# The Uno Newsletter: Rejuvenating Marxian Economics through Uno Theory

(Vol. II, No. 13) 25 December 2013

The Uno Newsletter (in Japanese) started after the 30th Memorial Conference (2007) in honour of Kozo Uno (1897-1977) who developed an approach to understanding capitalism (and appropriating Marx's ideas) that contains three levels of analysis: the general theory of capitalism; the stages of capitalist development; and detailed studies of particular countries and time-periods. 22 issues of the Newsletter in Japanese were published between December 2007 and October 2013. Now we have decided to publish an English edition of the Uno Newsletter once or twice a year.

In the open spirit of Japanese political economy, contributions in the Uno Newsletter draw on diverse intellectual traditions. The focus of The Uno Newsletter includes the basic theory of capitalism such as the theories of value, money, capital accumulation, business cycle, and labour process; the integration of heterodox economics such as Marxian, Post Keynesian, Institutional, Evolutionary, and Neo-Schumpeterian economics; the theory of capitalist development such as Uno's stage theory, the evolution of the capitalist world system, and intermediate theory; and finally the empirical analysis of capitalism such as the development of Japan, China, and Asia, or the financialization, globalization, and crises that tend to have global ramifications.

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# Introduction to Vol.2 No.13: the Uno School and the JSPE

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## The Uno School and the JSPE

The Japan Society of Political Economy (JSPE) has been the largest organization of heterodox economists in Japan since its founding in 1959. It has been an important laboratory for developing and debating ideas about capitalism and its dynamics. It has given rise to several distinct strands of Marxian political economy. Foremost among them is the Uno School. The Japanese political economist Kozo Uno developed an approach to understanding capitalism (and appropriating Marx's ideas) that contains three levels of analysis: the general theory of capitalism; the stages of capitalist developments; and detailed studies of particular countries and time-periods. This differentiation permits analysts to conceptualize and debate, separately, the economic dynamics of unadulterated capitalism, the behavioral modifications that arise because of the imposition of some defining rules that pertain to one or more capitalist economies for a period of time (that is, because of the creation or destruction of 'regimes' of capitalist accumulation), and the specific institutional characteristics of given markets at particular points in time. Further, it has made possible for many political economists in Japan to work with diverse approaches to political economy – the French Regulation school, the Cambridge Keynesian models, institutionalism and historical schools, and so on.

In this second edition of the English language Uno Newsletter, discussion among the papers covers wider interest than the first edition. Two papers by Robert Rowthorn and Madhura Swaminatahan are based on the discussion in the 61 JSPE conferences, Erik S Reinert and Ting Xu's paper was originally submitted for the conference. Tsuyoshi YUKI's paper was originally submitted to a Japanese language Uno News letter.

## Outline of the JSPE

The purpose of the JSPE has been promotion of academic research on the basic theories together with concrete analyses in the area of political economy, by facilitating cooperation and communication among its members. The membership is about 900. The JSPE has worked to pursue its purpose mainly in three forms of activities.

Firstly, it holds an annual conference once a year in October. Usually the conference consists of two plenary sessions one in Japanese and one in English, parallel sessions, a members' general meeting, and a social party. Titles of the plenary sessions in the last five years include: "The World Crisis of 2008 and the Future of Capitalism (2009)", "Agenda of Political Economy in the Era of Transformation (2009)"; "Financialization: What it is and how to analyse it (2009)"; "The Transformation of the Social Economic System and the

Challenges of Political Economy : Can Japan Change? (2010)", "The Structure of Employment, Globalization, and Economic Crises: Rethinking Employment Policy for the Current Era (2010)"; "The Global Economic Crisis and State: Alternative Approaches for Monetary and Fiscal Policies (2011)", "The Great East Japan Earthquake and the Nuclear Disaster (2011)"; "The Great East Japan Earthquake and the Nuclear Disaster, and a Research Agenda for Political Economy (2012)", "Building the green new deal: The U.S. case (2012)"; "Cataclysm of Global Economy and Future of Capitalism (2013)", and "The Emergence of China and India as Great Powers (2013)". In addition to the annual conference, meetings are also held based on the five local organizations.

Secondly, the JSPE has published *The Political Economy Quarterly* since 2004, following *The Bulletin of the Japan Society of Political Economy,* which was published annually from 1961 to 2003. *The Political Economy Quarterly* includes several reviewed papers and a few invited papers. The papers are mainly in Japanese with English summary. Every year the first issue of *The Political Economy Quarterly* contains the papers and a summary of discussions in the plenary sessions of the annual conference.

Thirdly, the JSPE publishes a volume of collected papers in English regularly. The first English publication of collected papers from the annual meetings was published by Routledge in 2012. The JSPE is now preparing the second volume.

## International academic cooperation

The JSPE promotes international academic cooperation with political economists all over the world.

The JSPE invites non-members to make presentations and engage in debates in the English sessions at these annual meetings in the following categories: English sessions I, topics relating to the plenary session; and English Sessions II, all proposals reflecting the tradition and analytical perspective of JSPE which include (1) Marxian and Heterodox economic theories, (2) regimes of capitalism, (3) economic development and the environment, and (4) gender and inequality. The JSPE have organized more than 40 parallel sessions in English since 2001.

Beginning in October 2001, the JSPE began inviting a distinguished non-Japanese guest for the annual conference to deliver a keynote presentation and engage in debates. Since then the JSPE have invited 11 distinguished scholars, including Robert Boyer (CEPREMAP), Gary Dymski (University of California Riverside), Ronald Dore (London School of Economics), Enfu Cheng (Chinese Academy of Social Sciences), Gerard

Dumenil (CNRS), Saskia Sassen (Columbia University), Costas Lapavitsas (SOAS, University of London), James Heintz (PERI, University of Massachusetts), Alain Lipietz (CNRS), Robert Pollin (PERI, University of Massachusetts), and Robert Rowthorn (Cambridge University).

The JSPE has introduced a special category of member, Overseas Academic Advisor in 2011 to play a more active role in promoting political economy and heterodox economics internationally. The JSPE invited the above mentioned 11 distinguished economists and Andrew Barshay (University of California Berkeley), all of whom have accepted our invitation.

## The JSPE English Publication

The first volume of the JSPE collected papers, *Crises of Global Economies and the Future of Capitalism: Reviving Marxian Crisis Theory* was edited by Kiichiro Yagi (Setsunan University), Nobuharu Yokokawa (Musashi University), Shinjiro Hagiwara (Yokohama National University), and Gary Dymski was published by Routledge in December 2012. This book represents an encounter between Japanese and non-Japanese scholars, on the common problem of how to understand the current economic situation. The Uno School is well represented in this volume. The contributors represented here have all participated in the JSPE annual meeting.

The first part of the book considers the mechanisms of the crisis of 2008 and their consequences. Six contributors, including Makoto Itoh, Tetsuji Kawamura, Costas Lapavitsas, Masayoshi Tatebe, Shinjiro Hagiwara, and Akira Matsumoto, discuss that understanding of Marx’s crisis theory can powerfully serve as a useful framework in the analysis of such a contemporary sub-prime world crisis. Financialization is the common concept of the six papers.

The second part of the book considers regimes of capitalism. Six contributors, including Nobuharu Yokokawa, Robert Boyer, Toshio Yamada, Gérard Duménil and Dominique Lévy, and Thomas Sekine, investigate the historical development of capitalism to define neoliberalism as a specific phase of capitalism. They share the concept of structural crisis which destroys the existing capital accumulation regime and gives rise to a new regime.

The third part of the book considers global reconfiguration of capitalism. Five contributors, including Gary Dymski, Kang-Kook Lee, Hitoshi Hirakawa, James Heintz, and Aki Aneha, emphasize that global imbalance such as macroeconomic imbalance and power imbalance have changed both international and domestic economic structure. They pay special attention to labor exploitation and the impact of East Asian industrialization on the world economy.

These essays do not reach one conclusion, but instead provide different angles of vision regarding the global crisis. As such, this volume provides a unique immersion in different approaches to political economy and to the crisis. The JSPE hopes this book contributes to the resurgence of radical analyses of the political economy, free from the market optimism of main-stream economics.

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# The Emergence of China and India as Great Powers

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**Executive Summary**

It has been widely predicted that China will soon overtake the USA to become the world's largest economy, and that India will overtake the USA within fifty years or so. Such optimistic projections have been thrown into doubt by recent macro-economic events in these countries, although most observers believe that China will overcome its present difficulties. There is less confidence about India.

This paper discusses briefly the economic and political obstacles to rapid economic growth in China and India. On the assumption that China and India will surmount these obstacles and return to their projected growth paths, they will both become great economic powers by mid-century. The paper explores some of the implications of such a development for the rest of the world. Attention is focussed on the following issues.

- *International Trade.* This section provides a brief survey of the widely discussed impacts of Chinese and Indian economic growth on world trade. As China moves up the value-chain, it will phase out its labour intensive exports and focus on more "knowledge-intensive" products. This will create new competition for established makers of knowledge-intensive products in today's advanced economies, but it will also create new demand for labour intensive-products from the poorer countries of South Asia, Sub-Saharan Africa and elsewhere. Primary commodity prices are another important issue. Commodity prices are still at a high level due to the additional demand resulting in part from the impact of Chinese and Indian economic growth. However, it is uncertain how fast such prices will continue to increase in the future. Because of new supply and demand side developments, it is possible that the real price of commodities such as oil and gas will stabilise or even fall over the medium term.
- *International Investment.* This section documents the scale and location of outward direct investment by Chinese and Indian firms. Despite the attention it has received, Chinese investment in the rest of the world is a still relatively small, even in Africa where it has been a cause for alarm in the Western media. The scale of Indian investment is even smaller. Outward investment by Chinese and Indian firms is growing rapidly, but it will be a long time before their overseas operations compare in scale to those of their established rivals from more advanced economies.
- *Is there a New Imperialism in the Making?* This section considers two issues that have classically been associated with the concept of imperialism: global rivalry between large firms; and colonial-style exchange in which industrial powers exports manufactured goods to impoverished countries in return for oil, minerals and other primary commodities. As Chinese and Indian firms expand overseas they will be drawn into global rivalry with other large firms, and like other firms they will draw upon their "home" governments for support. It is also the case that China, and to some extent India, has a colonial-style division of labour with many poor resource-based economies, especially in Africa, which import cheap labour-intensive manufactures from China in exchange for oil and minerals. However, this is only part of the story, since the money used to purchase cheap Chinese manufactures is often

derived from oil and mineral exports to non-Chinese destinations in Europe and elsewhere.

- *The Military Balance.* The emergence of China as a great economic power is provoking a shift in the military balance in the Asia-Pacific region. Concern about China's increasing strength and assertiveness is leading many countries in the region to upgrade their own military capabilities. The United States has also announced a rebalancing of its strategic priorities with greater emphasis on the Asia-Pacific region. China has one great advantage in this context. The United States is a global power which, despite its new priorities, cannot afford to divert too many of its military resources to the Asia-Pacific region. In contrast, China's military objectives are, for the time being at least, mainly confined to its geographical periphery where it can concentrate its armed forces. China is a long way from becoming a truly global military power, but is already a major regional power. As China grows stronger, this will confront both its neighbours and the United States with difficult strategic problems. Containment of China is the obvious kneejerk reaction, but a better response may be to seek a more cooperative solution in which China and the United States share leadership as equal partners, perhaps in concert with other major powers such as India and Japan. It is an open question how far such an arrangement would be acceptable to the parties concerned.

Despite its large GDP and its newly acquired statues as the world's leading exporter of goods and services, China is still what David Shambaugh calls a "partial power"[1]. It has few truly global companies and the overseas operations of Chinese firms are still small in comparison with those from the advanced economies. In military terms it is no match for the United States on a global level, although is a strong regional power in its immediate maritime periphery. If China continues on its projected trajectory, Chinese firms will continue their outward expansion and the Chinese military will acquire the capacity to act effectively on a global scale. China will then become a truly global power. The same observations apply in principle to India, although there is more uncertainty about its future growth prospects. Even if it does return to its projected growth path, India will take much longer than China to become a global power.

[1] Shambaugh (2013)

## 1. Take-off

By any standards China's modern economic growth has been remarkable. Growth has been widely spread across the country and not merely concentrated on the coastal region where most export industries are located. As a recent World Bank report noted, if mainland China's 31 provinces were regarded as independent economies, they would be among the 32 fastest-growing economies in the world[2]. China has grown somewhat faster than Korea and Taiwan at a similar stage of development, but its trajectory has been broadly similar with a lag of about 25-30 years. Indian economic growth has also accelerated, although its per capita income is currently well below that of China. The causes and exact timing of the Indian take-off are a matter of debate, but there is no denying that the economy has grown at a rapid if irregular pace for most of this century[3].

## 2. Future Economic Growth

Forecasting is a hazardous activity and projecting economic growth is no exception. In the 1980s, it was widely thought that Japan was poised to overtake the USA in terms of technology and per capita income. But this did not happen. On the contrary, Japanese growth faltered and the country entered a long period of near stagnation. The Soviet Union provides an even more dramatic example. With its impressive post-war expansion and its achievements in areas such as space technology, the Soviet Union was regarded by many as a formidable rival to the West. However, even its strongest critics did not expect its spectacular implosion during the Gorbachev era and its subsequent economic travails. These examples should be a warning against uncritical acceptance of the many optimistic long-range projections that are now available regarding future economic growth in China and India.

Such projections assume that both China and India will successfully meet the various challenges that will confront them in their pursuit of continued economic growth. These challenges can be conveniently divided into "economic" and "political", although in practice these are interrelated. The following is a brief survey.

### *China*

*Economics*: Following the financial crisis in the advanced economies, Chinese exports slumped in 2009 and the government responded by ramping up the investment rate to an unprecedented 48 per cent of GDP. This was accompanied by a massive increase in the volume of credit in the economy from around 125 per cent of GDP in 2008 to over 190 per cent in 2013[4]. Much of this credit has come from the poorly regulated shadow banking sector and the financial system as a whole is now somewhat unstable. The Chinese authorities are aware of the danger and are seeking to contain the growth of credit and prevent a financial crash.

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[2] World Bank (2013), p. 5.
[3] For a good discussion of this issue see chapter 3 of Corbridge et al (2013)
[4] IMF (2013a) page 11, Figure 4.

It is widely accepted that much Chinese investment in recent years has been misdirected and will be ultimately wasted[5]. It is also agreed that the old model of growth driven by investment and exports is no longer viable and there is a need to shift to a slower, high consumption growth path. This requires a higher share of both private and public consumption in GDP. The transition may not be easy, although other countries, such as Korea and Taiwan, have managed it in the past. The task may be more difficult in the case of China because its investment rate is currently much higher than the highest investment rates ever recorded by Korea and Taiwan which peaked at around 40 per cent of GDP.

A major challenge facing China in the medium term will be to avoid the “middle income trap”. The historical evidence suggests that after an initial development spurt, the growth rate of most countries slows down sharply and they fail to break through into the high-income class[6]. Only a minority of countries, including Korea, Singapore and Taiwan, have avoided this trap. During the initial phase of development, it is relatively easy to raise per capita income by investing heavily in infrastructure and productive capital, and by transferring excess workers out of agriculture, where their marginal product is close to zero, into more productive activities such as construction and manufacturing. The next phase is more difficult since it requires sustained productivity growth within individual sectors of the economy, especially the service sector where most of the labour force will soon be employed. Within the manufacturing sector it involves a shift towards higher value-added production.

China has not yet reached this turning point. Although depleted, its agricultural reserves are still substantial, so there are still gains to be had from transferring labour from farming into other economic activities. However, the end of the initial development phase is in sight and over the longer term continued growth in per capita income will require major improvements within individual sectors of the economy. It is also becoming more difficult to raise productivity through investment in fixed capital or the imitation of foreign countries, so the key to future growth will be innovation and greater efficiency in the use of capital. A recent joint report by the World Bank and Chinese researchers argues that this can be best achieved through the partial or complete de-regulation of many markets, increasing competition for state owned enterprises, increasing private participation in these enterprises, and giving the private sector a much greater role in the economy[7]. This is a familiar World Bank refrain.

The need to shift towards slower growth and to a more market-based, consumption-driven economy is a theme in the 12$^{th}$ Five Year Plan. The Plan also recognises the importance of services and intangibles such as R&D and education, and it stresses the need for upgrading to higher value-added and more environmentally friendly products and methods of production. The Plan identifies 7 priority industrial areas[8]. Three areas align with the aim of sustainable growth: energy savings and environmental protection; new energy; and clean energy vehicles. The other areas are consistent with China’s ambition to move up the value-chain: biotechnology; new materials; new IT; and high-end manufacturing.

The 12$^{th}$ Five Year Plan is an impressive document. It reflects a clear understanding of the direction in which the Chinese economy should move and of the popular needs that must be

[5] See Lee et al (2012)
[6] World Bank (2013), p. 12.
[7] World Bank (2013)
[8] The following summary is taken verbatim from KPMG (2011).

addressed. Since the publication of the Plan, there have been new policy initiatives, such as the right of farmers to "possess, use, benefit from and transfer their contracted land, as well as the right to use their land ownership as collateral or a guarantee."[9]

*Politics:* The fulfilment of the 12th and future Five Year Plans is predicated on continued political stability. This presumes that either the existing political system will continue largely unchanged or that any major change will be carried through without serious disruption. The leadership is aware of possible threats to stability and seeks to learn from events such as the collapse of communism in the Soviet Union and Eastern Europe or the mass upsurge of popular discontent in the Middle East and elsewhere. To minimise such dangers the leadership aims to address the sources of material discontent, to make the party apparatus more responsive to popular demands, to strengthen the rule of law and to reduce corruption and arbitrary behaviour, whilst maintaining tight security control. This should work in the short-term but whether it will work over the longer-term is an open question. There are various possibilities. China may retain the present one-party political system. Or it may eventually go down the road pioneered by Taiwan in the 1980s, where a centralised political organisation, the Guomingdang, surrendered its monopoly of power and allowed the formation of rival parties. The transition was fairly smooth in Taiwan but whether this would be the case in China is uncertain. Taiwan is a small country with a population of 23 million. What is feasible in Taiwan may be impractical in a large country like China with a population of 1360 million and fractious ethnic minorities in Tibet and Xinjiang (East Turkestan). The regime may even be brought down by an explosion of popular discontent as in the so-called Arab Spring. This seems unlikely now but who can say what will happen in twenty years' time? There are also other possibilities, but this is not the place to speculate about them[10]. Suffice it to say, that China may surprise us all.

***India***

*Economics:* India's 11th Five Year Plan 2007-2012 was a qualified success. Although some important targets were missed, overall GDP growth averaged 8 per cent over the plan period as a whole. However, the Indian economy took a sharp turn for the worse during the closing year of the Plan. GDP growth slowed to 3.2% p.a.in the fiscal year 2011-12 and there are now serious macro-economic imbalances. The government fiscal deficit has exceeded 8% of GDP for some years, the inflation rate is over 10% p.a., the rupee has depreciated sharply, and there is a balance of payments deficit equal to 5% of GDP.

