated without capital and technology. The educated intelligentsia in the CCP became increasingly critical of Mao. His position in the party weakened.

Picture 1. Leadership Structure.

Source: Leadership Structure. [in:] Navy Office of Naval Intelligence, 2015 [accessed September 17, 2020].

To regain the control of the CCP and silence his critics, Mao turned once again to the young communists he had once inspired to overthrow the Republican government decades earlier. In 1966, Mao initiated a "Cultural Revolution." Mobs of young communists holding small booklets of "The Thoughts of Chairman Mao" went on a rampage to destroy people and institutions of the state. The communist vigilantes took over the running of factories, schools, universities, and hospitals, basically replacing all educated professionals with slogan-shouting ignoramuses. Over the next ten years, millions of educated, innocent citizens, consisting of engineers, teachers, doctors, and scientists, were deported to rural communes for "re-education." Farming chores were supposed to return them back to the right ways of the party. Many perished of malnutrition and disease in these communes. However, the trauma of the Cultural Revolution laid ground for a departure from Communist orthodoxy and led to an "open door policy."

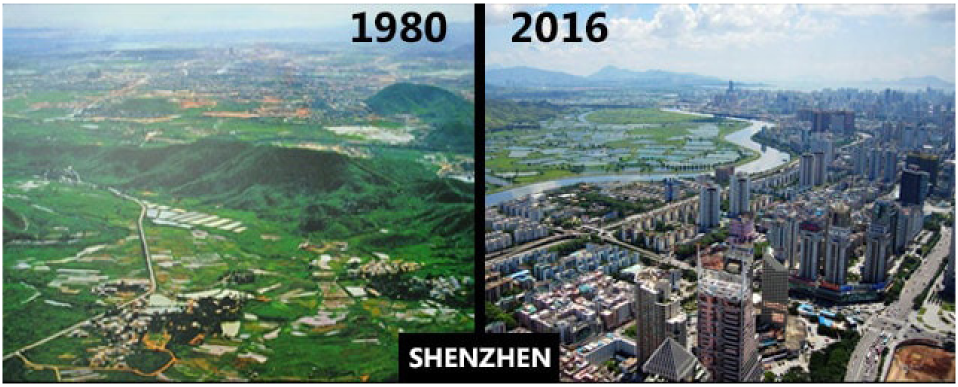
Deng reforms (Wong, 2014)

In 1973, Deng Xiao Ping, once Mao's deputy, was called back from "re-education" at a farm and given the task of reforming the economy. In 1976, Deng introduced sweeping reforms:

- Special economic zones (SEZs) for foreign investors outside direct economic control of the Communist government.
- One-child policy, or population control, allowing only one child per family (This policy was abandoned in 2015, when a second child was permitted).
- Higher contract prices for rural communes to resolve food supply problems and hunger.
- Permission given to farmers to leave their villages and take jobs in the SEZs.
- Village markets, permission to develop township and village enterprises and expand consumption.

The first SEZs were created in 1978 in Guangdong (next to Hong Kong) and later in Fujian Province. In a few years, this extended to Shenzhen, Zhuhai, Shantou, Xiamen, Hainan Island, and in the Pearl River Delta close to Beijing. A new growth model was born, which combined foreign direct investment and foreign technology and assembly parts with Chinese cheap labor. Over the next decade, there was an exodus of 300 million laborers from the country's villages to the east.

Today, the scale and influence of China's private economy can be summarized by the figure 56789—the private sector contributes 50 percent of tax revenue, 60 percent of gross domestic product, 70 percent of industrial upgrades and innovation, 80 percent of total employment, and 90 percent of the total number of enterprises.



Picture 2. Shenzhen.

Source:<https://www.alternativeairlines.com/blog/shenzhen-travel-guide>[accessed September 20, 2020].

In the first decade of the twenty-first century, the party further embraced the private sector and elevated its political status by opening membership and promoting a select group of businessmen to party and government positions. Despite its rising economic and political influence, however, the private sector, much like overseas investors, is still largely treated as a second-class player next to the state sector.

Like foreign investors who have long cried out for an even playing field, Chinese private firms have also largely been shut out of strategic and potentially lucrative sectors, such as banking, health care, energy, television, and broadcasting.

The Party-State (Heilmann, 2016)

China is a one Party-State ruled by the Central Committee (the CC has 205 full members and 171 alternate members). It is the highest body, but since the body meets normally only once a year, most duties and responsibilities are vested in the Politburo and its Standing Committee (SC). The SC currently has seven members, which are elected by straw vote. There is no general election of any kind, for members of either the CC or the SC. The CCP has 90 million members, or 1 in 16 Chinese are members of the Communist Party. There are four million party committees.

Critique of the CCP is illegal. Media news must always have their lead story be about the President, and the second about the Prime Minister. Opposition to the party line is not allowed because it represents most of the Chinese peoples' will, and, in the opinion of the party, there is no need to divert from the will of the majority.

The President for Life, Mr. Xi, has "three hats": President of the country, Chairman of the Communist Party, and Commander-in-Chief of the People's Liberation Army.

The government has 25 ministries and commissions, and each of the ministries has relevant departments in the CCP that oversee their function.

The Party-State has a monopoly on information. The PRC has ten channels of CCTV, which are controlled by the government. The equivalent of a Chinese YouTube has been strongly criticized and banned from posting Western programming. Forbidden web sites include Google, Twitter, Facebook, The New York Times, Instagram, Bloomberg, The Economist, and many others that are the staples of the Web. You will find connections to Alibaba, but not to Amazon or eBay. The global Internet is filtered and censored, and you will not find the above on any Wi-Fi connection. Many names and facts that are deemed politically or ideologically inappropriate will not pop up in a search. Western visitors often bypass these restrictions by logging in directly through their IP addresses, via a VPN. However, recently this loophole has been plugged by the authorities.

Since the early 1980s, the authority and legitimacy of the CCP has been based on ensuring fast economic growth and raising living standards, urbanization, and modernization. The Chinese people respect it because they have no other choice. The government does not allow the creation of public opinion and the democratic process. People must believe in the single truth, called "the party line."

Here's an important distinction between the PRC and the United States. The Party-State bureaucrats make decisions relatively quickly that would take years in the United States. Today building another Hoover Dam in the United States would take a long time because of the various economic and environmental interest groups. For example, the Chinese Three Gorges Dam on the Yangtze River required resettling 2.6 million people, flooding ancestral land, and building dozens of new cities. All this was justified by the need for electric power for Shanghai and the prevention of seasonal flooding. The decision was techno-utilitarian. In a democracy, it would require a lengthy consensus building among all concerned parties and a cost benefit-analysis. That's why Chinese scholars often talk about the superiority of the Party-State over the liberal democracy in construction of super-sized infrastructural projects.

This dilemma which system, market system and liberal democracy or centrally governed autocracy is better for economic development has extensive coverage in political science literature. The judgment always comes conclusion that democracy and individual freedoms come first. Some authors focus on the deficiency of the pure market system: the undersupply of public goods, such as mass education, public transportation, universal health care, equal wages, funding of culture, public parks and reserves, etc. In the Communist state, such services, if affordable, are supposed to be provided by the state, which is the custodian of the national property. In the market system, public goods are often are undersupplied because they have to come from taxes which nobody is willing to pay.

It is true that liberal democracy is slow in building consensus over many issues and is never ready to enact new taxes to pay for public goods. However, although the Party-State acting without checks and balances can make pragmatic choices, it can also claim the right to deny individual rights to vote for the government, limit privacy laws, and limit freedom of choice. It may mean more trains but also more pollution, extralegal punishment of critiques of the government, labor camp for minorities, forced abortions, prosecution of dissidents, and rolling out facial recognition for policing the people. Unlimited power held by unelected CCP bureaucrats is far more dangerous than a shortage of public goods in the United States, or broken bridges and inadequate transportation, which sooner or later will find a solution in the market by offering a higher return to investors.

For the techno-utilitarian Party-State, which holds the hammer, everything looks like a nail. The Politburo of the CCP gives the power of social engineering to seven individuals on the Standing Committee of the PB on behalf of 1.34 billion people. In the democratic system of the United States, there is a term limit and constitutionally guaranteed accountability of the President to the Congress. In 2018, the CCP decided to give Mr. Xi, the son of the former comrade in arms of Mao Zedong, the position of the *Chairman of the Party and the President of China for Life*. The element of accountability has been permanently removed from China.

The sources of economic success (Naughton, Tsai 2015)

The economic success of the PRC is not only the effect of the great foresight or wisdom of Deng Xiaoping, but a combination of the opportunity created by globalization, a corporate race for profits, demographic advantage, and the hard work of the Chinese people. Let's trace some of the developments leading to the economic rise of China:

First, the PRC was holding back wage increases for 30 years. Wages were much lower than in Thailand, Singapore, South Korea, and Malaysia. Since there are no independent labor unions in the PRC, wages were less than $200 per month for three decades. Since 2010, wages have doubled. In the SEZs, workers lived in inexpensive dorms and did not have the legal right to settle (hukou). Workers did not bring their families, saved money, consumed very little, and put their wages in state banks, which paid a minimal interest rate. The PRC had a very high capital accumulation, which was invested in the country's industrial sector and transport infrastructure.

Second, in 1997, during the Asian currency crisis, the production of textiles and assembly of electronics and home goods moved to China, which became the world's low-cost supplier of labor-intensive products. In addition, transportation and communication costs were cut by a factor of 500 because of the introduction of mega size container ships and Internet communication.

Third, in 2001, ending years of opposition by the United States, the PRC was admitted to the WTO. Import tariffs in the United States were very low, and prior to the 2008 financial crisis, consumption in the United States soared. Taiwanese and Hong Kong businesses were passing $50-60 billions of subcontracting dollars to China. Western brands had nameless cheap producers in the PRC, and their profits were soaring, and so was the US current account deficit.

Fourth, despite the "one-child policy," the PRC had a demographic advantage. Productivity in agriculture increased because of a massive use of fertilizers, and the Chinese interior had provided close to 400 million workers for the East Coast manufacturing and industrial construction sector. The government removed internal restrictions on travel and provided new transportation infrastructure for resources, people, and production.

Fifth, production costs were low because the government completely disregarded the negative externalities of production. Factories polluted air, soil, and water for years. But this is no longer possible on such a massive scale because of a health crisis in China. One fifth of the deaths in China are attributed to pollution, and the people are protesting. The CCP had to respond to hundreds of factories strikes in affected communities. Workers and people started to block the polluted sites and stalk party officials. The government had to act.

Sixth, there was an undervalued yuan. Despite gradual appreciation from 2001 to 2014, the RMB exchange rate to the US dollar is far below its "true exchange rate," which economists consider to be an equilibrium level, at which the US CA deficit with China would basically be 0. It's debatable what the purchasing parity exchange rate should be, because the tariff structure on the US side was favoring imports, and China protected its goods and service market.

Seventh, the existence of peace in Asia, the security of shipping, and the import of oil and resources to China. These things were provided by the US Navy and the US taxpayer, because US consumers were looking for bargain consumption, and US corporations were looking for high profits in the manufacturing sector. Some 2.4–2.6 million US jobs were transferred to China from 2000–2016, according to recent studies. There is no right or wrong in trade, and according to the comparative advantage studies, all countries can be winners. However, it's also true that the Chinese 15-year average $360 billion CA surplus destabilized the world economy, and this situation is no longer sustainable. Since world trade is a zero-sum game, there must be countries that have to cope with $360 billion in current account deficits.

The sustainability of the Chinese model in the twenty-first century

The Chinese Party-State model is based on three assumptions: a) the supply of low-cost labor, b) the world demand for Chinese goods, and c) the Chinese people's excessive saving.

Labor costs

According to the official Chinese data, between 2013–2016 average wages rose from $500 to $771 per month in urban areas. This is hardly a good representation for the rest of the country. My research puts the number on the East Coast at about $20 a day or about $400–$450 per month. By law, workers are entitled to have four days free in a month, which do not have to be on weekends.

The Chinese have few cars, mostly electric scooters, or they rent yellow bikes for 20 cents per hour. All cities have inexpensive electric bus and train transportation. China has more super-fast long-distance trains than the rest of the world combined, and they run at 160 miles per hour. In large cities, you will see modern infrastructure and very modest living standards.

The income gaps and GDP per capita are striking. Only 2 percent of the people in China make above $15,000 a year, but it has 104 billionaires. China has only 60 million households that make above $20,000 a year. On the lower end, 600 million people are in households that make less than $1,000–$2,000 a year ($3–$6 per day per person), 440 million are in households that make between $2,000 and $3,000 a year ($6–8$ per day per person). This means that 80 percent of the country live very frugally, even though the average income is around $14,500 (purchasing power parity). A rural and urban income gap is also present: 10 percent of the richest city dwellers earn 23 times more than the poorest 10 percent of rural dwellers.

There are also signs of social unrest, including 150–200 labor protests annually over wages, mistreatment by authorities, the environment, and corruption in the CCP. In 2016–2018, an average of 200–250 CCP party members were imprisoned for corruption.

The Chinese economic model

The Chinese trade model is extremely mercantilist. This model assumes that China will run large current account surpluses, and the rest of the world will run deficits with China, particularly the United States. The Chinese economy depends on external consumption, not internal consumption. This is a good economic model for Singapore, but not for China. The Chinese trade model is obsolete, that is, high volume, low profit margin, low value-added production using imported raw materials and parts. China has no global brand names, unlike South Korea, and still competes by "rolling back prices." Huawei and Lenovo are the only known world brands so far.

There is a shortage of labor. China's fast economic growth came from increasing the employment of the rural population in manufacturing. This can't continue forever, because the country is running out of its surplus labor force in agriculture, and the surplus of the working population overall. Families prefer one child and invest more in education rather than more children. The government plan to move 300 million more people from the countryside to the cities to raise the percentage of the urban population to 75 is not doable. It will take away too much farmland to expand the urban areas on the East Coast. The government built many cities in the northeast, but they have no investors and no jobs. The cities are empty.

The Chinese economic model needs fundamental restructuring. It has to move from a saving, export, and investment model to an internal consumption-dependent economy. Consumption is only 36 percent of GDP—about half of what it is in the United States and in emerging economies like India and Brazil. The main reason is that China saves too much:

- The government does not provide viable social security benefits and surviving parents and grandparents must save for living expenses after retirement. Families save for medical care and elective surgeries that are not covered in the state health care system.
- Chinese townspeople and the middle class save because they would like their children to attend private schools, learn English, play piano, and go to ballet classes. Building human capital even for one kid requires prudent savings.
- Parents save for old age because they have only one child and don't want to make them responsible for parental support.
- China is a digital cash economy. The Chinese use cell phones to debit their savings accounts, not credit accounts to buy goods. Credit cards are not popular at all. China bypassed the credit card payment stage, moving right to cell phone banking.
- Farmers save to buy inputs and farm equipment.
- State-Owned Enterprises don't pay dividends and retain their earnings in cash accounts because they don't issue stock.

The Chinese energy production model is also obsolete. This is not to say that it's any worse than in Bangladesh, Vietnam, the Philippines, or Central America, where the producers don't take care about the negative externalities aside from low wages. Its energy sources are dirty—78 percent of power comes from coal-fired plants, and over 300 million tons of coal are burned in households. (The country produces 1.1 billion tons.) Despite the success of the Three Gorges Dam, only 6 percent of energy comes from hydropower and 16 percent from nuclear and oil. China still builds 30–50 coal-fired electric plants a month at home, despite signing the 2017 Paris Climate Accord (PCA), and 1600–2000 coal-fired plants annually abroad. According to the PCA, China will not reduce CO_2 emissions until 2030. China, the United States, and the European Union are responsible for 75 percent of world CO_2 production from carbons, but China emits more CO_2 than the United States and the EU combined.

China has internal debt issues. The internal debt has created large public borrowing to finance fixed investments, which are still close to 50 percent of GDP. The government is financing construction of fast trains, airports, roads, and ports, but it also has empty apartment buildings, shopping malls, and, sometimes, literally empty "ghost" cities. Interest rates are low, and there's no stiff control of the profitability of lending.

The country is experiencing a real estate bubble. Empty apartment buildings are everywhere. The Chinese middle class doesn't save in the banks because the interest rates are too low, and there's no equity market. The Chinese stock market is very small for China's GDP, and citizens aren't allowed to own and trade in stocks. So, the families that have larger savings buy apartments and condos. The rich buy condos in upscale gated communities with American-like names: Oak Knoll, Golden Gate Condos, etc. The less affluent buy small apartments in 30-story buildings.

Construction companies borrow at a very low, state-controlled interest rate. The urban land is cheap because it is, again, state-controlled. If the construction company gets a license from a friendly bureaucrat, the profits on construction are very high, so they build more than is needed for actual occupation. The prices of unoccupied apartments and condos are rising 10 to 15 percent a year because of the way savers/investors are lured by the virtual appreciation.

Migrant workers can't afford or wouldn't live in the expensive apartments, because they don't have the right to resettle their families. This permit is called hukou. The city authorities, following the worries of residents who see more kids in crowded schools, more sick people in hospitals, and more travelers on crowded buses, want the hukou restricted. This also is a cause of anti-immigrant sentiments. In Beijing, in 2018 the government ordered the closing of 16,000 "illegal businesses" that provided jobs for migrants and the destruction of 150 traditional streets that were mostly occupied by migrant workers and elderly people.

The income gap is rising. There is a rising income gap between the rich, the urban east, and the poor, underpopulated interior in the central and western part of the country. Coastal areas are regarded by the people from the western provinces as cosmopolitan, with vested interests in having good relations with the United States and the West. Many of them are receptive to the local party leaders, who use the symbols, songs, and narrative of erstwhile Maoist egalitarianism. They are looked down upon by the Beijing political elite as dangerous dissenters and often found to be bribe-taking "breakers of the party discipline," a code word for malfeasance. The official Gini coefficients are not so bad, but the reality is indisputable. The interior is much poorer and more conservative, nationalistic, and ethno-centric; until recently it didn't seem to share the benefits of stellar growth; and it's basically anti-Western. Challengers to the bureaucratic monopoly of the coastal elite will show up here and there, but they won't make careers in the Central Committee of the CCP.

China is entering a Middle-Income Trap (MIT). This usually takes place in industrializing countries at a per capita income of $5,000–$10,000. (China already reached $14,500 in ppp GDP/pc.) The cause of MIT, briefly, is the depletion of the supply of cheap workers from the countryside. When this happens, the GDP growth must originate not from new employment but from actual productivity. This requires capital, education, inspiration, and entrepreneurship, which is not easily generated in a regulated state economy, or a socialist market economy, which the PRC claims to be. China will still grow rapidly by Western standards, but at much a slower rate than previously—not 10–12 percent annually, but 6–7 percent at best.

Pollution is out of control. According to the World Bank, China has seven out of 10 of the most polluted cities in the world, and about 20 percent of deaths in the country are related to air pollution (Chart 18). China's seven largest rivers are polluted in 80 percent of their flow, there's red tide in East China from fertilizer run-off, and there's a water shortage in an estimated 700 cities. The Chinese government is addressing the problem because of mounting public pressure. However, pressure can't be ultimately effective, because it is up to the government to determine what is a "legitimate concern of the citizen" and what is a "public peace disruption" that can end with a jail sentence. Here's where the pragmatism of the Party-State ends, and the authoritarianism starts (Gewirtz J, 2020).

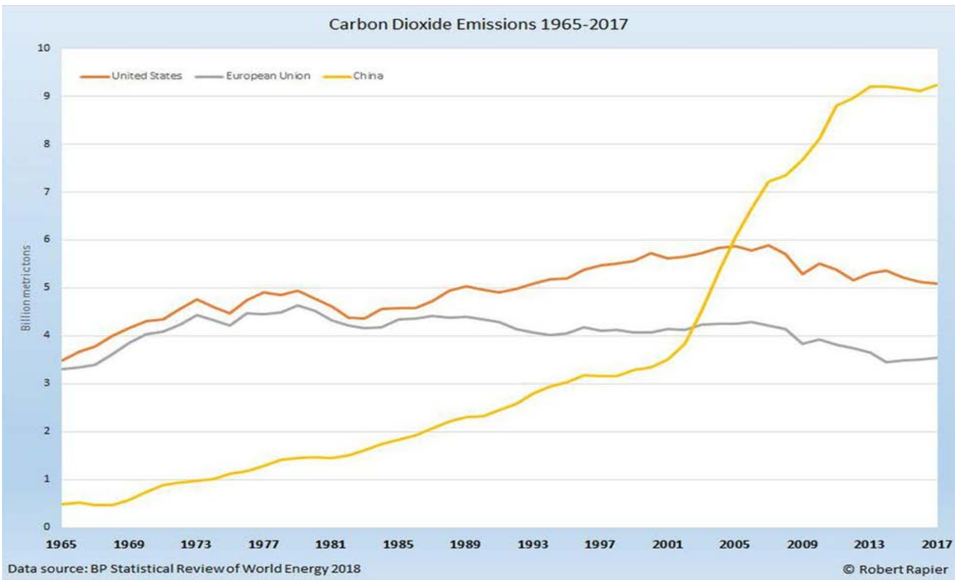


Chart 18. Carbon Dioxide Emissions 1965–2017.

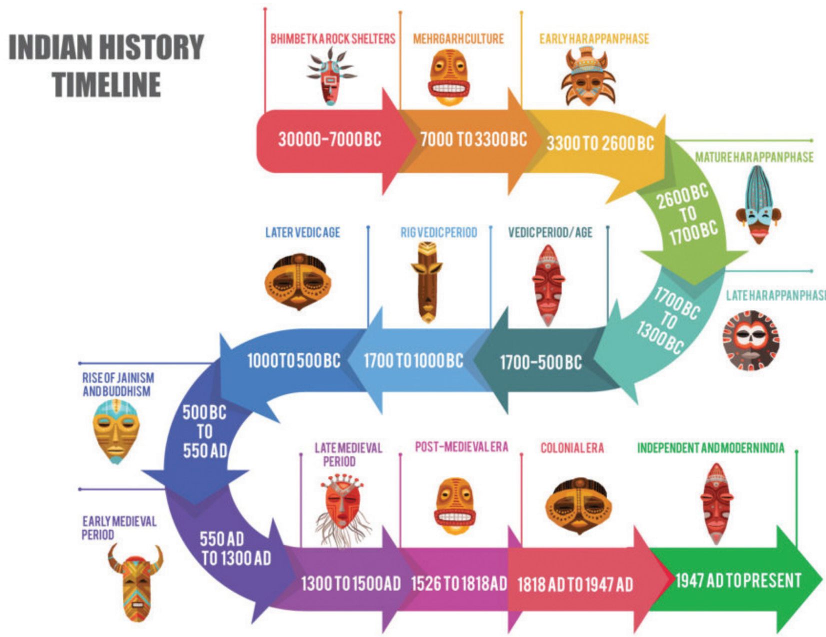
Source: Carbon Dioxide Emissions 1965-2017 [in] Why Curbing Carbon Dioxide Emissions Poses Such A Challenge by Robert Rapier https://www.forbes.com/sites/rrapier/2020/08/09/why-curbing-carbon-dioxide-emissions-poses-such-a-challenge/?sh=7b17c0c91e5d [accessed September 20, 2020].

The final word on China

Historically, humans have always preferred more freedom to less freedom, and the Chinese are not the exception to the rule. The question remains notify, but when the Communist Party will lose its self-proclaimed Mandate of Heaven since the Party-state continues to restrict freedoms of more and more affluent Chinese people.

3.2. India

The long view (Keay, 2011)



Picture 3. Indian History Timeline.

Source: <https://indianyug.com/indian-history-timeline/>. [accessed September 20, 2020].

The best analogy of the geopolitical map of India is "the island country." India is separated from its neighbors by **religion**. India, prevailingly Hindu (85 percent), is bordered by two Muslim countries, Pakistan and Bangladesh. India and Pakistan are both ambitious nuclear powers, very close culturally but too nationalistic to have permanent peace. The two countries already fought two wars over the northern territory of Kashmir. India is separated from China by its **political system**. India is the largest democracy in the world, and China is the largest communist autocracy in the world. India is also separated from China by **income**. The Chinese GDP per capita in real terms is three times higher than that of India. Finally, India is separated from the rest of Asia by **geography**. India's northern border rests on the highest mountains in the world, the Himalayas. This is perhaps the most important factor in historic terms, because migrations of Indians and other Asians were difficult for thousands of years.

Historically and currently, India and China have always been evaluating each other, comparing their growth rate, standard of living, and political systems. Since the 1980s opening of China to foreign investments and trade, China began to grow significantly faster than India. China thinks that it beat India to growth, infrastructure, and GDP, and India thinks that the future belongs to it because of its "demographic advantage." Indian politicians think that their democracy is long lasting, and they will outlast communist China.

Let's look at some quick facts about India and China in 2018. The population of India was about 1.2 billion, which was less than that of China (1.34 billion). The total GDP of India was $2 trillion, and China's was about $12 trillion. The real GDP per capita in India was $1,600, and in China it was $6,500 (ppp $14,500). Unemployment in India was about 8.5 percent, and in China it was 4 percent. Indian and Chinese growth rates were very similar as of 2019, around 7 percent, but India had significantly higher inflation than China. That's why Chinese leaders think they won the economic race with India.

India has a very uneven level of economic development. There is a 3-3-3 Paradox. The 3 richest states are 3 times richer than the 3 poorest states; India is a continent of peoples who are economically, demographically, and socially deeply stratified. It is equally a product of capitalism and a consequence of socio-economics castes, religion, culture, and colonialization.

To begin with, Hinduism is not a monotheistic religion. Every village, every state, every region has different deities and venerated gods. People are also strictly classified by professions, social roles, and the economic status that goes with these roles. At the top of the social hierarchy is a caste of priests, the Brahmins, then comes the warrior caste, Kshatriya, then the merchant caste, Vaishya, then the peasants, Sudra, and at the bottom Dalit, the untouchables, who perform the most unpleasant jobs of garbage collection and sewer cleaning.

Modern India has been trying hard to remove castes, discrimination, and ghettoization of the society, which have impeded not only social mobility (intermarriage) but, more importantly, the mobility of potential workers. The members of castes are expected to stay in their villages and places where they were born and raised. Though this may be discriminatory, it does save them from discrimination and attacks from members of the other castes. The Indian constitution bans caste discrimination and gives special quotas to discriminated classes. For, example, the Dalits have quotas in schools and government institutions and representation in the Lok Sabhas, local and national parliaments.

India's social, economic, and religious fragmentation led to a strong local political autonomy of the states and contributed to the weakness of the central government. During the colonial period, 1858 to 1947, the British perfectly understood this characteristic of India and used it to strengthen their colonial rule. For example, this jewel in the British crown the size of a continent several times larger than Britain itself required only 10,000 British foot soldiers and cavalry to control. The British knew that the local Maharajas, each very opulent, parochial, and greedy, wanted to expand their rule over the neighboring territories of other Maharajahs. The British usually encouraged their wars for power, and after the wars weakened them both, they established their own role as umpires. This was strategy very well known to the Romans: *divide et impera* or divide and rule.

The British colonial forces were very small, were well trained, and had modern machine guns and cannons that were quickly delivered to a battle by a large network of rail lines they had built in India to move cotton, salt, ores, spice, and timber to the ports. Some legacies of British colonial rule are the English language in schools and commerce; the legal system; the second longest railway lines after the United States; and the Cabinet system, in which the Prime Minister has the top executive position and the President performs merely ceremonial functions. India is a member of the British Commonwealth, which entitles Indians born before 1949 to be British subjects and get a British passport. Whatever one could say about the unfairness of British colonial rule, India had better luck than the colonies of Spain and Portugal in Latin America. The British wanted trade (the East India Company), exported textile technology to India, developed transportation, did not restrict education, and gave India the British judicial system and, most importantly, property rights, the lack of which has been a fundamental problem of Latin American economic development.

India in the twentieth century (Jeffrey, 2018)

India's democracy was born in 1947. After gaining independence from Britain, the Muslim leader *Muhammad* Ali *Jinnah* and Hindu leader Jawaharlal Nehru could not come to an agreement whether India should be Muslim or Hindu. They separated parts of India into West India, which became Pakistan, and Bangladesh, which is relatively surrounded by India in the East. This decision caused the largest people's migration in modern times, when dozens of millions of people were resettled from India to Pakistan and Bangladesh, and vice versa, simply because of religious identity. Today, India has about 15 percent Muslims, and Pakistan has almost no Hindus. Kashmir, the disputed territory, has close to equal representation of both religions.

This separation was not what Mahatma Gandhi, the father of the nation, had hoped for. Gandhi, the Indian barrister (lawyer), had defended the Indian diaspora (Indian immigrants) in South Africa against the British interests and the Boers (Dutch colonizers). He became well known not only in British colonies in Africa but also in his native India, to which he decided to return in 1915. His return to India was very well advertised in the newspapers and documented with many photographs. It's important to mention that because he used the media to make a statement. He descended from the ship dressed not as a British barrister, but rather like a poor peasant wrapped in a white homespun cotton robe. Gandhi wanted to make a statement to the Indian merchant middle class not to assimilate with the British colonizers. Gandhism had four main principles:

1. Economic self-sufficiency: Dress in homemade robes, do not buy textiles from the British factories. Use salt from the Indian Ocean instead of buying it from the British monopolies. Do not support British economic interests or generally Western investments. The model of self-sufficiency morphed into a semi-socialist planning and protectionism system called Swadeshi.