The above imbalances are openly recognised in the new Draft Five Year Plan[11]. It also points to infrastructure as a crucial bottleneck if India is to achieve the hoped for 8 per cent p.a. growth in GDP and almost double digit growth in manufacturing. The failings of India's infrastructure, especially in electricity and transport, are well-known. The electricity supply is limited in coverage, and where there is a supply it is often unreliable and subject to black-outs. Difficulties with the transportation of coal, which is the main fuel used for power generation, help to explain why the electricity system is so unreliable, although other factors such as a lack of installed capacity are also important.. In the case of rail, many projects are subject to long delays and cost over-runs. Only 1,750 km of new lines were added from 2006 to 2011, as compared to 14,000 km in China. Ports are congested and are operating at 90% capacity as compared to a global average of 70%. Only 24% of National highways have four

[9] Xinhua News agency cited in CNBC (2013)
[10] See Beardon (2013), chapters 7 to 10
[11] Government of India (2012a)

lanes[12]. In all of these areas the 11th Five Year Plan failed to reach its targets, whereas targets for airports and telecommunications were exceeded. Looking forward, infrastructure investment is supposed to rise from 7.2 % of GDP under the 11th Plan to 8.2% of a much larger GDP under the 12th Plan. If this could be achieved there would be a major improvement in India's infrastructure of all kinds.

There are also other obstacles to growth. Bureaucracy is a perennial problem. Small and medium size enterprises find it difficult to obtain finance from the banking sector. The education system needs improvement at all levels. Only 88% of men and 74% of women aged 15-24 are literate, as compared to 99% in each case in China.

*Politics:* India is the world's largest democracy. It has many flaws and its politics are a kaleidoscope of rival ethnic and regional parties. Patronage and corruption are widespread, the bureaucracy is cumbersome, and the provision of public services such as health and education is patchy[13]. There are huge inequalities of income and wealth with hundreds of millions of people still living close to or below the poverty line. There is also an unusual level of political violence for a democracy. Maoist guerrillas are active in many parts of the country and there are on-going conflicts between the army and separatists in Kashmir, and between tribal peoples and settlers in Assam. There are occasional pogroms against non-Hindu minorities, such as Sikhs, Muslims and Christians. A prime minister, Indira Ghandi, was even assassinated by her Sikh body guards in 1984.

Despite all this, elections are held and turnout is reasonably high by international standards. In the 2009 Indian general election 417 million people voted. The turnout was 56.5% of the population of electoral age which compares favourably with the turnout of 53.6% in the 2012 American presidential election. A surprising feature of Indian politics, until now at least, has been the ability of the state to formulate and implement ambitious plans for economic growth despite the fragmented party structure. Hopefully, this state of affairs will continue.

### *Projections: common features*

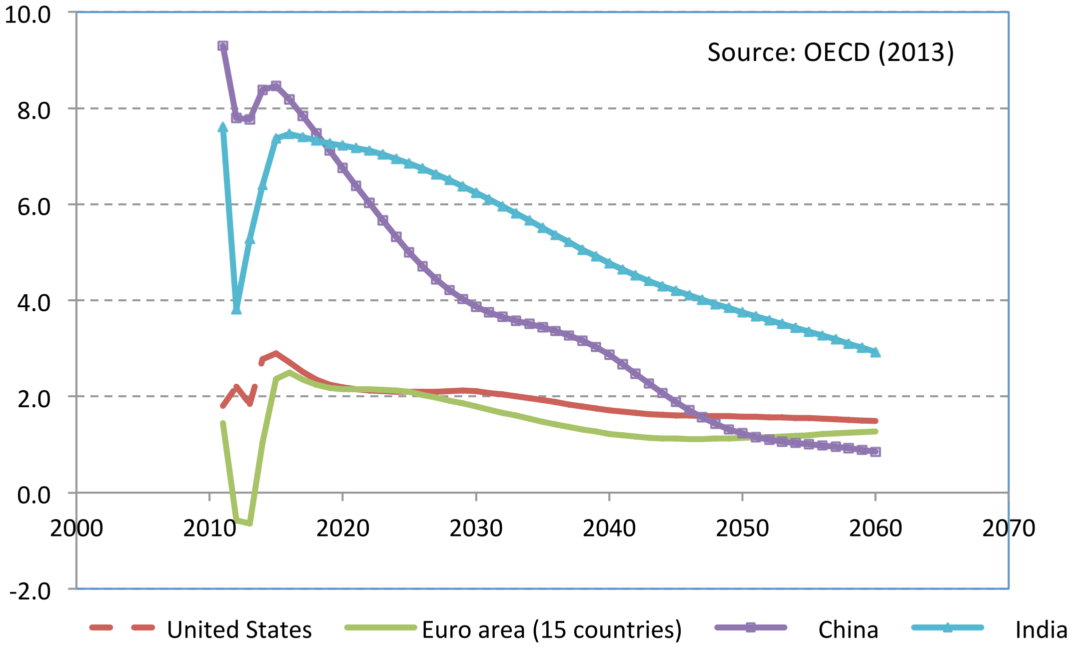
Most long-range projections of future growth in China and India assume that the above obstacles will be successfully overcome. These projections differ in terms of method and time horizon but they mostly agree on the following points:

- *Rapid growth*: China and India will overcome their current macro-economic difficulties and will grow relatively fast by international standards for the next few decades.
- *Future slow-down:* The rates of economic growth of China and India will slow down as they become richer. This is partly because they will have less scope for catching up by adopting easily imitated technologies from more advanced economies. It is also because reserves of excess labour will become depleted in the course of time and an increasing fraction of the labour force will be employed in the service sector where it is more difficult to raise productivity.
- *India will slow down later:* India is poorer than China and will be later to reach the turning point at which per capita income growth normally decelerates.

[12] Ernst & Young (2012)
[13] India ranks 94th out of 176 countries in the 2012 Transparency International Corruption Perceptions Index (Transparency International, 2012). This index measures public sector corruption.

- *India's demographic advantage*: The Chinese population of working age (20-69) is on the verge of decline, whereas that of India should continue growing at least up to mid-century. According to UN projections (medium variant) the population of China in this age group is projected to fall rapidly from a peak of almost 1,000 million in 2020 to 620 million by the end of the century, by which time India should have fifty per cent more people in this age group than China[14]. Provided they can be usefully employed, this additional working-age population will give India's overall GDP a boost. However, a larger population will put an increasing strain on the environment and it may prove difficult to employ all of these people productively.

**Figure 1. Projected Growth Rates of GDP 2012-2060**
**% p.a.**



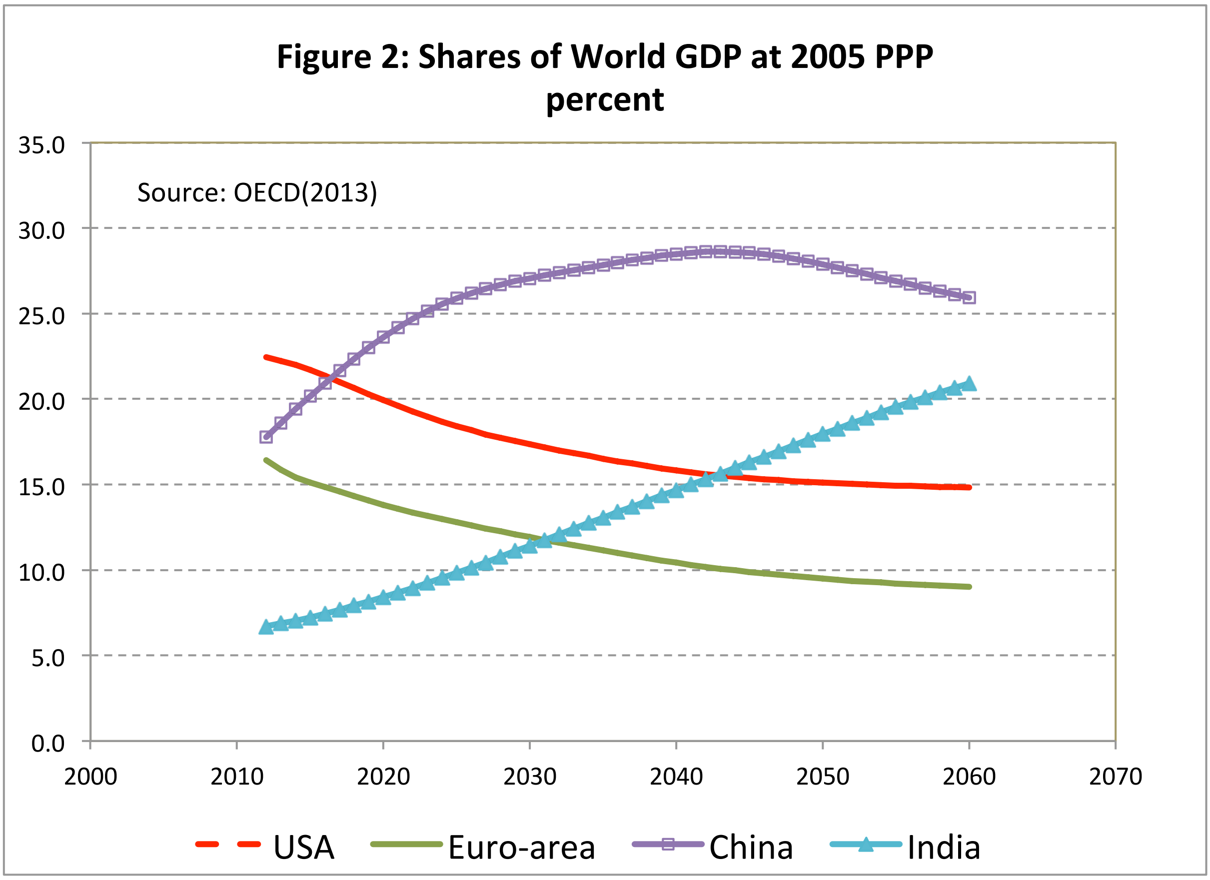

### *OECD projections*

The OECD has produced annual projections of total GDP and GDP per capita for China, India and certain other countries up to 2060[15]. These projections are representative of what is currently available in the field. The OECD projects that the growth rate of per capita income in China will decline from around 8% p.a.in 2015 to 1.6% by 2060. The decline is even more striking in the case of total GDP. By the end of the period Chinese population will be falling, and this pulls down the growth rate of total output to only 0.9% p.a. by 2060. This is below the rates projected for the USA and the Eurozone (Figure 1). Following a sharp recovery from recent difficulties, the Indian economy is also projected to experience falling growth

[14] UN (2013). The Chinese government has recently announced a partial relaxation of the one child policy (Xinhuanet (2013a). This change in policy is foreshadowed in the UN projection cited in the text which assume some increase in the Chinese total fertility rate over the next few decades.
[15] OECD (2013)

rates, although the pace of decline is much slower than in China. From around 2020 India starts to overhaul China in terms of both in per capita income and total GDP.

The above growth rates have dramatic consequences. By 2060 China is approaching the Eurozone average in terms of per capita income, although it remains some way below the US level. Because of its huge population, China's total GDP soon outstrips that of any other country. China's share of world GDP peaks in 2043 and then falls back to around 28 per cent in 2060 (Figure 2). India starts off well behind China and, despite faster growth rate it fails to close the gap completely by the end of the projection period. Even so, in terms of total GDP it easily outstrips the Eurozone and just overtakes the USA by the early 2040s. Assuming these projections are correct and can be extrapolated beyond 2060, they imply that shortly after 2070 India, with its larger population, will overtake China to become the largest economy in the world. These projections are highly speculative and should be treated with caution. For India to catch up with China it would have to overcome its current macro-economic and longer term structural difficulties and return to the kind of growth trajectory forecast by the OECD. This is by no means certain.




**4. International Trade**

It is now a commonplace that as China develops it will move up the value-chain into more "knowledge-intensive" activities. Exports of labour-intensive goods such as clothing are still rising, and many of China's more sophisticated exports, such as consumer electronics, still have a significant local labour-intensive content. But wages are increasing rapidly and such labour-intensive activities will be phased out as China loses the ability to compete with cheaper foreign producers. Korea and Taiwan reached this turning point in the late 1980s, and both of them eventually became net importers of clothing and the like. Given that China is following a similar trajectory to these countries with a lag of about 25-30 years, this would suggest that labour-intensive exports from China may be approaching a peak. Their share of exports is already falling but it may not be long before they start to fall in absolute terms.

These developments will affect the rest of the world in various ways. China will become a leading producer of sophisticated goods that were previously the preserve of highly developed economies. It will be a formidable competitor in both foreign and home markets, and its recent success in the market for solar panels will be replicated in many other fields. Many established producers in the developed economies will lose out. However, others will gain from the extra demand generated by Chinese growth. Provided China does not hoard its growing export revenue but spends it on imports, then somebody somewhere will be selling more goods or services to China. This someone may be a German firm selling luxury cars to China, or it may be an Australian firm exporting minerals to China. No matter how successful China is in the future, it will not impoverish the whole of the world by exporting. There will be gainers and losers. Some foreign producers will lose, but others will gain. Amongst the countries likely to face the biggest challenge will be Japan and Korea which rely heavily on exports of capital goods and intermediate goods to China. As China develops it will produce many of these items for itself, often with the help of Chinese and Korean multinationals, thereby reducing the need for imports.

As China moves up the value chain, this will create space for other countries to take over the abandoned activities. Some will be established exporters, such as Bangladesh, Indonesia or Viet Nam, whose exports of clothing, for example, have been rising strongly in recent years. India is also a contender. Despite recent growth, India's labour-intensive exports are still small in relation to the size of its economy and there are huge reserves of underemployed labour that could be used to produce labour-intensive manufactures for domestic consumption and export. Africa is also a possibility. Wages are now comparatively low in some Sub-Saharan countries and if other conditions could be sorted out these countries would be attractive locations for labour-intensive manufacturing. This issue is discussed below.

The industrialisation of China, together with India and certain other developing countries such as Brazil, has created a hunger for primary products, especially oil and minerals. This helps to explain why most commodity prices are currently much higher in both absolute and real terms than they were twenty five years ago. It is difficult to know what will happen in the future. Predicting the long-run (or short-run) behaviour of commodity prices is notoriously difficult since these depend on both supply and demand, and there are so many unknowns involved. This is illustrated by the wide range of projected outcomes in the various long range forecasts of the American Energy Information Administration. In its reference scenario, the EIA projects that world energy consumption will grow by 56 per cent between 2010 and 2040[16]. Half of the increase is attributable to China and India. This projection assumes that the real price of oil will rise by approximately 45% over the period. In addition to its reference scenario, the EIA presents high and low oil price scenarios under which oil prices in 2040 differ by a factor of more than three. There is also considerable uncertainty about the trajectory of world energy consumption although the range of variation is much less than for prices.

[16] EIA (2013), slide 2.

Higher prices stimulate economy in the use of commodities and encourage their replacement by cheaper alternatives. They also incentivise the exploitation of new or unconventional sources of supply, and encourage innovation in methods of production or extraction. Developments in all of these areas may also occur spontaneously without the spur of higher prices. Despite these qualifications, it seems fairly certain that the consumption of most commodities will continue to increase as world population and per capita incomes grow. What happens to commodity prices will depend on the evolution of supply. It is conceivable that supply-side developments, such as new sources of supply and methods of production, will make many commodities so plentiful that their real prices will fall on a permanent basis despite higher levels of output. A more plausible scenario is that real commodity prices will exhibit a gradual upward trend, punctuated perhaps by occasional large fluctuations.

## 5. Going Global: Will China (or India) Buy the World?

The emergence of China as an economic giant, a formidable competitor with a voracious appetite for oil and minerals, has caused widespread unease or even fear in the rest of the world.

Fear of Chinese economic prowess is nothing new. Many years ago the still popular left-wing children's writer, Jack London, wrote a short story called *The Unparalleled Invasion*[17]. This story describes a fictional world in which the Chinese out-compete other nations through hard work and intelligence, and how they threaten to dominate the world peacefully without the need for warfare. The story ends when the governments of other countries unite to exterminate the entire Chinese population by infecting them with the plague and other deadly viruses. Such fears have surfaced once again, although in less extreme form. A few years ago, it was the fear that low-wage imports from China would wipe out manufacturing industry in rich countries. Now it is the fear that the Chinese are using their supposedly vast financial wealth to buy up swathes of foreign business, and to monopolise the oil and mineral resources of African and other developing countries.

The above claims have been comprehensively rejected in a well-documented book by Peter Nolan[18]. He argues that the scale of overseas investment by Chinese firms is grossly exaggerated and that while some of these firms may have large operations at home, they are relatively small players on the world stage. This is true even in the case of natural resources, where Chinese overseas investment in oil and mineral extraction has given rise to claims of a new imperialism. A central theme of Nolan's book is that China is vulnerable. It is highly dependent on imported commodities, especially oil; and many of its overseas investments in natural resources are defensive in character and designed to ensure security of supply. Nolan points out that foreign multinationals have invested far more in China than Chinese firms have invested overseas. He also defends the role of the Chinese government in encouraging and supporting the recent outward thrust of state-owned firms because it is the only way to break into global markets which in many industries are currently dominated by a handful of established giants.

The evidence mostly supports Nolan's argument. In particular, despite recent developments, Chinese firms are still, for the most part, minor players on the world stage, although the situation may change if China continues on its planned trajectory. Let us review some of this

[17] London (1910).
[18] Nolan (2012).

evidence. The following remarks mostly concern China, but we also make reference to India where appropriate.

**Table 1. Outward FDI Stocks of Mainland China , Hong Kong and India US billions**

| | 2003 | 2010 | Growth rate (% p.a.) |
|---|---|---|---|
| Mainland China | 33.2 | 317.2 | 38.0 |
| *of which to* | | | |
| Hong Kong | 24.6 | 199.1 | 34.8 |
| Rest of World | 8.6 | 118.1 | 45.4 |
| | | | |
| Hong Kong | 414.6 | 1039.0 | 14.0 |
| *of which to* | | | |
| Mainland China | 146.4 | 426.8 | 16.5 |
| Rest of World | 268.1 | 582.7 | 11.7 |
| | | | |
| **China (incl. HK) to Rest of World** | **276.7** | **700.8** | **14.2** |
| | | | |
| India | 6.1 | 96.9 | 48.5 |
| | | | |
| *For comparison:* | | | |
| USA | 2729.1 | 4766.7 | 8.3 |

Source: China: Davies (2012); Hong Kong Government (2006, 2012): India, USA: UNCTAD database. The estimates for Hong Kong FDI are derived by converting the original figures from Hong Kong dollars into US dollars.

In 2000, the Chinese government announced its “go global” policy. One objective was to improve the operations of China’s large state owned enterprises (SOEs) by exposing them to the challenges and opportunities of global markets. Another was to secure future supplies of energy and raw materials[19]. Since then foreign direct investment (FDI) by Chinese firms has mushroomed and it is this development above all that has fed concerns about Chinese expansion[20]. There has also been a sharp upswing in outward FDI from Hong Kong and India. However, despite this recent growth, the stock of overseas investments held by these

[19] Davies (2010)
[20] Foreign Direct Investment (FDI) refers to an external investment whereby an investor who is resident (individual or organisation) in one economy acquires a lasting interest and a significant degree of influence or an effective voice in the management of an enterprise located in another economy. For statistical purposes, an effective voice is taken as being equivalent to holding 10% or more of the voting power of an enterprise. For a given economy, inward FDI refers to direct investment in this economy by foreign residents. Outward FDI refers to direct investment in the rest of the world by residents of the given economy.

economies is still relatively small. More than half of outward FDI stock of mainland China is located in Hong Kong and about 40 per cent of the Hong Kong outward FDI stock is located in mainland China (Table 1). When such cross-holdings are eliminated, the result is a total of $US700.8 billion for the FDI stock held by China (incl. Hong Kong) in the rest of the world in 2010. In the same year, the American direct investment abroad was valued at $4766.7 billon which is almost 7 times the Chinese total and 49 times the Indian total. To put the Chinese figure into perspective, it is less than one third of Italy's national debt.