2. Peaceful resistance, nonviolence: This was abandoned when India built its nuclear industry to confront Pakistan, which also acquired nuclear capabilities. Each country has between 150 and 200 warheads and medium range rockets. India also developed sophisticated military rocketry for civilian and military applications.
3. Restoration of Indian unity by returning to the balance of village life and the Hindu religion: Gandhi wanted to end the middle-class assimilation with the British. Today, the Hindu Populist Party, BJP, is returning to nationalism and Indian Hindu identity again.
4. Policy of Non-Alignment: Until the 1990s, India was neither pro-capitalist nor pro-communist. Gandhi wanted India to be the leader of the non-allied countries by adopting the "third way" between capitalism and communism. This hesitation delayed the privatization of the economy and the shedding of protectionism. Major industries and banks, railways, and airports are still state owned.

Later, this philosophy was endorsed by the Indian Congress Party. The Congress Party dominated India's politics for the next 67 years in every aspect of life: nationalistic and socialist economic Swadeshi, opposition to privatization, capital control, population control, import substitution, and protectionism. Politically, the Congress Party wanted independence from the West (the United States) and the East (the Soviet Union), promoted Hindu nationalism, and pursued nuclear power status.

Until losing power to the populist *Bharatiya Janata Party* (or BJP) in 2015, India's Prime Ministers came from one family, the Nehru family. They adopted the name Gandhi starting with the Nehru's daughter, Indira. Being called the "Gandhi" family not the Nehru family, meant to show their long-term adherence to Gandhi's philosophy. Although the PM posts were occupied by one dynastical line, India has been a functional democracy in a practical sense.

India in the twenty-first century (Crabtree, 2018)

In 2015, the election was won by the populist leader of the BJP Party, Mr. Narendra Modi. Mr. Modi came from the State of Gujarat in the northeastern part of the country, where he held the PM position of the local state. Gujarat was the most successful of the 28 Indian states, registering 8 percent growth for a 10-year period. Chowkidar (the Watchman), as Mr. Modi calls himself, has introduced many sweeping and sometimes controversial reforms in India. First, he has reformed tax administration and enacted a new value-added tax (a goods and services tax or GST). Prior to the reform, India had 1,000 tax rates across 32 states and territories for a basket of 1,700 goods and services. The new tax rate has been reduced to six rates: 0, 3, 5, 12, 18, and 28 percent. Tax administration has been improved and simplified.

This fiscal and budgetary reform is long overdue in India. According to various media reports, only 2 to 3 percent of Indians pay any personal income tax (PIT) at all. India's finance minister said that 2.89 percent of the population (or 36 million people) filed income taxes in a country of 1.2 billion, and the government collects only 10 percent of its budget from PIT. The central budget is poor and could not put money into roads, ports, communication systems, or electricity production to allow production and export, or create jobs for the overpopulated villages and towns. Over 94 percent of India's working population is part of the unorganized sector. In local terms, the organized sector or formal sector in India refers to licensed organizations, that is, those that are registered and pay GST.

It must be added that previously each Indian state required different invoicing for merchandise. The trucks were waiting in miles-long lines for days to cross state lines, applying for special licenses and paying fees. The new system introduced in 2017 is expected to generate and store 3.2 billion invoices every month at a peak rate of 120,000 transactions per second, which is a challenge to the government IT sector. This change is predicted to increase internal cross-border goods flows by 25 percent and boost GDP by 3–4 percent.

A more controversial reform is India's demonetization or confiscation of the most frequently used 500 Rupee (about $17) and 1000 Rupee bills. Hundreds of millions of Indians were forced to line up at cash machines/bank counters to replace old bills. It was intended to expose the informal economy and restore control over tax collection. Demonetization temporarily brought the commercial economy to a standstill, reducing GDP by 1.4 percent, but the government hopes to increase control over liquidity flow.

The future of India

What does the Indian government need to do to sustain economic growth in the future?

First, any country that wants to join the world supply chain needs infrastructure: good transportation, ports, and communication systems. Until now, the budgeting and taxation system was unable to accomplish this goal. Seventy percent of tax revenue comes from agriculture, and half of that remains in the states to pay for farm subsidies and welfare programs, which were socially justified by abject poverty. In addition, the previous Congress Party government spent too much on funding large state-owned monopolies, while the private sector had to rely on its own funding. The government borrowing "crowded out" commercial credit, and money was too expensive to support the small businesses sector.

India lacks good logistics and transportation. India's 3.3 million km road network is the second largest after the United States, but it is most pitiful. National highways are only 2 percent of the total, and only one-quarter have two-lane traffic. The container port of Mumbai has nine berths, whereas Singapore has 40. It takes 21 days to clear import cargo in India; in Singapore it takes three days.

Second, the country needs a more mobile labor force. The caste system reduces mobility. India also has a staggering gender imbalance. There are 7–8 percent more men than women, which you'd think should have produced more male workers. But it is just the opposite. The imbalance is a product of the tradition in Hindu families to have more boys because only boys can properly bury their parents, boys inherit the land, and girls are costly to marry off because of the traditional dowry in gold. (India is the largest buyer of gold jewelry in the world). Years of population control sponsored by the government and tradition did the damage. Husbands do not and cannot leave their wives and daughters alone without male protection. In addition, leaving the village to find uncertain employment in the industrial city does not make sense, because the farmer gets 100 days' minimum wage employment guaranteed by the government under the Mahatma Gandhi Rural Restoration Act. Despite educational gains, the *labor force* participation rate for *women* in 2017 was 28.5% (compared to 82% for men).

Third, the supply chain needs electric power, and India's power grid needs fundamental improvement. There are frequent blackouts, and 35 percent of power is stolen from the grid through illegally tapping the lines. Utilities can't collect money from users, so there's no cash flow to finance power generation. The government doesn't have enough money to build adequate supply capacity. India has some coal but doesn't have gas and oil, which it must import. However, India did develop a highly successful IT sector thanks to local power generation and satellite communication. The Indian IT sector works in banking; programming; medical services; and credit card, insurance, and other services.

Fourth, the country needs pro-trade taxation and tariff systems. The state sector, such as commercial banking, insurance, fertilizer, mining, chemicals, steel, oil, seaports, and airports, pays low corporate taxes, and the new GST tax targets consumption, not corporate income. The economy needs to simplify bureaucracy, which in India is monumental and earned the name "license raj." Indian bureaucrats are underpaid and expect gratification from foreign firms. Farmers get little money for their produce because there are six traditional levels of vendors to reach the buyer. India still has no effective wealth or inheritance taxes and, as some critiques say, it is still a tribal society which produces billionaires and extreme poverty.

For many years, Walmart wanted to build their chain in India. After years of negotiations, Walmart agreed to source from 65 to 100 percent of sales locally, build "cool chain" (special storage for frozen food) and get many permits. In the end, Walmart gave up on India. Walmart has some 360 very successful stores in China and none in India.

Fifth, the country needs to remove protectionist barriers to trade, quotas, foreign exchange control, and import licenses. The Chinese solution to cut through the communist bureaucracy was to create Special Economic Zones (SEZs). India has 423 SEZs formed by cities and states and only five that were set by the central government. There's no one set of rules for all SEZs. Each one has different rules. The purpose of an SEZ is uniformization, standardization of regulations, instead of repeating typical Indian bureaucratic complexity.

But in India, traditions are stronger than economic rationality. This is the bottom line of why India missed the opportunities of globalization. The central democratic government has been too weak to enforce change, but big progress has already been made under PM Narendra Modi. India is not a market that a global firm can ignore. Theoretically, it could become the world's largest middle-class consumer market by 2040, surpassing China and the United States in its number of consumers. In the next 20 years, India may add over 1 billion people to the global middle class.

India vs. China: is there even a comparison?

The GDP growth rate of India overtook the GDP growth rate of China in 2015. This has fuelled many newspaper articles in India stating that India is also on the path to replicating the Chinese growth story. However, the truth seems far from it. Despite the Indian media's frantic efforts to put India and China in the same league by using statistics that are misleading to compare the two economies, India is still a long way behind China. True, that India has made rapid strides on the path to becoming an economic powerhouse. However China has been doing so for decades. In this article, we will explain why India–China comparisons are totally baseless.

China's Economy is Four Times Larger Than India's Economy

The GDP of India is close to $1.5 trillion. At the same time, the GDP of China is close $7 trillion. The economy of China is at least four times as big as the economy of India. This means that even if China grows at the rate of a meager 1.5% and India grows at a rate of 7%, the Chinese economy would have added the same amount in output as the Indian economy would have!

Comparing the GDP growth rates of India and China is therefore a pointless exercise. China's growth rate has been consistently higher than India's growth rate over the past three decades or so. India has barely overtaken the Chinese growth rate for a couple of quarters. Only if India can continue to beat the Chinese growth rate by a huge margin for the next two to three decades, does India stand a chance of overtaking the Chinese economy.

Inflation in India is 6 times higher than it is in China

India's GDP growth has been accompanied by runaway inflation in the country. Growth rate accompanied by inflation cannot last for a long period of time. Instead, such growth rate is indicative of the short term impetus that has been given to the economy by the monetary policy.

On the other hand, China's inflation has been relatively stable at a negligible 0.8% for many years. This has been accomplished despite the fact that China has been recording fiscal surplus for the past many years and ideally should be reeling with inflation. To the contrary, China has established sovereign wealth funds, which invest the additional cash in foreign assets keeping the inflation rate low.

Given the fact that Indian economy is severely marred by inflation, it seems unlikely that they will be able to compete against China in the long run.

China's Manufacturing Productivity is 1.6 times than that of India

China produces a lot more than India does. It also does so remarkably more efficiently. Given the better quality infrastructure and better production techniques at China's disposal, it is not astounding that the average Chinese worker produces 1.6 times more output than that of the average Indian worker. This means that the productivity of China as a nation is 60% higher.

The Indian manufacturing sector has multiple problems. These problems include erratic electricity supply, slow and expensive transport systems as well as lack of skills that increase manufacturing productivity.

Given that a large portion of these problems is structural in nature, it seems unlikely that India will be able to overcome them in the near future.

Workforce

The Indian economy on the other hand, has a clear strategic advantage when the workforce is considered. The Indian education system was created by the British. As such, Indian workforce is global in nature. They can speak fluent English which gives them an edge over Chinese nationals who face language barriers. Also, the Indian workforce does high end jobs for the information technology industry and BPO industry as compared to the Chinese workforce which works menial jobs on the factory shop floor. Given that the future of the world lies in high skilled knowledge jobs, the Indian workforce may soon rise in prominence while the Chinese workforce may soon become redundant.

One-child Policy

Also, China faces what many economists call a demographic time bomb. For the past couple of decades, China has followed the one-child policy to control population. However, now China faces a situation wherein there are more people out of the workforce than in it. On an average, every Chinese worker is expected to pay for the costs of at least two Chinese retirees.

India, on the other hand, is facing a demographic dividend. It has a huge, extremely skilled workforce. Hence, if the government is able to provide jobs to these workers, the Indian economy is expected to grow by leaps and bounds. Given the fact that there will be a lot more people in the workforce than out of it, India is poised to become an economic superpower.

Entrepreneurship

China is still more or less a communist country. This means that all the enterprises there are run by the state. State run enterprises are usually not efficient and definitely not innovative. On the other hand, the Indian industry is based on innovative enterprises. Given the competitive nature of the world economy, the Indian industry stands a better chance at success in the future. This can already be seen as capital intensive Chinese industries such as coal and cement are going bankrupt whereas knowledge intensive industries such as information technology are thriving!

The China India comparison is therefore absurd at the moment. China is a full-fledged superpower that has begun to show signs of decline whereas India has just started rising. The path is long and uncertain and only time will answer certain questions!

3.3. Japan

The long view (Walker, 2015)

The Japanese live on the tips of four volcanic islands that are by nature very hilly and not easily accessible. That's why all of Japan's large cities are on the coasts, while the rest of the country is almost 68 percent covered by forests—an unusual geography for a highly developed country.

The cultures of these islands developed in isolation and are typically very hermetic and different from the rest of their neighbors across the sea. This separation was reinforced by history and decisions made by leaders. In the 1600s, Japan's ruler, Tokugawa Legasu (Shogun), decided to close the country to the rest of the world. The Shogun did not allow merchants, travelers, or Christian monks to set foot on the island. Anyone who left Japan was banned forever. Japan was destined to preserve unique traditions, culture, Shintoism, and the feudal state forever. The isolation ended in 1854 when American Captain Matthew C. Perry forced the entry of US naval vessels into the port of Edo (modern day Tokyo), demanding supplies for his ships, and was turned away. The American Navy fired their naval guns into the air. The guns and the smoke didn't cause any damage, but they permanently destroyed the prestige of the Shoguns.

Following this incident of "gunboat diplomacy," Japan removed the Shoguns and restored the ancient Meiji dynasty. The new emperor not only opened Japan to trade and people but also initiated an intense plan to catch up with the overdue industrial revolution. The Meiji Restoration included importing Western military and civilian technology; construction of roads, bridges, and rail connections; running telephone and telegraph lines; shipbuilding; chemical manufacturing; an aircraft industry; and Western education.

By the early 1900s, Japan had become a regional power, which threatened Russian interests in the region. The Russian Tsar, facing domestic political unrest at home, decided to wage a war on Japan in 1905. During the war, Japan beat Russia on land and sea with its newly acquired technology. This victory over

Russia marked the advent of Japanese imperial ambitions in Asia. Japan's emperor ordered military colonial expansion to Korea, Sakhalin, the Ryukyu Islands and Formosa (Taiwan), and the Pacific.

In the 1920s, Japan was clearly on a collision course with the United States in the Philippines. The Five-Power Pact intended to limit Japan's navy buildup was never implemented. The Great Depression and the problems at home weakened US resolve to confront Japan. In 1931, Japan invaded Manchuria (northeast China) and created a puppet state, Manchukuo. In 1938, Emperor Hirohito, Adolf Hitler, and Benito Mussolini launched the Axis Berlin-Rome-Tokyo. The three-country axis agreement envisioned a new division of the world: Europe and Russia under German control, the Asia-Pacific region under Japanese control, and North Africa under Italian control. In 1941, Japan attacked the US Pacific Fleet at Pearl Harbor.

The US entry into the war and subsequent defeat of Japan put a stop to Hirohito's imperial ambitions. Between 1945 and 1957, Japan was under US occupation. Today, the United States has 35,000 active military personnel and about 120,000 civilians living in Japan. The third largest world economy still depends on US protection.

Japanese immigration choices

Like Germany, Japan became a rich industrial country after WWII; however, their immigration policies are fundamentally different. Germany has allowed substantial immigration from Turkey since the 1970s (some 4 million) and has admitted close to 1.9 million immigrants from the Syrian war since 2016. Japan is practically closed to immigrants. Thirty years ago, Japanese lawmakers decided to limit the number of visas given to foreign workers and introduced impossibly difficult naturalization exams. Today, only 1.54 percent of Japan's citizens are foreign-born, while Germany has 12.5 percent, and the United States has 14.5 percent. Japanese corporations have large reserves of capital, but they are reluctant to invest at home, fearing labor shortages. They know that they will not find workers at home or obtain visas for their IT workers, nurses, doctors, or construction workers from South Korea, China, the Philippines, or India. The inflow of immigrants is restricted by the stiffest quotas in the world.

Japan's population is shrinking. Some of the recent demographic and social trends include the fact that many young Japanese men do not want to get married, and therefore stay with their parents well into their 30s. Japanese women seldom have more than one child. At work, women don't get promoted as readily as men. The Japanese cabinet leads the way in giving negative signals; it has just reduced the number of women in ministerial positions from four to one, even under the watch of PM Shinzo Abe, who pledged to encourage women in the workplace. The labor force shortage is one of the main causes of the slow growth of the economy and will continue to be so in the future.

Japan made a choice to maintain barriers to outsiders and maintain their ethnic purity, which is quite anachronistic in today's globalized world. It didn't work in the past, and there's no reason to believe it will work in the twenty-first century. Japan is trying to rediscover itself as a world power after 30 years of slowdown, but that won't be possible without reworking its immigration policies.

The Japanese export-driven economic model (Johnson, 1982)

Japan started its twentieth century rebirth from a very low point. During WWII, its industry was destroyed. The traditional fishing industry was not an option for this prewar industrial powerhouse. The silk industry had little demand—cheap nylon and synthetic fibers were better for the textile industry and military parachutes. Japan had no export markets in Asia, and anti-Japanese sentiments were very strong after its WWII rampages and brutal occupations.

Japan was the first neo-mercantilist country in Asia, before China, South Korea, and Singapore, and showed spectacular rates of growth in the 1960s and 1970s. Japan discovered the advantages of export-driven growth and made a priority of exports over consumption. The country was led by a pro-capitalist political leadership, the Liberal Democratic Party, with backing from small businesses representing 70 percent of the economy. There was no political pressure from the workers' unions to raise wages, and a broad consensus existed for sacrifice to rebuild the economy.

Japan was ready to provide the skilled and disciplined labor, but technology and resources had to be imported. The United States was the only place that could provide both technology and a rich consumer market for Japanese exports.

Japan couldn't count on foreign investors. The capital had to come from forced saving at home. The government didn't offer a social security system and required that all employees save large portions of their wages in pension plans. It was a voluntary choice but also an indispensable necessity for prudent Japanese. The government collected the savings from government-owned postal banks and paid minimal interest rates on the pension deposits. As custodians of a large pool of pension savings, the bureaucrats were free to invest them in infrastructure and technology and give low-cost loans to export monopolies. Generally, workers were paid small monthly wages while paying high taxes and high prices for consumer goods. The national saving rate skyrocketed to 23–25 percent.

The growth strategy relied on export monopolies called **Keiretsu**. The companies had a very specific ownership structure. Though in principle they were publicly owned, they did not create much stockholder ownership—they were **self-owned**. In the center there was the Keiretsu bank, which owned the stock of the member companies: production plants, supply chain companies, a trading company, a transport branch, maintenance, etc. In turn, the member companies owned the Keiretsu bank.

This structure had important consequences for the allocation of and return from capital. Lending was not competitive because banks were not expecting a high return (ROI or ROE). They were not concerned about **stockholder value but survival of the monopoly stakeholders**. Self-ownership gave Keiretsu freedom of capital allocation and reduced the risk of market failure. When Keiretsu had losses, they used "creative accounting" and hid the "unperformed loans" until they could get a government bailout. The monopolies did not face much inter-company competition because their markets were protected by the Ministry of Industry and Trade and the Ministry of Finance. Japan operated almost like a large Japan, Inc., with the government as a CEO.

Keiretsu were not expected to be profitable. They were not expected **to maximize profits but to maximize world market share** for Japanese cars, color TVs, camcorders, music players, and semiconductors. The state was ruling the economy, and the Keiretsu were working for a **national export goal**. The best analogy for a horizontal Keiretsu would be a holding company, and a vertical Keiretsu could be compared to integrated supply chains under one corporate structure.

The rule and control functions were tasked to two large ministries, the **Ministry of Finance (MOF)** and the **Ministry of Industry and Trade (MITI)**, which dealt with money supply, interest rates, taxes, imports, exports, foreign exchange, foreign direct investment (FDI), and antitrust. Both ministries hired the best professionals and paid good salaries. Retired MOF and MITI bureaucrats were placed as senior executives or board members in the Keiretsu banks or controlled companies. This structure was called "the descent from heaven." In addition, there were many formal institutional forms of control, such as "administrative guidance," "window of guidance," and "advisory councils." Industry leaders issued "white papers," which were de facto national economic plans. One my say, Japan was run as a single corporationcalled Japan **Inc.,** in which the government was the CEO.

Control of the labor force was also very important. Japan opted for "**a corporate welfare state**." Unlike in post-war Germany, where the state developed a social security system and provided health care and free professional training, in Japan all these functions were left to large corporations. The Keiretsu offered **lifetime employment contracts**, **education**, **and healthcare** for the employees and their families. The workers were never laid off, so there was **no need for state unemployment benefits**. The employers expected loyalty of the workers and maximum effort to accomplish the company production goals. When unions were asking for higher wages, the strikes were planned to not disrupt production and took place at an agreed time and place.

The Japanese industrial system was very efficient through the late 1970s. In the United States, some economists, politicians, and union leaders raised an alarm that Japan would "overtake" the United States by the size of its GDP, its income per capita, and, more importantly, technologically. This would happen sometime in the 1980s.

The mood in the United States was reminiscent of alarms voiced today about China. In 1984, Robert C. Christopher, in his book "*The Japanese Mind: The Goliath Explained*," asked a question: "Its [Japan's] 119 million people are squeezed precariously onto four Pacific islands virtually devoid of natural resources. Much of its industrial base was reduced to rubble by the end of World War II. Yet in less than 40 years, Japan has become the world's second greatest economic power, rivaling the United States in steel, producing an ever-increasing variety of high-quality consumer goods, and even surpassing the US in electronics and in auto production."

In the economically troubled United States and Europe of the 1980s, angry calls for protectionist measures were accompanied by a sense of awe at Japan's efficiency. Political economists credited the success to Japan's protectionism and precarious single-mindedness about growth and export without consumption, combined with the US policy of liberalization and the rise in demand for inexpensive industrial goods by more and more affluent US households.

Japan never took over the United States. In mid-1985, the United States was swamped by "Japan bashing." The antagonism was most apparent in the industrial Midwest, where importing Japanese automobiles was blamed for the loss of jobs. The Farm Belt protested import quotas on beef and other agricultural products. In California, executives in the electronics industry accused the Japanese of pirating the newest semiconductor technology. Americans become convinced that Japanese leaders were insincere when they said they wanted to narrow their trade surplus.

Following the general sentiment of Americans, President Reagan imposed a 100% tariff on selected Japanese electronic products for allegedly "dumping" computer memory chips, imposed import quotas on Japanese cars, and finally pressed during the G-5 Plaza Accord of 1985 (United Kingdom, Germany, France, Japan, United States) to revalue the yen from 240 per dollar to 120 per dollar. Japanese export prices doubled. The chances of Japan to "take over" the United States were gone.

This is a good analogy for the policy of President Trump toward China today. The United States has a historic tendency to create favorable rules of trade for certain nations, but when they become too powerful and too successful, they want to put the brakes on their growth and restore the rules of competition. As all nations do, they mind their long-term economic interests first.

Japan in the Twenty-First Century (Gordon, 2019)

Around 1990, a well-designed and productive Japanese economy plunged into a major recession with negative or no growth, which continues until today. The keys to understanding the current political economy of Japan are the **3 Ds**: **Debt**, **Deflation**, **and Demography**.

Debt: To be precise, we are talking about public debt, not household debt. To understand it, we must look back at the export-driven growth model. A country that depends on exports and the consumption of other nations has a fundamental problem when the world market slackens, and exports fall. For example, Japan suffered more from every US recession than the United States itself. Using a medical analogy, when the United States got the recessionary flu, Japan got pneumonia, with all the symptoms of economic depression. The United States got over the recession with an antibiotic of deficit spending, downward price flexibility, reduction of imports, and lower interest rates. We have a large consumption market that is generally very responsive to monetary incentives. The Japanese economy has small consumption, so it had to use public spending from the apothecary of John Maynard Keynes to initiate big infrastructural projects. The government overspent to maintain internal demand at times of imported recession.

Another source of the debt was the Keiretsu itself. The Keiretsu system was good for the first stage of the country's development; however, it was obsolete in the globalized economy, which required quick adaptation and flexible supply chain structures. Noncompetitive allocation of capital and government subsidies led to many commercial successes but an almost equal number of blunders and failures. Japan never produced a civilian aircraft, even though it had the supply components for Airbus and Boeing planes; never developed a good carbo-chemistry or pharmaceuticals industry; and wasted billions of dollars on a camcorder technology that never became a standard (Betamax).

The nonperforming loans were hidden in the balance sheets of the Keiretsu banks until a crisis hit in the 1990s. From 1995 to 1998, Japanese banks wrote off more than 50.8 trillion yen in bad loans. Though it was not yet called Quantitative Easing (QE), the Bank of Japan decided to help banks and bought trillions of yen in commercial paper. The QE policy continues today without a visible effect on GDP growth. In 2010, the economy shrank by 5 percent, though it recently returned to 1.0–1.7 percent growth. Japan is swamped with a 245 percent debt to GDP ratio, the highest among the industrialized countries and even higher than in the financially bankrupt Greece (around 200 percent at its peak).

Deflation: Japan is suffering from lack of internal demand. Traditionally restricted household consumption, high savings, pared with corporate reluctance to invest in the tight labor market pushed the prices down. In the early 2000's Japan's real estate prices, once the highest in the world, have been rolled back to the level of the 1980s. Japanese corporations have accumulated large amounts of cash, but they hold back on domestic investment. They prefer to invest in Southeast Asia, India, and Africa. Capital investment abroad replaced domestic investment.

The Bank of Japan (BOJ) keeps trying to print money to get Japan back to economic prosperity, and more than 15 years of **quantitative easing** (**QE**), or the buying of private and banks' assets to recapitalize businesses and prop up prices did not work. Negative interest rates were announced by the BOJ in January 2016 as a new iteration in monetary experimentation. Three years later, the Japanese economy showed no growth and its bond market and GDP in growth in 2018 was only 0.5 percent. The Japanese government can't rekindle domestic consumption and investment —doing so is very difficult without new consumers.

Demography: The population of Japan is 127 million and is shrinking and aging at a very fast rate. The Japanese have a very high life expectancy—81 for men and 87 for women—and can retire between age 60 and 70, with bonuses for those who retire after 65. Traditionally, even educated women stop working after having a child, and families have an average 1.43 children per family. It's not the lowest total fertility rate (TFR) in the industrialized countries—South Korea and Singapore both have 1.19, Hong Kong has 1.12, and Germany 1.38—but it's far below the replacement TFR of 2.1.

Some general takeaways from Japan

- Industrial countries can't open their borders to uncontrolled immigration; this would be unwise and create more harm than good in the short run. Rich countries should control their borders and have clear and honest laws, create work opportunities for immigrants, and promote inclusion in the society. Creating ghettos of immigrants is destabilizing and destroys political and social order. Japan took an extreme position on the issue and has paid the price. Beneficial immigration laws in Australia and Canada might serve as good examples. The United States was born as an immigration project, and its democratic system should lead the industrialized world in again setting a good example.
- Good governance is very important in a modern market economy. The government must make sure that startups and mature corporations have an adequate supply of educated people, resources, and capital. The government should promote technological progress and favor a balanced economy. But when it aspires to becomes a CEO, as the government of Japan did in the twentieth century, it is bound to fail. Japan still pays the price today of manhandling its market economy.

3.4. South Korea

The long view (Hwang, 2016)

South Korea's development over the last half century has been nothing short of spectacular. Fifty years ago, the country was poorer than Bolivia and Mozambique; today, it is richer than New Zealand and Spain, with a per capita income of almost $30,000. For 50 years, South Korea's economy has grown by an average of 7 percent annually, contracting in only two of those years. In 1996, South Korea joined the Organization for Economic Cooperation and Development, the club of rich industrialized countries, and in 2010, it became the first Asian country and the first non-G-7 member to host a G-20 summit.

Today, South Korean companies are major players in a broad selection of industries, such as cars, electronics, chemicals, and ship building. They created many well-known world brands, such as Kia and Hyundai. Foreigners own more than one-third of the stock on the KOSPI index (the Korean version of the S&P 500), which provides a very accurate picture of global trends. South Korea copied the Japanese system and improved on it.

Over the last decade, South Korea became the only manufacturing exporter that has gained significant market share in China. South Korea is pushing into several emerging markets. In 2003, two-thirds of South Korean exports went to Western developed nations; by 2011, two-thirds of their exports went to developing nations.

South Korea is a modern version of Japan. Both are conformist societies respectful of hierarchy, but unlike Japan, South Korea is an open society. Its readiness to adjust and learn from its failures is the core distinction of Korean success in the last 30 years, while Japan experienced stagnation.

The source of South Korean success

South Korea is an example of a country that grew very fast and yet violated the canons of conventional wisdom. Instead of liberalization, entrepreneurship, export specialization, and the play of market forces, they developed a regime based on hard government interference and family-owned monopolies, or **Chaebols**. South Korea's success can be attributed to strong government that gave large firms protection and support in return for good use of imported technology and cheap labor. On the surface, this also seems to be true of Japan. However, there are fundamental differences in the way the **Japanese Keiretsu** and **South Korean Chaebols** operated and implemented their business philosophies.

Japanese Keiretsu were self-owned. They had interdependent stakeholders, members of the same export monopoly. They shared profits but also losses, so it was almost impossible to identify the losers. In the Keiretsu, as described in the previous chapter, profit maximization was secondary to the survival of the brand. Keiretsu never failed, thanks to government subsidies and bailouts.

The main units of industrial organization in South Korea are called Chaebols. Like Keiretsu, Chaebols were tasked with the post-war reconstruction. For example, Samsung started as a village store in 1938. Today, it's still controlled by the same family. Chaebols are majority-owned family businesses but are also listed on the stock exchange. At the top is a holding company that controls every unit below in a strictly tree-like hierarchical pattern. The member firms (industrial units) are financially and operationally unrelated: they don't have interlocking boards, cross-ownership, or cross-bailout schemes and must be profitable individually. Unprofitable business divisions are easy to identify and dispose of. Family members exercise a great deal of influence on managerial activities but usually hire professional managers to run day-to-day operations.

Chaebols generally do not rely on less competent family members to run the company ("third-generation doom"). Often third-generation family heirs, having been raised outside business operations, have limited managerial experience, which, combined with voting power, multiplies their incompetence. Chaebol owners avoided making such mistakes by hiring experienced managers to run their businesses.

Chaebols' strong autocratic leaders, top-down decision-making and communication, and dauntless goal seeking created strong competition for many

American and European brands. These brands include Daewoo Bus, Hyundai Motors, Genesis, Kia, Proto, Renault Samsung Motors, SsangYong, LG Electronics, Samsung Electronics, and SK Telecom. For example, LG is the world's largest producer of OLEDs (organic light-emitting diodes), and Samsung and Sony rely on their panels in almost all of their lines of OLED TVs.

South Korea also has fashion brands you've never heard of: Antidote, Charm's, Antimatter, Dozoh, and Blindness. Although they haven't made it to the market in the United States, they make significant sales in developing countries.

South Koreans create many brands and try them at home. They apply in practice "**creative destruction**." **Joseph Schumpeter** (1883–1950) created this concept to describe the process of industrial mutation and elimination that constantly revolutionizes the economic structure from within, incessantly destroying the old, incessantly creating the new. The term gained popularity among neoliberal and free-market economists as a description of downsizing to increase the efficiency and dynamism of a company. It's a process compared to the pruning of fruitless tree branches to make space for new ones that grow in their place and bear fruit.

For example, during the 1997 Asian currency crisis, the IMF lent $58 billion to South Korea on the condition that it reduce the cross-debt-payment guarantees among members of the same Chaebols. Twenty four out of sixty largest Chaebols filed for bankruptcy in 1997. South Korean unemployment tripled from mere 2 percent in 1996 to 7 percent in 1999. Chaebols closed inefficient branches, while during the same crisis the Japanese government bailed out (recapitalized) most of its Keiretsu's.

The South Korean policy of "creative destruction" paid back and economy started growing two years later 5 to 7 percent GDP growth rate. The IMF was repaid in 2001, two years ahead of schedule. The crisis also gave an interesting insight into the South Korean philosophy. Nearly 3.5 million people, almost a quarter of the entire country's population, voluntarily participated in the campaign of gold collection to repay the debt. Queues of people—young and old, rich and poor—stretched for blocks outside special donation points, all of them answering the call to help their country. Yellow ribbons proclaiming "Let's overcome the foreign currency crisis by collecting gold" could be found pinned to people's shirts.

Big-name Korean corporations, from Samsung to Hyundai to Daewoo, lent their marketing strength to help spread the word, as did celebrities. Lee Jong-beom, a hot young baseball star, drew national attention when he brought in 31.5 ounces of gold, valued at over $9,000, all in the form of trophies and medals he had acquired over his five-year career.

On average, each person donated 65 grams of the yellow metal, or a little over $640 based on prices at the time.

In as little as two months, 226 metric tons, valued at $2.2 billion were collected, every scrap of which was melted into ingots and promptly delivered to the IMF. Although this amount was just a drop in the bucket, the gold collecting campaign served as an important rallying point early on in South Korea's effort to tackle its debt, not to mention the fact that it demonstrated the deep patriotism and unity of its people. The people of South Koreans wanted to share the pain of the failure, while in Japan the government tried to save the Keiretsu and the nation from "humiliation of the failure."

Japan and South Korea have very different business cultures and national philosophies. The South Korean philosophy is "**Wha**,"**harmony and sharing pain**, especially under extreme situations. A strong autocratic culture permits quick responses to changes in the market with little resistance. Businesses that close accept it as a sacrifice to share the pain.

The Japanese philosophy is "**Wa**" **harmony and no loser**. The Japanese do not accept defeat easily. The government is expected to bail out inefficient companies. Keiretsu member companies value good relationships with stakeholders and support each other. Loyalty was more important than stock value and profits. Member companies were not singled out for poor performance.

Comparison of Keiretsu and Chaebols

Features	*Chaebols (Korea)*	*Keiretsu (Japan)*
Ownership and control	• Family owned • Family-oriented • Strong autocratic leadership	• Cross-stock ownership • Stakeholder orientation • Collective leadership
Structure	• Unrelated, vertically integrated structure • Government does not allow groups to own banks • Expansions based on family moods and government policies	• Either horizontally diversified or vertically integrated • Banks are core group members • Expansions based on MITI's long-term plans and group's strategic planning
Finance	• Internal goals dictated by government's goal agenda • Cross-debt-payment guaranteed loans	• Internal goals dictated by own financial institution's long-term returns • Capitalized by using internal banks and financial institutions willing to take higher risks
Government influence	• Enforcement of industrial policy through direct grants and subsidies • Cause of undisciplined growth and overcapacity in some industries	• Supportive of industrial policy through research subsidies • Competition reduced by support of weaker firms and „no lose" strategy
Culture	• *Wha* enables quick decisions and ability Id sell or liquidate unprofitable units	• *Wa* requires time to reach consensus

Chart 19. Comparison of Keiretsu and Chaebols.

Source: Own elaboration.

The comparison of South Korean Chaebols and Keiretsu (Chart 19) shows clearly that protecting the status quo, protecting old industries against outside competition, and government bailouts are not effective ways to run a global company. Acceptance of failure and strong leadership are crucial for dynamic market economies. **South Korea's success stands as proof that government protectionism has its place in the reconstruction of the economy but over time may become the source of failure, as it happened in Japan.** However, that doesn't mean that government is not needed to set up a general economic strategy in foreign economic policy and political relations with the outside world. Today, South Korea wants to improve relations with North Korea and is taking steps to use trade and investment as an avenue to normalize political relations with the North.

South Korean Challenges in the Twenty-First Century (Tudor, 2018)

Demographic challenge: Economists normally ascribe growth to the availability of basic inputs—labor and capital—as well as to increases in productivity. In 2010, South Korea's "core productive population"—citizens aged 25–49—fell for the first time. If current trends continue, its dependency ratio will begin to rise within the next decade, and by 2030, its population will start to decline, falling below current levels by 2050.

Innovation challenge: South Korea will need to address productivity if it can't maintain its labor and capital advantage, especially given the competition it faces from its neighbors, low-wage China and high-technology Japan. But increasing productivity requires more than just technological innovation, which is difficult in the heavily regulated service sector. Until now, its companies have relied heavily on imitation and reverse-engineering technology invented abroad, but this will not replace innovation.

Inequality challenge: South Korea faces growing inequality of income and wealth. Encouraged by the historically symbiotic relationship between business and the state, the government has concentrated economic, political, and cultural life in Seoul, one of the world's most expensive cities. As with London in the United Kingdom, the pull of the capital city has stoked inequality elsewhere in South Korea.

Addressing the widening wealth gap is critical if South Korea hopes to avoid the kind of political backlash from the center-left that could damage its economic growth. Populism would turn the democracy into a plebiscite between the upper middle class and the workers and peasants, with the latter winning against the goal of economic growth.

North Korea: North Korea's Kim Jong Un is a third-generation hereditary leader with a penchant for nuclear provocation. South Korea is cautiously planning for reunification. Inter-Korean projects, such as the **Kaesong Industrial Complex** (closed for a while but recently reopened) and the opening of **railroad lines** along the east and west coasts, linking South Korea to Russia and China, are broadly popular in the South. **Gas pipelines from Russia through North Korea to South Korea** (and even on to Japan) are planned. China does not want Korean reunification before the United States agrees to completely withdraw militarily from South Korea. The United States needs a true art of the deal to not withdraw from South Korea without total denuclearization of the North.

Sixty years ago, the US government considered making its destitute ally South Korea a regular line item in its foreign aid budget; many Americans expected Seoul to remain an adopted child of the United States forever. South Korea, of course, has proudly proved that expectation wrong—and seems likely to keep defying skeptics for years to come.

3.5. Singapore

The long view (Barr, Trocki, 2018)

Singapore is a city–state at the tip of Malaysia. Its history and development are an example of a country in a constant search for comparative advantage, heavy-handed enforcement of social integration, and a relation between the rule of law and democracy in Asia.

Singapore lies on the shortest route from Europe, Africa, and India to Shanghai, Hong Kong, Manila, Japanese ports, and Busan in South Korea after the construction of the Suez Canal in the late nineteenth century. Until 1942, Singapore was a colonial post for the British East India Company, before the British surrendered the naval base to Japanese occupation. After WWII, the British controlled Singapore until leaving in 1963.

Singapore had an 80 percent Chinese population and a large Muslim minority. After a series of ethnic riots, Singaporean **Prime Minister Lee Kuan Yew** (LKY) worked out a deal to create a new independent state. LKY remained in office for the next 30 years. After his departure, the position of PM was taken over by his son, Hsien Loong, to be only the second PM in the history of Singapore. **Singapore is a democracy, but opposition never wins there.**

The People's Action Party usually had 82–84 seats out of 87 people in the Legislative Council (LC is one chamber of parliament). In the 2011 elections, its LC dominance was reduced to 60 percent of the seats, its lowest showing since independence. **Voting is compulsory in all elections.**

Holding such power in the LC, PM LKY could act as a "democratic ruler" in the multi-ethnic state. He had a vision of racial harmony, strong state control over the economy, and uncompromising imposition of the rule of law as a prerequisite of economic success. **The introduction of the rule of law before democracy is often the narrative of East Asian autocratic governments.** This was true in the 1980s in South Korea, and it is true today in Thailand and Myanmar.

LKY's governance style would not be possible in a Western democracy, but it was possible in East Asia. LKY governed Singapore as an economic and political fiefdom, which reached per capita income only $2K lower than the United States ($59K) and experienced 40 years of 9 to 10 percent average GDP growth.

The city state as a corporation

Sixty percent of Singapore's economy is still under state control. For many years, foreign investors were chosen only from family-owned businesses, for example, HP or Texas Instruments, because PM LKY believed that centralized decision making is better than dispersed public ownership. PM LKY also introduced a compulsory saving scheme called the **Central Provident Fund** (CPF). For some 30 years, employees were obliged to save 25 percent of their salaries, and employers had to additional 25 percent wage fund tax all into the CPF pension scheme. The CPF pension fund offered the government a low-cost pool of capital which was invested in infrastructure, housing, education, and research. CPF also invested in the Singaporean Stock Exchange through a sovereign (government-run) **investment fund Temasek.**

The CPF money built the state-of-the-art Changi airport, the hub of Singapore Airlines. In 2010, two new casinos, "Santosa" and "Marina Bay Sands," were co-funded by Temasek to increase the tourist traffic and revenues. The government-owned A* Star Fund and Biopolis offered subsidies to biotechnology and medical research start-ups. By government design, Singapore became a major producer of vaccines for East Asian and African health problems, malaria and dengue fever. Also by government design, Singapore has one of the best state-funded public school systems in the world and a good university with offshore campuses of UPenn and INSEAD. Singapore's traditional and controlled education system does not produce many Nobel Prize winners but offers many affluent Asians alternative to apply to Western world universities. Singapore has also become a medical hub for affluent Chinese middle class which can't get the same services at home at any price.

Singapore is a place to spend money in the casinos, show wealth, and pay no taxes. Income earned outside Singapore has zero tax. Investors who make money in Singapore pay only 14.2 percent tax. Compare that to top personal income tax rates of 32 percent in the United States, 49 percent in Germany, and on average more than 50 percent in the rest of the EU. There is no capital gains or inheritance tax. The Economic Freedom Index compiled annually by the Heritage Foundation places Singapore as the second-best place in the world to start a business after Hong Kong.

What's the cost of being a citizen of Singapore? Rich Asians, mostly Chinese and Indonesians, can buy investors' visas, which give them a path to citizenship. It's very difficult to get a working visa, but most of the people who come there don't come to work but to manage their capital. Most come with money made somewhere else, not always legally. This is not much of a concern for the government because money laundering takes place there as well. London is the place for Russian oligarchs, and Singapore, which has the same LLCs (limited liability companies) as London, is a destination for the (crazy!) rich Chinese. Under British law, LLCs provide a very good defense against foreign anticorruption forces, which are usually slow and underfunded.

The government is constantly searching for a new comparative advantage in transport. Entrepot is a big business. The location of Singapore is crucial. The shallow ports of China are not reachable by mega size container ships, which are the staple of intercontinental trade today. Smaller container ships leave their containers in Singapore where they are reloaded onto the 20,000-container ships heading to the Persian Gulf, the US West Coast, or the Panama Canal. Singapore has the seventh largest merchant fleet in the world and one of the best port services in Asia.

Average citizens and visitors feel the heavy hand of the "Nanny state." Possession of a pound of cannabis until 2013 meant a mandatory death sentence. (Now it can be commuted to life imprisonment.) Spitting and chewing gum are not permitted in public places. There are electronic cordons for taxis and mandated speed buzzers. Corruption in government is not tolerated, and a small gratification can cost a public servant S$100,000 in penalty and up to seven years in prison. Corruption practically doesn't exist also because public sector salaries are very high by Asian standards. LKY's salary was $3.8 million, and his son makes $2.2 million. More than half of the top eight salaries are in the government. The bonuses of public sector employees are prorated to the growth of the GDP.

Today's Singapore is the economic showcase of South Asia, a mix of very strong government and a market system. Its comparative advantage is its location, transport services, highly educated and very disciplined labor, low taxation, and technology industry. But the comparative advantage of location may be broken. The Thai Canal, also known as Kra Canal, refers to proposals for a canal that would provide an alternative to transit through the Straits of Malacca and shorten transit for shipments of oil to Japan and China by 1,200 km. China refers to it as part of its twenty-first century maritime Silk Road. The canal would be 102 km long and 400 meters wide. The final decision has not yet been made. It would have potential economic and strategic benefits for China and Singapore.

Sources of economic success (Kushnir, 2019)

Singapore has a stable government; an intelligent, ambitious, and honest leader; effective developmental strategy; strong government institutions; a high-quality bureaucracy; incentive pay; good education; a good regulatory system; and high-quality public officials.

Even though Singapore is not a poster picture for democracy, it's lucky that its leaders were not corrupt like in Malaysia or Indonesia. Political economy teaches us repeatedly that countries and nations can't count on luck but the electoral process that guarantees the replacing of the leaders who have exploited its usefulness for the country. No longer have useful leaders tried to stay in power and that's when democracy deteriorates into a state that we call illiberal democracy. Institutions such as free elections, freedom of speech, and an independent judiciary are restricted in various ways and means. Democracy is a very inefficient system of government, but it's the best we know.

The downside of growth

Singapore is ranked among the world's most expensive cities. Singaporeans feel squeezed by high property prices, a rising cost of living, and strains on the island nation's infrastructure amid an influx of immigrants, although they are essential to the state's continued growth. Cash-rich foreigners, especially from China and Indonesia, bid up prices of housing real estate. Financial services, such as wealth management and commodity trading, bid up prices of commercial real estate.

Inequality is on the rise, but Singapore doesn't produce data on poverty in the state. The government decided that publicizing that data is not necessary.

Chapter 4
The European Union and the Middle East

4.1. The European Union

The long view

Experts on Europe often make a mistake. They claim the EU is an obsolete dream of European liberals and federalists like Jean Monnet or Paul H. Spaak. They see the EU in a deadly crisis and talk about the possibility of Grexit or Italexit. These pessimists don't take the long view to understand that the EU has just gone through its 60-year-long first stage. The new stage, in which the EU will become more inclusive and multicultural, has just begun. It will be at least as long as the previous one.

The first stage, <u>expansion</u>, started in 1956,when the countries of Belgium, the Netherlands, Luxembourg, France, Germany, and Italy signed the Treaty of Rome, and **ended with the vote on Brexit in 2017**. It was the process of building an incomplete United States of Europe, by the Europeans and basically for the Europeans. The project was based on the common values and strong economic interest of 95 percent of the population. The values of minorities and the concept of building a multiethnic, multicultural union were mostly ignored.

The second stage, <u>consolidation</u>, started in 2018. Brexit can be read as either the sign of the dissolution of the EU or the moment of truth for the potential future "exiters." There will be fewer candidates to exit from the EU in the future because there is no easy exit from the single market and the benefits of which far outweigh political benefits for those who dream about being again lone European powers or culturally and ethnically "pure" nation states. The exiters understood that the alternative to being in the EU is political chaos, loss of economic potential and border problems with the rest of Europe.

The process will be also dialectic. In the second stage, the EU will reinstates some border control, reform immigration policy, and stop considering admission of any more countries to the EU, such as Ukraine and Turkey. The EU will become more realistic about its outreach policies and cut generous subsidies to poorer member states. Naïve federalism will be replaced by realism and a return to what the EU is all about, that is, market integration and common markets. **The consolidation stage may mean smaller Union but stronger EU. It will be historically a far better alternative than competition of the European Powers. Crisis is a unifier.**

Let's draw some comparisons between the creation of the United States of America and the United States of Europe. The United States of America was built because the settlers had a common enemy which started as a political union. Common cause led to the Declaration of Independence and later to the US Constitution and a troubled economic and consolidation. The European Union was created not because of a political union but because Europeans wanted to merge markets, open their borders to the free flow of capital and labor, and expand consumer markets. A common market and free trade in the entire continent are far better ideas than fragmented and protected national markets. **The EU started as the economic integration that led to political integration. European economic integration set up the foundation on which the political integration was built.** This path is the cause of both the strengths and weaknesses of the European integration project. The path from economic integration to political integration is a very complex process.

Now look at the USA. The political structure, constitution, congress, senate, and presidency were well in place when labor market integration of the North and the South became a major challenge to the existence of the USA as a political union. The challenge was the **free movement of labor, the freedom from slavery**. Gettysburg ended the Confederate secession. It was a war about the economy of the rights of the slaves but also about limiting the self-proclaimed right of land-owners to own the slaves. Elimination of slavery and full labor market integration took the USA 87 years, from 1776 until 1863.

The EU does not allow easy secessions from common EU law. Basically, Brussels says to the UK government: if you want the benefits of the common goods market (free trade), you must follow the laws on immigration and the free movement of labor. Brussels leverages economic integration, or the single market, to obtain the status of political supranationalism, or saying you must accept the common laws above your national laws on immigration; otherwise, you will suffer economic losses. Brexit shows the strength of the European Union as a political unit just like the USA showed the strength of not allowing the South to break the law of the Union on the freedom to maintain slaves. **The EU and the USA are at different stages in the building of their Union. We had a political framework (US constitution) before economic integration. The EU is building economic integration to have a common constitution or political framework.**

There is one more important distinction between the European Union of States and the American Union of States, in terms of the control of our borders. The USA has a better political geography than that of the EU. The USA is protected by masses of water. The USA can control who comes to live here, even if some politicians sometimes tell us that it can't. For the EU, protection of its borders is far more difficult. Europe is close to Turkey and the Middle East (Levant), and close to North Africa (Maghreb).

For example, the Greek island of Lesbos is only 3.5 miles from the Turkish shore. If an exhausted, shaken refugee family from Syria sets foot on Lesbos, they are in the EU, they are protected by EU legal due process, they can apply for political asylum, and they can wait for the immigration quota in Germany or Sweden, which is not in the EU but signed the Schengen agreement.

The USA is a country of immigrants and has the immigration system which has been developed over 200 plus years. The EU is not a land of immigrants and can hardly handle the process. Some EU countries are 8 to 10 percent immigrants such as France, Spain, Belgium, while Poland, Hungary, Slovakia has 0.01 or less percent of immigrant population.

For the EU, the resolution of the immigration issue fundamental. In terms of human history, great migrations have taken place before. Even if the EU restricts illegal immigration and steps up border control, the population dynamics and geography will reshape the EU. The EU will become more multicultural and multireligious, that is, it will look more like the USA in the next 50 years. The Brexit crisis and the rise of anti-immigrant parties in the EU have awakened the EU member states to the fact that uncontrolled immigration can threaten the entire project of the United States of Europe.

Map 2. European Union.

Source: VectorStock https://www.vectorstock.com/royalty-free-vector/map-europe-with-european-union-members-vector-14204938 [accessed October 10, 2020].

Here are two important general take always from the EU chapter:

First, the rich nations that have low population growth must make compromises and become multiethnic and multicultural, or their economic growth will substantially decline. A moral, ethical aspect is also involved. Rich nations can't be blind to the suffering of poor refugees. In the long run, it is economic opportunity, demography, climate, which will decide where humans want to populate the Earth, not the decision of the ethnic groups, political tribes, nation states. The Earth is a common property where humans live and they make an ultimate choice.

Second, in the long run, political economy laws take precedence over nationalist theories. Two World Wars started in Europe because a few ambitious emperors and leaders who thought that industrial technology would give them weapons to rule the world, the rich Aryan race would dominate, and other inferior races should be eliminated. Nationalist dreams of dividing the world into Aryan and non-Aryan races or forever rich and forever poor may only lead to yet another unthinkable war.

The European Union institutions

There were two conflicting visions of how to unite Europe after WWII:

The French vision—a weak union: The French statesman and philosopher Jean Monnet proposed a limited union of independent states. There would be a monetary union (MU) with common money but no control of national budgets. Later, a political union or common constitution, like in the USA, would be adopted after national referenda (Peterson Hodson 2017)

The German vision—a strong union: The German Christian democrats and social democrats wanted one government for all members, a monetary union, and a common currency. A common EU government implies the same taxes in all countries, a big budget, and one European Central Bank (ECB), much like in the USA, to control the money supply for the entire Union.

The European Union (EU) started as an economic union, a French and German cooperation after WWII, called **the European Steel and Coal Union**. Five years later, with the blessing of the United States, six nations—France, Germany, Belgium, the Netherlands, Italy, and Luxembourg—signed the **Treaty of Rome (1957)**. The countries expanded the **Tariff Free Zone (TFZ)** and added the **Common External Tariff (CET)** to create the **Customs Union (CU)**. The next step was to create **the Common Market (CM)**. The CM consisted of common agricultural markets, a common capital market, a common service market, and a common labor market. The objective was to guarantees the "**four freedoms**"—**free movement of goods, capital, services, and labor**—within the EU.

Even after Brexit, 27 member states would have access to a 502 million-person market, which includes not only EU members but also Iceland, Liechtenstein, Norway, and Switzerland, which belong to **the European Economic Area (EEA)**. For example, under the EEA rules, all corporations, investors, workers, goods, services, and banks enjoy the same treatment as EU firms. Establishing this system involved a massive task of abandoning national laws and adopting a body of common laws, standards, and procedures.

The **EU is also a political union**, with a quasi-government, with legislative, executive, and judicial branches and a central bank. The institution and the voting system were adopted as Constitutional Treaties. **There were eight constitutional treaties.** In the last one, the member states adopted **the Common EU Constitution** in 2007 in Lisbon, Portugal.

Here are short descriptions of the EU institutions:

The EU Parliament (EUP): The EUP is in two cities: Brussels, Belgium, most of the time, and once a month in Strasbourg, France. The French were reluctant to give up the privilege of hosting the European Parliament. Once a month, all 731 parliamentarians, their staff, and all offices must be transported some 220 miles from Belgium to France. This commute costs about $200 million a year.

The EU Parliament is not a legislative body but a political one that includes representatives of major European parties. The EU parliamentarians are elected in direct elections in the member states.

The European Union Council (EUC): This is the main legislative body of the EU. The EUC (also called the European Council or the Council of Ministers) hosts permanent ambassadors, and ministers create and work on Common European Laws. Once their job is done, the heads of the member states assemble four times a year to strike final deals on controversial issues and socialize.

Also, the European Parliament has the power to approve or reject EU legislation, though this doesn't happen often. The voting takes place in the **European Council**. There are three types of votes: **simple majority** (15 member states vote in favor), qualified **majority** (55 percent of member states, representing at least 65 percent of the EU population, vote in favor), **unanimous vote** (all votes are in favor). The qualified majority is the standard system. In the US Congress, we have big states and small states, and so does the EU. In the USA, parity between small and big states is achieved by giving each state the same number of senators (two) per state. In the EU, passing laws requires that 65 percent of the population is represented for the vote to pass. The qualified majority is a numbers game—bigger states must rally the support of smaller states; otherwise, they wouldn't be able to reach the required 65 percent of the population.

In practice, unlike the US Congress, the **EU Parliament** is not creating the laws but, most of the time simply approving the law created by the combo of the Europe Council and European Council of Ministers. The EU parliamentarians approve the laws during plenary sessions and make time-limited statements in their native languages. Their voices are very important in cases of immigration, economic rights, foreign policy, gender and minorities, and mistreatment of individuals, but they also make populistic speeches intended for their country's electorate.

The European Commission (EC): This is the quasi-government of the EU. The EU does not have a true government today and may never have one. The EC employs about 4,000 well-paid employees who, unlike federal government employees, pay very low taxes. The President of the Commission can be compared to a Prime Minister and the Commissionaires to the Ministers of a nonexisting EU government. The rulings of the EC are not supranational in a general sense because the EU is working based on a consensus. They become supranational (above the member states' governments) when the EC implements EU common laws and regulations.

In cases of breaking the fundamental rules of democracy (rule of law, separation of powers, independent judiciary, human rights), the member states may be sanctioned under Article 7 of the EU Constitution, which calls for the suspension of the member state's voting rights in the EU Council. This sanction has never been invoked in the history of the EU.

There is also **the Court of Justice of the European Union**, **the European Court of Human Rights**, and the **European Court of Auditors**.

The **European Central Bank (ECB)**, located in Frankfurt, Germany, is not a central bank for the member states, which have their own central banks. The ECB determines interest rates, but the ECB is not the lender of last resort, nor does it keep the reserves for the members. The ECB has limited rights to buy the bonds of members, which is a political, not economic, decision for the EU.

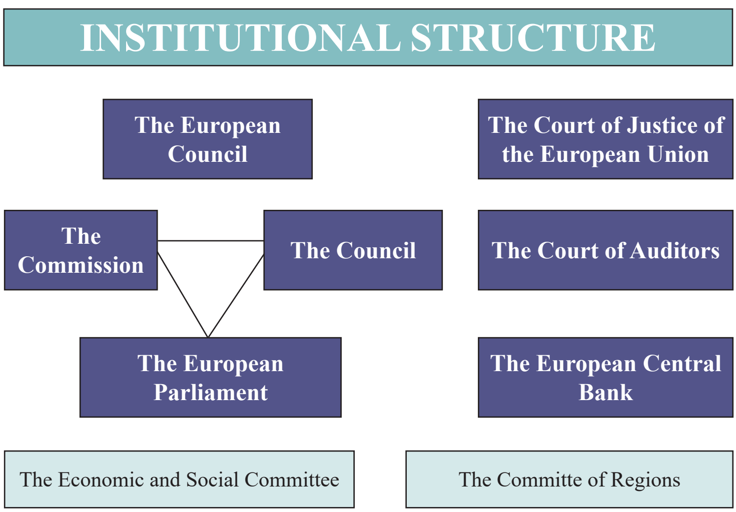


Chart 20. Institutional Structure.

Source: Institutional Structure. <https://slideplayer.com/slide/6963618/>. [accessed October 21, 2020].

The unfinished project: The USE

Creation of the United States of Europe (USE) will require: a common constitution, four freedoms (trade, services, labor, and capital), one federal government with a large budget, common taxes, common laws, a common army and police, common foreign policy, a single currency, and a central bank (Webber, 2018).

Government: The quasi-EU government, **the Commission**, has a budget that amounts to about 0.5 percent of the combined budgets of the member states.

Single currency: In 2000, the EU introduced a single currency, the euro, but only 17 out of 27 member states adopted it. As the economist Robert Mundell pointed out, any country or countries that want to have a common currency must become an Optimal Currency Area (OCA). The USA is an OCA; the EU is not. An OCA needs full freedom of the flow of the factors of production among the participating states. The EU states have established nearly full freedom of trade, capital, and labor but don't have the same productivity standards. There are two Europes in the EU, the productive north and the far less productive south. There's nothing wrong with the Southern European lifestyle: taking long lunch breaks and having small businesses that rely on skills rather than assembly lines and mass production. The issue is that they can't devalue (manipulate) their currency to make their exports more competitive.

For example, before joining the European Monetary Union (EMU), Greece, Italy, Spain, and Portugal had national currencies—the drachma, lira, peseta, and escudo, respectively. When they wanted to promote vacations on the Mediterranean or offer their low-cost labor at home, they were able to devalue their currencies against the French and Swiss francs, the German mark, the British pound, etc. After joining the EMU, they couldn't devalue their currencies against the German or French euro. Without raising productivity, the south must accept **social devaluation**, that is, lower wages, a lower living standard, and less generous welfare packages. This factor is creating a space for populism in Greece and Italy.

Southern Europe expanded the welfare state and never resolved tax dodging, slacking productivity, and raised public debt. Public debt is manageable when the national economy grows, but at a low growth rate it is ruinous. The north-south productivity divide is separating the EU members. The fiscal austerity forced on southern debtor countries ("Club Med Countries") by Germany and by other northern Eurozone states created a catch–22 situation. **Austerity measures** lowered their growth, and with lower growth they are not able to pay off their debts.

Low productivity turns into long-term economic stagnation. Ten years ago, 17 of the world's 50 largest corporations were European; today, they number only seven, compared with China's eight. In the last 25 years, average productivity growth in the EU was 2.7 percent a year, more than double the American figure of 1.3 percent. But at the dawn of the twenty-first century, most European countries made the wrong business choices; their focus on tried-and-tested sectors like heavy industry and banking led them to neglect the digital revolution.