There has been extensive, mostly negative, publicity in the Western media about Chinese investment in Africa. Yet despite its recent growth, China's investment stake in Africa is still small compared to that of Western countries. The same is true for India. In 2011, the stocks of Chinese and Indian foreign direct investment (FDI) in Africa were $US 16 billion and $14 billion respectively[21]. In the same year, the combined total for France, the USA and the UK exceeded $US150 billion. The Heritage China Global Investment Tracker records Chinese investment projects abroad worth at least $100 million each[22]. Because of their large size these are disproportionately concentrated in energy and mining. Of the 405 projects recorded over the period 2005-2012 a total of 45 were located in Africa, and the rest were scattered throughout the globe, including many in developed economies.

The above comparisons indicate how the stock of Chinese and Indian investments abroad is still relatively small. However, these investments are growing rapidly and their share in the world FDI stock is increasing. Between 2003 and 2010, the combined investments of mainland China and Hong Kong in the rest of the world grew at 14.2% p.a. (Table 1). For India and the USA the growth rates were 48.5% and 8.3% respectively. Under the improbable assumption that such growth rates were to continue unchanged into the future, India would overtake the USA in 2023 and for China (including Hong Kong) this would occur in 2047. The Indian projection is beyond the bounds of possibility, but it is conceivable that China as a whole may begin to rival the USA as an overseas investor by mid-century.

What actually happens in the future will depend on many factors. If China continues along its projected growth trajectory, the Chinese state-owned enterprises (SOEs) will continue their outward thrust. However, there may be resistance to this in foreign countries that fear a loss of autonomy if much of their industry or stock of natural resources falls under the control of Chinese SOEs or sovereign wealth funds. There have already been cases in Australia, the USA and elsewhere where Chinese SOEs or sovereign wealth funds have been discouraged from investing in local companies or setting up business on their own (see below). This may change if SOEs are privatised but so long as they remain under state control they may continue to be viewed with suspicion, and there will always be some suspicion of sovereign wealth funds. Moreover, if the Chinese economy falters, the pace of outward investment may also falter. In the case of India, the growth rate of investment abroad will depend on what happens to the India economy and on its ability to develop domestically controlled firms that are big enough to expand on a large scale abroad. During the present currency crisis the India government has imposed temporary exchange controls on most types of outward direct investment. This should, for the time being, reduce the pace of overseas expansion by Indian firms.

The overall picture can be summarised as follows. In line with the official "go global" policy, large Chinese firms are now rapidly expanding their overseas operations, and Indian firms are

[21] UNCTAD (2013) pp.7-8.
[22] Heritage Foundation (2013)

following suit. Despite these developments, Chinese and Indian FDI is still a small fraction of world FDI, and Chinese and Indian multinationals account for a tiny fraction of economic activity in the developed economies. The situation will begin to change as Chinese and Indian firms continue their outward thrust, but it will be a long time before the scale of their overseas investments begins to rival that of the USA or Europe.

## 6. A New Imperialism in the Making?

Book titles like *When China Rules the World* by Martin Jacques imply that we are witnessing a new imperialism in the making[23].

The term "imperialism" has many different meanings. In the *Dictionary of Human Geography*, it is defined as "an unequal human and territorial relationship, usually in the form of an empire, based on ideas of superiority and practices of dominance, and involving the extension of authority and control of one state or people over another"[24]. Other definitions have a more explicit economic dimension.

### *Rivalry*

In his classic work, *Imperialism, the Highest Stage of Capitalism,* Lenin identified imperialism as a special stage of capitalism "with the following five basic features: (1) the concentration of production and capital has developed to such a high stage that it has created monopolies which play a decisive role in economic life; (2) the merging of bank capital with industrial capital, and the creation, on the basis of this "finance capital", of a financial oligarchy; (3) the export of capital as distinguished from the export of commodities acquires exceptional importance; (4) the formation of international monopolist capitalist associations which share the world among themselves, and (5) the territorial division of the whole world among the biggest capitalist powers is completed. Imperialism is capitalism at that stage of development at which the dominance of monopolies and finance capital is established; in which the export of capital has acquired pronounced importance; in which the division of the world among the international trusts has begun, in which the division of all territories of the globe among the biggest capitalist powers has been completed"[25]

The world has not evolved as Lenin expected. The old empires have collapsed, formal colonies have virtually disappeared, and the world is not neatly divided in to spheres of influence; although there are still major inequalities of economic and military power. Some counties are still able to dominate others through economic means, and sometimes through the use of military force. The closest to an imperial power in the classic sense is the USA, which frequently uses its economic strength to influence or cajole foreign governments and on occasion seeks to impose its will by military force. However, with its current economic difficulties, and after a string of diplomatic or military setbacks in Afghanistan, Iraq, North Korea, Syria and elsewhere, and declining domestic support for war, America's hegemony is clearly on the wane. No other capitalist country has anything like the capacity to qualify as an imperial power. It is certainly not the case, as Lenin claimed that "the division of all territories of the globe among the biggest capitalist powers has been completed". However,

[23] Jacques ( 2012)
[24] Gregory et al (2009) p. 373. The quotation in the text is taken from the Wikipedia entry on imperialism
[25] Lenin (1917).

some of his other predictions were accurate. Large swathes of the world economy are now dominated by giant global firms ("monopolies" in Lenin's terminology) that operate in close collaboration with the big banks and compete fiercely with each other. And as he predicted, the export of capital as distinguished from the export of commodities has acquired exceptional importance.

Implicit in Lenin's thinking was the idea that individual states in the leading capitalist states would support "their" firms in the global struggle. It has been argued that with the growing internationalisation of their activities today's giant firms are losing their national identity. No matter where their headquarters are located, no matter what national label they bear they are all becoming very similar in terms of global spread and objectives[26]. There may something in this view. As the operations of large firms become more international, their interests are becoming less closely tied to the fate of their home economies. The giant food company Nestlé has its headquarters in Switzerland and is legally classified as a Swiss firm, yet only 2% of its sales and 3% of its employees are located in Switzerland, and its profits are largely unaffected by the performance of the Swiss economy[27]. However, this is an extreme example. Despite decades of globalisation, a substantial fraction, often a majority, of the operations of large American firms are still located in the USA. The same is true for Japanese firms. The picture is more complex in the case of European firms because their operations may be dispersed across several countries of the European Union. However, the Union as a whole still accounts for a substantial proportion of their operations and sales, and the fate of these firms depends to a significant extent on what happens to the European economy.

The top management of the large multinationals is certainly becoming more cosmopolitan and their R&D activities are often widely dispersed amongst many countries. But one should not exaggerate the scale of what has happened. Many multinationals, even when their production is mostly located overseas, still conduct a disproportionate share of their R&D in their home economy. Despite the fact that only a tiny fraction of its total production and sales are located in Switzerland, Nestlé still conducts 35% of its R&D in Switzerland.

Geoffrey Jones has challenged the notion that large multinational firms are becoming stateless global webs and that corporate nationality is increasingly irrelevant. Writing in the *Harvard Business Review*, he says: "Today, technological advances may permit different parts of the value chain to operate in different places, companies may hold portfolios of brands with different national heritages, and leaders, shareholders, and customers may be dispersed. Still, the nationality of a firm is rarely ambiguous. It usually has a major influence on corporate strategy, and it seems to be growing in political importance" [28.]

National governments and the EU Commission support "their" own firms in various ways. They lobby to gain better conditions for these firms in foreign markets, sometimes under the slogan of a "level playing field". For example, the USA and the EU have been pressing for the reduction of inward investment restrictions in China and India so they can penetrate local markets more effectively. In the case of China they seek to protect the intellectual property rights of American and European firms.

How do China and India fit into all this? Large firms from both countries are starting to push outward and extend their external operations. However, as we have seen, this process is in its infancy, especially in the case of India which has hardly begun. Outward investors from

[26] Rowthorn (1971). Nolan (2012), Reich (1991, 2013).
[27] Nestlé (2012)
[28] Jones (2006)

India are normally private firms and, as such, pose no particular conceptual problem. They are similar in terms of ownership structure and motivation to most existing multinationals. The situation is different in the case of China, where most outward FDI is undertaken by large state owned enterprises (SOEs). Chinese leaders are concerned to promote overseas investment by private firms but this has not so far happened on a large scale. The primary objectives of the SOEs are laid down by the government and the profit motive plays a smaller role in their decision-making than in the classic capitalist enterprise.

The close relationship between the large SOEs and the government has sometimes inhibited Chinese expansion abroad. A country may be reluctant to allow large parts of its economy to fall under the control of firms whose actions may be guided by the political imperatives of a foreign government[29]. There have been some high profile refusals. In 2005, the Chinese National Offshore Oil Corporation (CNOOC) made a $US 18.6 billion cash offer to buy the American oil company UNOCAL, but this was abandoned after opposition in the US congress. In 2007, the Chinese company Huawei was prevented from taking over 3Com in collaboration with Bain capital, because of Huawei's alleged links with the People's Liberation Army[30]. One way to allay such fears is to reduce political control over the large SOEs and put their operations on a more transparent commercial basis, whilst retaining formal state ownership, perhaps with a minority private shareholding. This has been the practice so far. Full privatisation is a potential alternative. Many of the smaller SOEs have been privatised, but so far the large firms which dominate the "commanding heights" of the economy remain in public hands.

To the extent that the large SOEs become subordinate to market forces and driven by the profit motive, their behaviour will come increasingly to resemble that of capitalist enterprises, although their profits will accrue to the Chinese government rather than private owners. So long as these SOEs remain in public hands, the Chinese government will have a backstop control over them and will retain some ability to shape their global priorities. Even if some of the large SOEs were to be eventually privatised, so long as the major financial institutions remained in the public sector, the government would retain an indirect influence on the behaviour of former SOEs through its influence of the terms under which they can borrow.
The entry of China and India will not alter fundamentally the nature of global rivalry between the large multinationals, although the fact that many of the large Chinese players are state-owned may alter the rules of the game somewhat. Moreover, as the external activities of the large state enterprises increase in importance, there will be increasing pressure to relax government control of their activities or even to privatise them. This is already happening anyway, but the going global policy may accelerate the move towards commercialisation and, ultimately, privatisation of the remaining state owned enterprises. The "commanding heights" of the Chinese economy are at present controlled by the government. It is an open question how far this will be compatible with continued global expansion of the large Chinese firms.

Is this imperialism? If by imperialism we merely mean the global rivalry of large firms which enjoy support from their "home" governments, then the present world system can be described as "imperialism" and China may be on the way to becoming an imperial power. This may also be true of India further down the track. However, the term "imperialism" in this context is unduly pejorative and is overloaded with outmoded symbolism. It is probably best to avoid it.

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[29] Drysdale and Findlay (2009)
[30] These examples are from Davies (2013).

### *The Scramble for Resources*

China's spectacular industrialisation has created a hunger for primary products, above all fuels and other minerals, many of which are imported from developing countries in Africa, Latin America and elsewhere. These countries are also valuable markets for Chinese exports. The growing engagement with China has been welcomed by many developing countries, if only because China provides a counterweight to the previously dominant Western powers. However, this engagement has its downside and some of the expected benefits have not materialised. In what follows, we shall focus mainly on China's relations with Africa, although there will be the occasional mention of its relations with Latin America. India's role as an importer of primary products will also receive some attention

Until recently, Africa's political élites have been enamoured with China. In return for access to the continent's natural resources, China has been willing to offer generous aid, cheap credit, expertise and manpower for infrastructural and other projects. In line with the Chinese policy of non-intervention in the internal affairs of other countries, such deals have come with few political strings attached, and are especially attractive to countries with poor records in terms of corruption or human rights. These generous and unconditional terms have allowed China to break into what was previously almost a European and American monopoly in Africa. However, there are signs of African discontent with the arrangement.

In an interview in the *Financial Times*, the governor of Nigeria's central bank, Lamido Sanusi, has warned that China is a "competitor as much as a partner … capable of the same exploitative practices as the old colonial powers…"[31] Africa is "opening itself up to a new form of imperialism. China takes from us primary goods and sells us manufactured ones. This was also the essence of colonialism….China is a major contributor to the de-industrialisation of Africa and thus African underdevelopment."

Is the above picture of China's economic relations with Africa accurate? The answer is yes up to a point. A number of African countries now depend heavily on their exports of primary products, mainly oil and minerals, to China; and African producers of labour-intensive manufacture have been damaged by competition from Chinese exports. However, China is by no means the dominant player in Africa. China's direct investments in Africa have grown rapidly but are still modest in comparison to those of Europe and America; trade between Africa and China has also grown rapidly but most of Africa's exports, including oil and minerals, still go to non-Chinese destinations, such as Europe and the USA, and most of its imports come from these areas. Similar observations apply to China's economic relations with Latin America and Central Asia. With certain important exceptions, India's economic relations with developing countries does not compare in scale to that of China.

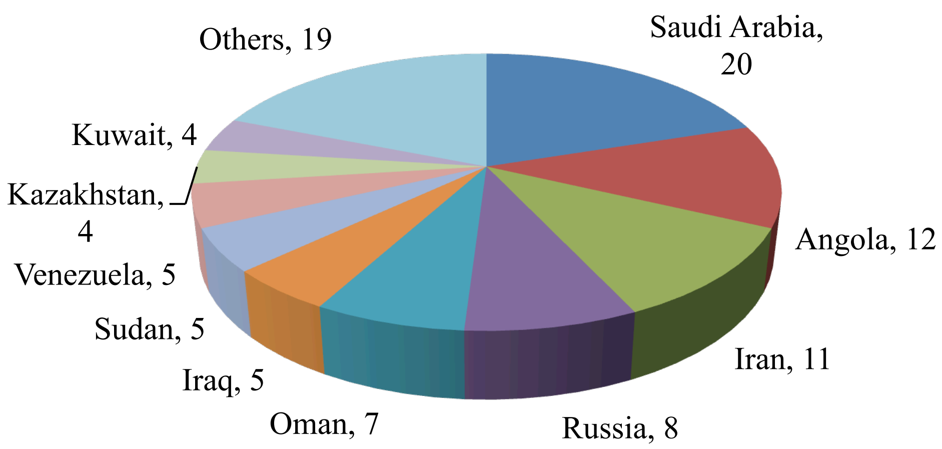
As mentioned previously, China and India's growing dependence on imported primary products makes them vulnerable to interruptions in supply. An objective of their external economic policy has been to reduce this vulnerability. Nowhere is this more evident than in the case of oil. According to a recent report to the US Congress, China has been involved in energy projects in more than 50 countries, spanning nearly every continent[32]. This investment in energy assets is driven to a large degree by its increasing dependence on imported energy

[31] Wallace ( 2013)

[32]This paragraph draws heavily on Department of Defense (2013) pp. 19-20. .

and its suspicion of international energy markets. In 2011 approximately 58% of China's oil was imported and this figure is projected to rise to three quarters by 2030. In addition to ensuring reliable energy sources, China is diversifying transport options and energy producers. In 2011, 85% of China's oil imports came through South China Sea and the Straits of Malacca. It is seeking to reduce its dependence on sea lines of communication by building pipelines to Russia, Central Asia and the Middle East for oil and natural gas. Despite its diversification strategy almost 40 per cent of China's oil supplies still come from the Middle East and, with the exception of Angola, no single African country supplies more than 5 per cent of China's imports of crude oil (Figure 3). This suggests there is scope for further Chinese expansion in Africa.

**Figure 3. China's Crude Oil Supplies 2011 (%)**




Source: Department of Defense (2013)

In the case of India, it has been estimated that total energy consumption will rise by 141% between 2010 and 2040[33]. Much of this will have to be imported and to ensure adequate supplies it is government policy to encourage "investments in energy assets in foreign countries, especially for coal, oil and gas and uranium"[34]. In line with this objective, Indian state-owned oil companies are exempt from the emergency restrictions imposed on outward direct investment during the recent foreign exchange crisis[35]. The Indian government is keen to diversify its oil and gas supplies and to this end the state-owned Oil and Natural Gas Corporation has acquired shares in oil fields in countries like Sudan, Syria, Iran, and Nigeria. There are plans for a pipeline through Afghanistan that would bring natural gas to India and Pakistan from Turkmenistan. Another gas pipeline linking Iran to India via Pakistan is currently under construction.

Exports of fuels and minerals from Africa to China and India have grown exceptionally fast over the past decade or so (Table 2). As a result, the share of China in African exports of fuels and minerals has risen from 4.0% in 2000 to 14.1% in 2012. India's share has risen from 1.1% to 6.8% over the same period. Despite such growth China and India between them

[33] Exxon Mobil, p 49.
[34] Government of India (2012b) p.135.
[35] Mallet (2013.)

still account for less than a quarter of Africa's total exports of this type. The picture is similar for fuel and mineral exports from Latin America. Another important development in the case of Latin America is the growth of agricultural exports to China. These have risen from $2.0 billion in 2000 to $26.0 billion in 2012. Even so, China and India between them still account for only one sixth of agricultural exports from Latin America.

**Table 2 : Exports of Selected Products from Africa and Latin America 2000 and 2012, $US billions**

| | 2000 | 2012 | 2000 | 2012 | 2000 | 2012 |
|---|---|---|---|---|---|---|
| | Agricultural Products | | Fuels & Mining Products | | Manufactures | |
| Africa to: | | | | | | |
| Africa | 3.3 | 13.5 | 4.2 | 27.4 | 5.9 | 29.7 |
| Latin America | 0.2 | 1.5 | 3.3 | 25.8 | 0.5 | 2.9 |
| China | 0.4 | 3.1 | 3.4 | 61.7 | 0.2 | 2.1 |
| India | 0.5 | 1.5 | 1.0 | 29.8 | 0.8 | 2.6 |
| Rest of world | 13.9 | 37.7 | 74.9 | 293.1 | 28.5 | 66.2 |
| World | 18.3 | 57.4 | 86.8 | 437.7 | 35.8 | 103.4 |
| Latin America to: | | | | | | |
| Africa | 1.6 | 14.8 | 0.3 | 1.9 | 0.8 | 4.1 |
| Latin America | 9.8 | 35.5 | 15.9 | 71.3 | 24.7 | 94.5 |
| China | 2.0 | 26.0 | 1.2 | 53.9 | 0.4 | 5.5 |
| India | 0.5 | 2.2 | 0.4 | 8.2 | 0.1 | 0.9 |
| Rest of world | 38.9 | 126.7 | 52.3 | 184.3 | 46.8 | 94.5 |
| World | 52.8 | 205.2 | 70.0 | 319.6 | 73.0 | 199.5 |

Source: WTO data base

*Labour-intensive Manufacturing*

Labour-intensive manufacturing in Sub-Saharan Africa and elsewhere has been damaged by competition from China. Many local producers have been driven out of business by imports from China or by Chinese competition in third markets[36]. The Chinese combination of superior organisation and low wages has proved unstoppable.

The situation is worst in countries which rely heavily on the export of primary products. If a country starts to export primary products on a large scale, this will drive up the real exchange rate, making locally-produced manufactured goods more expensive in comparison to foreign

[36] See Hardy (2013) on Latin America, and Geda and,Meske (2007) and Morrissey and Zgovu (2011) on Africa.

goods. Exports of such items will fall, imports will rise and the domestic manufacturing sector will shrink or fail to expand. This effect, which is known as the "Dutch disease", has been observed in a number of countries in Africa and Latin America[37]. However, primary product exports to China and India are not the only culprit. As we have seen, despite the rapid growth of trade with China and India, most primary product exports from Africa and Latin America go to developed countries, such as Europe and the USA, or to other developing countries.

The domestic impact of revenue from primary product exports depends on how it is used. If it is invested wisely in areas such as health, education and infrastructure it will generate employment and provide the foundation for sustainable growth. It is also wise to invest some of this revenue in a sovereign wealth fund that can be used to smooth out the effect of fluctuations in commodity prices. All too often, however, especially in the case of oil and minerals, the export sector is an enclave which has few links to the rest of the economy and much of the revenue is siphoned off by a corrupt elite[38]. The danger is summarised in the following quotation from the African Development Bank[39]:

> *The discovery of oil and minerals in a growing number of African countries is of enormous significance for Africa's development. However, it may also have the effect of sharply increasing the level of corruption and the risk of conflict. In addition, natural resource booms can suppress growth in other parts of the economy – a phenomenon that is often referred to as "Dutch disease".*

In its pursuit of oil and minerals, China and India have been willing to tolerate a high level of corruption in the countries they deal with. However, China and India are not the only culprits. Despite some improvements in recent years, corruption is still rife in much of Africa, including countries where Western oil companies have a dominant presence[40].

The experience of African countries shows how rarely resource wealth is translated into self-sustaining and inclusive economic growth. Fuelled by income from natural resources, GDP in a number of African countries has grown rapidly but unemployment is rife and there has been little or no trickle down of income to the impoverished mass of the population. Report after report of the African Development Bank echoes this theme. All that varies is the name of the country.

It is this experience that informs Lamido Sanusi's warning. However, the culprit is not simply China as he implies. Whilst China may supply many of the cheap labour-intensive manufactures that compete with African producers, the revenue which is used to purchase these imports often comes from primary product exports to non–Chinese destinations.

*The Future of African Manufacturing*

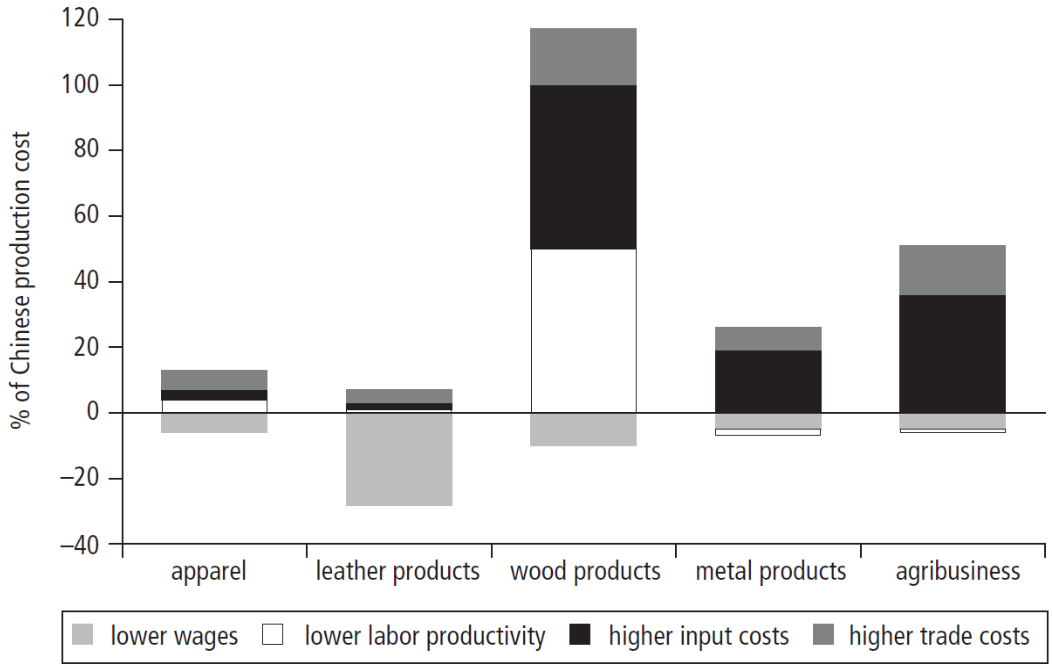
China's rapid development is creating new opportunities for African manufacturing. Wages in many African countries are now lower than in China, and Chinese firms are starting to

[37] See Van der Ploeg and Venables (2013) for a general discussion of the Dutch disease.
[38] See Carmody (2011).
[39] African Development Bank (2011), p. 20.
[40] Of the bottom 38 countries Transparency International's 2012 Corruption Perceptions Index 16 are in Sub-Saharan Africa (Transparency Internationaal, 2012).

invest in labour-intensive manufacturing in Africa. However, this process is in its infancy and labour-intensive manufacturing is still virtually absent in many African countries. According to a recent World Bank report, employment in the apparel sector was 4,587,000 in China and 1,194,310 in Vietnam; the corresponding figures for African countries were Ethiopia 9,746, Tanzania 2,000 and Zambia 1,500[41]. There are still many obstacles to overcome before manufacturing takes off in Africa. There is a scarcity of well-serviced land with suitable transport links and utilities, local workers often lack the required skills, and suitable inputs

**Figure 4. Sources of Excess Production Costs of Medium Firms in Africa: Average across Ethiopia, Tanzania, and Zambia**

**Percentage of Chinese Production Cost**




Source: Dinh et al (2012), p. 55

may be hard to obtain or expensive. When these factors are taken into account, despite lower wages, Africa is often a more expensive place to produce than China (Figure 4). If such difficulties can be overcome, Africa may attract much of the labour-intensive manufacturing that will migrate in the future from China to other countries.

If Africa does eventually stop importing labour-intensive manufactures from China, this does not mean that it will stop importing Chinese manufactured goods altogether. It may simply be that manufactured imports from China will become more sophisticated. For the foreseeable future, Africa will continue to export oil and minerals to China and it will continue to import manufactures of some kind from China. This is not an intrinsically exploitative relationship. Provided African economies can utilise their revenue from oil and mineral exports to develop other sectors of their economy including domestic manufacturing, the exchange with China will be of mutual benefit. So far this revenue has often been misused, but this is not

[41] World Bank (2011), p 77.

inevitable. There are several examples, such as Canada, that export natural resources in return for manufactured imports, but also maintain a vibrant domestic manufacturing sector.

**7. The Military Balance**

The emergence of China, and further down the line India, as great economic powers is provoking a shift in the military balance in the Asia-Pacific region. Concern about China's increasing strength and assertiveness is leading many countries in the region to upgrade their own military capabilities and to forge new alliances or strengthen old ones. In the case of Japan, Prime Minister Abe is seeking to revise article 9 of the Constitution which forbids the use of force as a means for settling international disputes and limits Japan's ability to expand its armed forces. Total military expenditure in Asia will soon surpass that of the European Union and Russia combined[42].

China's military strategy was outlined as follows by President Hu Jintao's in his report at 18th Party Congress[43]:

> "*Building strong national defence and powerful armed forces that are commensurate with China's international standing and meet the needs of its security and development interests is a strategic task of China's modernization drive……"*
>
> *"We should make active planning for the use of military forces in peacetime, expand and intensify military preparedness, and enhance the capability to accomplish a wide range of military tasks, the most important of which is to win local war in an information age….*
>
> *China pursues a national defence policy that is defensive in nature. Our endeavours to strengthen national defence aim to safeguard China's sovereignty, security and territorial integrity and ensure its peaceful development. China's armed forces have always been a staunch force upholding world peace and will continue to increase cooperation and mutual trust with the armed forces of other countries, participate in regional and international security affairs, and thus play an active role in international political and security fields.*

The above statement of strategic objectives ignores the fact that there is no universal agreement about what constitutes Chinese territory or about China's maritime rights. China has settled its former border disputes with Pakistan and Russia, but points of conflict with other countries remain. There are unresolved territorial disputes with India, which have already given rise to one major war between the two countries and are still the cause of frequent skirmishes between their armed forces. There are also on-going disputes with most of China's Pacific neighbours. What China regards as legitimate defence of its territorial integrity is seen by many of its neighbours as territorial aggrandisement.

Much of the friction between China and its Pacific neighbours is concerned with disputed islands, and related fishing or undersea mineral rights. This helps to explain why the regional

[42] Comparison based on data from the SIPRI (Stockholm International Peace Research Institute) database.
[43] http://news.xinhuanet.com/english/special/18cpcnc/2012-11/17/c_131981259_11.htm

arms race has an important naval dimension. China and India are both investing in new aircraft carriers; Japan has just launched a new destroyer with carrier-like features; China, India, Malaysia, Singapore, Vietnam, Indonesia, South Korea, Australia, Japan and Pakistan are all expanding their existing submarine fleets or creating new ones; and in the case of China and India, some of their new submarines are nuclear powered and will be equipped with nuclear missiles. There is also expansion and upgrading in other military domains such as land-based missiles, aircraft, surveillance, advanced command and control systems and cyberspace. China's upgrading programme lays particular emphasis on electronic warfare which is seen as of equal importance to traditional ground, sea and air forces[44]. Through the use of electronic warfare the Chinese military hope to reduce or eliminate U.S. technological advantage in other domains.

The United States is currently the strongest military power in the world by a long way. Its military capacity, except in terms of manpower, greatly exceeds that of any country in the Asia Pacific region, not just in crude numbers (see Table 3) but also in the sophistication of its equipment. However, the balance is shifting. The International Institute of Strategic Studies projects that in terms of military expenditure China will overtake the United States at some time between 2025 and 2050[45]. Uncertainty about the timing of this event derives from uncertainty about future economic growth rates and about the shares of GDP that the two countries will in future commit to military expenditure. India is a long way behind but it is also upgrading its armed forces. Over the decade, 2002-2012, annual military expenditure by China increased by almost 200 per cent. For India the figure was 68 per cent[46].

One constraint on India's military expansion is its high dependence on imports of high-tech weapons, mostly from Russia. Whereas China has a strong and increasingly sophisticated indigenous defence industry, the Indian defence industry is inefficient and produces mostly low-tech weapons. India is currently spending twice as much on imported weapons as China and such imports account for 65 per cent of its total expenditure on military equipment[47]. As India develops economically, this dependence will presumably decline.

In response to China's growing military prowess and the potential for regional conflict the United States has announced a rebalancing of its strategic priorities with greater emphasis on the Asia-Pacific region. China has one great advantage in this context. The United States still sees itself as a global power which, despite its new priorities, cannot afford to divert too many of its military resources to the Asia-Pacific region. In contrast, China's military objectives are, for the time being at least, mainly confined to its geographical periphery where it can concentrate its armed forces[48]. Faced with this reality, the United States is hoping to share the military burden with China's regional neighbours. Indeed, this is already happening. In 2012, the combined military expenditures of the ASEAN countries plus Japan, South Korea and Taiwan amounted to $135 billion which is not far short of China's military

[44] Department of Defense (2013), p. 37

[45] IISS(2013), p. 256

[46] The figures for China and India are from the SIPRI (Stockholm International Peace Research Institute) database. Expenditure is measured at constant (2011) US dollars.

[47] IISS (2013)

[48] See Shambaugh (2013) chapter 7.

expenditure of $166 billion.[49] The United States could in theory forge a formal alliance with China's Asia-Pacific neighbours similar to NATO in Europe. However, quite apart from the fact that many countries would refuse to join such an alliance, it is likely that such a policy would be seen by China as a threat to its security and would stoke up tension in the region.

**Table 3. Military Strength of Selected Countries in 2011/2012**

| | Military expenditure US$ billions | Number in armed forces ('000) | Tanks | Aircraft | Aircraft carriers | Sub-Marines |
|---|---|---|---|---|---|---|
| USA | 645.7 | 1520 | 8325 | 15293 | 10 | 71 |
| China | 102.4 | 2285 | 7950 | 5048 | 1 | 63 |
| Russia | 59.9 | 845 | 2867 | 4498 | 1 | 58 |
| Japan | 59.4 | 247 | 920 | 1252 | 0 | 16 |
| India | 38.5 | 1325 | 3555 | 1962 | 1 | 15 |
| S. Korea | 29.0 | 655 | 2466 | 871 | 0 | 14 |
| Australia | 25.1 | 57 | 59 | 377 | 0 | 6 |
| Taiwan | 10.3 | 290 | 2005 | 805 | 0 | 4 |
| Singapore | 9.7 | 73 | 132 | 359 | 0 | 6 |
| Indonesia | 7.7 | 396 | 400 | 444 | 0 | 2 |
| Pakistan | 5.9 | 642 | 3490 | 1531 | 0 | 8 |
| Thailand | 5.5 | 361 | 584 | 743 | 1 | 0 |
| Malaysia | 4.5 | 109 | 69 | 244 | 0 | 2 |
| Vietnam | 3.3 | 482 | 2860 | 644 | 0 | 0 |
| Philippines | 2.6 | 125 | 41 | 184 | 0 | 0 |
| N. Korea | ? | 1190 | 5400 | 1667 | 0 | 70 |

Source: Expenditure and number in armed forces from IISS (2013).
Other items are from http://www.globalfirepower.com/countries-listing.asp
Countries are ranked according to their military expenditure in 2012

The strategic dilemmas facing the United States in its future relations with China have been recently analysed by James Dobbins, formerly American ambassador to the European

[49] Data from the SIPRI database.

Community and Assistant Secretary of State[50]. He identifies the causes most likely to occasion a China–US military clash over the next 30 years as follows: "changes in the status of North Korea and Taiwan, Sino-American confrontation in cyberspace, and disputes arising from China's uneasy relationships with Japan and India."[51] He goes on to argue that, although the United States still has the capacity to offer direct defence to China's neighbours in the event of a conflict, this capacity will decline as China grows stronger. The United States will eventually be forced to rely on some alternative to direct defence. The aim would be to deter China by threatening some form of escalation, such as a first-strike nuclear attack or a comprehensive economic boycott. The analogy here is with the containment of the Soviet Union in Europe after World War Two. However, there is a problem with such threats. A nuclear first-strike on China would be suicidal for the United States since China could retaliate by using the second-strike force of land and submarine launched missiles that it is now developing. It is hard to believe that the United States would launch a nuclear strike if China were to occupy the Spratly islands, for example. A comprehensive trade war with China could also be damaging to the United States, although it might develop out of a tit for tat escalation.

On a more positive note, Dobbins argues that China is seeking neither territorial aggrandisement nor ideological sway over its neighbours, although he warns that:

> *"A climate of mutual distrust and suspicion clouds the US–China relationship, producing a potent security dilemma. If ignored, this dynamic could spiral out of control. Altering it will require both the United States and China to fundamentally rethink their national security goals and strategic assumptions in Asia and beyond..... As China becomes a true peer competitor, it will also potentially become a stronger partner.....Even as the United States seeks over the next several decades to sustain its defence commitments and advance its interests in East Asia, it will also have an interest in encouraging the world's other emerging superpower to assume greater responsibility for international peace and security. China's efforts to combat piracy in the Indian Ocean, and its growing interest in United Nations peacekeeping, should become the basis for enhanced US–Chinese cooperation. In the long term, the United States will want to look for other ways to leverage Chinese power as well as restrain it"*[52]

There is also the question of failed states. Both Pakistan and North Korea are potentially unstable and either of them may collapse into disorder at some time in the future. If this happens the question will arise as to who controls their nuclear and other weapons of mass destruction, and there may be outside intervention to ensure that these weapons do not fall into the wrong hands. This in turn may lead to intervention by other powers. In the case of Pakistan, the first country to intervene would probably be India or the United States, but this might in turn provoke some form of action by China which can quickly mobilise powerful forces along its disputed border with India[53]. In the case of a collapse in North Korea, the initial intervention might come from South Korea and the United State, although China might well respond by sending in its own forces to prevent a complete take-over of the North by its rivals. In either case, the result of collapse might be a confrontation between the future great

[50]Dobbins (2012).
[51] Dobbins ( 2012) pp. 7-8
[52] Dobbins (2012), p.22
[53] Nair (2013)

powers. This prospect makes it especially important to establish a working partnership between the great powers to deal with such contingencies in a co-operative fashion.

The theme of power-sharing is explored in depth by the Australian military analyst, Hugh White[54]. He proposes a new political settlement in which leadership in Asia would be shared between four great powers: China, India, the USA and Japan. These countries would negotiate agreed ground rules to regulate competition and cooperation between them. They would also establish a framework for the regulation of interstate relations involving other Asian countries. Japan appears as an independent power in this list because, in White's view, a rising China will become increasingly hostile to the present status of Japan as an American strategic client. Conversely, the USA would not tolerate the absorption of Japan into China's sphere of influence. White's vision involves the full-scale re-armament of Japan, including the proposal that Japan should acquire sufficient nuclear weapons to act as a minimal deterrent against a Chinese nuclear attack.[55].

It is conceivable that the USA will gradually scale back its military engagement in the Asia Pacific region, because it is too expensive to compete with China and the region is no longer seen as of vital national importance to America. A precedent for this would be the withdrawal of most British armed forces from "East of Suez" from the 1970s onwards, partly on grounds of expense and partly because British interests in Asia were no longer deemed sufficient to justify a large military presence there. The gap left by the departure of the USA might open the way for China to become a hegemon in the Asia-Pacific region to which other countries in the region must defer. Even if the USA remains a major military power in the Asia Pacific region, China will have a growing influence over its neighbours, if only because of the enormous size of its future economy and its ability to confer economic costs and benefits on these neighbours.

## 8. Concluding Remarks

Despite its large GDP and its newly acquired statues as the world's leading exporter of goods and services, China is still what David Shambaugh calls a "partial power"[56]. It has few truly global companies and the overseas operations of Chinese firms are still small in comparison with those from the advanced economies. In military terms it is no match for the United States on a global level, although is a strong regional power in its immediate vicinity. If China continues on its projected trajectory, Chinese firms will continue their outward expansion and the Chinese military will acquire the capacity to act effectively on a global scale. China will then become a truly global power. The same observations apply to India, although there is more uncertainty about its future growth prospects. Even if it does return to its projected growth path, India will take much longer than China to become a global power.

[54] White (2013)
[55] White (2013), pp. 84-5
[56] Shambaugh (2013)

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# Declining Diversity and Declining Societies: China, the West, and the Future of the Global Economy

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*At a crucial point in the history of human life, imperial China decided to scrap the technology of interoceanic shipping and navigation that, if pursued, might well have converted the central historical scheme of European westward expansion to an alternative tale of Oriental eastward exploration in the New World.*[1]

Stephen Jay Gould (1941-2002), Harvard biologist and historian of science.