Another unfinished project is the **European Central Bank (ECB)**. The ECB is not "the lender of last resort," doesn't enforce common deposit insurance, and doesn't have full authority or resources to bail out the indebted member states. Just to compare, for example, the US Fed is authorized to bail out any of the states of the union, whereas the ECB can't do so without the political decision of the European Council.

In fall 2018, Germany proposed to create the **European Monetary Fund**, which would be outside of political control. Technically, no-strings-attached loans would be dispersed to countries with a deficit below 3 percent—or with at least 0.5 percent consolidation each year, for three years—and a debt-to-GDP ratio below 60 percent. Under normal circumstances, distress funds would only be released under strict conditions, ensuring there would be no "moral hazard" in dispersing low-interest loans to EU member states. If this is accepted, the EU might be inching itself forward toward becoming the United States of Europe.

The German proposal is based on the **Convergence Criteria** spelled out by the **Maastricht Treaty**. This treaty was a compromise under which the EU would have common money without the common government. The problem is that very few countries have kept to the **Maastricht limits of a 3 percent deficit and 60 percent public debt**.

The rule of law in EU

Strengthening the rule of law – and in particular judicial independence – has been on the EU agenda for several years and it is still a high priority. The situation in Poland and Hungary has confirmed that the measures provided in the Treaties are not sufficient to effectively counteract certain risks or infringements of the rule of law that may occur in the Member States. On May 2018, the Commission presented the Proposal for a Regulation on the protection of the Union's budget in cases of generalized deficiencies as regards the rule of law in the Member States. In general, the proposed Regulation allows activation of a system to block access to EU funds in order to protect the Union's financial interests from the risk of financial loss in the event of "generalized deficiencies" as regards the rule of law are detected.

The proposed Regulation on the protection of the Union's budget in case of generalized deficiencies as regards the rule of law in the Member States was developed in response to the acknowledgment that no swift, effective response is currently coming from the Union institutions, in particular to ensure sound financial management. But when dealing with infringements of or risks for the rule of law detected in a certain Member State, it is important that the steps taken and the decisions adopted under this new mechanism do not cause an even greater detriment to the EU's values.

The introduction of a financial sanctioning system, such as the one foreseen in this Proposal, although it can undoubtedly be very effective and have a strong deterrent effect in preventing infringements of rule of law principles, can also lead to a polarisation within the EU. In the end, this could have a negative impact on the cohesion and integration needed. In opting for strong responses to non-compliant Member States, the risk of dividing the European Union should not be overlooked.

Article 2 TEU values	*Democracy*	*Rule of Law*	*Fundamental Rights*
	• Separation and balance of powers (the legislative, executive and judiciary: each branch can independently carry out its own respective function) • Independence of the judiciary • Pluralistic system of political parties and organisations • Accountability and transparency • Free, independent and pluralistic media • Respect for political rights	• Legality • Legal certainty • Prohibition of arbitrariness of the executive • Independent and impartial courts • Effective judicial review including respect for fundamental rights • Equality before the law	• Universal • Indivisible • Interdependent • Interrelated Fundamental rights have been divided into three generations: • First-generation human rights („blue" rights) are fundamentally civil and political rights. • Second-generation human rights are economic, social and cultural rights. • Third-generation human rights („green" rights) are fundamental rights which have been recognised in the latest times including, for instance, the right to self-determination, the right to a healthy environment and the right to data protection.

Chart 21. Key concepts.

Source: L. Pech, Erik O. Wennerström, Vanessa Leigh, A. Markowska, L. D. Keyser, A. Gómez Rojo, H. Spanikova "An EU Mechanism on Democracy, the Rule of Law and Fundamental Rights." 2016 https://www.semanticscholar.org [accessed October 21, 2020].

The European nation

Over 60 years, the EU has grown to 28 nations with a total population as of January 1, 2018, of about512.6 million people. The Schengen agreement has been adopted by 22 of the 28 nations. Of the six EU members that are not part of the Schengen Area, four—Bulgaria, Croatia, Cyprus, and Romania—are legally obliged to join the area, while the other two—the Republic of Ireland and the United Kingdom—maintain opt-outs. EU citizenship gives you the right to travel, work, and settle in any of the member states and expect protection by the EU rule of law. The same rule of law applies to immigrants. If you set foot in any country of the EU, you are not deported, and you can ask for refugee immigrant status in any of the member states.

Most of the people who carry an American passport would say "I am an American." If you ask about the nationality of a person with the Schengen passport, you can expect 28 different answers: "I am Austrian," "I am Belgian," "I am French," "I am German," etc. The creation of the United States of Europe would require the exchange of not only identity cards but the national identity of Europeans. It took a long time for Americans to stop saying "I'm a Southerner" or "I'm a Yankee," to underline their different opinions on slavery and race, or "I'm Italian" or Irish or German. It will take perhaps an equal amount of time for Continentals to first say "I'm European" before stating their nationality. Paradoxically, if Brexit passes, some British citizen may start saying, "I'm Scottish, and the capitol of my country is in Aberdeen" or "I'm Irish, and my capitol is in Dublin."

The EU nation is in a demographic decline. Negative feedback exists between growth, productivity, and demography mechanisms known to economists. A lack of productivity growth increases joblessness, even with long-term decline of birth rates. There's no question that about 40 percent of low-skilled young workers and even university graduates in many parts of Europe have no chance of finding work. The years since 2008 have seen unemployment in the EU rise by 10 million people to 26 million. The EU's slow growth compounded by southern Europe's stagnation is alarming.

It's generally accepted by economists that a growing labor force is key to growth, as we have pointed out in the case of Japan. Even if tighter immigration controls lead to a slowdown in America's forecast demographic growth from 320 million to around 400 million by mid-century, the US economy is on a steady upward trend. That of the EU is not. The present population of the European Union, including the United Kingdom, looks likely to fall to around 450 million by 2050. Raw numbers like these are less significant, though, than the ratio between workers and dependents. How far and how fast Europe's workforce will shrink will be determined by the flow of immigrants.

One overwhelming reality counters the brand of the populist politicians in France, Germany, Hungary, and Poland. Europe is aging at an alarming speed, and its workforce is shrinking, while social security costs are soaring. As a rough average, there are at present four working-age people to support each pensioner. But by mid-century, that ratio will have shrunk to just 2:1. The formerly communist countries of Eastern and Central Europe that joined the EU in 2004 have, overall, thrived economically, after overcoming the hardships of adapting to free-market conditions, because they had lower costs, high productivity, many young people, and a much better total fertility rate then the western EU.

Immigration

Fears over immigration and resentment against the job-shifting effects of globalization have seen the rise of anti-establishment populists on both the extreme left and extreme right ends of the political spectrum. Alarm bells have been ringing on both of these issues for some time but were widely ignored by vote-seeking populist politicians.

Developments in France, Germany, and Austria will be crucial to the continent's future. France and Germany have been economic powerhouses. In recent years, though, the wasting of France's industrial sinews has become a cause for concern. The populist siren calls, notably anti-immigrant rhetoric and demands for trade barriers to protect French jobs, have produced a steady rise in support for the far-right National Front Party. Elsewhere, extremists on both the left and right, offering simplistic solutions to complex problems, have become prominent figures in national politics and pose very real threats to Europe's continued integration.

The answer to the continent's rapid aging and growing labor shortage was to increase immigration—a visceral issue that has seen populist parties across Europe garner millions of votes. The arrival in 2015 of about a million refugees and economic migrants from conflict zones in the Middle East triggered a surge of support for the anti-EU Alternative fur Deutschland (Ad) Party, which came almost from nowhere to gain support from 16 percent of voters in 2018. From Greece to Italy to Spain, and even in level-headed Scandinavian countries, the voters are upset by newcomers who challenge the EU and its values. Following 2016, the "Brexit" vote has deepened a climate of doubt. Europeans are no longer confident that their 60-year project of progressive economic and political integration still has a rosy future.

Voters are increasingly anti-immigrant. It's a mood that did much to determine the outcome of the Brexit referendum in the United Kingdom, and it is shaping election outcomes across the continent. Yet the economic effects of halting or severely curtailing immigration are potentially catastrophic. Without new blood from beyond Europe's borders, the present workforce could number only 169 million in 2050, taking a huge chunk out of the European economy and limiting its maximum attainable growth rate in gross domestic product to barely 1 percent a year.

No one is more worried about this trend than Germany's hugely successful export industries. Daimler, the Stuttgart-based producer of luxury Mercedes automobiles, has warned that, come 2020, more than half of its skilled workers will be more than 50 years old—and it is struggling to find enough young apprentices to replace them. Meanwhile, Volkswagen has revealed that a third of its vehicles are already being produced by factories in Asia.

The USA and the EU

Where, then, do Europe's difficulties leave the transatlantic relationship? The short answer is: largely unaffected for the time being, but vulnerable to substantial change in the longer term.

More than half a century of trade and investment across the Atlantic has created an extraordinarily robust joint economy. American-owned assets in Europe are worth $14 trillion, says the US Bureau of Economic Analysis, accounting for 60 percent of all US foreign investment around the world. For their part, European investors account for two-thirds of all foreign-owned holdings in the United States. The recent US "pivot" to Asia still has a long way to go before it makes a dent in the transatlantic relationship.

Trade in goods across the Atlantic is, at about half a trillion dollars yearly, rather less buoyant. That's a reflection of the competing local attractions of the European and American domestic markets, but also of protectionist tendencies in both. It is also why, in recent years, Brussels and Washington have invested a good deal of political capital in the unsuccessful effort to conclude a Transatlantic Trade and Investment Partnership.

Some have begun to question the value of the **North Atlantic alliance** after the 1989 fall of the Berlin Wall and the subsequent collapse of the Soviet Union. Since then, Russia's military resurgence and more assertive foreign policy have given **NATO** a new lease on life, but that has been somewhat negated by the failure of its European members to even maintain their modest defense budgets. Their "freeloading" has long provoked irritation in the United States, and President Trump's apparent hostility to the alliance may even spur the EU to spend more on defense. **Without Washington's encouragement, the EU risks stagnating and depriving the United States of its most powerful ally.** For Europe to take greater responsibility for its own defense seems highly desirable.

The EU in the Twenty-First Century

The Europeans would like to have all the benefits of the United States of Europe without paying the price that the 50 states of the USA had to accept to be part of that Union. It's a constant process of argumentation and debate about what functions in the EU are supranational, that is, decided by Brussels, and what is to be decided in the member states. The benefits of the common markets are very convincing. The joint market of 512 million people is much better than that of France or Malta alone, the largest and smallest EU members. he real problems that remain are daunting: productivity, economic stagnation, immigration, low population growth, and the rise of populist parties. The EU is at a crossroads.

Where does that leave the European Union? The EU faces many problems: demographic shrinkage, a declining share of the global economy, the absorption of immigrants, low productivity in Southern Europe, and Brexit. But by no means can one herald the EU's disintegration. On the contrary, the **consolidation stage** of the EU has just started. The option of leaving the EU is not attractive at all. Brexit is frequently seen as the democratic decision that will lure other countries into leaving. Instead, it sent a message that **plebiscite democracy** and divorces from the EU are messy deals without winners. In the ever-tougher conditions of the globalizing world economy, Europeans know that not even the continent's largest countries can expect to make their voices heard and advance their own interests if they act alone (Matthijs, 2020).

Case Study: Poland

How can democratic countries of the EU limit separation of powers and become illiberal democracies?

Let's consider the recent example of Poland. Poland's nationalistic and populist government has the majority in the Polish Parliament, called the Sejm. The Sejm passed laws that allows government officials to retire many of the current judges they think would not support the government in their judicial decisions. In addition, the new law allows it to do the same to all members of the Supreme Court and the Constitutional Court. The ruling party wants total control of the judicial system, in practice eliminating the separation of powers between the judicial and executive branches.

The EU has criticized the Polish government and invoked Article 7 of the EU, which could suspend the right of Poland to vote in the European Council. The passing of Article 7 requires a unanimous vote in the Council. However, the voting was blocked by Hungary. Its President, Viktor Orban, is a populist who closed the independent media and many nongovernment pro-democratic organizations in his country. He is afraid that Article 7 will be invoked against him, so he stopped the vote on Poland. The EU Court is now being asked by many judges in the EU member states if they should treat the Polish court decisions as expressions of the rule of law. The EU Court of Justice is now likely to say no. It pressed the Polish government to make some compromises on judicial appointments, making it a bit less partisan and more democratic.

This process has been the work of Mr. Timmermans, the Dutch politician who has served as the First Vice President of the European Commission and the European Commissioner for Better Regulation, Interinstitutional Relations, the Rule of Law, and the Charter of Fundamental Rights since 2014. There are 29 commissioners and seven vice presidents in the commission. The work of the commissioners is absolutely needed in many cases involving trade, industrial relations, taxation, budgeting, etc. They make sure that the common laws of the EU are implemented in all member states.

Definitions:

Free trade zone = Tariffs are removed or reduced among participating nations (like NAFTA, the North American Free Trade Agreement)

Customs union or tariff union = Free trade + common external tariff (CET)

Common market = Opening of the production factors markets: common capital market, common agricultural market, common labor market, etc.

Economic union = Common market + common monetary union (same currency, like the Eurozone/Maastricht Treaty)

European Union is a political union = Economic union + common constitution (common presidency, foreign policy, military forces, citizenship/Schengen citizenship treaty)

Brexit Agreement:

The first Brexit agreement with the EU has 585 pages and has the following provisions as of November 2018:

- Britain will pay a divorce bill of about $50 billion, and each side will guarantee the status of citizens living in the other's nation.
- There will be a 21-month standstill during which EU–UK relations will be unchanged.

- If there is no free-trade agreement by December 2020, to avoid a physical border with the Republic of Ireland, the UK will stay in the customs union (they will comply with the Common External Tariff) and Ireland will stay in the single market (basically, they will not leave the EU). The UK agreed not to establish a physical border with Northern Ireland after 2020.
- The European Courts wanted to remove itself from the jurisdiction of the European courts, but they will continue to respect the agreements signed with courts.

4.2. Russia

The long view

In 2014, the year President Putin ordered the invasion of the Crimea, the Minister of Defense of Russia listed the United States as an enemy of the country. Here are the facts: The United States does not threaten Russia, never attacked Russia, and has no intention to go to war with Russia. Why does Mr. Putin's government appointee want a diplomatic confrontation with the United States, a country that has a 14 times larger GDP than Russia, spends 10 times more money on defense, and has a 2.2 times larger population? The simple explanation is that Mr. Putin wants to use nationalism to prolong his rule and the dysfunctional economic and political system he has created. He tries to appeal to a strong Russian nationalism as the economy is winding down before yet another crisis. Today Russia looks more like Saudi Arabia than a modern industrial economy. it's resource exporter which has no other exports than weapons and his mercenaries. Again, in the twenty-first century, Russia is missing the chance to become a normal country and is destined to be confronted with yet another defeat of self-perceived greatness like the one that occurred in the twentieth century

The Communist Revolution and the rise of the Soviet Union (Lewin, Elliott, 2016)

Communism is an abstract concept. It was conceived by two philosophers, Karl Marx and Friedrich Engels, the authors of a book called *The Capital* published in 1886. Their followers, Marxists, criticized early monopoly capitalism and hoped that one day it would be replaced by socialism and later communism. Socialism should precede communism, and it will be a system where all people will be paid back for what they contribute to society. Communism will be a better system, in which everybody will receive according to his and her needs. The book had very vague definitions of how to reach both stages. The authors of Das Kapital (the German name) predicted that revolution would first break out in England and Germany, countries with the most advanced monopoly capitalism, where exploitation of the proletariat (workers and peasants) was the most painful. This was the education Mr. Putin got in the 1960s and 1970s in school and later at the University of Leningrad, which today is St. Petersburg.

The Tsar of Russia, Nicholas II, was a relative of British royals, who denied him and his family asylum in London after the 1917 revolution. He was not cut out to be a ruler, had a weak personality, and was a poor politician. His power base, the land-owning narrow-minded aristocracy, was against modernization. Because the industrial revolution came late to Russia, the industrialists had very little political power to modernize the state. When the opposition to his rule mounted, the Tsar sent millions of young men to war, first with Japan in 1905 and later with Germany in 1914. He wanted to take the revolutionary testosterone out of the streets to preserve the crumbling empire. He was the last eighteenth century-type autocratic monarch in Europe.

Russian peasants were desperately poor and illiterate, a perfect ground for Marxist revolutionaries offering quick solutions to eliminating hunger, bringing equality through the destruction of the wealthy, and giving their riches to the poor. Much of the responsibility falls on the Russian aristocracy, which was not eager to educate Russian peasants about constitutional democracy, the rights of workers, and modern life. Some of them were convinced that their backwardness and illiteracy was a natural state and, in a sense, the foundation of their strength and stability. In 1905, the Bolsheviks, Marxist revolutionaries, called for starting a revolution, eliminating private ownership of the means of production, and creating a collectivist government-run society and economy. But the Tsar sent young revolutionaries to fight the war with Japan, which they lost. By 1914, Russia was at war with Germany. The German secret police smuggled back to Russia the popular Bolshevik leader Vladimir Lenin. Sending back a popular rebel journalist seemed like a perfect ploy. A revolution in Russia against the Tsar and chaos in the country could make the German victory over Russia almost certain. In October 1917, the revolution broke out in St. Petersburg, and the mobs led by the Bolsheviks took over the Winter Palace and imprisoned the Tsar and his family. After a period of chaos, the revolutionary government introduced military rule in the country, nationalized the economy, and created the Red Army. By then, WWI had ended, and the communist government was expanding the revolutionary terror over the entire country.

After the death of Vladimir Lenin, the country was put under the dictatorial rule of Joseph Stalin, a former seminarian turned communist. The Stalinist period lasted until 1953, during which Soviet Union rapidly industrialized. Stalin knew that the communist state would be a pariah for the West. Investors would avoid it; they would never sell them technology. Stalin introduced forced saving; put industry, trade, and agriculture under state control; and sent a network of operatives abroad to steal technology and rally communist sympathizers.

At home, Stalin created a planned socialist economy. Prices and wages were fixed, and each enterprise was assigned a quota of production according to a central plan. To enforce the system, Stalin used an unprecedented level of internal terror waged by a security force called the NKVD, the predecessor of the KGB. The NKVD was tasked with searching for alleged enemies of the state and supplying prisoners to labor camps. Each NKVD office was assigned a monthly quota of "the class enemies of the Soviet state."

These "enemies" were imprisoned and sentenced to spend many years in the labor camps. Stalin ordered some 4,000 gulags to be set up all over the country. The gulags would provide zero-cost slave labor in the mineral, energy, and timber industry. Historians estimate that the Stalinist system incarcerated, executed, or led to perish in the gulags about 18 million people between the 1920s and 1953. Siberia was one large labor camp. There was no escape because the distance was too great, the rivers were too cold to swim, and the ice wasn't thick enough to walk on in the winter. The Russian historian Yuri Brodsky said, "it was the camp on which all future norms were designed: how much food to give, what kind of clothing, how to execute people and get rid of their bodies." It was a model for the Nazi concentration camps.

The timing of Soviet industrialization was significant. At the time when the United States was in the Great Depression of the early 1930s, the Soviet Union became self-sufficient in food and built mega-industrial centers, canals, showpiece public palaces, a university in Moscow, a lavish metro, and cinemas for propaganda films.

It all came at the cost of forced saving, a terrorized population, and massive purges among intellectuals and other innocent people. For example, during the forced nationalization of land in the Ukraine, Stalin ordered the starvation to death of 3.3 million peasants and their families. The communists treated religion as the "opiate of the masses" and replaced it with dialectical materialism. Churches were turned into warehouses or destroyed. Clergy were sent to gulags. Despite all this, communism and Russia's industrialization successes had an increasing number of followers in the West.

Internationally, Stalin was involved in the European power game. In early 1939, he signed a cooperation pact with Germany and started sending oil and grain to support the German military machine. In September 1939, Nazi Germany and the Soviet Union attacked Poland. Russia's support of Nazi Germany continued when Hitler attacked France, Belgium, and Holland and, finally, launched an air campaign against Great Britain. When the British campaign was abandoned, Hitler attacked Germany's Russian ally in 1941.

Now of the German attack on the Soviet Union, Stalin "rebranded" himself from a dictator to a defender of Mother Russia. For Russians, it was a war of national survival. The Nazis regarded Russians as sub-humans and ordered massive executions of captured soldiers and civilians. On the other side, Stalin executed Russian soldiers who retreated alive from the battlefield as traitors. The Russian soldiers were very brave but, in many cases, they had no choice but to perish in battle. Retreat was not an option.

Compare these numbers. According to the Eisenhower Institute, the United States lost about 400,000 soldiers (killed or missing) and almost no civilians during World War II. The Soviet Union, depending on estimates, lost at least 6 million soldiers (killed and missing). In total, the country lost an estimated 16.8 million citizens—over 15% of its population.

At the end of WWII, Stalin was a winner. Moscow had control of East Central Europe and one third of East Germany. In 1949, four years after the United States, the Soviet Union tested its first nuclear bomb. We need to remember two very important facts about the United States and Stalin. First, Stalin's WWII victories would not have been possible without the hundreds of US Liberty-class transport ships that delivered American war supplies to Russia through the non-freezing port Archangel (Archangelsk), in European Russia next to the White Sea. Second, the successful turnaround of the war in the winter of 1942 at Stalingrad would not have been possible without the Japanese attack on Pearl Harbor. This attack brought the United States into the war in such a way that Japan couldn't open a second front in Russia. Stalin was able to move winter-trained Far Eastern Russian Armies to the European front and encircle the German Sixth Army. This started the German retreat from Russia.

Today, President Putin is reviving the mythology of Stalin as a leader who gained Russia the control of Central Europe and Central Asia. He wants to place himself in the pantheon of Russian national heroes who expanded the territorial control of his country and put Russia on the world stage as a nuclear power. His policy is based on false premises: the misinterpretation of the history of WWII and the Soviet Union's failure in confrontation with liberal democracy and the United States at the end of the twentieth century.

The Failure of the Soviet Union (1917–1991) (Konstantin, 2017)

The Soviet Union was very inefficient. The economy was put under central control. The state can never replace the market. Even if the USSR had supercomputers, they would not be able to replace the price mechanism to manage supply and demand. The Soviet economists who visited London in the 1970s were surprised there were no bread lines in front of bakeries. They asked their English hosts who told the bakers how many loaves of bread and rolls to make at night, so they would be fresh and plentiful in the bakery windows. They were told nobody. They could not understand it at all.

The planned economy fixes prices and quotas of production. There is no price-messaging between the buyer and the seller, just the command given by the government planner. The Soviet government never produced enough bread, apartments, or white goods (appliances). The workers there over time became very apathetic and unproductive. At the beginning, production increased because the state-owned economy limited consumption and exploited and terrorized its workers. Communists wanted to create a socialist/communist heaven; instead, they created homo-sovieticus—apathetic people with lack of initiative, avoiding taking any individual responsibility for anything. After two generations of communism, people become indifferent to common property, accepted petty theft from the workplace, and waited for the initiative from above to change anything.

The USSR spent too much money on the military. The state had plenty of money for weapons and resources for the military and notorious shortages of all consumption goods. The USRR had a 5-million-man army, hundreds of military bases inside and outside of Russia, military jets, and rockets to launch Sputnik and Yuri Gagarin into space, but it couldn't produce enough food for the people. When in the mid-1980s President Reagan launched a "Star Wars" program of future space-based defense, the USSR was at its maximum defense spending capability. The communist leadership could not keep up with the upcoming arms race, they could only start a suicidal nuclear war or try to reform the economy. A last-ditch effort to reform the Soviet system was introduced by Mikhail Gorbachev: Perestroika and Glasnost.

Perestroika: It was a quasi-capitalist management system without private ownership. State-appointed managers could decide what and how to produce, hire and fire workers, and set prices (!). The supply of consumer goods improved, but prices were too high for people with meager government wages and pensions. Russians had been spending days in lines to wait for cheap goods to show up; now they saw that goods were in the stores, but they were expensive. They blamed Gorbachev personally for raising prices.

Glasnost: Finally, the media could publish news without censorship. Russians accustomed to the "propaganda of success" learned the painful truth about the bad condition of the Soviet State. People were shocked to learn that Russian planes crashed because of poor maintenance and lack of spare parts, and to hear about poverty, derailed trains, and drunkenness. The communist government led by Gorbachev was blamed.

Here is an important lesson for global political economy. Autocrats always try to eliminate free speech; blame the media; and imprison, prosecute, and kill journalists. Free media are their worst enemy. Gorbachev survived five years, and the Soviet Union was bound for collapse.

The failure of a Marxian dream (1886–Today)

- **Economic failure:** A planned economy can never replace the market because of allocative inefficiency.
- **Socio-economic failure:** Communism created **Homo-Sovieticus**, i.e., people who expect mediocre reward without work, with an **entitlement mentality**. **Equal wages** do not motivate people, productivity decreases, and employment without work does not work. **When the state employer pretends to pay, people pretend to work.**
- **Political failure:** Lack of basic freedoms becomes unbearable when combined with unequal distribution of poverty. Elites are poor by Western standards, but they are much better off than the average poor in the country. It's called **elitism**.

- **Strategic failure:** President Reagan pushed Russia to the financial brink with the "Star Wars" arms race. The Soviet Union could attack the United States and be destroyed or give up and break up.

Post-Soviet Russia: The Russian Federation

President Putin has stated many times that the fall of the Soviet Union was "the greatest catastrophe" of the twentieth century. Compare the territory of the Soviet Union and the Russian Federation in 1991 (Maps 3 and 4).

Map 3. U.S.S.R.

Source: Union of Soviet Socialist Republic Scale not given. < https://allcountries.org/maps/ ussr_maps.html > [accessed December 20, 2020].

Map 4. Post-Soviet States Scale not given.

Source: < https://en.wikipedia.org/wiki/Post-Soviet_states> Last updated 19 February 2021 [accessed December 20, 2020].

- **Territorial reduction:** One-third of the Soviet Union. New states created in 1991 in alphabetical order: Armenia (1), Azerbaijan (2), Belarus (3), Estonia (4), Georgia (5), Kazakhstan (6), Kyrgyzstan (7), Latvia (8), Moldova (9) Transnistria (10), Russia (11), Tajikistan (12), Turkmenistan (13), Ukraine (14), Uzbekistan (15).
- **Population reduction:** From 260 million to 146 million. Russians became a minority in 14 new states, except for Russia. Most of the former Soviet Republic communist leaders became the presidents, prime ministers, and new economic and political elite. In central Asian states (6, 7, 13, 14), communists became Muslims, very rich populists who ensured economic and political power for their family clans for years to come. Russia will try to include them in the Euro-Asian Union, a new version of clientelism. Russia will try to tie these countries up economically and provide military protection in exchange for denial to join NATO and weakening their relations with the United States and the EU.
- **Strategic reduction**: Russia lost direct control of military bases and launch sites for ICBMs Kazakhstan, rocket production plants and aviation industry in the Ukraine, naval access to the Baltic Sea except for Port of Kaliningrad as an exterritorial enclave in Lithuania, the Port of Odessa in the Black Sea except for the 99-year lease on the naval base in Sevastopol in the Crimea (recontroled through invasion 2014)
- **Economic reduction**: Russia lost oil and gas export revenues and taxes from 14 new states, which extended full control over their own resources and budgets.

The first President of the Russian Federation, Boris Yeltsin, was pro-Western. Following the advice of Russian liberal economists, Russia, between 1991 and 1993, underwent radical economic reform named "**Shock therapy**." Prices were deregulated, foreign trade was privatized, the ruble became convertible, and the state's national property and mineral and energy industries were slated for a **mass privatization scheme** (Nove, 1993).

Privatization, stage one: During 1991–1992, all Russians were given some 140 million vouchers, one for every adult. Vouchers were the new currency with which Russians could theoretically buy the stock of oil and gas fields and various other enterprises at auctions. Foreigners were banned from the auctions. But there was a problem. For example, one unit of stock of the Far East Timber Company, the Norilsk nickel mine, or the AutoVaz car maker could cost 300 or 400 vouchers at the auction. It would take 300 or 400 Russians to own one unit of common stock. This was incomprehensible and made vouchers worthless for a single voucher owner. Russians started selling single vouchers for the price of a bottle of beer or less.

A few close friends of President Yeltsin were able to borrow money from the state banks, buy the vouchers in the open markets, and trade them for stock at the auctions, which were announced to only a few select insiders. Some 20-plus oligarchs took ownership of the most valuable industrial, pharmaceutical, and car companies, and oil and gas fields. Western observers were shocked with the process. Western journalists asked the designer of the scheme, Mr. Gaydar, if he knew about the degree of theft of state property that was taking place. Several thousand dollars would buy the stock, which would be worth hundreds of millions or even several billions of dollars. Mr. Gaydar answered that he was aware of this, but that private ownership was, in his opinion, still better than state ownership, and the educated children of participants would be the future elite of Russia.

Privatization, stage two: The oligarchs started lending money to the Russian government, which was still the largest employer in the country. The oligarchs demanded collateral in stocks of state-owned oil and gas fields. Since the loans were never paid back, taking over legal ownership of the stock was just a formality. The Russian state transferred the energy sector to some 100 oligarchs for a fraction of its market value.