Recent scholarship on global history (e.g., Pomeranz 2000; Wong 1997) has criticized the Eurocentric portrait (e.g. Landes 1998) of the long-term backwardness of 'the East'. Pomeranz argued that Europe only superceded China in development around 1700. Most modern scholarship agrees to this new interpretation, but most scholars think the date was earlier by a hunded years or less than the date suggested by Pomeranz. This paper will not discuss *when* the West superceded China, but rather discuss some of the mechanisms as to *why* this happened, and also why Europe seems to be consciously promoting the same forces which weakened China and started a process of decline some 400 years ago.

In this paper we argue that a key element in China's relative decline – as compared to the West – during the 16th to 18th century, lies in the elimination of diversity under a consolidated and centralized regime with few ambitions for territorial and colonial expansion. During the same period, or rather starting in the 1400s, Europe – and later the West in general – experienced a virtual explosion of intellectual creativity and development, the indispensable basis of which we argue was a huge diversity of polities, policies, cultures, contexts, and – consequently – also of opinions. In other words, simultaneously with China's process of de-diversification and falling behind, Europe forged ahead[2] based on an explosion of increasing diversity. Starting with the Renaissance, Europe became a huge laboratory where a plethora of ideas flourished and – to a larger degree than now – this immense number of ideas were allowed to survive and thrive because of the existence of literally hundreds of small states, each with a different economic and cultural context and a different intellectual agenda.

We would argue that the historical record shows that succesful policy making consists not in standardizing policies in all setting – which appears to be the present policy of the European Union – but rather in adapting the successful policies in foreign settings to one's own context.[3] Matching policies to context – e.g. successful indistrialization in anti-pope England to the Papal States in Italy – was the name of the successful game. We even argue that the Renaissance – normally perceived as a monotheistic and Catholic affair – contained an important injection of neo-paganism and polytheism, religious diversity, also by one of its key promoters.

Today's mainstream economics is ill-positioned to handle diversity and its implications.[4] At its very core, in the economic heritage of Adam Smith and David Ricardo stands a *de facto*

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[1] Gould, Stephen Jay, *Full House. The Spread of Excellence from Plato to Darwin*, New York: Harmony Books (Crown Publishers), 1996.

[2] „Falling behind" and „forging ahead" are terms introduced by Stanford economist Moses Abramowitz (1912-2000).

[3] See Reinert, Sophus, *Translating Empire: Emulation and the Origins of Political Economy*, Cambridge, MA: Harvard University Press, 2011.

[4] Reinert, Erik, 'The Terrible Simplifers: Common Origins of Financial Crises and Persistent Poverty in

negation of diversity which is rarely discussed. Smith and Ricardo's perhaps main theoretical achievement was that they created order by converting the enormous diversity both in production and in trade into one single common denominator: *labour hours*. By doing this they sweepingly did away with diversity. At the very core of modern economics, then, stands an "equality assumption" [5], i.e. the absence of diversity.

As Joseph Schumpeter argued, economics faces an eternal trade-off between accuracy and irrelevance. Western economics opted for the accurate but fundamentally counterintuitive level of abstraction – the labour-hour based economics where money is absent – founded by Smith and Ricardo. We all understand that labour hours spent doing surgery in a hospital are qualitatively different from the labour hours spent washing the floors of the same hospital, and that a country inhabited by surgeons would have a higher income than one inhabited by cleaning personnel. In terms of Ricardian logic of comparative advantage, the cleaning personnel would specialize in a comparative advantage in being poor.

However, imperial power and David Ricardo's arguments combined to convince the colonies – including China and Japan – that it was in their interest to let England specialize in manufacturing industry. It was only towards the end of the 19th century, after having signed long-term trade treaties with the West, that the reality of the Ricardian logic was discovered in China and Japan. These trade treaties with the West both in Chinese and Japanese tradition are still called *the unfair treaties*.

This contrasts with 19th century US economics and industrial policy, which was based on an understanding of diversity and hierarchies sometimes expressed through a biblical metaphor: the US did not want to be the 'hewers of wood and drawers of water' (Joshua 9: 21), i.e. the performers of menial tasks, in the global economy.[6] The high level of abstraction in mainstream economics – labour hours – was a prerequisite for making colonialism morally acceptable, i.e. closing the eyes of Westerners and Europeans alike to the fact that your wealth did not depend on what you produced, that free trade was to everyone's benefit.

With modern evolutionary economics (Nelson & Winter 1982) diversity was reintroduced in the profession. So far, unfortunately, this approach has been limited to relatively narrow studies of innovation and studies of innovation systems on the national level[7]. This paper addresses the wider role of diversity *per se*, and although it can not do much more that scratching the proverbial surface, we believe modern economics' failure to incorporate the role of diversity has serious implications. These implications are now becoming visible in a relative decline of the West and the reemergence of China and Asia.

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Economic Theory and the New „1848 Movement", DESA Working Paper No. 88, 2009, in particular pp.2-3.

[5] Reinert, Erik S. 2007

[6] For a discussion of diversity and hierarchy, see Reinert, Erik S. 'Emulation vs. Comparative Advantage: Competing Principles in the History of Economic Policy'. In Cimoli, Mario, Giovanni Dosi and Joseph Stiglitz (eds), *Industrial Policy and Development; the Political Economy of Capabilities Accumulation*, Oxford University Press, 2009, pp. 79-106.

[7] This need for a broader application of evolutionary economic principles, also in development economics, was the logic behind the edited volume by E. Reinert (2004).

We argue that the neglect of diversity for a long time was the basis of standard economic theory, including Ricardian trade theory, and also indirectly of Western hegemony. But in spite of past successes from the application standard economic theory, this theory is now backfiring or boomeranging. The West created a set of economic theories that benefit the world technological leaders, and – as their leadership is now being challenged – should have reverted to a more defensive theory. But the West essentially started to believe in its own propaganda – that comparative advantage and not technological leadership is what counts – and now experiences that its technological leadership is being eroded. [8]

Diversity and the 'evolutionary discovery process' have been crucial to Europe's technological leadership. Eighteenth-century Europe was trying to establish a national 'best practice' from a large number of practices in a large number of different states. By contrast, China's centralization and standardization in the eighteenth century stifled diversity, experiments, creativity and innovation. However, Europe now is losing diversity and becoming 'standardized' and 'homogenized' in a lot of areas from currency to bank supervision to standardization of shapes of cucumbers to research policy, whereas China is becoming a laboratory for different experiments with local reforms. Europe and China appear to be changing places again, just as they did some time during the 17$^{th}$ century.

Diversity is clearly part of nature's strategy for the suvival of species from natural shocks of all kinds, but diversity as a strategy is also consciously employed in so-called "primitive" societies for the same reason. In the high Andes up two twenty different species of potatoes are often planted in the same field. One species survives frost in the flowering season, another sevre drought in the growing season, etc. Among Saami reindeer herders in Northern Fennoscandia the degree of diversity is the most important criterion for the beauty of a herd, and for the same reason. Diversity represensts an insurance policy.

This paper examines and compares the trajectories of the rise and fall of diversity in Europe and China and the implications of such a comparison for the future of global economy. Drawing on the discourses of evolutionary economics, the paper re-evaluates the changing nature of the 'market' and the institutional and legal frameworks created in order to regulate the market. The paper argues that the 'market' is much more than a mechanism setting prices, and that the idea of the 'market' should be extended to being an arena where different ideas, in the form of laws, types of government, efficiency of armaments, and economic policies are compared and tested against each other. This is crucial to the promotion of creativity and innovation and the future of global economy.

**Evolution and Development as Increasing Diversity.**

[8] Se Mathews and Reinert, forthcoming (2013), for a discussion of this as regards energy technology.

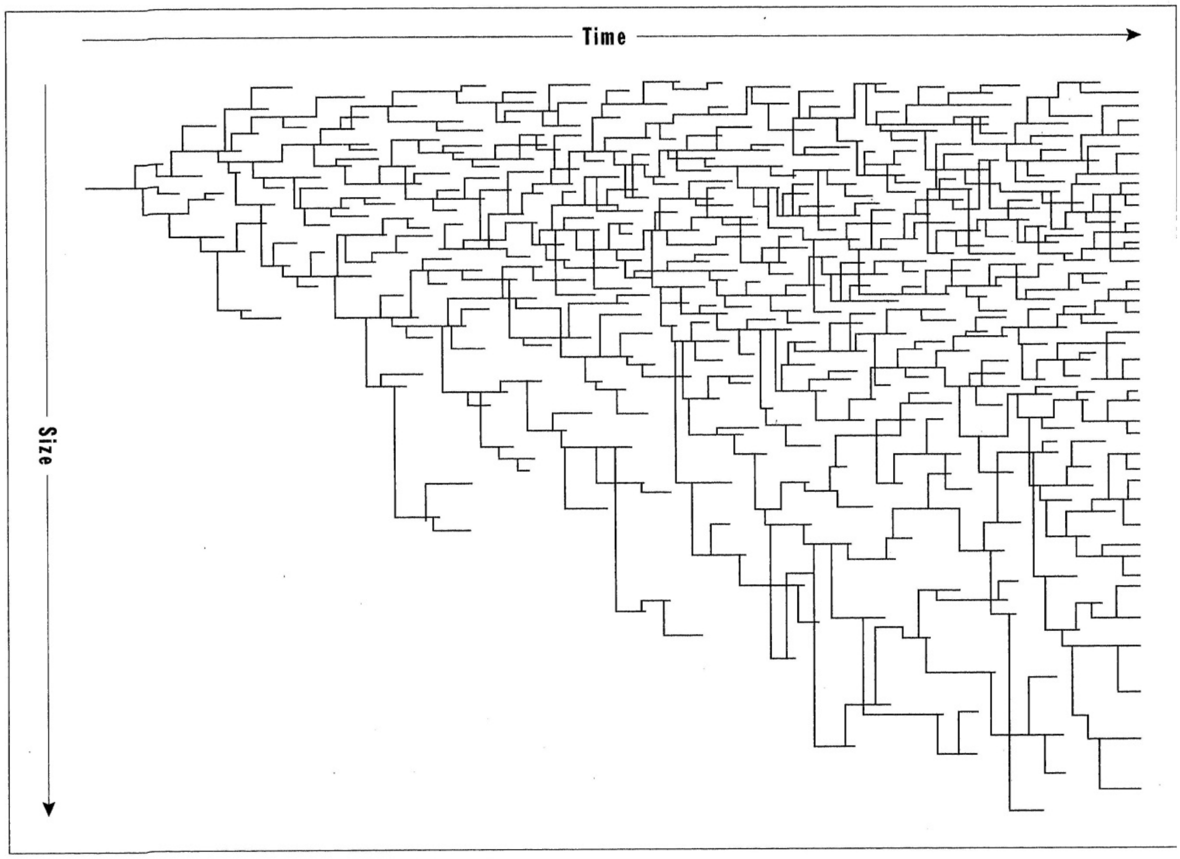


**Figure 1: Increasing Diversity over Time.**

Source*:* Gould, Stephen Jay*, Full House. The Spread of Excellence from Plato to Darwin*, p. 165.

The evolution of diversity may be illustrated through Figure 1, where the process of evolution co-exists with an increase of diversity in terms of biological species. The process starts from a common founding member at the left wall of the drawing. The founding members of a species are unspecialized, in the sense that they can tolerate a wide range of climates and habitats. As the evolution evolves randomly, more specialized species appear, some of them very large, those indicated in the right part of the drawing. One example of such a specialized species is a Chinese panda which can only survive on one species of bamboo. With this Gould proposes world history as a "history of expanding variation" (p. 169).

Transferring this picture to economic diversity, each end point represents a technology and / or a product.[9] End points that do not reach the right-hand side of the drawing are products, or technologies, that no longer exist. Near the left wall life and technologies are necessarily simple. One cannot suggest that a lion sprang out of the primeval soup, bacteria had to come

[9] This drawing was first used for the purpose of explaining economic diversity in a 1996 paper written in Norwegian.

first. Likewise, you cannot expect the Information Age to precede the Stone Age.[10] Gould discusses the differences between biological and technological evolution, and argues that a main difference obviously is the speed with which technological evolution proceeds.

Let's say that the single starting point, on the far left in the drawing, of the wine industry is the recognition that fermenting grapes produces wine (*unspecified* wine to use Gould's terminology). Then diversity is introduced, there are green and red grapes which may be fermented – with or without skin – and then three varieties of wine appear: red, rosé, and white. Adding a multitude of grape varieties that develop over time – spontaneously and as results of conscious breeding – employed in a huge amount of contexts (microclimates) yield an enormous variety of wines. The grapes grown on one side of a small hill in Piedmont in Italy would have one famous trade name, the same grapes grown on another side of the same hill will be known under a different name.

Attempting to avoid the miserable state of 'perfect competition' – where no money is made – market economies produce great diversity. A standard supermarket in the United States may stock 30.000 different items. While present-day economics pays scarce attention to this phenomenon of diversity, it is extremely important to note that early economists, starting with Botero (1589) and Serra (1613 /2011) saw this increase in diversity as being the key to wealth creation and to bringing about the wealth of the cities (Serra 1613 / 2011).

The argument is picked up almost 200 years later by Adam Smith under the heading of 'division of labour', but one can justifiably ask what role the division of labour plays in today's economics. After all economic activities became alike – reduced to labour hours – the division of labour became irrelevant. When increasing and diminishing returns were eliminated from mainstream economics in the 1930s – in order to make room for equilibrium – Serra's point from 1613 disappeared: that increasing returns under a large division of labour was the key to wealth and that diminishing returns was the key to poverty.

In 1841 German economist Friedrich List described the connection between diversity and political freedom like this:

> "This is why the population of an industrialized society is brought together in a few conurbations in which are concentrated a great variety of skills, productive powers, applied science, art and literature. Here are to be found great public and private institutions and associations in which theoretical knowledge is applied to the practical affairs of industry and commerce. Only in such conurbations can a public opinion develop which is strong enough to vanquish the brute force, to maintain freedom for all, and to insist that the public authorities should adopt administrative policies that will promote and safeguard national prosperity. ..."

[10] German economist Karl Bücher (1847-1930) was the foremost represenetative of a now defunct tradition of economics which united the study of technologies to the study of ever-increasing size of economic units, from tribal economies to the global economy, through various stages. For a discussion, see Reinert 2000.

**Standardization – for and against.**

Standardization creates technological progress increasing the size of the market. However, traders in Early Europe faced an enormous number not only of tariffs, but also an enormous variety of standard measures varying from city to city. An early 16th century volume (Pasi 1521) is a handbook comprising more than 200 pages attempting to serve as a guide for the bewildered tradesman. For example, the *Brenta* was a volume for liquids in both Switzerland and Italy, but in spite of the name being the same, the size of this varied considerable from town to town. It Renaissance Italy the length measurements were shown by metals attached to the church wall, so both travelling salesmen and resident customers could consult.

In the 20th century mass production standardization was the key to wealth, both Western capitalism and communism were based on this principle of Fordist mass production. In that sense communism and capitalism were isomorphic, they employed the same productive principles under politically very different regimes. It may indeed be argued that a communist planned economy on a large scale was only possible under the Fordist paradigm, when the number of different products the system had to handle was limited. It may be argued that the timing of the collapse of the Soviet system was probably also a result of the transition from the Fordist mass production paradigm – with few final products – to a techno-economic paradigm based on information technology, flexible production, and a plethora of final products.

Carlota Perez describes the challenges form Fordist mass production to the present production paradigm as follows:

> 'The very essence of the mass production paradigm was homogenization. The more you could standardize consumption patterns and the greater the mass of people involved, the more you could increase productivity and the higher the standard of living you could hope to attain for the majority. The blue uniform of Mao Tse Tung's cultural revolution was only an extreme case of Ford's original dictum "you can have any color, as long as it is black". So egalitarian ideas were strongly backed – probably unconsciously – by the nature of the emerging potential for wealth creation and "felt" more realistic the more this potential came to be understood.
>
> By contrast, the presently diffusing information technology paradigm seems to thrive in diversity and differentiation. Both the adaptable nature of microelectronics technologies and the flexibility of the modern organizations allow astonishingly high levels of productivity while handling diversity. Changes in product mix, in quantity and quality, modifications to models or adaptations to customer requirements can often be made automatically. Differentiation in products and markets is seen as the route to maximum value creation (even if increasing the volume of each segment is also profitable). There are tens of thousands of little "niche" markets that are comfortably accommodated by the distribution channels. The unconscious ideal which guides product and market segmentation is that of a "personalized service".

> All these trends towards variety would suggest that egalitarian ideas have a much weaker footing. But this need not be an obstacle for the construction of an effective solidarity program. Indeed, the present form of differentiation by income levels is not the only one possible. An alternative and socially welcome differentiation can take place "horizontally", by multiple life-styles, fostering the flourishing of national, occupational or other characteristics and identities; where people are proudly different and socially recognized as of equal value. The most varied ways of living can provide equivalent levels of satisfaction, inside countries and across the planet, while creating favorable conditions for dynamic wealth generation through the flourishing of diversified worldwide production..'[11]

The question here is if Chinese market-leninism might be doing a better job than European capitalism in the transition described above. Both the traditional and the contemporary Chinese governance system tell us that there are often confrontations and tensions in the relationships between the central government and the localities.[12] Although the pre-1978 Chinese economy is generally labelled as one of 'central-planning', decentralization in China has some roots dating back to the 1950s, in particular in the latter years of the first Five-Year Plan (1953-1958).[13] At that time the efficiency of vertical administration was constrained by the variations in China's geography, transportation conditions and communications capacity.[14] So unlike the former Soviet Union, where the strong vertical administration sidestepped local governments and allocated plans directly to enterprises, 'the Maoist system decentralized economic and administrative power to the localities', and most of the reform initiatives were from the 'bottom up'.[15] As a result, the power of provinces was expanded, and the control of a large number of industrial and commercial enterprises was transferred to the hands of local management.[16] Although decentralization in the 1950s did not change the entire central-planned scheme in the pre-1978 era, this kind of decentralization increased a certain degree of economic power at the local levels that survived into the 1960s and 1970s.