Russia under president Putin (Stent, 2019)

President Putin was born in 1952, a year before the death of Joseph Stalin. He was close to 40 years old when the Soviet Union collapsed. His entire socialization and world view collapsed with the Soviet Union. Young Vladimir Putin, like all Soviets, was told that the United States was an imperialist country run by the military-industrial complex and that NATO's goal was to encircle Russia with military bases and conquer Russia under the label of Western democracy. He was told that the Soviet Union can destroy the United States with intercontinental ballistic missiles (ICBMs). He saw many Russian movies in which the brave KGB agents always won against the CIA agents.

After graduation from Leningrad University, he was hired by the KGB. When he completed spy training, he was posted to Dresden, East Germany. His task was to recruit agents in West Germany. After the collapse of the USSR, Putin worked for the Mayor of St. Petersburg while still being in "active reserve." In 2008, a deal was made between President Boris Yeltsin and the KGB. The KGB demanded from Mr. Yeltsin that he hire Mr. Putin as Prime Minister and later support him in the presidential elections. In exchange, Mr. Yeltsin's billionaire daughter would never be tried for tax evasion.

The voters supported Mr. Putin because he promised to end the war in Chechnya and stop the looting of state property by the oligarchs. A heavy-handed order was restored in Russia, and many oligarchs started paying a new flat 13 percent CIT. Mr. Putin brought his trusted KGB friends to the Kremlin and put them at the top of the government ministries and as CEOs of Gazprom, Azprom, Rosneft, Rosatom, Lukoil, and Transneft.

President Putin also reversed private ownership in the energy sector. The government made offers to owners of many energy companies they could not refuse sell the majority stock to the state monopolies, or the tax court will find you liable for the unpaid taxes. In Russia, the new tax law, worked backwards. It was levied on past income, that is, income accrued before, not after, the tax had been enacted.

Here's one example. The largest Russian oil company in 2008, Yukos, learned its lesson the hard way, even though it had a reliable Price Waterhouse Cooper audit. The Yukos owner made a mistake, because in the presidential election he put his name against Mr. Putin in 2008. He was found guilty of tax evasion and sentenced to 12 years in a hard labor camp. His company was taken over by the state monopoly Gazprom. Mr. Putin had his favorites oligarchs, but they had to be either former KGB officers or his old university colleagues. Others became his personal enemies.

Here's another example. One of Mr. Putin's personal enemies was Bill Browder, an American owner of the Hermitage Fund. Browder knew that he would be charged with the bogus accusation of tax fraud, so he liquidated his assets worth an estimated $3.5 billion. Browder left Russia before he could be put in jail. Meanwhile, Browder's Russian lawyer, Sergey Magnitzky, had discovered a tax fraud by some state officials close to President Putin. Instead of Browder, Mr. Putin ordered Magnitzky to be jailed. He was beaten to death in prison. Later, Bill Browder successfully lobbied the US Congress to enact the Magnitzky Rule of Law Accountability Act (2012), a bipartisan bill that banned from the United States all people who were responsible for Magnitzky's death.

These are the unwritten rules of the Russian President. If you have made money in Russia, your money is not your money, the state decides how much you own. Never attempt to use your money in politics unless you want to support the President and his party: One Russia.

Money is not the only issue. Opposition journalists and politicians die in assassinations by criminals who are never found (for example, Mrs. Politkovskaya, Mr. Gongaze, Mr. Niemcov). Former KGB agents who escape to the West are poisoned (Mr. Skripal, Mr. Litvinenko).

Political opponents in the country are not permitted to run in elections. In March 2018, Mr. Aleksey Navalny, a popular political figure among young voters who watch YouTube and get news from the web, was banned from participating in elections. The police arrested Mr. Navalny at a political rally, and his name was taken off the ballot.

Mr. Putin has been elected practically for life, and 95 percent of the people watch pro-government private and state TV and read the pro-government private and state press. Few people dare to join any organized opposition. For many people, to be against Mr. Putin is to be against Russia. Workers like him because during live nationally televised five-hour sessions he answers people in the audience and solves their problems on the spot, like a strong and good Tsar. The democratically inclined intelligentsia see the comedy being played on the stage; they know that Russia has become a textbook example of an illiberal democracy. Russia's courts, the government institutions, the armed forces, the police, the KGB, the GRU (military intelligence) all are the tools of Mr. Putin's personal power, not the institutions of a state.

The Russian educated people, the intelligentsia, are becoming apathetic—they do not want to fight for democracy. They are rationalizing, just like the nineteenth-century Russian elite and aristocracy, that Russia doesn't need Western democracy, and it's a kind of chosen country that must have a strong Tsar. After all, they say, Russia is the descendant of the Eastern Roman empire. It's a vodka-inspired historical philosophy. Nothing could be more wrong than that. Russia needs democracy like any other state.

Putin's policy goals (Stent, 2019)

Be life-long leader of Russia, the modern Tsar. This requires control of the free press and the opposition. The independent newspapers like Commersant and Novaya Gazeta, Novaya Izvestia, Ekho Moskvy radio, and are under tremendous pressure from sponsors and advertisers to not report anything that the Kremlin wouldn't like. Private media and TV are pure entertainment and support the President. The independent journalists and critiques of the regime die, gunned down by "unspecified terrorists." Russia under Putin operates like a mafia state at home and abroad. Doing business with the favorites of the Kremlin is a very risky proposition—you can never win.

Restore Russian territorial and political control over the former Soviet Union's area. Moscow's military control has been restored to parts of Georgia, Crimea, and Donbass in Eastern Ukraine. The central Asian states were offered the status of a client state, that is, to join the Euro-Asian Union or economic, military, and political union. In Ukraine, the policy failed, and the pro-Russian president was voted out. After the invasion of Crimea in 2014, 76 percent of Ukrainians wanted to join the EU, whereas before there had been many supporters of the Euro-Asian Union (Barbashin, 2015).

Break up the EU. President Putin devotes a large amount of state resources, money, and cyber war trolls to weakening and breaking up the EU. Russian or proxy oligarchs' money supported a media campaign to vote "yes" on Brexit, as well as extremist, anti-immigrant parties and politicians in Holland, France, and Austria. The UK was one of the strongest EU members pushing for sanctions against Russia after the invasion of Crimea. After Brexit, Germany and France may weaken or remove US led sanctions. The UK will be an easier target for energy leverage. The Russian-German consortium built two gas pipes under the Baltic Sea, Nordstream 1 and 2, which directly connect the Russian supplier terminal to Germany.

Half of German gas comes from Russia through the Nordstream system at deep price discounts. At the same time, Gazprom increases prices in different gas tubes supplying Eastern European countries (Poland, Slovakia, the Czech Republic, and Hungary) from Russia. This splits EU common energy policy and pushes Eastern Europeans to accept a greater dependence on Moscow than Brussels. Hungarian

President Viktor Orban toned down his criticism of Russia and got a better deal on gas from Moscow. Poland built a new Baltic Sea liquefied gas terminal and started importing gas from the United States and the Middle East to reduce its dependence on Russian gas. Other countries in the area are not so lucky. They are landlocked, and you can't reverse gas flow from the western EU to the eastern EU. It's too costly.

Map 5. Nord Stream Scale not given.

Source: Rura Nord Stream jak nowy mur berliński 2011 < https://en.wikipedia.org/wiki/Post-Soviet_states> [accessed October 20, 2020].

Undermine democracy in the United States. The current leadership in the Kremlin treats the United States as an enemy and American democracy as a target. Russian oligarch Oleg Deripaska, one of Mr. Putin's most trusted friends, set up the company Glavset, also known in Russian Internet slang as the Trolls from Olgino, in St. Petersburg. The main purpose of Glavset is to influence operations on behalf of Russian political interests. They design bots and trolls that try to influence the US political scene, although not necessarily breaking into electronic voting machines. The agency has employed fake accounts registered on major social networks, discussion boards, online newspaper sites, and video hosting services to promote the Kremlin's interests and influence the 2016 US presidential election. More than 1,000 employees reportedly worked for the agency in 2017.

How Might Mr. Putin's Rule May End? Mr. Putin created a "limited-access order," a state where economic and political resources are not made available by the rule of law but are privately granted from above. Putin became a "Patron" or the "Tsar," the head of a mafia-like state. Oligarchs report to him personally, and the courts and the government serve the Tsar personally, not the rule of law. Putin is looking for the dignity of Russia in giving the nation "sugar highs" by invading Crimea or Eastern Ukraine or removing the United States from Syria, and by becoming a top player between Turkey, Iran, Saudi Arabia, and Israel. He wants to prop up nationalistic euphoria to prolong the life of his deeply corrupt regime. Instead of unleashing the great potential of Russia's middle class, he threatens to move into Baltic States and the rest of Ukraine.

Appeasing Putin's aggressive foreign policy, the West prolongs his political life. Putin gets "low cost" propaganda scores at home. Russia can't afford open conflict with NATO, because the Russian oligarchs will end his rule if such conflict is provoked. They have their assets in the West. Putin has used nationalism and anti-Western propaganda to divert attention from the country's 20 percent loss of real income, 50 percent decline of the ruble, and negative growth in the last two years.

In the March 2018 elections, Putin won his sixth four-year term in power. Seventy-six percent of Russians supported him because he has convinced them that without Tsar Putin, there is no Russia. There is no succession mechanism after him because Tsars elect themselves. At some point, the oligarchs will find out that to use billions of dollars they have removed from Russia, it would be better to run legal businesses in democratic countries of the West where their wealth is protected by law, not by Mr. Putin and his trusted friends from the KGB. He will have to go and will be replaced by a more pro-Western leader.

Russia's timeline:

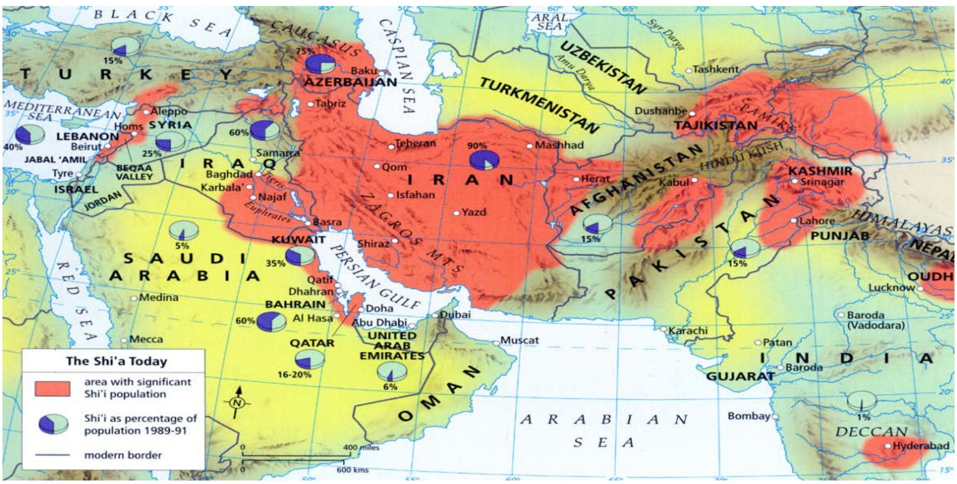
Until 1917 – Russia ruled by Tsar Nicolas II from the Romanov Dynasty
1914 – Russia at World War I with Germany
1917 – The Bolshevik Revolution—the beginning of the Communist period until 1991 (approx. 75 years)
1940–1945 – U.S.S.R at war with Nazi Germany
1945–1991 – The Soviet Bloc (Eastern Europe and Baltic States under Soviet control)
1991–1998 – Collapse of the Soviet Union; transition to democracy and the theft of state property by oligarchs
1998–2005 – First term of Putin's Presidency—pro-Western period, economic reforms, high growth period fueled by energy export
2008 – The Invasion of Georgia and occupation of the Ossetia and Abkhazia regions; economic decline; Putin turns against the West and the United States
2014 – Invasion of Crimea and Eastern Ukraine
2015 – Russian air strikes in Syria from the airbase in Lakatia
2016 – Defense minister threatens to use nuclear force against the United States
2017 – Russia interferes in the US elections
2018 – Some 100 Russian diplomats expelled from US allies

4.3. The Middle East overview

The long view

In 1958, the State Department defined the region of the Middle East (ME) as: Egypt, Syria, Israel, Lebanon, Jordan, Iraq, Saudi Arabia, Kuwait, Bahrain, and Qatar. The World Atlas defines the Middle East as a geographical and cultural region located primarily in western Asia, but also in parts of northern Africa and southeastern Europe. For this chapter, the authors also will include Turkey and Iran in the definition of the ME.

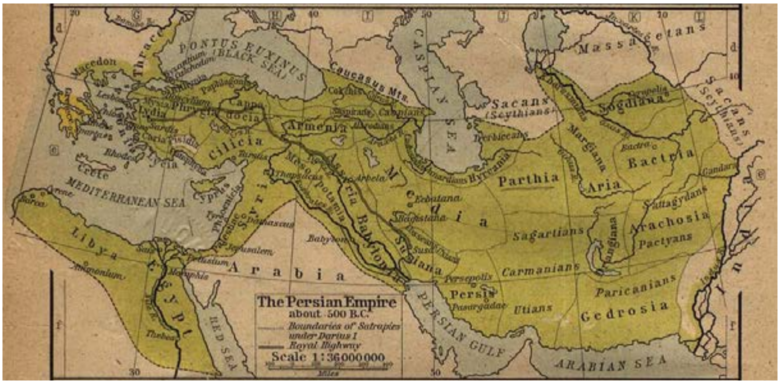
Adherents to Islam constitute the world's second largest religious group, after Christianity. According to a study in 2015, Islam has 1.8 billion adherents, making up about 24% of the world population. Most Muslims are one of two denominations: Sunni, 80–90 percent, roughly 1.5 billion people, or Shia, 10–20 percent or 170–340 million people.



Map 6. The Shi'a Today. Scale not given.

Source: <https://cpb-uw2.wpmucdn.com/voices.uchicago.edu/dist/1/1282/files/2019/09/Maps-of-Religious-Diversity-across-North-Africa-and-the-Middle-East.pdf> [accessed October 20, 2020].

The followers of Sunni Islam have no one geographic center. Indonesia is the largest Muslim country by the population in the world, and the most conservative Muslim country is Saudi Arabia (SA), which also calls its branch of Islam "Salafism" or "Wahhabism." The geographic center of Shia Islam is Iran, that is, ancient Persia. The non-Arab Persians and Arabs were competing for influence in the ME before Islam (mid-7th century) and certainly long before oil was discovered in SA in the 1930s. The Persian Empire's rule over the ME was interrupted after 1,100 years by the Arabs in 651 AD. The Prophet Muhammad was born in 570 AD. After the spread of Islam, Persia adopted a more centralized Shia Islam, while the Arab tribe in the ME and the Turks adhered to Sunni Islam (Map 6).



Map 7. The Persian Empire (539 BC -650 AD) Scale not given.

Source: < https://enacademic.com/dic.nsf/enwiki/6859400> [accessed October 30, 2020].

The Muslim religion is monotheistic, like Christianity and Judaism. The founding prophet of all Muslims was Muhammad, born in Mecca around 570 AD and 62 years old when he died. We don't know what he looked like because images of the Prophet are forbidden by Islam. The reason is that the concept of God and Prophet should not detract the believers from God.

Muhammad was an orphan, a caravan attendant in the Quraysh tribe. He married his employer's widow, Khadija, and they had six children, out of which only Fatima survived. Because of the wars between Hashemite and Umayyad tribes, Muhammad had to escape from Mecca to Medina. He is buried in Mecca. Today, the Saudi Family claim a special status in Islam as the guardians of the two holiest places (Mecca and Medina) and, overall, guardians of Sunni Islam.

Shia Islam originated as a splinter group from the Sunnis. The founder of the Shia was Ali, Fatima's husband, and Muhammad's son-in-law, who became the fourth Caliph or religious leader. Ali's son and the grandchild of Muhammad, Hussein, was killed with a group of his Shia followers in the city of Karbala (in today's Iran), where he was later buried. Ali is buried in Najaf in Iraq. This is an important distinction for Muslims—there are three of the holiest places: Mecca, Karbala, and Najaf, in three different countries.

The Quran is not like the Old or New Testament of the Bible, or the Torah, it is considered holy because it carries the words of the Prophet. Mistreatment of the Quran is blasphemy and represents a capital offense against the Prophet and God. The Quran was written in Arabic and is always read or chanted in Arabic. There are translations of the Quran, but they are not treated as "true scriptures" because Muhammad recorded his revelations in Arabic.

Here are a few prescriptions from the Quran that tell Muslims how to live: Muslims should pray five times a day; give one seventh of their income, Zakat, to the poor; visit Mecca at least once in their lifetime as a Haji; and observe a 40-day Ramadan or fasting from sunrise to sunset.

Besides the Quran, there are hundreds of Hadith or collections of reports claiming to quote what the prophet Muhammad said verbatim. There is no single codification of Islamic Law, the Sharia. In addition, there are rulings by living leaders, called Fatwas, that may have nothing to do with the teachings of Muhammad, but they are made in the name of Islam by the Ayatollahs and the Caliphs.

The language of the Quran is very important. Iranians speak Farsi, which is a member of the central Asian languages; Iranians do not speak Arabic. Written Arabic is shared commonly. The Shia rely on the mullahs or ulemas, the teachers of Islam who interpret the teaching of the Quran and the Hadith (Ayoub, 2013).

The doctrinal differences between Sunni and Shia are minimal, but they play a crucial role for power elites in the ME. For example, Iranian Shia celebrates the Ashura, the day Hussein was killed at the Battle of Karbala some 1,500 years ago. Shia Muslims mourn with eulogies and poems but also by processions in which men and boys walk in white robes, covered with blood from self-inflicted lacerations. They call on every Shia to avenge the death of the Prophet Hussein. The current President of Iran, Rouhani, told the Iranians in 2017 that every day is Ashura for them, so, basically, they should be at war with the Sunnis whenever they can to avenge the death of the Prophet Hussein.

Today, the different holidays, varying Sharia laws, and the triumvirate of burial places are not furthering the unity of Muslims but emphasize their differences and political ambitions. Political economists would say that the Iranian Ayatollahs and the Saudi aristocrats use Islam to preserve their power and privilege, and they are correct. The present wars in the ME are the continuation of centuries-old wars between Arabs and non-Arabs for control of precious real estate, trade routes, access to fresh water and arable land, access to Jerusalem, and, today, about the income from carbon-based fuels and religious tourism.

In countries where the religious leaders are permitted to dominate the society, the state becomes fully engaged in enforcing a socioeconomic straitjacket. Uncodified dogmas are political tools, quasi-legal codes that repress women and spell hatred, marginalization, and persecution of other religious or ethnic groups and are the reasons for waging wars.

For example, Saudi Arabia follows a strict interpretation of the Quran. Women in most Islamic countries must follow dress codes, and their freedom of movement is dependent on the permission given my male members of the family. SA women now, as of 2019, are permitted to drive and go to the movies and sports events but only if accompanied by their husband or other male kin. In more modern Islamic states like Turkey, Jordan, or Egypt, gender roles are not that extreme. Also, Sharia law is not understood or practiced uniformly in the

Muslim countries. However, Islam universally does not permit renunciation of religion—leaving Islam is forbidden—and in strict interpretation of the Quran (Ayoub, 2013).

The weaknesses of the Arab States

The 2010–2011, the Arab Spring removed or destabilized the autocratic regimes in the Middle East and North Africa. The vacuum of power resurfaced and strengthened suppressed tribal animosities and conflicts in the region. However, the historic weaknesses of the Arab states predate the Arab Spring (Feldman, 2020).

1. The ME countries' borders are artificial creations of the post-colonial period. They were drawn by the Europeans after World War I and often cut across ethnic, tribal, and religious lines. Many of the countries are based on colonial possession and have very weak demographic and cultural justification. For example, the Kurds don't have their own state, even though they have a very distinct identity, culture, and customs. They live in Turkey, Syria, and Iraq and have been trying to build an autonomous state with little success.
   That is why after the Arab Spring the nominal states of Iraq, Syria, Yemen, and Libya ceased to exist in practical terms, with people crossing the borders, resettling, migrating, and joining millions of refugees from states that exist only in political maps drawn a century ago. Today the borders of Lebanon and Bahrain are also practically undefinable.
   The tragedy of Middle Eastern and North African refugees pouring into Europe proved that the best solution would be to redraw the antiquated, artificial map of the Middle East, thereby creating new, homogeneous viable nation-states. Today the maps are true only for Egypt, Morocco, Algeria, and Israel, but not for Lebanon, Jordan, Palestine, Southern Saudi Arabia, Yemen, Syria, Tunisia, or Libya. These states, with the exceptions of Israel or the Kingdoms of Jordan and Morocco, were maintained for a considerable period by dictatorships where one tribe, one family, had total control.
2. Arab societies are deeply tribal, and the tribes continue to be a crucial part of the social and political landscape. During the 600 years of the Turkish Empire, the Ottoman discouraged unity of the tribes, fearing a rise of opposition to their power. Tribes put their group interest before that of the nation or state; their identity supersedes loyalty to the central power.
3. The power in many countries is held by the minority, be it religious or tribal. This is a legacy of the colonial design, which often gave power to the minority because their fate would always depend on support from the external power, not the ability to unify the competing groups inside the country. The minorities resorted to repression, policing force, and religious orthodoxy of the clerics to maintain their power and privileges at the expense of the other groups.
4. The rich Arab states do not share wealth with the poor Arab states, although that doesn't mean that resources don't flow from one country to the other. However, money is used to buy influence or change regimes. For example,

secret transfers from the Saudi family paid for the Iraq–Iranian war in the 1980s and financed the Sunni militants fighting with ISIS in Syria and Yemen, and Iran paid money and sent weapons to the al-Berri, al-Baggara, al-Hasasne, and al-Zeido Alevite Shiite tribes in Syria.

The US policy toward the Middle East

In response to the Iraq and Syrian wars, the United States has aimed to reduce its role in the Middle East. Three factors have made that course both more alluring and more possible (Feldman, 2020).

First, conflicts between states that directly threatened US interests in the past have largely been replaced by security threats inside states.

Second, other rising regions, especially China and Asia in general, have taken on more importance to US global strategy.

Third, the diversification of global energy markets has weakened oil as a driver of US policy.

Today, the chief threat in the Middle East is not a state-on-state conflict but the growing internal violence spilling across borders—a challenge that is harder to solve from the outside. The terrorism and civil war plaguing the Middle East have spread easily in a permissive environment of state weakness.

This environment was fostered the Arab states' dysfunctional governance that led to the Arab uprisings of 2010–2012 and the subsequent repressive responses. The region's most violent hot spots are those where dictators met demands from their citizens with force and drove them to take up arms. The United States can't fundamentally alter this environment of terrorism and chaos without investing in state building at a level far beyond what either the American public or broader foreign policy considerations would allow. It simply can't hope to do much to counter the Middle East's violence or instability. The primary threats are in Saudi Arabia, Yemen, and Libya, where dysfunctional state-led economic systems and unaccountable governments are failing to meet the needs or aspirations of a large, young, reasonably healthy, and globally connected generation. Change will have to come from the Arab states themselves, and although the United States can support reformers within Arab societies, it can't drive this kind of transformation from the outside. The Arab states themselves must stabilize and develop loyalties to the functional state rather than tribes, and they must lay the foundations for a lasting peace by pushing states to overhaul the social contract between rulers and ruled.

This outcome is not impossible to imagine. But the experience of the United States in Iraq, Libya, and Syria suggests that this path would be rockier than it might first appear and that it would be extremely challenging to sustain domestic political support for the large, long-term investments that these goals would require.

US global interests have also changed—most of all when it comes to Asia. Today, the United States is concerned whether China can rise peacefully, especially with its territorial claims in the South China Sea and over Taiwan.

Then there is oil—the fuel that first drew the United States into the Middle East after World War II. Middle Eastern oil remains an important commodity in the global economy, but it is weakening as a driver of US policy. One reason is the more abundant global supply, including new domestic sources aided by technologies such as fracking. Another is a widely anticipated stall in global demand, as technological advances and concerns about greenhouse gas emissions cause countries to shift away from fossil fuels. The result is a Middle East that is less central to global energy markets and less able to control pricing—and a United States that can afford to worry less about protecting the flow of oil from the region.

Middle East: country focus

The more than 100-year-old status quo of the ME ended with the arrival of the Arab Spring (AS). The AS began in late 2010 in response to decades of rule by oppressive regimes. The spark came from a street protest in Tunisia, when a young street vendor burned himself to death after mistreatment by the police. Social media spread the revolution from Tunisia to Egypt, Libya, Yemen, Syria, and Bahrain, where either the regime was toppled, or major uprisings took place. Street demonstrations also took place in Morocco, Iraq, Algeria, Iranian Khuzestan, Lebanon, Jordan, Kuwait, Oman, and Sudan. Since the AS, the political situation in the ME has revealed deep weaknesses in the Arab states and the political and social construct of the region. We will focus on some countries of the region, adding the historic perspective of the developments up until today.

4.3.1. Saudi Arabia

History and political system

Petroleum was discovered in Saudi Arabia (SA) in 1938. Since then, SA has become the world's second largest oil producer behind the United States. The country's oil export is handled via Aramco (Arabian American Oil Company), which is 100 percent owned by the members of the royal Saudi family. Ibn Saud (1875–1953), the founder and first king of SA, had 90 children from 22 wives, and all his direct descendants claim to be a direct descendant of King ibn Saud. The number of princes is estimated to be at least 7,000 to 8,000, and some 200 or so male descendants claim the right to the throne and the wealth of the country. The family's vast numbers allow it to control most of the kingdom's important posts and to have an involvement and presence at all levels of government. The key ministries are generally reserved for the royal family, as are the 13 regional governorships. SA is an absolute monarchy. According to the Basic Law of SA adopted in 1992, the king must comply with Sharia and the Quran, which were declared to be the country's constitution. No political parties or national elections are permitted. Outside of the Al-Saud family, participation in the political process is limited to the ulema (Quran teachers), tribal sheikhs and members of important commercial families (al-Rasheed, 2018)

Rule of law

Capital and physical punishments imposed by Saudi courts include beheading, stoning to death, amputation, crucifixion, and lashing. The death penalty can be imposed for a wide range of offenses, including murder, rape, armed robbery, repeated drug use, adultery, witchcraft, and sorcery. Families of someone unlawfully killed can choose between demanding the death penalty or granting clemency in return for a payment of diyya (blood money) by the perpetrator.

Even after allowing women to drive and work, public places in SA are still gender-segregated, and the kingdom has very strict laws on how unrelated men and women can dine together. In September 2018, a man was arrested by the Saudi authorities for appearing in a video with his female colleague while having breakfast at a hotel, where they both works. Most trials are held in secret. An example of sentencing is that UK pensioner and cancer victim Karl Andree, aged 74, faced 360 lashes for home brewing alcohol. He was later released because of intervention by the British government.

SA remains one of the very few countries in the world not to accept the UN's Universal Declaration of Human Rights. In response to the continuing criticism of its human rights record, the Saudi government points to the special Islamic character of the country and asserts that this justifies a different social and political order. The US Commission on International Religious Freedom has unsuccess fully urged US presidents to raise human rights concerns.

In 2013, the government deported thousands of non-Saudis, many of whom were working illegally in the country or had overstayed their visas. Many foreign workers were tortured by employers or others. This resulted in many basic services suffering from a lack of workers, as many Saudi Arabian citizens are not keen on working in blue collar jobs. In August 2017, ten Nobel Peace Prize laureates, including Desmond Tutu and Lech Walesa, urged SA to stop the executions of 14 young people for participating in the 2011–2012 Saudi Arabian protests. On October 2, 2018, Saudi journalist and *Washington Post* columnist Jamal Khashoggi went missing after entering the Saudi consulate in Istanbul. According to Turkish government sources, there is audio and video evidence of him having been murdered inside the consulate.

Between the mid-1970s and 2002, SA expended over $70 billion in "overseas development aid." However, there is evidence that the majority was, in fact, spent on propagating and extending the influence of Wahhabism at the expense of other forms of Islam.

Is Saudi Arabia a typical weak Arab state?

Saudi Arabia is a book example of a weak Arab state. There are three significant traits that does not differentiate Saudi Arabia (SA) from some of the weak/poor Arab states: 1) Saudi Arabia has tribal origins, it is ruled by the Saudi artistic family, 2) Its borders were created by the British after the fall of the Ottomans in 1914, 3) The population, the merchant class, other tribes are loyal not to the nation state but to the royal family which represent the ultimate authority in the state (Haykel, Hegghammer, Lacroix, 2015)

Saudi Arabia has strong tribal origins. In 1915, the British helped King ibn Saud liberate Saudi Arabia from the Ottoman Empire and they established colonial powers there that developed a stable leadership organization. After World War II, however, the United States removed British and French colonial powers and handed over power to the Saudi family, who has been in control ever since. Due to this organized passing on of power, there is not nearly as much tribal uprising or in-fighting in Saudi Arabia as there is in weak Arab states. The Saudi family is in charge and operates the country in an undemocratic, authoritarian manner.

Another characteristic is that the Saudis were able to keep social peace in the country by the mix of conservative Wahhabism, brutal enforcement of the sharia law and oil welfare.

The 2010 Arab Spring impacted Saudi Arabia differently than weaker Arab states. Whereas, the Arab Spring in other Arab states removed autocratic rulers (Egypt, Tunisia, Algeria), and sparked domestic tribal wars (Iraq and Syria), fragmentation of the country (Libya) there was no overthrow of the government or the King of Saudi Arabia. The Saudi family initiated a massive government giveaway to appease the general population. This helped the Saudis to consolidate the power of the Saudi clan, there was an increase of support for conservative Muslim leaders. The Saudis also deported millions of migrant workers from Muslim and Arab states as a precaution.

Saudi Arabia faces significant challenges within its economy and, particularly, within its workforce. The Saudi Arabian population, generally speaking, is not highly educated and they depend heavily on domestic oil welfare and foreign workforce.

It would be inaccurate to describe SA as weak Arab state in militarily sense but this country is bound to face very serious challenges in the years to come. It's a tribal operation of one family protected by the US air and naval power, dependent on the revenue from gas and oil. SA is exporting half of its output to the United States and at home is ruled autocratically by Crown Prince Mohammad bin Salman, a young, unpredictable autocrat, who defies the norms of the civilized states by authorizing the extortion of money from the family members, assassination of the critiques of the regime and waging regional war in Yemen. Saudi Arabia today spends $15–20 billion per month from the oil reserve and once this cash is depleted will become a strategic problem for the USA in the region.

Foreign policy

Relations between the United States and SA have significantly improved under the presidency of Donald Trump, who has since forged close ties with many members of the Saudi royal family. In the first decade of the twenty-first century, the SA paid approximately $100 million to American firms to lobby the US government. On May 20, 2017, President Donald Trump and King Salman signed a series of letters of intent for SA to purchase arms from the United States totaling US$110 billion which have not yet materialized.

China and SA are major allies, with the relationship between the two countries growing significantly in recent decades. Most Saudi Arabians also express a favorable view of China. Russia Saudi Arabia and Russia are also closing the ties after Russia helped to break up the impasse in the OPEC negotiations in April 2019.

To protect the house of Khalifa (the monarchs of Bahrain), SA invaded Bahrain by sending military troops to quell the uprising of Bahraini people. The Saudi government considered the two-month uprising a “security threat” posed by the Shia, who represent most of the Bahrain’s population.

In 2015, Saudi Arabia, spearheading a coalition of Sunni Muslim states, started a military intervention in Yemen against the Shia Houthis and forces loyal to former President Ali Abdullah Saleh, who was deposed in the 2011 Arab Spring uprisings. At least 56,000 people were killed in armed violence in Yemen between January 2016 and October 2018.

4.3.2. Turkey

World War I brought about the end of the 700-year-old Ottoman empire (1299–1908). Historically known as the Turkish Empire or Ottoman Empire (OE), it controlled much of southeast Europe, western Asia, and North Africa between the fourteenth and early twentieth centuries.

The OE was multinational and multilingual, containing 32 provinces and numerous vassal states, with Constantinople, today’s Istanbul, as its capital. Over time, the Ottoman military system fell behind that of its European rivals, the Habsburg and Russian empires. In the final stages of the empire, the Ottomans allied with Germany and joined World War I on the side of the Central Powers. In the aftermath of World War, I, the OE was partitioned and lost its Middle Eastern territories, which were divided between the United Kingdom and France.

The Republic of Turkey was established in 1923. In 1926, Mustafa Kemal Atatürk, the first president, enacted numerous reforms, many of which incorporated various aspects of Western thought, philosophy, and customs into the new form of Turkish government. Atatürk started the de-Islamization of Turkey; abandoned Arabic characters for the Latin alphabet, rendering many people illiterate; removed Islam from education; and introduced a new constitution, European laws and jurisprudence, and modernized administration. Turkey was not a stable democracy. The government alternated between civilian governments and military rule. Some authors say that Turkey was not comfortable in its secular democratic skin (Bay, 2011). However, until 2016, Turkey was on a **road to democratization** that had three sources:

First, Turkey had a democratic constitution that separated the Islamic religion from the state and, most importantly, had secular education, European laws, free elections, and freedom of speech.

Second, Turkey has very close relations with the EU and the West generally. It is a member of the North Atlantic Treaty Organization, the IMF, the World Bank, the OECD (Organization for Cooperation and Development), and the G-20. Turkey is an associate member of the European Economic Community trade agreement and is party to many tariff agreements with the EU, as well as having special visas for workers. Turkey's negotiation toward EU membership was stopped in 2017 because of "Turkey's path toward autocratic rule."

Third, Turks have a very strong diaspora, particularly in Germany (estimated 4 million) and France (estimated 1 million).

In 2004, elections were won by the AK Party. Since then, Turkey has become progressively more Islamic and undemocratic. In 2018, Turkey adopted a presidential system in place of its parliamentary system. President Recep Tayyip Erdoğan enacted measures to increase the influence of Islam, reversed Kemalist policies, severely limited freedom of speech, increased control of the judicial system, restricted opposition, and repressed the critiques of the president. Hundreds of journalists were put in jail, independent media were closed, protestors were sentenced to long prison terms, and university deans were fired and replaced by government appointees.

Why did Turkey turn away from liberal, secular democracy toward authoritarianism and Islam? There are several factors at play in Turkey (Cagaptay, 2019):

First, Turkey's bid for EU membership has been postponed indefinitely. Erdogan is looking in other directions. Without EU membership, Erdogan is acting as an independent entity, bringing his country closer to Russia and the rich Persian Gulf states. Instead of being a minor member in the EU, Turkey under the rule of the AK Party wants to become a regional economic and military power, a quasi-sheriff state, policing much of the issues in the volatile region.

Second, a conservative Islamic and nationalistic party and strong president appeal more to a majority of an 85 million population country than a secular Turkey run by a weak coalition made up of old-style leaders or generals. Turkish voters prefer the country run by a nationalist and an active player in the region.

Third, the AK Party power base is in Eastern Anatolia. Anatolia is a rural and strongly Islamic area that has witnessed a manufacturing boom in the last ten years. It also became a source of inexpensive labor supply and exports to the EU, where Turkey enjoys free trade privileges as a member of the EEC. Turkish construction businesses from Anatolia got many lucrative contracts in Istanbul and the EU. Construction of a massive airport, shopping centers, luxury apartments, and mosques made many of the president's Anatolian friends rich. Income increased in traditional and more religious areas. Erdogan's power base moved clearly from the west to the east of the country.

Erdogan's game plan to turn Turkey into a regional power has worked so far. The United States needs to keep Erdogan as a friend because the US Air Force operates from Turkish bases. Also, the EU is funding Syrian refugee camps in Turkey to hold them from crossing the EU borders. Moreover, Syria and Iraq need Turkey to stop Kurds from creating a new state and carving out pieces of their countries. SA needs Erdogan's cooperation to silence the world's criticism after the killing of journalist Mr. Khashoggi. Turkish democracy is paying the price of Erdogan's ambition to create a mini-Ottoman empire in the region. (Karaveli, 2016)

4.3.3. Syria

The war In Syria started in 2010 as a peaceful demonstration of high school students who protested the regime that had been run by the al-Assad family since 1971. The power base of President Bashir al-Assad is the al-Berri, al-Baggara, al-Hasasne, and al-Zeido Alevite tribes. The brutality and the torturing of children that occurred after the peaceful street protests al-Assad in 2011 sparked a revolution in the Aleppo region and later the rest of the country. The Alevite Shia war with the Sunni majority soon became the war with ISIS for the West. ISIS chose Syria because it was in the middle of the sectarian war and had plenty of Sunni refugee military from Iraq. ISIS also attracted thousands of European Muslim mercenaries who wanted to fight a new jihad with the West. At the outset, the home war would most likely end with a collapse of the al-Assad minority regime.

However, such a result was not acceptable to Iran, Russia, and Turkey. Iran sent military support and Shia Hezbollah fighters to Syria. Russia was afraid of losing the only pro-Moscow regime in the ME and sent air support and mercenaries. Turkey took the refugees from the Syrian war and sealed off the border with Syria to stop the expansion of Turkish Kurdish YPG army to control Northern Syria. Turkey is strongly opposed to Kurdistan's YPG Party, which wants to proclaim an independent state between Turkey and Syria. President Obama was not willing to commit US forces to end Bashir al-Assad's rule and have yet another country in chaos on the list, after a similar territorial breakup took place in Libya after removal of Muammar Qaddafi.

In 2016, during the war with the Sunni Islamic State (ISIS), Syria's population was 22 million. In 2018, the UN identified that 13.1 million needed humanitarian assistance, 6 million were internally displaced within Syria, and around 5 million were refugees. This was the largest humanitarian disaster since WWII.

The Bashir al-Assad regime survived, and in late 2018, President Trump ordered the removal of the last 2,000 US military personnel from Syria. The clear winner in the Syrian war was Russia, which presented the postwar plan for Syria in November 2018 in Sochi. Russia went into Syria in September 2015 to defeat ISIS and to block an attempt at regime change by outside powers, such as the United States and Saudi Arabia. More than two years later, Moscow's military engagement has paid off. ISIS has been defeated, and Assad's regime has survived but will be controlled by Moscow.

Syria is de facto divided into several enclaves controlled by different forces: the Assad government; anti-Assad opposition groups; pro-Turkish and pro-Iranian militias; and the Kurds. Russia has military power on site to achieve its preferred outcome. In Syria, as in Iraq, Russia favors autonomy for the Kurds by playing them against the United States now when the Kurds feel that the United States has betrayed them.

Moscow will accommodate with Teheran's Hezbollah because both countries would like to reduce the American military presence in the ME. Russia understands Iran's interests, but it also understands Israel's, and it seeks to strike a balance between the two. Israel has security concerns about the presence of armed Hezbollah groups too close to its border and hopes to use the Russians to curb their influence in Syria.

Moscow and Washington have cooperated on the establishment of de-escalation zones, but the Kremlin's diplomatic coordination with the United States is symbolic. Russia will try to use the United States, the EU, China, and Japan to pay for the reconstruction of Syria. Russia secured its own core interests in Syria by taking full control of the Latakia naval base, the Khomeini air force base, and the Tartus naval facility. This access will seal Russia's main geopolitical and military foothold in the Middle East (Van Dam, 2017).

4.3.4. Iraq

Iraq's population is half Shia and half Sunni. The Shia live in the southern provinces of the country, consisting mostly of a rural, agrarian population that depends on the supply of water and flooded marshes between the Euphrates and Tigris rivers. The President of Iraq from 1979 to 2003, Saddam Hussein, came from the northwestern (Sunni) part of Iraq. Even though he was not religious by any means, his tribal loyalty was strictly Sunni. He populated his government and the military with loyal Sunni tribesmen from the city of Tikrit, where he was born. Saddam Hussein systematically eliminated any Shia from power and punished any sign of peoples' discontent by military pacifications, which sometimes involved chemical weapons as well as cutting off water to the marshes that provided the source of livelihood of the Shia farmers.

His ruling style was not atypical for the Arab countries: Bashir al-Assad, the President of Syria who belongs to the Shia Alevite minority, used the military to gas and kill opposition from Sunni regions in Syria, and Egypt's Sunni President Mohammad Morsi didn't protect Coptic Christian church burning, etc. Arab politics is always tribal, and the introduction of the concept of an inclusive, multi-tribal, democratic state is an extremely difficult goal, if not impossible, today. This explains the frustration of American voters with spending $2 trillion on the liberation of Iraq and the attempts to create a Sunni-Shia coalition government there. The current president of the country is Shia and is unwilling to cooperate with the Sunni vice president. He also made an apparent agreement with an Iraqi Shia cleric, Shia Muqtada al-Sadr, and the leader of a Shia militia to remove American military personnel from the country. Al-Sadr is the key man of the Iranian influence in postwar Iraq and was key in fighting against the Sunni ISIS in Syria (Polk, 2006).

4.3.5. Egypt

The Egyptian Arab Spring started in 2011. It consisted of demonstrations, marches, occupations of plazas, and nonviolent strikes. Millions of protesters from a range of socio-economic and religious backgrounds demanded the overthrow of Egyptian President Hosni Mubarak. Violent clashes between security forces and protesters resulted in some 850 killed and over 6,000 injured. A year later, President Mubarak was found guilty of complicity in the murder of protesters and sentenced to life imprisonment, but the sentence was overturned on appeal and a retrial ordered. After the revolution against Mubarak, through a series of popular elections power in Egypt was taken by the Muslim Brotherhood, and the Islamist Presidency was given to Mohamed Morsi. Morsi attempt to pass an Islamic-leaning constitution and issued a temporary presidential decree that raised his decisions over judicial review to enable the passing of the constitution. In 2013, Morsi was deposed by a coup d'état led by the minister of defense, General Abdel Fattah El-Sisi, who become Egypt's president by popular vote in 2014.

President El-Sisi receives more than $1 billion from the United States each year. But meanwhile, his state-manipulated media is filled with anti-Western diatribes, and Americans working in Egypt, and Egyptians who work with Western organizations, have faced trumped-up charges under increasingly harsh laws criminalizing not only funding but even contacts between Egyptians and foreigners. Egypt's prisons, filled with thousands of young men and women arrested arbitrarily, then physically abused and tortured, have become incubators of radicalism.

It's not only Islamists who suffer repression. President El-Sisi has cracked down on secular groups, from Egyptian human rights organizations to youth groups. On the economic side, El-Sisi gets high marks in the United States for taking long-postponed moves such as floating the currency and reducing energy subsidies. But he has failed to take badly needed steps to train the burgeoning labor force and to encourage job creation in the private sector. In 2018, Egypt had 33 percent inflation and 12 percent unemployment, and unemployment among Egyptians under 30 is much higher.

Meanwhile, the government of El-Sisi has funneled billions into the vast business empire of the Egyptian military, funding mega-construction projects such as the $8 billion Suez Canal expansion and a project to build a new $45 billion desert capital city, which as of now has been put on hold (Ketchley, 2017).

4.3.6. Iran

After WWII, Prime Minister **Mohammad Mossadegh** nationalized Iran's petroleum industry and oil reserves. The loss of control of oil exports and profits was not acceptable to the Anglo-American oil interests. Prime Minister Mossadegh was deposed in 1953 by an internal coup d'état, and the Shah restored almost absolute power in the country.

During the 1960s and 1970s, the Shah, **Mohammad Reza Pahlavi**, became increasingly autocratic and repressive. The Muslim radical cleric **Ruhollah Khomeini**, an active critic of the Shah, was arrested and imprisoned. After his release in 1964, he was sent into exile to France. Because of the 1973 spike in oil prices, Iran was flooded with foreign currency, which caused inflation and an economic crisis that lasted for several years. The anti-inflation protests spilled into a revolution, which deposed the Shah.

Iran became the Islamic Republic under the rule of the supreme cleric **Ayatollah Ruhollah Khomeini** in 1979. In late 1979, a group of Muslim students seized the United States Embassy and took **52 American personnel hostage for the next 444 days**. On the first day of **Ronald Reagan's Presidency**, **January 20**, **1980**, the hostages were released.

Iran is an **absolute theocracy**. For example, Iran's current president, Hassan Rouhani, was elected in 2013 in national elections. However, all his government appointments and decisions, and all laws passed by the Iranian Parliament, as well as all election candidates, must be approved by the Council of Experts of the Islamic Republic of Iran. The Supreme Leader directly chooses the ministers of Defense, Intelligence, and Foreign Affairs. Iran calls itself an Islamic Republic, but it is not a republic by any definition of the word.

Iran funds Hezbollah, the Party of God, which is a foreign army of the Iranian Revolutionary Guards, its elite military force. Hezbollah started to operate in Lebanon as a military brigade to tip the balance of power between the Christians and the Muslims. The Lebanese war ended with the destruction of Beirut and thousands of civilian deaths. Hezbollah extends Tehran's influence into the entire ME and the Gulf region (Axworthy, 2016).

Hezbollah, which has amassed thousands of surface-to-surface missiles and rockets over the last 40 years, is a serious threat—if not to the United States then to its closest Middle Eastern ally, Israel. Both have good reasons to deter Hezbollah from starting a war with Iraq, and to prevent Iran from establishing a permanent military presence in southwestern Syria. Even though Hezbollah refrains today from attacking US forces or using terrorism to target US assets, it is a serious threat to our interests in the ME. The United States withdrew from the nuclear deal with Iran in 2018, which is still supported by US European allies in NATO. The United States believes that putting pressure on Iran is going to accelerate the financial breakdown of the Iranian theocracy. Some observers point out that not engaging Iran in the nuclear deal makes them more willing to cooperate with Moscow. This is a matter of opinion.

Chapter 5
Latin America overview

The long view

An early twenty-first century comparison of Asia and Latin America (LA) presents a great puzzle. Asian countries, with very few exceptions, became open economies before they started to industrialize. Asia also modernized its agriculture and created hundreds of millions of jobs for displaced farmers. Latin America did not. Even today, after a quarter century of globalization, Latin America is struggling to open up to foreign investors and has millions of displaced migrant farmers.

In Asia, economic growth was launched through the export of low-labor-cost textiles and manufactured items. That's how growth was manifested in Japan, China, South Korea, Malaysia, Singapore, Bangladesh, Vietnam, and other countries. Latin America still exports mostly resources and agricultural goods and has a quite small indigenously developed manufacturing sector.

In Asia, the rule of law came before democracy. In Latin America, democracy came before the rule of law, which is currently deteriorating and paving the way for presidents who promise the curbing of democratic civic freedoms in exchange for safety.

In Asia, the infrastructure was built by forced savings. In Latin America, savings and foreign loans were wasted on poorly designed populist social programs and monies were squandered by corrupt elites.

In Asia, leaders were sometimes terribly corrupt but were eventually ousted. Democratic institutions were improving over time. In Latin America, politicians who proclaimed serving the people as their goal destroyed democratic institutions. Populists used state budgets to buy election pork.

The evidence of the last 70 years reveals that Latin American economists, populist politicians, and nationalists had their priorities wrong. South American elites never learn from their past mistakes, they repeat them. For an entire century, the continent was passing through a carousel of democracy, military coups, populists, and socialists.

More recently, Latin America has experienced some general improvements over the past few decades. However, social and economic progress—especially poverty reduction and job creation for the region's 160 million young people—recently slowed.

The big question for Latin America in 2019 is, will voters take constructive actions, or will they embrace the populist anger and nationalist pride that seems to be sweeping much of the world?

Forty percent of the Central and South American population today are migrants. The tragedy of people in Venezuela, Honduras, and El Salvador is reaching the point of despair. The political power in the two largest countries of LA (Brazil and Mexico) has fallen into the hands of right-wing nationalists. Argentina faces almost 50 percent inflation and has asked for an IMF bailout. The continent that from a demographic and natural resources point of view should be rich, prosperous, and safe is again departing toward an uncertain and unstable future in 2019.

Two wrong choices in the twentieth century

The wrong economic model: Import substitution industrialization (ISI) is a trade and economic policy that advocates replacing imports with domestic production. ISI is based on the premise that a country should attempt to reduce its foreign dependency through the local production of industrial products. Even though the theory dates to the seventeenth century, it made a career in the twentieth century because of "Latin American structuralism."

For example, Argentine economist Raul Prebatch advocated that Latin American countries should have declining terms of trade (TOT). The TOT measured the index of the main export staples, such as agricultural goods and resources, against the index of imported manufactured goods. According to the study conducted some 70 years ago, the LA TOT was declining. The conclusion was that LA should abandon the modernization of agriculture and pursue state-directed centrally planned development favoring local manufacturing. Many governments were convinced that only a direct bureaucratic interventionism would save their countries from "the vicious circle of agrarian poverty" and acted accordingly.

The first step was to raise the protectionist tariffs for imported manufactured goods to save the domestic "infant" manufacturing from outside competition. Second, they fixed their currencies, which, when mixed with high inflation, overvalued the currencies and led to the flight of capital. As a result, they subsequently introduced capital controls to stop loss of reserves. Third, the banks under state control abandoned investment in agriculture, and this bankrupted many plantations and cattle breeding enterprises. The consequences were the turning of millions of landless farmers to narco business, or causing them to immigrate to large cities, or both.

We must mention here a very important characteristic of Latin America. In the United States and most of the Western world, but also in Asia, the farmers own the land on which they feed their families and sell surpluses. In Latin America, a limited number of colonizer families (originally from Spain and Portugal) were rewarded with vast estates. The estates resisted the waves of land privatization during the Bolivarian early nineteenth century revolutions: Bolivia, Colombia, Ecuador, Panama, Peru, and Venezuela. As a result, the 505 million Latin America farmers are effectively landless farm workers.

As the ISI progressed, these landless farmers emigrated to the cities, creating mega metropolises with old-post colonial centers surrounded by favelas (shanty towns), where poverty, economic deprivation, and crime escalated out of control. However, the legacy of the republican Bolivarian revolutions was voting rights for all Latin America citizens. Impoverished voters almost always support politicians who offer them the fairy tale illusion of quick and radical improvement in their miserable lives.

Populism: Populism has deep roots in Latin America. It dates to the leaders and revolutionaries who dominated Latin America politics in the first half of the twentieth century—La Torre, Gaitan, Cardenas, Vargas, Peron, Guevara, Castro, and Allende are some of these politicians. Populist leaders tried to unite the poor and the lower classes against the old power structures, landowners, and imperialism. From a historic perspective, it's not difficult to connect ISI to the rise of poverty, political instability, crime, populism, and the so called "pink tide" in the later part of the last century. When the elected democratic governments failed to deliver on their promise of social equality and a steady increase in living standards, they were then replaced by socialists and populists, all of them charismatic leaders from outside of the old elites who offered quick solutions. They advocated the nationalization of industry and mineral resources, massive spending for the poor, and expulsion of foreign monopolies as alleged robbers of national wealth and profits.

Generally, Latin America populists tend to make bad choices. They wrongly believe that resolving social problems by the government is a precondition to economic growth, and that they can improve the standard of living only if they have a monopoly of power. That's why they treat the state as their own fiefdom, misuse state funds, and protect the economy from foreign capital.

Overall rank	Country	Score	Political regime
1	2	3	4
15	Uruguay	8.38	Full democracy
19	Costa Rica	8.13	Full democracy
21	Chile	8.08	Full democracy
43	Trinidad and Tobago	7.16	Flawed democracy
45	Colombia	7.13	Flawed democracy
46	Panama	7.05	Flawed democracy
48	Argentina	7.02	Flawed democracy
49	Suriname	6.98	Flawed democracy
50	Jamaica	6.96	Flawed democracy
52	Brazil	6.86	Flawed democracy
58	Peru	6.60	Flawed democracy
60	Dominican Republic	6.54	Flawed democracy
67	Ecuador	6.33	Flawed democracy
70	Paraguay	6.24	Flawed democracy
71	El Salvador	6.15	Flawed democracy

1	2	3	4
71	Guyana	6.15	Flawed democracy
73	Mexico	6.09	Flawed democracy
89	Honduras	5.42	Hybrid regime
93	Guatemala	5.26	Hybrid regime
104	Bolivia	4.84	Hybrid regime
105	Haiti	4.57	Hybrid regime
122	Nicaragua	3.55	Authoritarian
140	Venezuela	2.88	Authoritarian
143	Cuba	2.84	Authoritarian

Chart 22. Democracy Index 2019 A year of democratic setbacks and popular protest.

Source: EIU.com. [accessed July 27, 2020].

Brazil's Workers' Party, the Revolutionary Institutional Party in Mexico, and Venezuelan Marxists wasted state funds, eliminated the middle class, and indirectly or directly created underground economies. A strong middle is the source of growth, and Latin America has not been able to develop it so far.

Latin America in the twenty-first century

Latin American economies have posted an average annual GDP growth of 3 percent over the past 15 years—far slower than growth in other developing regions. And almost 80 percent of that growth came from population growth rather than productivity. Between 2000 and 2015, productivity across the region grew at only 0.6 percent, one of the weakest performances of any region in the world. Without higher productivity, growth is set to come under threat from **three disruptive forces hitting at once** (Ellis, González, 2019).

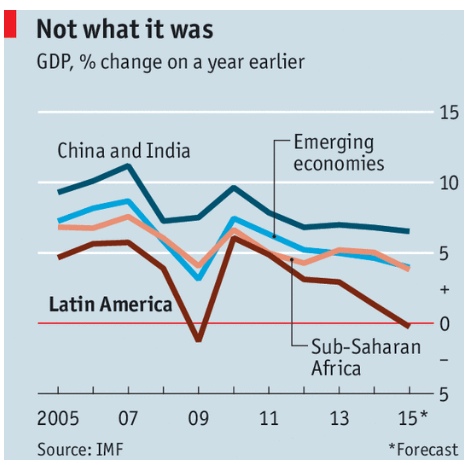


Chart 23. GDP% change on a year earlier.

Source: Economist.com https://www.economist.com/ [accessed November 16, 2020].

The first disruption is that the fertility rate in Latin America has plunged in the past 15 years, from nearly 2.7 births per woman on average to 2.1 births. With the lower fertility rate, Latin America in the next few years will experience, unknown before shortage of working population. Between 2015 and 2030, the rate of employment growth is expected to decline by more than half, falling to only 1.1 percent a year. With unchanged productivity growth, this implies that GDP growth in Latin America will be 40 percent weaker over the next 15 years than it was in the previous 15.

The second disruption is the end of the commodity super cycle, which had fueled GDP growth, particularly in the Andes region. Latin America will continue to benefit from its abundant resources, but the current context requires a shift toward producing and using those resources more efficiently.

The third disruptive force is the risk of rising protectionism after decades of declining trade barriers. Protectionism in the United States is of concern because that country is the destination for 45 percent of Latin American exports (World Bank, 2018).

To counter the threat to growth, the political economist should see four major priorities for Latin America:

1. The region needs to **expand high-value-added activities across** key value chains by **removing obstacles to competitiveness**. Today, Latin America's most productive sectors account for less than one-fifth of total employment in the region. On average, Latin American workers produce 25 percent of what US workers produce.
2. Latin America's economies need to **engage fully in the current wave of digitization and automation**. Yet, according to the World Bank, the region invests only around 0.8 percent of GDP in R&D activities, compared with an average of around 2.4 percent in countries that are part of the Organization for Economic Cooperation and Development and 1.8 percent in China. About half of the full-time hours worked in Latin America could be automated—potentially covering more than 76 million full-time-equivalent workers. Productivity would rise, but measures would need to be in place to help workers gain skills as they transition to new types of jobs.
3. To address challenges created by pressure on the labor pool, the region's countries need to raise skills through improved education and training. They also need to better match those skills to the ones needed by business. According to a survey, between 40 and 50 percent of Latin American employers cited a lack of skills as the main reason for entry-level vacancies. **The entry of more women into the labor force would help mitigate pressure on labor pools and boost GDP growth (McKinsey surveys).** If all Latin American countries matched the progress toward gender parity of the best performer in the region—and raising women's labor force participation is a huge part of that—they could create an additional $1.1 trillion of GDP by 2025, which is 14 percent above what can be achieved at current rates of progress.

4. Finally, an inclusive and sustainable growth strategy requires strengthening macroeconomic fundamentals as well as **investing in the capital and infrastructure that enable productivity growth and competitiveness**.

The country focus

Nearly two-thirds of Latin American nations will have chosen new leaders between 2018 and 2019: Mexico, Chile, Paraguay, Colombia, Brazil, and Venezuela. There's a chance for these nations to choose among democracy, socialism, populism, or authoritarianism. As the center-left "pink wave" of the early 2000s recedes, a new cohort of more conservative leaders in Argentina, Brazil, Chile, Colombia, and Peru has tipped the regional balance against Venezuela's dictatorship, but the lack of actionable options bedevils them as well. Venezuela's exasperated neighbors increasingly see the crisis through the prism of the refugee problem it has created.

5.1. Mexico

At the end of 2018, the new President of Mexico, Mr. López Obrador, or AMLO, as he is known, presented a budget for 2019, giving Mexicans their first idea of the trade-offs, he is prepared to make in pursuit of his "fourth transformation" of the country. This transformation is supposed to uplift the poor, make the economy more self-sufficient, and reduce corruption and crime. The budget shows that AMLO remains a populist, but that he hopes to be a fiscally responsible one.

Before the inauguration, he shook the financial markets by saying that he would stop Mexico's biggest infrastructure project, a new airport for Mexico City. At the same time, he was traveling to launch new investments, including a tourist train in southern Mexico and a refinery in his home state of Tabasco.

AMLO has scaled back his plans for higher social spending and is bringing back the idea that the state should provide energy that is abundant and cheap. He is also raising spending on scholarships for the young, but less than he proposed in his campaign when he talked about a universal pension. To help pay for these still-large programs, the government will slash elsewhere, in some departments by more than 20 percent.

An overhaul of migration policy will carry little weight. The foreign minister announced spending of $5 billion a year to discourage migration from Central America to the United States—partly to please President Donald Trump.

The austerity will not affect AMLO's favorite infrastructure projects: the "Maya" tourist train and a new refinery for Pemex, the state-owned oil company. This is part of his expensive scheme to make Mexico self-sufficient in energy, which includes freezing auctions of rights to international oil companies to prospect for oil and gas for three years. AMLO hopes to cut fuel prices once the new refinery is built. Pemex, which has a history of inefficiency and corruption, is supposed to raise oil production by 50 percent during his six-year term.

AMLO's Morena party in the Congress is debating measures to scrap former PRI President Peña Nieto's education reforms, which sought to enforce higher standards of teaching in Mexico's terrible schools. AMLO wants to make education free at all levels.

Mexico's Supreme Court has suspended a law passed by Morena votes that cuts the salaries of senior officials (including judges). That pay cut would not save the government much money, but it was a popular promise of AMLO.