In the process of marketization in the post-1978 era, the authority of the Party-state and the centralized control of Beijing have declined further, and the political and economic powers have been gradually devolved in practice to local governments. While the centre still has political control over the local through the system of party-sanctioned appointments of officials, its fiscal capacity went into decline. Decentralization is also manifested in law-making. As Perry Keller points out, 'the Chinese legal order therefore effectively remained split between the formal legal powers of the NPC, which symbolized the unitary nature of the state, and the administrative power of the central and … [provincial] bureaucracies to issue

[11] Perez, Carlota, 'The Social and Political Challenge of the Present Paradigm Shift', Oslo: Norsk Investorforum, Working Paper No. 5, 1997. Downloadable on http://carlotaperez.org/papers/1-thesocialandpolitical.htm#9
[12] For the central-local relationship and China's governance system, see Ting Xu, *The Revival of Private Property and Its Limits in Post-Mao China* (London: Widey, Simmonds and Hill Publishing), 2013, forthcoming).
[13] See Lardy, *Economic Growth and Distribution in China*, 3-4.
[14] See ibid, 20.
[15] See Jean C. Oi, 'The Role of the Local State in China's Transitional Economy', *The China Quarterly*, no. 144 (1995): 1134.
[16] See Lardy, *Economic Growth and Distribution in China*, 33.

and enforce normative documents'.[17] The term 'federalism' has been widely used to characterize the changes that have taken place in the Chinese polity.[18] Scholars have described (albeit in different ways) the nature of the decentralization from the central to local governments in contemporary China as quasi-federal or simply, federal,[19] although the Chinese political and legal systems lack the institutional infrastructure of 'constitutional federalism' and local governments in China do not have 'formal political [and legal] autonomy *vis-à-vis* the centre'.[20] Some scholars argue that the de facto federalism that has taken place is market-preserving and underpins economic growth in China.[21]

In the process of decentralizing power from the central government to local governments, the previously assumed 'zero-sum model' of the relationship between the centre and the local is no longer sufficient.[22] First, local governments have developed various kinds of strategy to cope with the central government in decentralization. In this sense, rather than preserving and stimulating the market, 'federalism' has also set up barriers to marketization. For example, local protectionism involved 'the illicit and irregular use of administrative controls by local governments to interfere with the flow of commodities between localities'.[23] Huang Yasheng also demonstrates that domestic capital mobilizing across regions in China is very low.[24] Secondly, some scholars also remind us of the possible check function of local governments. For example, various kinds of reform have conducted across different regions in China. In the wake of the Tiananmen Square crackdown in 1989, the centre could not bring these local reforms to a halt and restore the central planning completely, due partly to the resistance of local leaders.[25] Thirdly, regional inequality and variations should also be taken into account when examining the transformation of the governance system.[26] Nevertheless, this kind of 'involuntary' decentralization has promoted a certain degree of diversity in China especially in the area of economic policy. For example, since the 1980s, Special Economic Zones have been set up including Shenzhen, Zhuhai and Shantou in Guangdong Province, Xiamen in Fujian Province and the entire Hainan Province. They enjoy special economic policies and more power in making governmental decisions. The first auction of land use rights was done in Shenzhen on 1 December 1987, although this practice obviously contravened the

[17] Perry Keller, 'Sources of Order in Chinese Law', *American Journal of Comparative Law* 42, no. 4 (1994):, 723. See also the Legislation Law of the PRC (2000).
[18] See Goldstein, 'China in Transition': 1127.
[19] See e.g., Cao, Qian and Weingast, 'From Federalism, Chinese Style to Privatization, Chinese Style'; Huang Yasheng, *Inflation and Investment Controls in China: The Political Economy of Central-Local Relations During the Reform Era* (New York: Cambridge University Press, 1996); Tsai, 'Off Balance': 4.
[20] See Tsai, 'Off Balance': 4.
[21] See e.g., Qian Yingyi and Barry R. Weingast, 'China's Transition to Markets: Market-Preserving Federalism, Chinese Style', *Journal of Policy Reform* 1 (1996): 149-185; Qian Yingyi and Barry R. Weingast, 'Federalism as a Commitment to Preserving Market Incentives', *The Journal of Economic Perspectives* 11, no. 4 (1997): 83-92; Barry R. Weingast, 'The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development', *Journal of Law, Economics & Organization* 11, no. 1 (1995): 1-31. There are also critiques on this arguement that it is rather 'market-thwarting federalism', see Kellee S. Tsai, 'Off Balance: The Unintended Consequences of Fiscal Federalism in China', *Journal of Chinese Political Science* 9, no. 2 (2004): 1-26.
[22] See generally, Linda Chelan Li, *Centre and Provinces—China 1978-1993: Power as Non-Zero-Sum* (New York: Oxford University Press, 1998).
[23] Wedeman, *From Mao to Market*, 17.
[24] See Huang, *Selling China*, 66.
[25] See Huang, *Inflation and Investment Controls in China*, 1-2.
[26] Yang Dali, *Beyond Beijing: Liberalization and the Regions in China* (London: Routledge, 1997), 137-139.

Constitution; four months later, on 12 April 1988 the constitution was amended to allow the transfer of land use rights (Clause 4 of Article 10). The Chinese government has recently annouced its decision to open a Free Trade Zone in Shanghai with the aim to attract foreign investment and to boost the economy.[27]

Yet, the extent of diversity in China should not be exaggerated. China still lacks a 'market' of ideas which, in our view, is the key to the examination of the question whether China is 'forging ahead'. The Chinese government has the ability to mobilize a significant amount of resources and money to invest into high tech. For example, China is now taking the lead by developing renewable energy and building its 'green economy'.[28] Human capital is accumulating rapidly – the number of the science and engineering degrees granted by Chinese universities is now comparable to US total. Yet the US (now has superseded Europe as a global superpower) remains the ideal place for the Chinese elites to further their studies and to enhance their academic or professional careers. According to the figure from a survey by the Oak Ridge Institute for Science and Education in Tennessee, ninety-two percent of the Chinese who gained a PhD in science and engineering in 2002 were still in the US in 2007.[29] The US continues to retain the best and the brightest Chinese students. Within China, becoming a civil servant, similar to the situation hundreds of years ago, remains the number one career choice for university graduates. Pursuing alternative careers in science and engineering or in private business sector seems less attractive. Chinese universities are still being run as government bureaus. Directors of universities hold governmental ranks. Space for free academic discussion and diverse modes of thought is still limited. Many scholars still function in the 'velvet prison'. [30] Similarly, many high-tech and innovation schemes are still directed by the top-down approach. There are also many obstacles to entrepreneurship and innovation. For example, it is still difficult for small-sized private enterprises to access bank loans.[31]

Standardization sometimes presents a dilemma. One the one hand it is clear that standardisation of measures and technological platforms allows for mass production. This is why the lack of standardization in Renaissance Italy – the most progressive country at the time – to some extent comes as a surprise. It is e.g. clear that early bandwidth standardization for cellular telephony achieved by the telephone companies in the Nordic countries was key in giving Nordic producers like Nokia and Ericson a technological advantage to run down the learning curve and capture volume and market share. On the other hand, not adhering to international standards may protect a country. Russia, having a different railway gauge from the rest of Europe, delayed invasion by rail and Switzerland, not adhering to building

[27] See http://news.xinhuanet.com/english/china/2013-08/27/c_132667878.htm (accessed 27/08/2013).
[28] Mathews, John and Reinert, Erik, 2013, 'Renewable, Manufacturing and Green Growth: An Energy Stragety Based on Capturing Increasing Returns', *Futures* (forthcoming).
[29] http://www.universityworldnews.com/article.php?story=20100305112257670 (accessed 21/05/2012).
[30] Miklos Haraszti, *The Velvet Prison: Artists under State Socialism*, trans. Katalin Landesmann and Stephen Landesmann (New York: Basic Books, 1987).
[31] See Ting Xu review on Martin Jacques. *When China Rules the World: The End of the Western World and the Birth of a New Global Order*, 2nd edition. London: Penguin Books, 2012. *LSE Review of Books*, available at http://blogs.lse.ac.uk/lsereviewofbooks/2012/06/16/when-china-rules-the-world-martin-jacques/#more-3286, published on 16 June 2012.

standards (e.g. widths of household equipment), efficiently protected its own producers by erecting high barriers to entry for foreign producers of refrigerators, stoves and washing machines.

Stephen Jay Gould dreads the lack of variety in modern society: “In a society driven, often unconsciously, to impose uniform mediocrity upon a former richness of excellence – where McDonald’s drives out the local diner, and the mega-Stop & Shop[32] eliminates the corner Mom and Pop – an understanding of full ranges as natural reality might help to stem the tide and preserve the rich raw material of any involving system: variation itself” (Gould pp. 229-230).

Like so many entities diversity comes with qualitative attributes. We may also have to distinguish between superficial diversity and real diversity. Superficial diversity may refer to having access to 10 pieces of art by the same artist or 20 different breakfast cereals in your local supermarket versus possessing 10 pieces of art from 10 different centuries or 20 different technological solutions for the production of energy. What is required are fundamental differences, fundamentally different approaches like different general purposes, technologies.

Our fear is that the European Union project fails in its balance of diversity, a failure which is a residual of 20$^{th}$ century Fordist thinking. There are arguments for standardizing vegetables – like the curvature of cucumbers – but standardizing fruit and vegetables also tends to deprive them of, yes, diversity. There are arguments that nations converging in a process UNCTAD once called “symmetrical development” could indeed benefit from a single currency. That was the original plan for the Euro – a currency for symmetrically developed core countries – and the key problem of the EU today is that the diversity between the strong core economies – which would have benefitted from a common currency – and the rest was not observed. Peripheral EU countries, like Italy and Greece, were still under inflationary pressures which had a political origin. To stem the pressures of the political extremes, these governments – like traditional democratic governments in Latin America – tended to spend more money that they had. Inflation had been the price to pay in order to achieve political stability, and devaluations represented the safety valve of the system. Joining these peripheral countries in a currency union with the economically strong countries – not observing this crucial difference – lies at the core of EUs problems today. In other words, not understanding diversity lies at the core of Europe’s problems.

Unifying research projects under huge umbrellas is probably not a god idea for several reasons. Serendipity – discovering what you did not look for but which is more interesting than what you looked for – may be lost. There is also a risk that interesting projects which do not fit under the verbal umbrellas that happen to be in fashion in the research bureaucracy never get funded. Decentralizing research programmes – which will come to follow different paths and grow apart – may prove more successful.

[32] Today the example would have been Wallmart.

Close observers of the growing eurobureaucracy also comment to the elitist and non-integratory way this bureaucracy is being developed. Being isolated in Bruge, Belgium, the European College is an example of regional policy, but rather than bridging diversity it seems likely that this will develop an isolated and self-contained eurobureaucracy, of the kind the new European parties – The Five Star Movement in Italy, UKIP in England, and Allianz für Deutschland in Germany– are loathing.

**Monopolies of Power vs. Diversity and Balance of Countervailing Powers.**

The history of Florence reveals an apparently inconsistent political model. Florentine society balanced between oligarchy (the Medici family), corporatism (*la signoría*) and democracy. Perhaps also here the blend – the apparent lack of a coherent model – in fact not only represented a strength but was a key success factor. Maybe – in the name of diversity – all these three models of governance have their advantages.

Before democracy, Europe went through what might have been close to a mandatory passage point of Enlightened Despotism, typified by the 18th century Enlightenment rulers. The problem with this system is of course that despotism rarely remains enlightened for a long time. However, the presence of enlightened philosophers was in itself a sign of prestige for which rulers strived, and their influence on 'despotism' was strong.

The corporatist dimension guaranteed a diversity of representation across professions.[33] Being elected through balloting for only two months at the time, the government of Florence – the *signoría* – was protected against the economic interests of a single economic and political group. The nine members of the *signoría* were required to consult with experienced specialized bodies (for instance for trade or war), but the main continuity of the Florentine political system was in the hands of the professional guilds, not – as it would have been under a democracy – by individuals. The fact that the financial sector, banks, was only one of the nine members of the *signoría* would presumably have prevented the financial sector from achieving the power it has now achieved in the West.

As the *signoría,* Enlightened Despotism was also expected continuously to consult with the wisdom of the age. We can use Sweden as an example. During what in Swedish history is dubbed "The Age of Greatness", the Swedish monarchy imported key European intellectuals. Dutchman Hugo Grotius (1583-1645), generally considered the father of international law, became a Swedish citizen and served as Sweden's ambassador to Paris from 1635. Philosopher Rene Decartes (1596-1650) went to Sweden on the invitation of Queen Christina in 1749, but died there of pneumonia the next year. German philosopher Samuel Pufendorf (1632-1694), of Natural Law fame, became a professor at the university in Lund and stayed in Sweden from 1668 to 1688. It is important to notice that the import of this illustrious foreigner was part of a nationalistic campaign: the University of Lund had been re-founded in 1666 as part of an attempt to swedify a recently acquired territory. The same cult of foreign knowledge – rather than of foreign capital – in order to increase national strength was at the

[33] Najeemy, John M., *A History of Florence, 1200-1575*, Malden, MA: Blackwell, 2008.

core of Elizabethan England[34]. Still in the tradition of Giovanni Botero, strengthening the nation meant increasing diversity through the employment of foreigners.

Indeed one of us has argued that one representative starting point for European civilization was the shift from venerating the bodies of religious Saints to venerating the bodies of dead philosophers. This can be exemplified with the brave and violent leader of the Venetian forces against the Turks – Sigismondo Malatesta, *the Mastiff of Rimini* (1417-1468) – who wanted to bring prestige to his native Rimini by bringing home the body of Plethon (Georgius Gemistus) (1389-1464) from the Peloponnese. [35]

If we are to pinpoint one politically related event which started the Western Renaissance, the best candidate is probably Plethon's lectures in Florence which caught the attention of the ruler – Cosimo de Medici the Elder (1389-1464). Plethon's presence in Florence led to the revival of Greek knowledge in Western Europe. The fact that Plethon himself was an adherent to polytheism – the cultivation of a pantheon of many Gods – also partly explains why the Renaissance did *not* reinforce the role of the Catholic Church, but rather increased diversity by bringing back competition from gods and beliefs of the past.

As the art of the period so wonderfully testifies – e.g. in the paintings of Sandro Boticelli (1445-1510) – the Renaissance brought back the primitive gods and joys of life from the pantheon of Greek gods and their Roman counterparts. From Giovanni Botero's cult of the diversity of nature and culture to Plethon as the philosopher who created the political spark behind the Renaissance, the key aspect – indeed a mandatory ingredient of the European Renaissance – was an increase in diversity.

This stands in sharp contrast to China starting from the Ming period (1368-1644), which was subject to the opposite phenomenon, a decrease in diversity combined with an entrenched orthodoxy, public administration and law and order. China was losing the diversity that existed in the Tang-Song period (618-1279) which has been recognized as the most prosperous period in Chinese history based upon cultural pluralism and the generation and diffusion of useful knowledge (proto science and technology) among cultural, intellectual and business networks. However, this efflorescence in Tang and Song China ended in a state of equilibrium. Cultural pluralism was superseded by unity.[36] Although Neo-Confucianism at its early stage engaged in debates with other modes of thought, it matured into state orthodoxy under the Yuan (1271-1368) and Ming (1368-1644) dynasties. Contemporary China now faces the same problem – the lack of cultural pluralism and the equilibrium state in its economic development. Whether there will be a transition from the economic and geopolitical 'great divergence' to the 'convergence' between China and the West and China's eventual

[34] Yungblut, Laura Young, *Strangers Settled Here Amongst Us: Policies, Perceptions, and the Presence of Aliens in Elizabethan England,* London: Routledge, 1996.
[35] For a brief discussion of Plethon and Malatesta and the role of diversity, see Reinert, Erik S. 'Emulation vs. Comparative Advantage: Competing Principles in the History of Economic Policy'. In Cimoli, Mario, Giovanni Dosi and Joseph Stiglitz (eds), Industrial Policy and Development; The Political Economy of Capabilities Accumulation, Oxford University Press, 2009, pp. 79-106.
[36] See Ting Xu, 'Efflorescence in Tang-Song China', URKEW Working Paper, available at: http://www.lse.ac.uk/economicHistory/Research/URKEW/papers/Ting.pdf,

'forging ahead' will largely depend on whether China could continue promoting diversity and break through the equilibrium state.

This is not to say that all Italian city states of the Renaissance were based on the same political model as Florence. Also in Venice the corporatist – profession-based – element of power and rule was important (the Venetian guilds were called *Corporazioni*). The *de juris* ruler of Venice – the Doge – was elected in an extremely intricate process insuring the absence of corruption, verging on paranoia in its absurd complexities, but the power of the Doge was very limited. Not even able to leave Venice without the consent of the Senate, the Doge was normally a professional businessman who virtually had to give up his business when he was elected. Being a Doge was a duty to the Polis, so Venice is probably the political system which has come closest to the old wisdom of giving power only to those who do not want it. In this philosophy wishing power automatically disqualifies one from public office. Limited by the political power of the guilds, the composition of the Venetian senate was sufficiently open to new powerful players to create a *circulation of elites* in Pareto's and Schumpeter's sense. Both the Florentine and the Venetian systems were created with built-in checks and balances, to achieve – in John Kenneth Galbraith's felicitous term – a balance of countervailing powers. In both states a very large number of citizens served in the government bodies for very brief periods. Again, diversity was a key element in governance.

The key element in the growth of European welfare, however, was that literally hundreds of different states – each exhibiting more or less despotic tendencies – were in intense competition in war, in luxuries and in intellectual prowess.

In the United States antitrust laws, starting in the 1890s, and the 1934 Glass Steagall Act are examples of laws consciously acting to maintain the diversity which is the basis of competition and of the reduction of vulnerability. The Glass-Steagall Act decision that no US bank could have offices in more than two federal states is a crystal clear recognition that the diversity of banks – having a large number of banks – is the best insurance policy against financial crises. After the abolition of the Glass-Steagall Act, the crisis that started in 2007 has proved beyond doubt how wise this legislative emphasis of diversity was. It should be noted that the Communications Act of 1934 similarly limited the number of newspapers and radio stations that one company or group of companies could own. This was a parallel decision to maintain diversity, also in this case in order to save democracy.

**How Lack of Diversity Stifles Development.**

Not only is technological change a very undemocratic process, it is also often not very well understood even by the people who are very close to what is happening. Before the advent of electrical light, people who would have been consulted as to what direction research on lightening should take would probably have suggested inventing a kerosene lamp that produced less black soot. On the other hand, Chinese water clocks are an example of a dead-end technological trajectory, one of the lines that never reached the right hand wall in Figure 1. The alternative to the water clocks, mechanical clocks, were invented in the West.

An important feature in the history of technology is that even the persons near the inventions did not initially see their full potential. The steam engine was initially just seen a pump for drawing water out of mines, and in the early days microprocessors only found use in hearing aids.Werner von Siemens never thought electricity would be used in homes, and in 1943 IBM's chairman Thomas Watson thought there might be a world market for five computers.

So it is important that many more ideas than those which in the end succeed are being promoted. All organisms tend to produce more offspring than can possibly survive, a process which Darwin gave the name 'superfecundity'. These offspring are not all alike. On the average the members of a species that do survive will be more fit to survive the ruling conditions than those who do not survive. Similarly, a human society which produces a superfecundity of ideas and approaches to solving problems – as did Europe during the Renaissance – will by definition also produce many more solutions which will be tried out in government offices and by market actors. A society which is content with things the way they are and only perpetuate the ideas on which present status quo is founded will block the superfecundity that is at the root of the selection mechanisms behind progress. So, almost by definition, the centralization policies of the European Union would tend to limit the superfecundity of ideas.