5.2. Brazil

It's the largest country in Latin America. The 2018 election put an end to the rule of the Workers' Party. Following the imprisonment and impeachment of two Worker's Party Presidents, and the brief Presidency of a conservative successor, Brazilians opted for a strongman. The new President, Jair Bolsonaro, a former army captain who, at various points in his political career, advocated shutting down the National Congress and restoring military rule, is modeling himself on US President Donald Trump. He has also long been a staunch advocate of protectionist economic policies (though he has more recently attempted to portray himself as an advocate of open markets), looser gun laws, and repressive approaches to public security.

Bolsonaro's past statements and current policy proposals suggest that his presidency may pose a direct threat to democratic norms and institutions, the rule of law, social justice, and the improvement of security in Brazil. Under President Bolsonaro, relations with the United States will improve, and a military action against Venezuela—unthinkable until recently—will be on the table.

Mr. Bolsonaro has stacked his administration with former generals. These include the vice president and the national security adviser. His closest associates in the government will be his three sons, the most influential of whom is Eduardo, a congressman from São Paulo who has courted the Trump administration. He reportedly urged his father to name as foreign minister Ernesto Araújo, a hitherto-obscure diplomat who regards action against climate change as a globalist plot and advocates a Christian alliance among Brazil, the United States, and Russia.

The new education minister wants to fight the supposed influence in schools of left-wingers and gay rights advocates. The environment minister calls climate change a "secondary issue" and opposes many of the penalties levied for environmental damage.

Mr. Bolsonaro is keen to move Brazil's embassy in Israel from Tel Aviv to Jerusalem (as Mr. Trump has done), but the agriculture minister, Tereza Cristina, worries that Muslim countries will punish Brazil by buying less of its beef.

Mr. Bolsonaro is suspicious of China, which, according to him, wants to "buy Brazil"; however, he is not going to cut trade with the largest importer of Brazil's minerals and soybeans.

The President's challenge is promising to stabilize public debt, which at 77 percent of GDP. The rising interest rates due excessive government borrowing is "crowding out" more productive spending of the capital in the country.

Mr. Bolsonaro is unwilling to engage the former Workers' Party in an exchange of political pork and patronage for political support; he has tried to marginalize political parties and their leaders. He prefers dealing with congressional caucuses, such as those representing the so-called "Bullet, Beef, and Bible" (guns, ranching, and religion) interests. He hopes to assemble case-by-case coalitions in Congress to pass laws.

But there's little popular enthusiasm for reforms, especially pension reform to extend the retirement age from 62 to 65. The recent strength of Brazilian financial markets reflects local optimism about economic reform, but foreign investors have been wary.

Mr. Bolsonaro has lately opened channels with Congress's leaders, not the parties, which have been "demonized" because of corruption. Mr. Bolsonaro's hopes of being a transformational president depend on his ability to couple pragmatism and economic reform. As important will be fighting corruption and crime in ways that reinforce the rule of law rather than undermining it. Achieving those changes will require wisdom and a talent for political management. The military men turned presidents in past and present LA, like Juan Peron in Argentina, Stroessner in Paraguay, and Maduro in Venezuela, suggest that they become not a solution but a problem for their countries.

5.3. Venezuela

Venezuela echoes Angola, Brunei, Iran, and Russia, which, after having found oil, were unable to launch or maintain democracy. For four decades, Venezuela seemed to have miraculously beat these odds—it democratized and liberalized in 1958, decades after finding oil—but eventually it became an authoritarian failed state, as it is today.

When the decades-long oil price boom ended in 2014, Venezuela lost not just the oil revenue on which Chávez's popularity and international influence had depended but also access to foreign credit markets. This left the country with a massive debt overhang: the loans taken out during the oil boom still had to be serviced, but from a much-reduced income stream. Venezuela ended up with politics that are typical of autocracies that discover oil: a predatory, extractive oligarchy that ignores regular people as long they stay quiet and that violently suppresses them when they protest.

The resulting crisis is morphing into the worst humanitarian disaster in memory in the Western Hemisphere. Economists estimate that it is comparable to the 40 percent contraction of Syria's GDP since 2012, following the outbreak of its devastating civil war. Hyperinflation has reached one million percent per year, pushing 61 percent of Venezuelans to live in extreme poverty, with 89 percent of those surveyed saying they don't have the money to buy food for their families and 64 percent reporting they have lost an average of 11 kilograms (about 24 pounds) in body weight due to hunger. About 10 percent of the population—2.6 million Venezuelans—has fled to neighboring countries.

The Venezuelan state has mostly given up on providing public services, such as health care, education, and even policing; heavy-handed, repressive violence is the final thing left that Venezuelans can rely on the public sector to consistently deliver. In the face of mass protests in 2014 and 2017, the government responded with thousands of arrests, brutal beatings and torture, and the killing of over 130 protesters.

Meanwhile, drug trafficking has emerged alongside oil production and currency arbitrage as a key source of profits for those close to high-ranking officials, and members of the President's family are facing narcotics charges in the United States. A small connected elite has also stolen national assets to an unprecedented degree. In August of 2018, a series of regime-connected businessmen were indicted in US federal courts for attempting money laundering in illegal scams that are part of the looting of Venezuela.

The entire southeastern part of Venezuela has become an illegal mining camp, where desperate people displaced from cities by hunger work in unsafe mines run by criminal gangs under military protection. All over the country, prison gangs, working in partnership with government security forces, run lucrative extortion rackets that make them the de facto civil authority. The offices of the Treasury, the Central Bank, and the national oil company have become laboratories of financial crimes. As Venezuela's economy has collapsed, the lines separating the state from criminal enterprises have all but disappeared.

Here's the dilemma the United States is facing in LA. Although a US led military assault would likely have no problem overthrowing Maduro in short order, what comes next could be far worse, as the Iraqis and the Libyans know only too well. When outside powers overthrow autocrats sitting atop failing states, open-ended chaos is much more likely to follow than stability—let alone democracy. The fantasies of military invasion are deeply misguided and extremely dangerous. Nonetheless, the United States will be facing the reality of creating a vacuum of power in the continent. In the meantime, Russia has sent two top-of-the-line bombers to Venezuela capable of launching cruise missiles with nuclear loads.

Finally, the other LA countries are finally grasping that Venezuela's instability will inevitably spill over across its borders. Some have suggested using harsh economic sanctions to pressure Maduro to step down. But such measures are redundant: if the task is to destroy the Venezuelan economy, no set of sanctions will be as effective as the regime itself. The same is true for an oil blockade: oil production is already in free fall.

5.4. Argentina

Argentina is famed as much for its financial crashes as for its juicy steaks and good soccer players. But even compared with its usual performance, 2018 was a particularly bad year for the economy. The worst drought in 50 years wrecked the corn and soybean harvests, knocking 2 percent off the GDP. The peso lost half its value against the dollar, pushing inflation to 46 percent. That tipped the country into its second recession in three years and led to a crisis that forced it to seek one of the largest credit lines in IMF history. The approval rating of President Mauricio Marci was at an all-time low.

So far, neither raising interest rates to 40 percent (introduced in in May 2108) nor securing a $50 billion credit line with the IMF in June halted the peso's slide from 20 pesos/$ to 40 pesos/$.

To repair the economy, Argentina's government agreed to balance the budget in 2019, partially by reducing spending on infrastructure, transfers to provincial governments, and subsidies for energy and public transport. It also levied a temporary tax on rising exports, which was the main cause of feedback inflation.

The IMF demanded changes at the Argentine central bank (ACB). The ACB had to abandon discredited inflation targets and instead freeze the expansion of the monetary base. The bank also adopted a floating exchange-rate band, meaning it will limit its interventions in currency markets to when the peso's value falls outside a certain range. These policies have succeeded in stabilizing the exchange rate and curbing inflation expectations, allowing the bank's benchmark interest rate to fall from a high of 74 percent to 59 percent in October 2018. As inflation falls, real wages should rise, boosting consumption.

President Macri faces an election in October 2019. His populist predecessor, Cristina Fernández de Kirchner, is thought to be considering another presidential run, despite facing six separate federal corruption charges relating to her time in office. The prospect of the return of discredited Peronism shook the market. Many things can go wrong in Argentina. Social unrest is expected in the future as unions haggle over pay raises. If the recovery is delayed, another drought could prompt another bout of capital flight like the one that devastated the economy in 2002.

Chapter 6
Africa overview

The Long View

Africa still accounts for less than its expected share of global activity. The economists call this "the problem of less than 3 percent." Even though it is home to almost 15 percent of the world's population, Africa accounts for less than 3 percent of Google hits, less than 3 percent of global trade, less than 3 percent of mobile broadband subscriptions, and less than 3 percent of global private equity investment.

Africa also suffers from serious gaps in infrastructure. Only 32 percent of sub-Saharan Africans have regular access to electricity, and only one in four has a bank account. Africa's road network is sparse and potholed, with Nigeria, the continent's economic powerhouse, having a rate of road penetration that is just 15 percent of India's.

However, **Africa is transforming rapidly and keeping the pace up (Oloruntoba, Falola, 2020)**:

First, there is tremendous promise in the dynamism of young African entrepreneurs; in Africa's vibrant, growing cities; and in countries on the continent that have dramatically improved their leadership and institutions. The region's abundant world-class innovation and talent are increasingly being harnessed to improve lives and generate wealth. This is an essential story to tell, and its telling is long overdue.

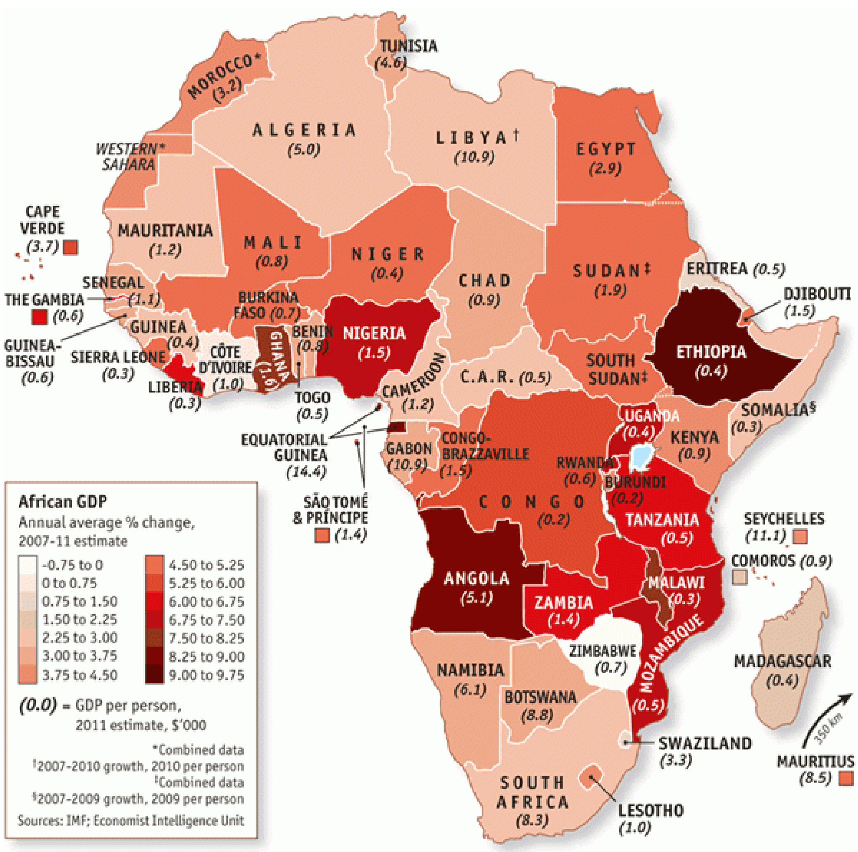
Second, in today's interconnected economy, no region's destiny is entirely within its own control. The early twenty-first century has been very good for Africa. High commodity prices and strong Chinese investment, rising energy exports, and African innovations in mobile banking have fundamentally changed the growth equation. The perceptions of Africa among investors from Asia and the West are rapidly improving. African designs, music, and travel appeal to many Americans. Also, African immigrants are altering labor markets in Europe and sending billions of dollars home.

Third, Africa is opening to the outside world and inside the continent. The world seems to be moving away from multilateralism and questioning the benefits of globalization. The United States has withdrawn from the Trans-Pacific Partnership

(TPP) and the Paris Agreement on climate change, operates outside the World Trade Organization, and is on the way to starting several trade wars. The United Kingdom is negotiating a messy exit from the European Union. But one place is resisting that trend.

Over the past decade, Africa has moved rapidly toward a regional integration called the African Union Agenda 2063 (a shared road map for the integration and socioeconomic transformation of Africa by 2063), a promised African Union passport, the new Single African Air Transport Market (SAATM), closer integration of most of the region's economies, and the signing of the African Continental Free Trade Area (AfCFTA).

SAATM could mirror the European Union's Internal Market for Aviation, which has increased air safety and improved competition between airlines, lowering fares. So far, 23 countries have signed up to join the SAATM, and Africans can now travel without a visa or obtain a visa on arrival in at least 30 of the continent's 55 countries. In 2018, 44 countries that have signed the AfCFTA committed to removing tariffs on 90 percent of the goods that they trade with one another.



Map 8. African GDP.

Source: IMF Economist Intelligence Unit.

Africa in the Twenty-First Century

It is unmistakably clear that the full measure of progress in Africa is not captured by increases in GDP or by any statistical yardstick used by Western economists. At best, such metrics may be imperfect proxies for improvements in the human condition; at worst, they distract from qualities and experiences—peace, health, fulfillment, and so on—that also matter and might be considered more indicative of genuine progress. A more useful analysis would consider alternative metrics derived from real experiences in Africa, such as quality of entrepreneurship, number of start-ups, the penetration of the mobile payment system, and the role of women in society.

6.1. Rwanda

Rwanda is proof that improved leadership, as exemplified by President Paul Kagame, an innovative telecommunications industry, an energetic youth population unleashing its pent-up demand, and the return of a highly educated diaspora can contribute to the growth of a country. This is especially obvious after the 2008 global financial crisis and after the **1994 genocide changed gender roles.**

The Rwandan genocide was instigated by the Hutu-led government against the Tutsi minority. Following 100 days of slaughter in 1994, Rwandan society was left in chaos. The death toll was close to 1 million. Many suspected perpetrators either were arrested or fled the country. Records show that immediately following the genocide, Rwanda's remaining population of 5.5 million was 60 to 70 percent female. Most of these women had never been educated or raised with the expectations of a career. In pre-genocide Rwanda, it was almost unheard of for women to own land or take a job outside the home. The genocide changed all that. The war led to Rwanda's "Rosie the Riveter" moment: it opened the workplace to Rwandan women just as World War II opened it to American women.

In America, most WWII opportunities were short-lived. Millions of men came home after the war to claim their former jobs, while women returned to domestic roles or went back to being nurses, teachers, or secretaries. This was not the case in Rwanda, and the change has had a long-term effect on the culture, the composition of the government, and the local economy (Thomson, 2018).

A new constitution was passed in 2003 decreeing that 30 percent of parliamentary seats be reserved for women. The government also pledged that girls' education would be encouraged and that women would be given leadership roles in the community and in key institutions. Women soon blew past the 30 percent quota, and today, with 64 percent of its seats held by women, Rwanda's parliament leads the world in female representation.

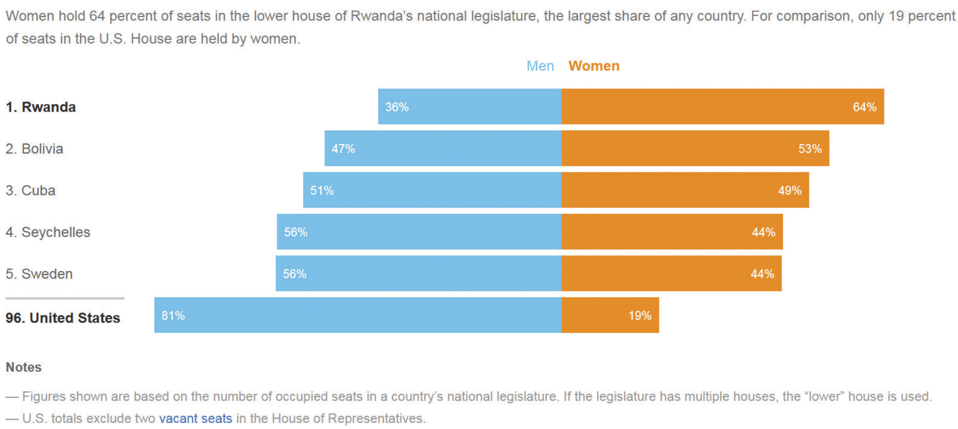


Chart 24. Women represented in lower house in 2016.

Source: Inter-Parliamentary Union.

In the last 20 years, life expectancy has doubled in Rwanda. The country has built a near-universal health care system that covers more than 90 percent of the population, financed by tax revenue, foreign aid, and voluntary premiums scaled by income. Deaths of children under five have been cut in half. A compulsory education program has put boys and girls in primary and secondary schools in equal numbers. Women can now own and inherit property and are active leaders in all sectors of the nation, including business, while national mandates are reducing violence against women. All these factors point to the fact that despite its past trauma, Rwanda has come out on top.

6.2. Nigeria

Nigeria is the second largest economy in Africa after South Africa. Nigeria in size and income is comparable to Texas. It is the world's eighth-largest oil exporter and the largest in Africa. Ten percent of its close to $400 billion GDP comes from oil sales. At the same time, Nigeria is severely underpowered. The country is currently consuming 80 percent less electricity than other countries at a similar income level. As the country grows in population and wealth, energy demand will only rise. By comparison, for Nigeria to rise to the average energy consumption level of today's Tunisia or Egypt by 2045 would require the country to generate at least a 20-fold increase over its current capacity. Clearly, incremental changes won't do it.

Solving Nigeria's structural energy problem is complicated, and it involves a long chain from production to generation to transmission and distribution. At each step is a tangle of government agencies, regulators, and private companies, often working at cross-purposes. For now, small businesses that need power can buy it from local mini-grid entrepreneurs.

But off-grid solutions are deceptive in both scale and price. To be sure, off-grid solar energy can provide rural homes with light and power for basic appliances, and urban ones with backup. Nigeria needs abundant, reliable, and inexpensive electricity; the rising demand for clean water, irrigated farming, fertilizer, cold storage, and especially air conditioning will only accelerate this need.

The United States Agency for International Development (USAID) or a private consortium and Nigeria should negotiate an energy contract to install some 30 gigawatts, for example by 2030, and pursue a road map for how to achieve these goals. A successful partnership would start by giving the resources and mandate it needs to coordinate all the different US agencies and to leverage American energy and technology companies. An energy partnership would also put the United States and Nigeria on the fast track for a bilateral investment treaty, which would promote Nigeria's development by mitigating risk to investors. Nigeria already has such treaties with Germany, China, France, and Great Britain, but not with the United States.

A quick solution came to Nigeria from the China National Offshore Oil Corporation (CNOOC), which signed an agreement for its venture in the Nigerian oil and gas sector, especially its offshore investments, for about $17 billion total imports. The CEO of the Beijing-based corporation disclosed that Nigeria was a key destination for the national oil firm.

6.3. Kenya

In 2018, three of the ten fastest growing economies in the world were in East Africa. The African Development Bank (AfDB) has forecast growth of greater than 6 percent in 2019 for Djibouti, Ethiopia, Kenya, Rwanda, Tanzania, and Uganda. By 2020, East Africa will be the continent's fastest growing region. The middle class will make up about 10–15 percent of its 430 million population.

Nairobi, Kenya's capital, is at the heart of East Africa's transformation. It has earned the moniker "**Silicon Savannah**" because it pioneered mobile money technology. The electronic wallet service—which allows users to store, send, and receive money using their mobile phones—has transformed how many Africans receive their pay and spend funds. The service is actively used by an estimated 66 percent of all adults in Kenya, Rwanda, Tanzania, and Uganda.

Nairobi has start-ups in high-value sectors, such as health care, financial technology and Information and communications technology (ICT). Dublin-based provider **Oxygen 8** offers mobile payment solutions through its **Tola** subsidiaries in Kenya, Mozambique, Tanzania, Uganda, and Rwanda, as well as Ghana in West Africa. Other EU start-ups include **Group Vitro Software** and **Nasc Technologies**. They were able to connect to savvy Silicon Savannah; identify sectors and opportunities; make introductions to potential partners and buyers; and advise on important procedures, market entry barriers, and license requirements.

Chapter 7

Ideas wrap-up. Four practical mega lessons

Anyone glancing at a newspaper these days finds a litany of woes: war, crime, disease, terrorism, and environmental disasters, all sandwiched between predictions of the coming collapse of market capitalism and liberal democracy.

The world does indeed face challenges. Yet by almost any measure, life for most people has been getting better in almost every way.

- Levels of war and conflict are near historic lows.
- People are living longer and healthier lives and are better educated than ever before.
- Incomes for most families are higher than at any time in history.
- One billion people around the world have been lifted out of extreme poverty in the last two decades, and although income inequality has worsened within many Western countries, around the globe, income is more equal than it has been in centuries.
- Far fewer people than ever go hungry, and the world now grows more food than it needs. Women have more opportunities, democracy has expanded, and basic human rights are more widely respected than ever before. Electricity, automobiles, the Internet, modern medicines, and simple conveniences have made most people's lives far easier than their great-grandparents could have imagined.

Amid the prevailing pessimism, few people—especially in the West—are aware of the extent of this progress. That ignorance matters.

In three recent books (2018)—Gregg Easterbrook's *It's Better Than It Looks*, Hans Rosling's *Factfulness*, and Steven Pinker's *Enlightenment Now*—the authors make it clear that continuing this progress is possible but not guaranteed. If people fail to appreciate the institutions and policies that have generated this success, citizens and policymakers are more likely to abandon them going forward (Radelet, 2018).

7.1. Lesson one: always look on the bright side of life

Gregg Easterbrook, a writer for *The Atlantic*, focuses primarily on the United States, while also examining global patterns. He wants to explain why the country's politics have gotten so gloomy at a time of such prosperity. In his view, Donald Trump succeeded in 2016 in part because he convinced voters that their country was near collapse: its economy broken, its borders overrun by illegal immigrants, its cities rife with crime. Bernie Sanders played into the same sentiment by arguing that the country was getting even worse for all but the wealthiest few.

Very little of the above is true. Unfortunately, selectively quoted scientists and media outlets strengthened this pessimism by predicting what never happened: humanity has not starved, nor has it run out of energy; there are no runaway plagues; pollution has not made the world's air unbreathable or its water undrinkable; and dictators have not taken over. Just the opposite has occurred.

Technology, far from bringing annihilation, has made nearly every aspect of human life safer and easier. Violent crime in the United States has fallen by almost 30 percent since 1993. More Americans, especially minorities and women, have greater freedom than ever before. Air pollution in the United States has fallen sharply over the last 50 years: levels of lead are down by 99 percent, carbon monoxide is down by 77 percent, and smog is down by 33 percent. The share of the world's population that is malnourished has fallen from 50 percent to 13 percent since the 1960s. Between World War II and 1990, there were an average of ten military coups each year; since then, there have been about three each year as democracies have replaced dictatorships.

Easterbrook recognizes that not all is well. The United States and other countries must contend with climate change, inequality, and other threats. But his core argument is that to tackle those problems, the world needs to recognize its successes and draw the right lessons about how they were achieved. Optimism is not naiveté. "Optimism," Easterbrook believes, "is the conviction that problems can be solved if we all roll up our sleeves and get to work." He devotes a full chapter to addressing climate change and another to overcoming inequality.

Easterbrook is clearly exasperated by popular myopia. He lays a large part of the blame on the media, where "if it bleeds, it leads," and part of it on politicians who demonize their opponents, cast nearly everything as a failure, and hark back to an idealized past. Research centers and government agencies, he says, "lean towards doom predictions because they justify more funding." Demographic changes add to the pessimism: Western societies are getting older, and Easterbrook argues that older people tend to be gloomier. And he asserts that part of it is simple human nature: "People want to believe the worst about society," and this is simply untrue (Radelet, 2018).

7.2. Lesson two: don't base your worldview on media stories but factful trends

In *Factfulness*, Rosling steps in to fill this gap. How, he wonders, can so many people get the world so wrong? In the book, which was co-written with Rosling's son Ola and daughter-in-law Anna, he draws on years of research he carried out during his career as a professor of international health in Stockholm, which was cut short by his untimely passing just before the book was published. "This book," he writes, "is my very last battle in my lifelong mission to fight devastating global ignorance."

Rosling carried out surveys that asked thousands of people simple questions about global trends. The results show that people are not just uninformed but also systematically biased toward pessimism. In 2013, Rosling asked what had happened to the proportion of the world's population living in extreme poverty during the previous 20 years and provided three choices: almost doubled, remained the same, or almost halved. If people had guessed randomly, about one-third would have chosen the correct answer (almost halved). But only 7 percent got the answer right. He asked what share of one-year-old children have been vaccinated against various diseases and again provided three options: 20 percent, 50 percent, or the correct answer of 80 percent. This time, 13 percent of respondents chose correctly. On question after question, people did not just guess wrong. They consistently demonstrated that they believed the world was much worse off than it is.

In the book, Rosling's goal is not just to provide the facts, although he offers plenty of them. He wants people to change the way they think so that they can see the world more accurately and better equip themselves to solve problems. He frames the book around ten human instincts that lead people to see disaster rather than progress. The "**fear instinct**," for example, is an evolutionary trait that helps people avoid danger, but it also pushes them toward irrational fear of rare events, such as shark attacks and lightning strikes. That instinct also helps explain the constant crisis mode of the press, which profits from public anxiety: "Fears that once helped keep our ancestors alive, today keep journalists employed." Another human trait, the "**gap instinct**," pushes people to divide the world into "us" and "them" and to imagine much larger differences between themselves and others.

Rosling argues that people can combat these instincts by consciously learning to be "factful": examining the data, being wary of stories of impending doom and skeptical of quick fixes, and seeking to understand the reality that lies behind simple averages and extreme events. **Pursuing a mindset of "factfulness," in his view, will allow people to control their negative instincts, see the world's true trends more accurately, and act to improve it.** (Radelet, 2018)

7.3. Lesson three: we are in the age of miracles

What accounts for all this progress of humanity in the first place? Pinker, a psychology professor, aims to provide an answer. *Enlightenment Now* is the most comprehensive and compelling of the three books. In it, Pinker offers rich historical data on a wide variety of indicators of human development. On average, people are approximately 100 times as wealthy as they were 200 years ago. IQ scores have increased at an astonishing rate of three points per decade over the last century. Americans are more than 90 percent less likely to die in a fire or from a lightning strike than they were a century ago, thanks to better safety measures. Deaths in car crashes per mile driven have fallen by over 95 percent since 1921, for the same reason. Annual global deaths in battle have fallen by 75 percent since the 1980s (although they have recently increased because of the Syrian civil war).

Pinker underscores how widely these gains have spread and the speed with which gaps in well-being between rich and poor countries are closing. For example, child mortality has fallen in every single country in the world since the 1950s. The share of the global population living in extreme poverty fell from 40 percent in 1980 to less than 10 percent in 2015. And although income inequality has worsened within the United States and many other Western countries since 1980, globally it has improved: the global Gini coefficient, which ranges from zero (perfect equality) to one (perfect inequality), improved from 0.60 in 1990 to 0.47 in 2013.

Pinker argues that the progress has gone beyond material gains: individual and societal norms of behavior and morality are also improving. At the same time as technology has advanced, morals have too. Tyranny, slavery, torture, violence, racism, and the subjugation of women were all accepted by past generations; today, most people understand them to be morally wrong.

In Pinker's view, these gains stem from the eighteenth-century Enlightenment and the accumulation of knowledge and changes in thinking that it brought about. Pinker focuses on four Enlightenment themes—**reason**, **science**, **humanism**, **and progress**—and the accompanying belief that applying these ideas would lead to continuous improvement in the quality of life. It was these forces, he argues, that transformed a world of near-universal poverty, disease, illiteracy, and violence into one of healthy people earning middle-class incomes and having much greater personal security and freedom. "The Enlightenment has worked," he writes. Its success is "perhaps the greatest story seldom told."

Yet for 250 years, various counter-Enlightenment movements have tried to turn back the tide. Nationalism, authoritarianism, religious orthodoxy, antiscience campaigns, and various forms of "declinism" that predict impending global doom have all sought to supplant reason and a belief in progress. Pinker argues that Enlightenment values are once again under attack by those who denounce scientific knowledge, espouse nationalism and tribalism, and seek to erode trust in modern institutions. He sees these attacks coming from the political left and right alike.

Pinker spares no criticism for antimodern intellectuals and those he terms "romantic Green" activists, who resist new technologies, and he jabs at the antiscientific beliefs of those who oppose the use of genetically modified organisms and nuclear power. But he sees the rise of authoritarian populism as the greatest threat to Enlightenment values. The central problem with these movements, Pinker argues, is that they focus on tribes rather than individuals and place no value on protecting the rights of those outside the chosen group or promoting human welfare in other countries. They disdain knowledge and diverse opinions; valorize strong leaders; and scorn rules-based governance, compromise, and checks on power. They look backward to the greatness of a fictionalized past rather than embracing progress. Yet despite the populist threat, Pinker believes that liberal democratic institutions will survive. Right-wing populism, he argues, is "better understood as the mobilization of an aggrieved and shrinking demographic... than as the sudden reversal of a century-long movement toward equal rights." (Radelet, 2018)

7.4. Lesson four: trust and empower optimists not declinists

One of the dangers of public pessimism is that it empowers political leaders who want to destroy the institutions that foster progress. In the United States, this is especially true when it comes to foreign policy. After World War II, Washington advanced an **international rules-based system** designed to ensure US security and prosperity while spreading, however imperfectly, the ideals of freedom, opportunity, and the rule of law. The United States aimed to strengthen countries that shared those values so that they would become allies in promoting them, something that in turn would help secure the peace.

These goals have been achieved far more fully than anyone in 1945 could have imagined. Germany and Japan, once sworn enemies of the United States, are now among its closest allies. Western Europe is at peace. Most countries around the world have signed on to the economic and political system founded by the United States. Even China has joined the club and is closer to sharing some of these ideals than it was in the days of Mao Zedong and the Cultural Revolution. China now has more economic opportunities, a slightly greater degree of personal freedom, and better rule of law.

The fact that there has been so much progress does not mean that all is well and that no changes are necessary—far from it. The very breadth of this progress means that the global institutions that produced it must change if they are to keep working to address the world's problems. The structures, decision-making processes, and power balances that functioned well after World War II are no longer appropriate, now that so many countries rightly demand a voice in the system. The United Nations, the International Monetary Fund, the World Bank, the World Trade Organization, regional security pacts, and other institutions will all have to give developing countries greater influence. Only then will these countries be willing to work with the United States to fight the major challenges the world faces. The United States must be willing, once again, to share power rather than simply wield it. It needs to understand that doing so will strengthen, not weaken, its long-term security.

The liberal world order that has brought so much progress is not dead, nor is it doomed. But it is under threat, not from some outside hegemon but from within. The threat is aggravated by the widespread inability to recognize progress and people's tendency to focus on only bad news. As all three authors point out, pessimism can be self-fulfilling: in countries where people believe the world is getting worse, they may dismantle some of the very institutions that made it better and thereby fulfill the predictions of decline. As has always been the case, the supporters of the liberal order will have to fight hard to keep it—and to improve it. Only that way will the world sustain the unprecedented progress in the human condition that the order helped create and continue to expand the reach of peace, prosperity, and freedom.

Remember: Public pessimism empowers political leaders who want to destroy the institutions that foster progress (Radelet, 2018).

Chapter 8

Multinational Corporations behavior in times of emergency

What was once considered philanthropy or goodwill, today is crucial in the strategy of companies that look for a sustainable development in the long run. The value of a corporation is no longer profitability only but the responsible behavior of that company with its various stakeholders. Thus, corporate reputation is based on the type of relationship cultivated with employees, providers, customers, shareholders, communities, unions, NGOs, governments, and society as a whole.

In periods of crisis (like COVID 19, earthquakes, floods, wars, hurricane devastations, etc.) the engagement of the private sector in the system of emergency management has increased considerably in the last decades, transforming companies in a key actor when handling catastrophes and rebuilding processes. There are numerous cases of companies deploying support in affected areas even prior to the government, despite that their operations have also been impacted.

However, the participation of the private sector and the level of assistance provided is neither equal nor transversal. While some companies share their expertise, offering innovation, and plenty of money for local communities in need, others take advantage of the situation, raising prices of essential products, searching for higher profits in the short term, and barely compensating for the damage caused by their own operations. The decision to give assistance to the host communities and society is on a voluntary basis, and at the international level there are no clear and strong guidelines (Beauchemin, 2020).

The question how the big companies behave in periods of disasters has no common and clear answer. Literature shows that since the beginning of the globalization process (from 1980's) the engagement of the private sector has increased progressively as an actor in the management of disasters, due to a parallel escalation in the number of large-scale natural disasters. In this context, as multinational companies operate in a variety of world markets, they extended their traditional programs of corporate social responsibility (CSR) to embrace a bigger role in global society (White, 2012).

The concept of CSR was described in 2008 by the World Economic Forum's founder and executive chairman, Klaus Schwab, who presented the Forum's vision of this extended role of businesses in a Foreign Affairs journal. In his article Schwab explains how the state power has been shrinking and the sphere of influence of business has widened, becoming essential to the survival of governments and the political stability of the countries and regions. Schwab also highlighted the importance of the private sector working with civil society and governments to address key global societal challenges. *"A new imperative for business, best described as "global corporate citizenship," must be recognized. It expresses the conviction that companies not only must be engaged with their stakeholders but are themselves stakeholders alongside governments and civil society."* (Schwab, 2008)

World regulations

Although corporate action in periods of emergencies is generally on the raise, the level of giving and the "when, how and where" remains highly variable. Studies show that different types of companies take the lead in different disasters and in a variety of ways.

The reason for this confusing scenario may be due to a lack of concrete guidance on what business can and should do in terms of addressing emergencies. At the international level, there are no binding legal framework to regulate the private sector collaboration in periods of emergency, only voluntary agreements and initiatives mainly led by the UN to promote the establishment of public-private partnerships for disaster risk reduction activities. The most relevant frameworks on this matter is the *Sendai Framework for Disaster Risk Reduction 2015–2030*, adopted by the Third UN World Conference on Disaster Risk Reduction held in Japan, and the *"Guiding principles for public-private collaboration for humanitarian action,"* developed in 2008 by the World Economic Forum and the UN Office for the Coordination of Humanitarian Affairs (OCHA). However, none of them offer a legal instrument to guide relationships.

It is necessary to mention, that the Sendai Framework is a relevant progress in engaging the private sector in this matter. In fact, the Office for Disaster Risk Reduction (UNDRR) led the creation of ARISE, a network of private sector entities that voluntary compromise to work for disaster resilient societies and commit to implement the Sendai Framework Disaster Risk Reduction 2015–2030. The United Nations Office for Disaster Risk Reduction also provides tools such as the DRR Community site PreventionWeb and publications on good practices.

Another framework sponsored by United Nations is the UN Global Compact, a voluntary policy initiative for businesses committed to aligning their operations and strategies with ten universally accepted principles in the areas of human rights, labor, environment and anti-corruption, but it is not designed for corporate engagement in the area of emergency management.

A similar initiative was promoted recently in the 2019 G7 Biarritz Summit, where the "Business for Inclusive Growth" (B4IG) coalition was launched, a group of 34 leading international companies that committed to step up business action to "advance human rights throughout their value chains, build inclusive workplaces and strengthen inclusion in their internal and external business ecosystems" (OECD 2019). The initiative –that is sponsored by French President Emmanuel Macron and coordinated by OECD- seeks to tackle inequality by building bridges between companies, governments and philanthropic organizations. They do not specify action in the area of emergency management, however, since the start of the coronavirus crisis, the B4IG companies "have dedicated over €38bn in relief plans or support of their employees, communities, clients and suppliers" (OECD 2020).

Public-private cooperation

The analysis of CSR in times of disasters is generally linked to the public-private alliances made to face serious emergencies. This type of partnership in the sphere of international action has not been simple, it has involved a deep work of mutual understanding of both worlds and has required constant adjustment. The creation of knowledge is still a work in progress, for the reason that with each international disaster new information has been generated about how best to employ and coordinate resources and expertise (White, 2012).

The role of companies has become vital in a tactical response to emergencies, since the private sector has more flexibility to act swiftly in the deployment of help and timely funding. Companies have become an easier way of access for communities, since they are free of many of the administrative transactions (Chandra, Moen, Sellers, 2016). As stated by Busch and Givens in *Achieving Resilience in Disaster Management: The Role of Public–Private Partnerships*, "Public– private partnerships can reduce the burdens placed on government to provide certain goods and services immediately and over time, permitting the public sector to focus on other important strategic priorities."

The private-public collaboration is also highlighted as essential by the US Federal Emergency Management Agency (FEMA), in its report "Crisis Response and Disaster Resilience 2030, Forging Strategic Action in an Age of Uncertainty," in which recommends that government must proactively engage business in all emergency management phases. "This partnership will become increasingly important in the future. Working in concert with the private sector, rather than competing with it, the public sector has an opportunity to further enable private sector resources and capabilities to assist in recovery efforts and resilience building throughout communities. Engaging the private sector in policy development is also important so that the private sector has the appropriate frameworks in place to work effectively and cooperatively with the public sector to address issues of mutual concern" (FEMA 2012).

At the international level there are different platforms design to enhance collaboration. The UN Office for the Coordination of Humanitarian Affairs (OCHA) launched in 2016 the Connecting Business initiative (CBi), a joint work with the Development Programme (UNDP), that aims to "transform the way the private sector engages before, during and after crises". It is the only joint initiative between United Nations organizations at the intersection of the humanitarian, development and peace agendas that engages with the private sector (OCHA).

The World Economic Forum also works to coordinate private sector partnership in response to natural disasters, with the Engineering & Construction Disaster Resource Partnership (DRP). This model of collaboration aims to form an ongoing alliance between private industry and the public sector/humanitarian organizations in order to ensure a fast and effective deployment of Engineering & Construction expertise when a natural disaster occurs. The engagement depends on each company's proximity to the disaster area, its assets and skills, and the needs of the affected communities (World Economic Forum).

However, according to the CSIS report "Corporate Engagement in Natural disaster Response," there is still a tendency for many companies to say "here is what we have to offer" instead of asking what is actually needed. In this sense, the report states that is fundamental to design a collaborative platform for all stakeholders when facing a disaster, in order to connect demand and supply in an appropriate manner and allow exchange of best ideas (White, 2012).

A lot of studies highlight the relevance of the private sector in building resilience, describing it as a key player in preparedness and early response to emergencies. "Businesses play a key role in building resilient communities. As businesses consider what they need to do to survive a disaster or emergency, as outlined in their business continuity plans, it is equally important that they also consider what their customers will need in order to survive. The ongoing involvement of businesses in preparedness activities paves the way to economic and social resilience within their communities," states the FEMA report (FEMA, 2012).

Conclusions

As described above, corporate engagement has become more important with each new emergency, especially with large-scale natural disasters that occur with increasing frequency worldwide, mainly due to climate change.

With every disaster, the business sector has acquired new skills to contribute in all emergency phases and has internalized that in today's society. Standing still is no longer an option if it intends to be perceived as a "responsible participant" by consumers and other stakeholders. Big companies and especially multinational corporations have taken the lead in this approach, although it has not been a process without mistakes, difficulties and challenges.

There is still much to improve, and one way to do so is by looking to examples of past events. For instance, one of the main challenges that remains is an inequality of corporate responses in periods of emergency. Business action is highly variable and corporations are often reluctant to publish contribution figures because the monetary sums that are actually donated remain very arbitrary. "Actual contribution sums can fluctuate wildly, dependent on annual profit projections, on what other companies are doing and on how many disasters have already occurred during the fiscal year," states the report "Corporate Engagement in Natural Disasters" (White, 2012).

However, what is certain is that businesses and nonprofit organizations are increasingly central to the process of disaster management, offering critical support in immediate relief and also contributing to the funding of community recovery. The expectations for the private sector are high for each new disaster. However, the reality is that there is no fully clear guidance or metrics for how and when companies should participate in disaster recovery and financing.

Despite this scenario, companies are extending the reach of their emergency preparedness, response, and recovery activities to include employees, family members, community and other stakeholders. For example, Office Depot educates small businesses about emergency preparedness through its foundation and Wal-Mart uses its website to promote preparedness among employees and to share tips of disaster information (Chandra, Moen, Sellers, 2016).

The rise of business engagement in disasters and the reinforcement of corporate social responsibility has also been tested in the current coronavirus pandemic. So far, within the first three months of the crisis, we have seen swift action from the private sector, for example fashion companies are transforming their factory lines to produce face masks, various companies have donated ventilators, hotels are giving free accommodation for doctors and nurses, breweries are producing hand sanitizer and Uber is giving free rides and food deliveries for health workers and senior citizens, amongst others.

One way to reflect this increasing engagement of the private sector in the current COVID-19 crisis is by comparing the number of corporate donors registered in the Corporate Aid Tracker of the US Chamber of Commerce Foundation. With a daily update, the website shows more than 33 pages with names of companies and their actions towards the crisis, compared to only 1 page in the 2016 Zika virus outbreak and the two-page list of business aid for the California Wildfires of 2018 (US Chamber of Commerce Foundation).

Another source of information that shows a rise in the engagement of the private sector is the survey report “Giving in Numbers,” conducted by Chief Executives for Corporate Purpose (CECP), a CEO-led coalition of more than 200 large companies, that promotes corporate philanthropy and social investment. The survey states that the total giving by these 250 companies increased by 11% between 2016 and 2018, reaching $25.7 billion. The top areas to which companies allocate their resources are “Health and Social Services” and “Education,” a trend seen in the latest annual reports. Another point to highlight is that “Disaster Relief” was the program area that had the largest median giving increases despite representing a smaller portion of the total giving in 2018 (Chief Executives for Corporate Purpose).

The need for stronger guidelines at the international level

The behavior of companies in exceptional emergency periods has tested the actual implementation of their CSR policies and the level of integration of their civic responsibility. The present investigation could demonstrate that, despite an increasing growth in the engagement of the private sector in periods of emergency, the reality is still unbalanced and lacking clear guidance towards how, what, and when to contribute. There's a clear unevenness in the aid provided by each company and many factors influence this situation, such as the magnitude of the event, the interests of the company in the affected area, the impact of their operation, and the budget already allocated for social help and previous disasters.

An analysis of case studies and a revision of the lessons learned from other large scale disasters demonstrates a lack of accountability by the private sector in its response towards emergencies. Access to and monitoring of the financial contributions deployed by companies are very difficult to analyze and compare since the information is not always broken down and detailed. Corporations are often reluctant to publish contribution figures because the monetary sums that are actually donated remain very arbitrary. This scenario makes an in-depth analysis of business behavior very difficult, although it also represents an opportunity for future studies. Another problem when facing emergencies is that many corporations define the type of help they can offer themselves, instead of asking what is really needed.

The study shows that the most effective and most used model to face an emergency is through public-private partnerships. In periods of emergency, international organizations such as the UN recognize that the State has the primary role to reduce disaster risk, but also states that the responsibility should be shared with other stakeholders including the local government, NGOs, and the private sector. The role of companies has become vital in the tactical response to emergencies since the private sector has more flexibility to act swiftly in the deployment of help and timely funding. Thus, it is clear that the challenge is to improve these types of alliances and to enhance cooperation models in order to achieve increasingly successful results.

The International framework in this regard is weak and unclear when facing emergencies. Although there are multiple guidelines for good practices for business, there is no strong or legally binding consensus on how private companies should act in periods of emergencies; it is always up to individual criteria or the degree of pressure exerted by the government. Certainly, when a company is directly responsible for a catastrophe, the law forces them to compensate, but when the responsibility is not direct, their collaboration remains at the discretion of each manager. Studies show that different companies take the lead in different disasters and in many different ways.

In this sense, the topic of this research still provides a large canvass for future thinking and debate since there is a need for more clear instruction for companies in periods of emergency. It is not an easy subject, considering that firms need to be competitive and survive in the market. It may therefore be more feasible to apply stronger guidelines than compulsory measures. Policymakers, diplomats, and especially multilateral and international organizations, can further develop guidelines for good practices for business with special focus on exceptional periods and crisis. For instance, the last revision of the OECD Guidelines for Multinational

Enterprises was made in 2011 which suggests a pressing opportunity to make new recommendations for corporate behavior in this regard, especially considering that emergencies and natural disasters are increasing worldwide. Large corporations certainly have a relevant role to play in the response system.

What is clear is that the engagement of the private sector has been increasing, although it still has many aspects to improve. In general, it is possible to affirm that today companies understand that they are part of an interdependent ecosystem that they must take care of, and they are under pressure to be responsible in times of emergencies, but there is still much to do regarding inequality in their implementation.

A reflection of this has been business behavior in the face of the current coronavirus health crisis, where while there are some who have wanted to take advantage of this tragedy, the vast majority have had an active and innovative reaction to go to the assistance of those most in need. With what we have seen at the moment, it is highly likely that the coronavirus pandemic will represent a new turning point in the corporate engagement in emergencies and CSR evolution, and a proper evaluation must be made in the future.

Chapter 9

Post Pandemia COVID-19 World

The COVID-19 pandemic serves as a reminder to economists that we are actually social scientists, and we need many adjustments to the way we model the economy of the future. The data we are collecting now give us some definite clues how we will work, create energy, take care of and entertain in the near future. What are these mega trends or lessons from the second year of the pandemic?

The effects of the pandemic are comparable to a world war, with 2 million victims and hundreds of millions of unemployed and under-employed workers. Historically, after each world war there was at least a decade of economic expansion. The shock of war forces radical new solutions which otherwise would have taken years to occur.

Thanks to COVID-19 the productivity "great stagnation" documented by top economists is ending Gordon (2018). First is the flurry of recent discoveries with transformative potential. Because of a remarkable ability to predict and edit the shapes of proteins through messenger RNA, BioNTech/Pfizer and Moderna developed a COVID-19 vaccine in months instead of years. Soon, the bio-tech companies will be able to treat many diseases, edit genes or even to "grow" meat. Last summer Open AI unveiled GPT-3, the best natural-language algorithm to date, and driverless taxis maneuver around Phoenix, Arizona. Second, there has been a spectacular drop in the price of renewable energy, providing governments the option to confidently invest in green energy. Artificial intelligence is at last displaying impressive progress in a range of contexts.

In 2020 the US private sector spent more on computers, software and research and development (R&D) than on buildings and industrial gear. This contradicts the absurd idea that short-termism is dooming R&D spending in the developed market economies. This trend is visible across all 24 OECD countries. Investors spend money on industrial robots and semiconductors. All car manufacturers have declared an intention to abandon the production of ridiculously complicated and suffocating combustion engine cars in 10-15 years. The battle against climate change, and AI technology competition between the US and China have spurred the EU not to be left behind in a new bipolar world and to accelerate R&D spending.

Decarbonizing economies will boost demand for energy efficient buildings, households, transportation and finally energy-hungry industry for renewables. These revolutionary mega trends emerged due to the COVID War and will be a part of the post war recovery.

The pandemic moved several trillion dollars of business worldwide to digital platforms, videoconferencing, and industrial automation. Consumers moved to e-commerce, digital payments, telemedicine. There is no returning to the “pre-war” economy even when the bars re-open and the beer starts flowing.

In the last decade central bankers in the rich part of the world were pushing the debt to 120-130 percent of GDP and prayed to see merely 2 percent inflation. The S&P 500 reached new heights, and nobody seems to have a clear sense where the inflationary impact of post COVID-19 helicopter money really is. American Democrats would like to spend nearly 2 trillion dollars, Republicans warn about monetary prudency. Most economists are silent because their track record of accurate predictions is not strong. In this decade we should expect a radical rise in productivity in all developed countries which is likely to offset the loose monetary policy. The grim predictions of 5-10 percent inflation look like politically motivated pessimism. After all there is always fiscal policy, in case anyone forgot.

Although private sector investments ultimately determine developed countries’ growth, governments will have an important role to play in the near future.

During this technology-led restructuring, the state can offer more and better subsidies for R&D, such as prizes for solving clearly defined problems. The state also can influence how fast innovations diffuse through the economy. Governments will be required to make sure that regulation and lobbying do not slow down disruption, in part by providing an adequate safety-net for those whose livelihoods are upended by it. Good governments ensure that the whole economy harnesses new technologies, and they use antitrust enforcement and intellectual-property regimes. If governments rise to the challenge, then faster growth and higher living standards will be within their reach, allowing them to defy the pessimists warning about inflation.

The pandemic accelerated existing trends in remote work, e-commerce, and automation, with up to 25 percent more workers than previously estimated potentially needing to switch jobs. However, a significant structural adjustment is taking place in the labor market. As societies in the USA, the EU, and China get richer and more mature, they spend a greater share of their income on labor-intensive services, such as restaurant meals, medical treatment, education, childcare, retirement services and home care. Since in these areas productivity growth and automation is limited, a new job market is going to expand for a vast number of people–provided there is adequate rise in minimum wage to draw people from welfare (Pie, 2020).

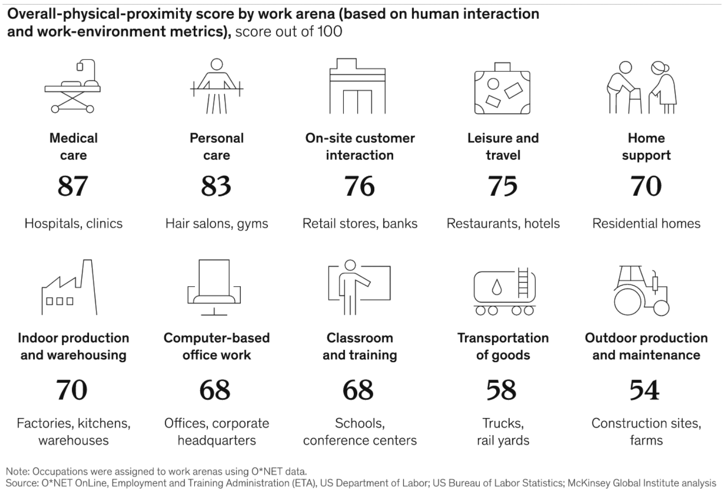


Chart 25. Work arenas.

Source: O*NET OnLine, Employment and Training Administration (ETA) (https://www.mckinsey.com/featured-insights/future-of-work/the-future-of-work-after-COVID-19?cid=other-eml-alt-mgi-mck&hdpid=ef77708e-97cb-4375-abe3bc174c2f6edf&hctky=12236565&hlkid=2098c121ea1e4b799a5c83d8ecadf9dd#) [accessed January 15, 2021].

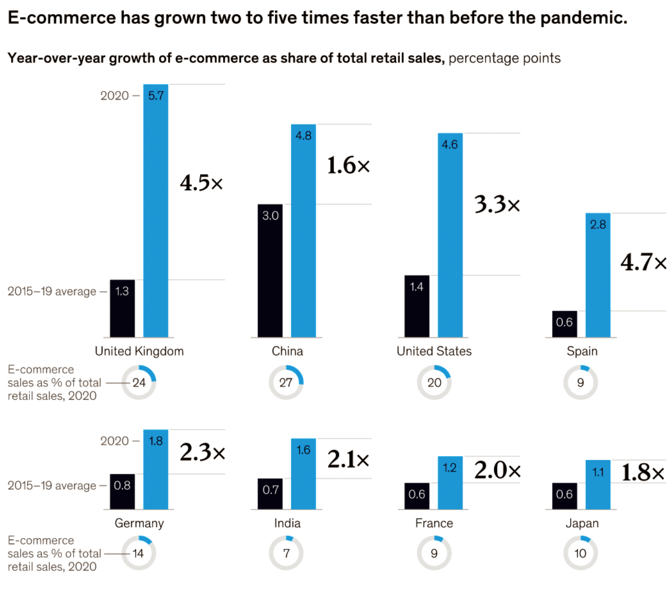


Chart 26. Year over year growth of e-commerce as share of total retail sales.

Source: Retailing by Euromonitor International 2021, https://www.mckinsey.com/featured-insights/future-of-work/the-future-of-work-after-COVID-19?cid=other-eml-alt-mgi-mck&hdpid=ef77708e-97cb-4375-abe3-bc174c2f6edf&hctky=12236565&hlkid=2098c121ea1e4b799a5c83d8ecadf9dd# [accessed January 15, 2021].

Before the pandemic, McKinsey estimated that just 6 percent of workers would need to find jobs in higher wage occupations. In the post-COVID-19 research, they found not only that a larger share of workers would likely need to transition out of the bottom two wage brackets but also that roughly half of them overall would need new, more advanced skills to move to occupations one or even two wage brackets higher.

The skill mix required among workers who need to shift occupations has changed. The share of time German workers spend using basic cognitive skills, for example, may shrink by 3.4 percentage points, while time spent using social and emotional skills will increase by 3.2 percentage points. In India, the share of total work hours expended using physical and manual skills will decline by 2.2 percentage points, while time devoted to technological skills will rise 3.3 percentage points. Workers in occupations in the lowest wage bracket use basic cognitive skills and physical and manual skills 68 percent of the time, while in the middle wage bracket, use of these skills occupies 48 percent of time spent. In the highest two brackets, those skills account for less than 20 percent of time spent. The most disadvantaged workers may have the biggest job transitions ahead, in part because of their disproportionate employment in arenas most affected by COVID-19. In Europe and the United States, workers with less than a college degree, members of ethnic minority groups, and women are more likely to need to change occupations after COVID-19 than before. In the United States, people without a college degree are 1.3 times more likely to need to make transitions compared to those with a college degree, and Black and Hispanic workers are 1.1 times more likely to have to transition between occupations than white workers. In France, Germany, and Spain, the increase in job transitions required due to trends influenced by COVID-19 is 3.9 times higher for women than for men. Similarly, the need for occupational changes will hit younger workers more than older workers, and individuals not born in the European Union more than native-born workers (McKinsey, 2021).

Globalization was the last stage of the industrial revolution. Specialization of the world is the first stage of the new post-COVID War economy. We are at the stage when countries' economic borders will matter less and less. The EU has annulled economic borders and Brexiters are learning the hard lesson that leaving a single market is a very misguided decision.

World trade is transitioning towards a single global market. Since 1947 when the General Agreement in Tariffs and Trade (GATT) was formed, the "trade openness index" which looks at all exports and imports as a share of the total world economy (GDP) rose from merely 10% to around 60% today (after temporary drops due to the 2008 and 2019/2020 crises). In the last few years, we have seen the realization of the revised Trans-Pacific Partnership (TPP – minus the USA because of the previous president), the EU-Canada deal, the EU-Japan deal, the EU-China deal, and the African Continental Free Trade Area. It is true that since 2008 there were hundreds of small new protectionist measures, but their net effect is moderate. The average tariff in the industrialized world in the 1960s stood at 15%. In 2017 the global average – even including traditionally trade–skeptical developing countries – was under 3%.

Free trade is better than protectionism, multilateral agreements are better than bilateral agreements, a single market with "four freedoms" (trade, services, capital, and people) is better than a collection of single economies. The trade creation effect of a single market is larger than the trade diversion effect of bordered economies, an economic union with a single currency is better than a single market, and a common currency is better than multi-currency systems. There is solid research which proves all the above and more (Sharma, 2020).

Capital movement across the world is not taxed and never will be because there is no chance for a world government–but there is a chance to create a global single market with visible regional specialization. And it is coming.

There is a crucial problem in the relationship between democracy and economic development. This is not what the rich and free world would like to see. The Peoples Republic of China, the source of the pandemic, stopped the spread at home because of its authoritarianism and secrecy. It was able to restart its economy relatively quickly, whereas much of the rest of the world is paying a steep price.

Is liberal democracy doomed because it will take longer to turn around in future pandemics and climatic disasters? The truth is that all governments and political systems test their viability and legitimacy only if they provide protection and economic welfare to their people.

Democracies and autocracies must provide protection against pandemics and climatic disasters. It is reasonable to believe that the gap in people's thinking in both China and the West between local and global has narrowed because of the pandemic. However, what is the difference between the rich in China, Russia and the West?

Generally, we assume they think alike. However, they are different: Russian oligarchs take their money out of Russia to protect it against the mafia state (which allowed them to be become rich in the first place); super-rich Americans want to save the world, not just the USA; many Chinese top communist princelings and their families became the county's supper rich and resettled their families to Singapore and Canada. The good news is that hopefully, thanks to wealthy communists who did not emigrate, they will care to sacrifice their wealth for communism and nationalism by confronting the USA.

Apparently, the strongest argument for the relative validity of the nation-state is that of the retention of control over borders so that a unique cultural identity (a form of a kinship) can be preserved. If borders are not "protected," people will feel uprooted, displaced, and deeply frustrated by loss of a sense of belonging. This kinship is "fundamental" to human consciousness so it will never disappear, goes the argument. According to this argument, people want to keep their religion, customs, language, symbols to love and protect, history to teach, and heritage to pass on to future generations.

One possible alternative for the future is that in the next 40–50 years we will continue to witness the gradual demise of the economic nation-state altogether. A supra-market would be a higher level of global economic organization in which market forces, or **supra commercialization,** would lead to higher world specialization and productivity.

The present division of the world into nation-states and national (or regional) currencies was born on the ruins of the old empires and lasted millennia. However, we did not have internet and block chain and quantum computers for almost the equivalent amount of time, save the last 30 or so years.

It is possible that we will live in a **supra market** among **global oligopolies.** The game theory and laws of entropy tell us that the world must gravitate to new model of world organization. In the new *modus operandi* the nation-state's economic borders will become nothing more than a political and economic illusion.

In the first stage lasting about 40–50 years, governments will continue opening their markets to a freer flow of goods, services and capital and then imitate each other's moves, *de facto* following the same path and acting in unison. As the **supra corporations** take over the control of central governments' surveillance and security functions, we may also see a deeper production specialization of people working in dispersed manufacturing and research centers and also in space above Earth. Also, supra corporations will determine the rules of the game, and perhaps replace the lobbying of the governments by putting oligopolistic game theory into practice (Attali, 2007).

The good news is that as the economies become more complex and interconnected globally, social global responsibility will become **a must** as Earth's resources become scarcer and more expensive. Definitely, fighting wars for resources is the most inefficient way of solving the problem of scarcity and global warming. Wars may still happen, but they will last 15 minutes and will be fought in space, both virtual and real.

Every hypothesis needs verification by applying historic data. As we know one cannot obtain data relating to the future, so we are bound to project observable mega trends which may reveal very probable, if not absolute, truth about the future.

We tend to think in short terms: inflation, budgets, and political parties preference for income redistribution. We all need to think what is important in the longer term and base current advice on the long-term survival of the people of Earth.

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