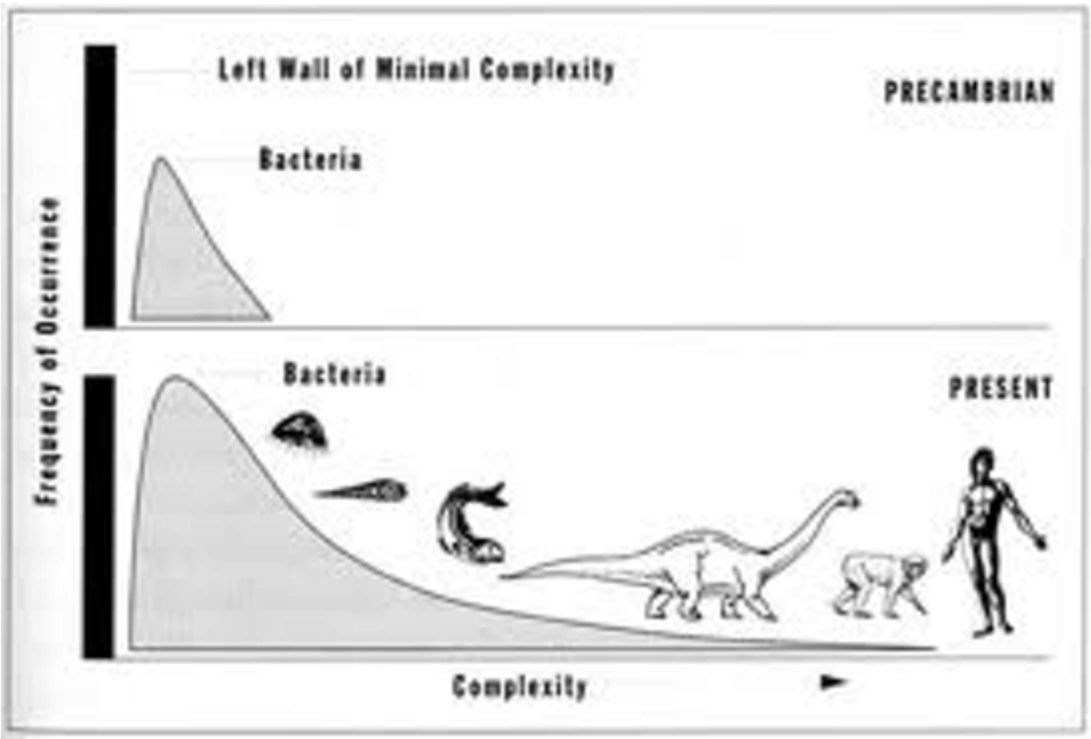


**Figure 2. Low Complexity vs. High Complexity Evolutionary systems.**

Source: Gould, Stephen Jay*, Full House. The Spread of Excellence from Plato to Darwin,* p. 171.

In figure 2 we again find the left-hand wall where evolution begins. From here the Age of Bacteria evolved into the Age of Invertebrates, followed by the Age of Fishes, Reptiles, Mammals, and finally, The Age of Man. If we draw a parallel to the subsequent periods within the Age of Mankind, of Stone Age, Bronze Age, etc, developing into what Christopher Freeman and Carlota Perez have called techno-economic paradigms.

In spite of so many early technologies actually having been developed in China first – from gunpowder and paper currency to movable type printing[37] – it was Europe that led the world into the Industrial Revolution. It is also normally accepted that the science and art of public administration was first perfected in China.[38] We argue that a key explanatory variable here was the presence of diversity in Europe and the absence of diversity in China at the time. Because of its lack of diversity, China got stuck in what Gould calls a low-complexity system. The superfecundity that creates the many alternatives from which selection of technological solutions takes place was stopped. The lack of superfecundity, and a parallel diversity of national approaches in which the selection takes place, would tend to keep societies in the simple 'bacterial' mode. The rare events – or mutations – which produce the great leaps forward will simply not be present.

The extreme centralization of China severely diminished diversity and caused society's decay into a low-complexity system. On the other hand, starting in 15th century Italy a ferocious European inter-state competion in war, luxuries and art made the continent into a high complexity system[39], into a large scale laboratory where thousands of ideas – for everything from war machines to water wheels – were continuously tested against each other.

One sad conclusion may be that China's lack of geographical expansionism – its peacefulness – may have contributed to its decay. Two decisions stand out here: 1. The decision to discontinue interoceanic shipping after the disasterous naval expedion against Japan in 1371 and 2) the decision to pay the Mongols not to attack rather than fight back under the Song (960-1279) ( the role of the Chinese Wall was to protect from this invasion).

As David Landes wrote once, the two alternative explanations of the supremacy of the West tend to be either that "we (the West) are so good and they so bad; that is we are hardworking, knowledgable, educated, well-governed, efficacious and productive, and they are the reverse". The other story is that "we are so bad and they so good: we are greedy, ruthless, exploitative, aggressive, while they are weak, innocent, abused, and vulnerable". From the perspective of this paper, both explanations have an element of truth in them. At the root of China's falling behind and the forging ahead of the West lies a key element of diversity, partly attributable to China's lack of expansion and desire for peace (i.e. paying the Mongols not to attack) and the diversity of the myriad of European nations competing not only in intellectual prestige – e.g housing competing philosophers – and in luxury, but also competing among themselves in war.

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[37] See Needham 1956.

[38] For a discussion, see Drechsler, Wolfgang, „Three Paradigmes of Governance and Administration: Chinese, Wester, and Islamic", *The Other Canon Foundation and Tallinn University of Technology Working Papers in Technology Governance and Economic Dynamics*, No. 50, 2013.

[39] See Sombart 1913a and 1913b for an early statement of this.

As Europe and the West now are becoming the laggards, the military activities of the West are accompanied by falling wages at home, while China seems to be gaining a technological edge in key areas like energy under strong wage growth. That the West fails to understand why Europe and the US got rich – not through free trade but through emulation and national competition in production[40] – may constitute an important stumbling block for the future, as the West may have to protect its industries in order to protect its living standards. It is also in the interest of China that purchasing power in the US and Europe does not fall.

**The Political Implications of the Need for Diversity – or, reinventing the spirit of Giovanni Botero (1544-1617).**

The European reaction to the rest of the world as it became known, starting with the Renaissance, was initially the opposite of later eurocentrism. The most famous of the Jesuit fathers who went to China was Matteo Ricci (利瑪竇) (1552-1612), who not only translated the Bible into Chinese, but also the writings of Confucius into Latin. This idea of mutual respect and reciprocity – the latter a term we know from so called 'primitive' societies – was an intellectual hallmark of early European contacts with China which continued through most of the European Enlightenment until the decade of the 1770s. This decade saw both the expulsion of the Jesuits from Latin America and from China, where they –as good anthropologists – came to be seen to identify too much with the native population and were in the way of European expansion as it became increasingly imperialistic.

Giovanni Botero, a contemporary of Matteo Ricci and also a Jesuit, became a very early economist and social scientist. The places of his early publications – Würzburg (Germany), Cracow (Poland), and Milan – testify to the pan-European nature both of the church and of academic life at the time. In spite of the laudable programs for student exchange in Europe – like the Erasmus Programme – the percentage of foreign students at European universities were bigger at the time of Ricci and Botero than it is today.

Botero not only was the first scientist to observe the importance of diversity for the creation of wealth (*Sulle Grandezze delle Cittá*, 1589), he was also the first to produce a general description of the nations of the world (*Relazioni Universali*, 1599). Botero's description of the different countries and cultures of the world reads like a celebration of Nature's diversity. The Lapps in Northern Scandinavia are celebrated for their ability as archers, their ability to make boats without nails, and for having the fastest means of transportation in any culture, the reindeer sleigh on snow. How sadly different is the European attitude to their remaining aboriginals today! The key element here is not any loss of a "romantic" view of other cultures, it is the lack of respect for diversity, as if the Fordist cult of standardization had become a permanent feature of Western culture. Individual diversity is tolerated and even encouraged, but in the West a left-over of the 20th century Fordist mind-set is that tolerance is often based on 'we are all alike' instead of 'we are all different'.

[40] See Reinert, Sophus, *Translating Empire: Emulation and the Origins of Political Economy*, Cambridge, MA: Harvard University Press, 2011

Botero writes on China with the same respect he gives to aboriginal culture like the Lapps, but he marvels at the immense size of the country, its '70 million inhabitants', the land and irrigation, the "marvellous industry", and the fact that nothing gets wasted ("not a palm of land nor a gram of product"). "There is no country (on earth) who studiously better manage their government, and which have better organized the punishments and the bounties" says Botero.[41] The generalized admiration of China which was found in European culture until around the 1770s is not generally known today.[42] At the time the admiration for China was much more marked in France and Germany than in England.

We now potentially face a situation where the West apparently is falling behind in inventing, just as China was in the 17th century, and the roles will again be reversed. If, at the same time, the West aims at dominating the world created in its own partly anachronistic and Fordist image, this will lead the wrong direction. Western dominance grew in the age of the Havana Charter (late 1940s to late 1970s) when Third World nations were encouraged to industrialize. This would have created a world of symmetrical dependence, and potentially of mutual respect. Presently Western political power is bound to decline if the West insists that the rest of the world shall emulate its political structure without allowing this rest to emulate its economic structure (as was possible during the rule of the Havana Charter). The Havana Charter came to an end when neo-liberal economics gained the upper hand, reintroducing context-free and diversity-free Ricardian economics, and particularly trade theory. Having kept an industrialization strategy in place since the late 1940s, India, China, and other East Asian countries form an exception from the rest of the Third World. Under these diverse circumstances it is high time the West brings back an understanding of diversity – that economic structure will be reflected in political structure – and that the prospects of a Western dominated *Globalistan* [43] are far from tempting to many. In this sense understanding and respecting diversity is a precondition peace.

This paper starts with a quote from Stephen Jay Gould's book *Full House*. Towards the end of this volume Gould – perhaps the most celebrated biologist of the last generation – states that his model "does teach us to treasure variety for its own sake"[44]. This should be our goal across a whole range of fields, from political diversity and cooperation between equals, to research and the preservation of biological diversity. Having lost diversity as China once did, we fear that the West will be losing out to China in a similar way that China lost out to Europe 400 years ago.

If a goal is both to eradicate world poverty and to prevent the West from gradually declining into a society with an economic structure that once characterised feudalism – huge differences between a wealthy few and the poor masses – we must rediscover how the West once managed to develop in symmetrical diversity, while at the same time China declined. Understanding this it will also be understood that it is not in the interest of any of the parties that the West be deindustrialized.

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[41] *Relazioni*, 1622 edition, pp. 106-107.
[42] For an overview, see Maverick, Lewes A. *China as a Model for Europe,* San Antonio: Anderson, 1946.
[43] Escobar, Pepe*, Obama does Globalistan*,
[44] Gould, *op. cit.*, p. 229.

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# Income Inequality in an Era of High Growth: the Indian Experience

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ABSTRACT

In recent years, the discussion on India, particularly among economists, has concentrated on the high rate of economic growth. During the Tenth Plan period, 2002-2007, per capita income (net national product) grew at 10.7 per cent per annum at current prices and 6 per cent per annum at constant prices, as compared to 3 per cent during the Ninth Plan period (the previous five years).

I would like to raise two concerns in this paper. First, per capita income of India still remains very low, and much lower than countries with whom a comparison is made, including China. The euphoria with the rise of the South and the BRICS (Brazil, Russia, India, China, South Africa) countries, in particular, has to be tempered in the case of India by the fact that India has the lowest average income among the BRICS countries.

Secondly, the nature of economic growth will be very important in determining the standard of living of India's people, particularly the several hundred million residing in rural areas. In particular, it will depend on the extent to which the benefits of growth reach all sections of the population. The pitfalls of focussing on high growth alone (or what Amartya Sen had termed unaimed opulence) have now been recognized widely, including in policy circles, and in the last few years, the discussion on development has turned towards strategies for "inclusive growth."

However, to understand whether growth is equalizing or unequalising, one needs to start with empirical facts on the levels of inequality. It is here that research on the Indian economy is seriously lacking. There is an impression – both within India and outside – that India is a country of relatively low income inequality. In this paper, I shall argue that the idea of India – particularly rural India – as that of a region of relatively low inequality in incomes is very likely wrong. The picture of low inequality is based on data on consumer expenditure and not income, as in the rest of the world. From the limited data available on household incomes, surveys conducted by the National Council of Applied Economic Research, and detailed village surveys reported in this paper, it appears that levels of income inequality in rural areas are high.

I briefly discuss levels of income inequality in China. While most studies agree that income inequality has risen over the last two to three decades, levels of income inequality in rural China are not higher than in rural India.

In conclusion, I argue that given the low average income, high incidence of poverty, and the prevalence of high inequality in rural areas, the present path of economic growth has serious implications not only for welfare of the population but also for generating domestic demand to sustain future economic growth.

## *1 High rate of growth but low absolute income*

In recent years, the India story has appeared worldwide as one of a high rate of economic growth. From an average growth of around 3 per cent a year in the first three decades after Independence, the growth rate went up to over 5 per cent in the 1980s and 1990s, and finally to over 7 per cent in the 2000s (Table 1).

Table 1 Annual rate of growth of GDP from 1950s to the present, India (% per annum)

| Period | GDP |
|---|---|
| 1950s | 3.6 |
| 1960s | 4.0 |
| 1970s | 2.9 |
| 1980s | 5.6 |
| 1990s | 5.8 |
| 2000s | 7.2 |
| 2002-07 | 7.6 |
| 2007-12 | 7.9 |

Source: India Development Report 2012-13

The period of high growth occurred from around 2003 to 2008 (Table 2), when GDP grew at around 9 per cent per annum. However, this growth rate has not been sustained. The forecast for 2013-14 is of a growth rate between 5.5 and 6 per cent, at best.

Table 2: Annual rate of growth of GDP in 2000s, India (% per annum)

| Year | Total GDP |
|---|---|
| 2003-04 | 8.5 |
| 2004-05 | 7.5 |
| 2005-06 | 9.5 |
| 2006-07 | 9.6 |
| 2007-08 | 9.3 |
| 2008-09 | 6.7 |
| 2009-10 | 8.4 |
| 2010-11 | 8.4 |
| 2011-12 | 6.5 |
| 2012-13 | 6.7 |

Source: India Development Report 2012-13

During the last one decade, 2002 to 2012, per capita income at constant prices has grown at a decent 6 per cent per annum (Table 3).

Table 3: Annual Rate of Growth of Per Capita Income, India, at current and constant prices

| Period | Plan period | At current prices | At constant prices |
|---|---|---|---|
| 1980-85 | Sixth | 12.8 | 3.1 |
| 1985-90 | Seventh | 11.4 | 3.3 |
| 1990-92 | Annual | 13 | 0.8 |
| 1992-97 | Eighth | 14.2 | 4.6 |
| 1997-2002 | Ninth | 8.6 | 3.5 |
| 2002-2007 | Tenth | 11.1 | 5.9 |
| 2007-2012 | Eleventh | 14.6 | 6.3 |

Source: India Development Report 2012-13

Nevertheless, in absolute terms, India remains a low-income country. Average income in India is much lower than in other BRICS countries, a set of countries with which it is often compared.

To illustrate, the gross national income per capita, in PPP dollars, was 3,285 in India as compared to 7,945 in China in 2012 (Table 4).

Table 4: Gross National Income (GNI) Per Capita in BRICS countries, 2012 (in 2005 PPP dollars)

| Country | Level of GNI per capita |
|---|---|
| India | 3,285 |
| China | 7,945 |
| Brazil | 10,152 |
| South Africa | 9,594 |
| Russia | 14,461 |

Source: Human Development Report 2013

Not surprisingly, the incidence of absolute poverty remains unconscionably high. There is a big debate about the measurement of absolute poverty in India, and there is serious criticism of the current official poverty line as being too low, and being a destitution line (Swaminathan 2010). Nevertheless, even with the official poverty line, 42 proportion of the rural population was counted as poor in 2004-05 and the proportion was 34 per cent in 2009-10.

The first important point to note about the Indian growth experience is that the average income still remains relatively low, and lower than all the other BRICS countries. Per capita income of India is less than one-half the per capita income of China.

*2 India as a country of low inequality*

The standard of living of all persons will depend not just on the average but on the distribution of incomes across households. The pitfalls of focussing on high growth alone (or what Amartya Sen had termed unaimed opulence) have now been recognized widely, including in policy circles, and in the last few years, the discussion on development has turned towards strategies for "inclusive growth." To understand whether growth is equalizing or unequalising, one needs to start with empirical facts on the levels of inequality. It is here that research on the Indian economy is seriously lacking.

Source: Motiram and Vamsi (2013)

Based on official statistics, an impression has been created – both within India and outside – that India is a country of relatively low income inequality.

In the latest Economic Survey of the Government of India, it is stated, "according to HDR 2010, inequality in India for the period 2000-2010 in terms of the income Gini coefficient was 36.8 (on a scale of 0 to 100). India's Gini index was more favourable than those of comparable countries like South Africa (57.8), Brazil (55), …,China (41.5)…and even the USA (40.8)…which are otherwise ranked very high in human development."

The latest estimates of inequality based on per capita expenditure, from large scale surveys on consumer expenditure carried out by the National Sample Survey Organization at regular intervals are shown in Table 5. We can see that both rural and urban inequality increased in the decade of 1993 to 2004. Rural inequality remained the same thereafter whereas urban inequality continued to rise. Taking the country as a whole, inequality in household expenditure worsened between 1993 and 2009.

| Table 5: Gini coefficient of per capita consumption expenditure, India | | | |
|---|---|---|---|
| Region | 1993-94 | 2004-05 | 2009-10 |
| Rural | 0.286 | 0.305 | 0.300 |
| Urban | 0.344 | 0.376 | 0.393 |
| Total | 0.326 | 0.363 | 0.370 |

Expenditure is likely to be less unequally distributed than incomes. This is so for several reasons. First, for rich households, savings are expected to be large and so the gap between expenditure and incomes is going to be relatively large as compared to households in other income groups. Secondly, for the poor, even when incomes are low, zero or even negative, household expenditures will have to be positive for survival (see Anand and Harris 1994). The aggregate expenditure Gini of 0.37 in 2009-10 for India was, as expected, below the income Gini coefficient for several other countries.

My second point is that this picture of relatively low inequality in India is based on data on consumer expenditure and not incomes, as in the rest of the world. In the World Income Inequality Database, the data for India are on household expenditures (UNU-WIDER). It is therefore misleading to compare, as done in the Economic Survey above, as well as in various global estimates of income inequality, data on household expenditure in India with data on household incomes in other countries.

*3 Income Inequality: Data availability*

The major national data collection bureau, the National Sample Survey Organisation or NSSO, does not conduct regular household income surveys. There have been some pilot surveys, but on account of problems encountered, the project of income surveys has been abandoned (Bakshi 2010).

The National Council of Applied Economic Research (NCAER), an independent think tank, has conducted household surveys and collected data on incomes. In 1993-94, NCAER conducted a survey, with a sample size of 35,130 households from 1765 villages in 16 States of India (this is a large survey but smaller than the official consumption expenditure surveys). The data were collected for the "Human Development Profile of India" (Shariff 2001). In 2004-05 the NCAER conducted another survey titled "India Human Development Survey 2005", in collaboration with the University of Maryland (Desai, Dubey, Joshi, Sen, Shariff and Vanneman 2010). Data on household incomes, consumption and other human development indicators were collected in this survey too.

The main purpose of these surveys was not to collect data on household incomes but to gauge human development. Accordingly, the questionnaires indicate that detailed data were not collected on all major components of income, making estimates of household income from these surveys not very reliable.[1] To illustrate, in 1993, no information on income from different crops was collected. Data were collected from each household only on the extent of land holdings and crops grown (by season and variety). Incomes from crop cultivation were simply imputed for each household using some standard values. The 2005 survey conducted by the NCAER used a different and more detailed questionnaire, but some serious problems remain. For example, in calculating incomes from crop production, households were asked to report total annual expenses in rupee terms for major items of cost (hired labour, seeds, fertilizers, pesticides, irrigation, machinery, loans and maintenance). The lack of accuracy arises from asking cultivators

[1] For the exact problems with the questionnaire, see Bakshi, Rawal, Ramachandran and Swaminathan (2012).

to value all inputs, irrespective of crop, crop-mix or season, recall costs for a whole year and aggregate them in a consistent manner.[2]

In short, survey data on household incomes in rural and urban India are scarce.

*4 Income inequality in village India*

In this paper, I use data from a set of village studies to estimate income inequality. These studies comprised detailed village-level household surveys conducted by the Foundation for Agrarian Studies between 2005 and 2012 in villages selected from different States and agro-climatic regions of India.[3] The questionnaire used in these census type household surveys has several modules that enable us to estimate household incomes (Bakshi et. al. 2012). The estimates of income here include all cash and kind incomes; they account for all cash and kind receipts other than from borrowing and from sale of assets (including cash transfers).[4] All incomes are net of costs incurred by the households in the process of production and income generation. The surveys used detailed modules on incomes from each of the sources: crop production; animal resources (including rental income from animals); wage labour; salaried jobs; business and trade; money-lending; income from savings in financial institutions and equity; pensions and scholarships; remittances and gifts; rental income; and any other source.

I now illustrate the degree of income inequality in rural India using data on household incomes from eight village surveys conducted between 2005 and 2007 (Table 6). In 2005–06, we conducted in-depth census and sample surveys in three villages of Andhra Pradesh: Ananthavaram, a village in the paddy-growing region of Guntur district; Bukkacherla, a village in the dry and drought-prone district of Anantapur; and Kothapalle, a village in a groundwater-irrigated region of north Telengana (Karimnagar district). This was followed in June 2006 by census-type surveys in two villages of Uttar Pradesh: Harevli, located in the canal-irrigated, sugarcane-growing district of Bijnor; and Mahatwar, selected from eastern Uttar Pradesh. Mahatwar is in Ballia district and is located in a groundwater-irrigated wheat–paddy-growing belt. In 2007, surveys were conducted in two villages of Maharashtra. Nimshirgaon, located in Kolhapur district, has a relatively prosperous agriculture based on irrigated sugarcane and a variety of vegetable and fruit crops. Warwat Khanderao is a village in the unirrigated, cotton-growing tracts of Buldhana district. 25 F Gulabewala village, in the Gang Canal region of western Rajasthan, was also surveyed in 2007. While eight villages can hardly give us a picture of rural India, these villages are located across diverse agro-economic regions, and this study can be a first step towards understanding patterns of income distribution in Indian villages.

[2] In India, there is an established methodology for the estimation of crop incomes. Standard cost concepts have been specified in the Comprehensive Cost of Cultivation of Principal Crops (CCPC) surveys, that currently collect data on crop incomes for 24 crops across 20 States (CACP 2010). Neither the methodology used in the NCAER survey, nor the net incomes from crop cultivation reported in the NCAER survey, correspond to those in the CACP surveys; the reliability of the NCAER data thus cannot be validated by cross-checking with CCPC data.

[3] For details of the Project and villages and States covered, see http://www.fas.org.in/pages.asp?menuid=16

[4] See Bakshi, Rawal, Ramachandran and Swaminathan (2012) for an elaboration of the accounting framework used for estimation of incomes.

Table 6 *Location and agro-ecology of survey villages*, *2005 to 2007*

| Village | Block | District | State | Agro-ecological type |
|---|---|---|---|---|
| Ananthavaram | Kollur | Guntur | Andhra Pradesh | Canal-irrigated paddy cultivation |
| Bukkacherla | Raptadu | Anantapur | Andhra Pradesh | Dry and drought-prone, groundnut area |
| Kothapalle | Thimmapur | Karimnagar | Andhra Pradesh | Groundwater-irrigated, multi-crop system |
| Harevli | Najibabad | Bijnor | Uttar Pradesh | 100% canal-irrigated with supplementary groundwater, wheat–sugarcane |
| Mahatwar | Rasra | Ballia | Uttar Pradesh | Groundwater-irrigated, wheat–paddy rotation |
| Warwat Khanderao | Sangrampur | Buldhana | Maharashtra | Rainfed cotton–growing region |
| Nimshirgaon | Shirol | Kolhapur | Maharashtra | Irrigated sugarcane and multi-crop system |
| 25 F Gulabewala | Karanpur | Sri Ganganagar | Rajasthan | Canal and groundwater irrigation, with cotton, wheat, and mustard cultivation |

4.1 Estimated household and per capita incomes

I begin with estimates of annual mean household and per capita incomes (Table 7).[5] The village with the highest annual household income, of USD 3,328, was 25 F Gulabewala in Rajasthan, and the village with the lowest was the village of Mahatwar in eastern Uttar Pradesh. In Mahatwar village, where the majority of the population belongs to the Scheduled Castes, the annual household income averaged less than USD 700. So, there was wide variation across these eight villages in respect of average household income. Not surprisingly, median incomes were much lower than mean incomes in every village.

The highest per capita income of USD 600 was observed in 25 F Gulabewala, a village in the Gang canal region, followed by Ananthavaram in coastal Andhra Pradesh (USD 370) and Nimshirgaon in western Maharashtra (USD 307). All three villages are characterized by access to canal irrigation and relatively advanced agriculture.

To put these numbers in perspective, the per capita national income at current prices was USD 602 or Rs 27,123 in 2005-06. Thus, of the eight survey villages, in only one village – Gulabewala in Rajasthan – was the average per capita income of households close to the per capita national income in the corresponding year.

[5] For four villages, a complete census implies that the figure reported is a population estimate. In Nimshirgaon and the three villages of Andhra Pradesh, where samples were used for income estimates, appropriate weights have been assigned to arrive at population estimates.

Further, the median per capita income was less than one dollar a day in all eight villages, and the mean per capita income was less than one dollar a day in six out of eight villages.[6]

Table 7 *Mean and median household income and per capita income, study villages* in USD per annum at 2005-06 prices (1 USD= Rs 45)

| Village (State) | Year of survey | Mean | | Median | |
|---|---|---|---|---|---|
| | | Household income | Per capita income | Household income | Per capita income |
| Ananthavaram (AP) | 2005-06 | 1322 | 370 | 570 | 190 |
| Bukkacherla (AP) | 2005-06 | 813 | 212 | 434 | 140 |
| Kothapalle (AP) | 2005-06 | 755 | 209 | 496 | 131 |
| Harevli (UP) | 2005-06 | 1566 | 259 | 590 | 122 |
| Mahatwar (UP) | 2005-06 | 694 | 100 | 442 | 66 |
| Warwat Khandearo (MAH) | 2006-07 | 1291 | 247 | 654 | 143 |
| Nimshirgaon (MAH) | 2006-07 | 1535 | 307 | 837 | 183 |
| 25F Gulabewala (RAJ) | 2006-07 | 3328 | 600 | 781 | 177 |

Notes: Numbers in USD have been rounded off. AP stands for Andhra Pradesh, UP for Uttar Pradesh, MAH for Maharashtra and RAJ for Rajasthan. Figures for 2006-07 were deflated to 2005-06 prices.

Source: PARI Survey data.

[6] This is, of course, using the normal exchange rate and not the PPP conversion factor.

Table 8 *Distribution of per capita income by decile, persons ranked in ascending order of per capita income, study villages and combined data* in per cent

| Decile | Ananthavaram | Bukkacherla | Kothapalle | Harevli | Mahatwar | Warwat Khanderao | Nimshirgaon | 25 F Gulabewala | For all villages |
|---|---|---|---|---|---|---|---|---|---|
| 1 | 0.43 | -0.37 | -0.13 | 0.73 | 0.97 | 1.12 | 1.80 | 0.64 | 0.63 |
| 2 | 1.64 | 2.03 | 2.21 | 1.86 | 2.61 | 2.41 | 2.65 | 1.06 | 1.84 |
| 3 | 2.60 | 2.95 | 3.11 | 2.56 | 3.58 | 3.25 | 3.47 | 1.41 | 2.66 |
| 4 | 3.42 | 4.15 | 4.41 | 3.36 | 4.56 | 3.99 | 4.41 | 1.88 | 3.45 |
| 5 | 4.39 | 5.91 | 5.71 | 4.12 | 5.87 | 5.11 | 5.36 | 2.49 | 4.45 |
| 6 | 5.94 | 6.89 | 6.91 | 5.41 | 7.39 | 6.65 | 6.77 | 3.66 | 5.62 |
| 7 | 7.68 | 9.16 | 8.66 | 7.17 | 8.40 | 8.58 | 8.95 | 6.06 | 7.42 |
| 8 | 9.92 | 11.93 | 10.24 | 10.03 | 10.39 | 11.61 | 12.55 | 10.52 | 10.21 |
| 9 | 14.28 | 17.56 | 12.33 | 16.85 | 13.69 | 16.29 | 16.54 | 18.36 | 15.66 |
| 10 | 49.70 | 39.78 | 46.55 | 47.92 | 42.53 | 40.99 | 37.50 | 53.92 | 48.06 |
| All | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |
| D10/D9 | 3.48 | 2.27 | 3.77 | 2.84 | 3.11 | 2.52 | 2.27 | 2.94 | 3.07 |

*Source:* Survey data.

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# Proudhon's Socialism and Marx's Market Theory: the Theory of Free Credit and the Theory of Value Form

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## Background of the Problem

From the 1980s to the present, faith in Keynesian economic policies has faltered globally, and the Soviet model of socialism as an alternative to capitalism has crumbled. These two historical facts have increased the number of socio-economic movements, more suitably called *the new anarchism*,[1] specifically the anti-WTO protests in Seattle in 1999 and in Genoa in 2001, as well as local currency movements. From an equitable market society standpoint, some of these movements have goals similar to Pierre-Joseph Proudhon's (1809-65) principles. Thus, to understand the anarchism that is currently on the rise, a basic consideration of Proudhon's theories is required.

The theory and concepts of socialism based on equitable markets are often viewed as anarchism, whose theoretical underpinnings are represented in Proudhon's theories of money and credit reform, which are also referred to "the theory of free credit".[2] In Proudhon's era, Karl Marx (1818-83) defined this mutualism as "labour money theory" and criticized it both theoretically and thoughtfully; however, several issues remained.[3] Marx presented his criticism of the labor money theory in his work "The Poverty of Philosophy" (1847), which preceded "Capital" (1867). His works in "The Poverty of Philosophy" was further developed in "Economic Manuscripts of 1857-58" (Grundrisse) and "A Contribution to the Critique of Political Economy" (1859). While these works dealt directly with the labor money theory, they primarily explained Marx's thoughts on Proudhon. It has been overlooked that the theoretical development in "Capital" includes the criticisms of the labor money theory. In particular, the development of value form theory in relationship to the exchange process theory passed over his criticisms of "Proudhon's socialism" (Marx 1867, p. 79), which were latent in the theory of money creation.[4] In addition, while Marx's definition of the labor money theory is historically accepted, doubts remain as to whether this definition is on target.[5] Thus, rather than adopting Marx's stance, a summary of the free credit theory espoused by Proudhon is in order. Finally, drawing on the summary, one must analyze how reasonable Marx's criticisms were and the plausibility of Proudhon-style anarchism, particularly in view of the support that anarchism receives today.

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[1] Graeber and Grubacic (2004) declared that "there are some obvious reasons for the appeal of anarchist ideas at the beginning of the 21st century." They note as one of the reasons, "the failures and catastrophes resulting from so many efforts to overcome Capitalism by seizing control of the apparatus of government in the 20th century."

[2] Proudhon called himself an "interest-free loan theorist" (Proudhon 1849, p. 69).

[3] In this paper, we use the term "labour money theory" to refer specifically to Marx.

[4] For example, refer to Oishi (1989), Yamanobe (1974), and Yamamoto (1989).

[5] Sato (1977) declared that "if there is anything in common between Owen and Proudhon, it is their insistence on doing away with money rather than the labor money system" (p. 319), making it impossible to view Proudhon as a labor money theorist.

## I Proudhon's Theory of Free Credit

The Exchange and People's Bank, the embodiment of Proudhon's theory of free credit, was proposed during the February revolution of 1948.[6] According to Proudhon, the February revolution was the proletariat's "cry of distress" and their demand for a resolution of the "Lack of work," which was the source of poverty (Proudhon 1851, p. 19). Although French citizens had gained political freedom through the abolition of feudal privileges and serfdom during the Revolution of 1789, they had not yet arrived at economic freedom and independence, rendering lingering economic dependencies unresolved. In other words, "liberté, égalité, fraternité," the guiding principles of the French Revolution, were realized in the political but not in the economic sphere, making the revolution incomplete. This was society's perception of Proudhon (*ibid*, p. 43).

The proletariat's impoverishment and mass unemployment led to an economic crisis that spread throughout Europe in 1847. The turmoil in France can be summarized in the following three points: (1) a surge in imported wheat and the foreign outflow of specie due to the poor harvest in 1846,[7] (2) railway stock speculation and its collapse due to a privileged financial aristocracy,[8] and (3) the expansion of treasury expenditures and increased taxation.[9]

For Proudhon, however, the above developments were nothing more than extrinsic factors in the crisis. This was because, while such factors could possibly induce a crisis, the actual external causes of the shocks were deficiencies in the credit system. A worsening

[6] When examining the timeline of Proudhon's transition plan, articles of the incorporation of the "Exchange Bank" were published in 1848 in "Les représentants du people." Subsequently, the name of the Bank was changed to "People's Bank." In September of the next year, through April 1850, with the exile of Proudhon, the bank was forced to liquidate. He proposed a "Permanent Exposition" during the Paris Expo of 1855, a showcase for production at the Palace of Industry. From the above, it can be surmised that Proudhon's plan was two-fold, including the Exchange and People's Banks, and Permanent Exposition (Sato 1977, pp. 323-25). Also, in "General Idea of the Revolution in the Nineteenth Century" (1851), Proudhon uses the term "National Bank." This was probably due to it being used as a revolutionary model for the National Discount Bank, established by the February Revolution's provisional government.

[7] Proudhon's disciple, Alfredo Darimon (1819-1902), defined "stoppages in circulation" as a "feature of a crisis," and explained the outflow of capital in response to a currency crisis as "direct speculation in the foreign outflow of precious metals held by banks." As this outflow takes place, the amount of precious metal holdings drops, and guarantees for bank notes are weakened. Banks then "increase the discount rate for notes, reject payment in specie, and shorten the period on notes, creating a credit crunch." Darimon criticized banks' behavior as exacerbating the situation by tightening credit, particularly when bank credit is needed the most, during a currency crisis. He also argued the necessity of releasing precious metals, stating that bank fund protections are no more than "an illusory guarantee." The original guarantees of bank notes were produced goods, and free credit allowed for exchanges or buying and selling without hard currency; the inherent "equivalent exchange system of products" needed to be restored (Motoike 1979, pp. 41-2).

[8] For more details on railway stock speculation, see Koga (1964, Chapter 2) and Tsugita (1972a, 1972b).

[9] In addition to military expenditures, the "expansion of expenditures, including public works expenses, and the accumulation of public debt…led to increased taxes" (Mori 1967, p. 112).

economic situation requires credit for producers; similarly, banks and financiers must tighten lending requirements and increase the discount rate on notes, precipitating the crisis. This crisis was a result of extremely tightened credit that constrained purchasing power that shrank sales channels. Thus, "of all economic forces, the most vital, in a society reconstructed for industry by revolution, is *credit*" (*ibid*, p. 51).

Proudhon discovered the greatest significance of credit system reforms and identified two internal deficiencies in the system of credit. First was the precious metal reserve system that demanded banks keep precious metals to guarantee bank notes. Thus, the general exchangeability of bank notes was dependent on the metal held in reserve. Consequently, bank notes were issued to maintain a certain circulation rate that accorded with the Bank of France's reserves. This resulted in an external outflow of specie because poor harvests forced a tightening of various monetary policies. The basis for Proudhon's theory of free credit was the critique of a metal currency, that is, precious metals used as guarantees and hard currency. He believed that such metals were an impediment to the exchange of goods due to the special position they metals were given in exclusively monopolizing general exchangeability. According to Morino's introduction to the materials of "Exchange Bank Theory," metal monopolized the exchangeability of gold and became the basis for the feudal authority to collect interest on exchanges (Morino 1998b, p. 52). In other words, precious metals deprived products of their exchangeability as well as generated the authority to collect interest from those not holding precious metals but exchanging products for them. A solution to the first argument is a simple method that offers freedom from exchanges based on precious metals so that currency does not obstruct the exchange of goods.

The second internal deficiency was the Bank of France's tendency to impose a high interest rate given the private nature of the Bank; in other words, the existence of interest itself. The Bank of France was freely granted "the privilege of issuing bank notes and of gradually displacing coin by paper in circulation" (Proudhon 1851, p. 176). The Bank of France was established as a corporation because banks were forced to pursue their own private profit. Based on the above two privileges, the Bank of France's primary shareholders were able to gain profit in addition to that generated by their own capital, while on the other hand, this same "financial aristocracy" enabled bankers and lenders to earn vast profits by setting interest rates arbitrarily high.[10] The second internal deficiency of the credit system, the private nature of banks that

[10] "It was not the French bourgeoisie that ruled France under Louis Philippe, but one faction of it: bankers, stock-exchange kings, railway kings, owners of coal and iron mines and forests, and part of the land proprietors associated with them – the so-called financial aristocracy. It sat on the throne, it dictated laws in the Chambers, it distributed public offices, from cabinet portfolios to tobacco bureau posts." (Marx 1850, p. 48). Marx pointed out that vast finances were generated by fraudulent market manipulations and speculation in government bonds on the part of the financial aristocracy, and this activity devoured the railway projects. According to Tsugita (1972a), the financial aristocracy "ruled on

exclusively enjoyed the privileges of precious metals was, unquestionably, a consequence of interest. Interest is nothing more than a device to misappropriate producers' profits using two economic powers: the privileged position given to precious metals and the monopolization of banks by financial aristocrats. According to Proudhon, banks proper should not be allowed to obstruct exchanges by collecting interest, an act influenced by financial aristocracy monopoly, thereby causing the stagnation of circulation. Banks needed to be liberated from the metal reserve system, and the private nature of banks needed to be turned public. In doing so, interest-bearing discount bills and lending would be converted to non-interest bearing credit, and the causes behind the bank's obstruction of circulation could be converted to promote circulation.

Proudhon also argued two points regarding extrinsic artifical issues, or French issues in particular. To support deficiencies in the credit system from the outside, Proudhon first addressed the credit system and the predatory nature of financial aristocracy, which monopolized the Bank of France's management and influenced interest rates. The inevitable consequence was "economic chaos" (*ibid*, p. 50). Second, Proudhon criticized that the state was a known hotbed of financial aristocracy and others living off interest. Social programs such as national retirement pay, national bonds, and pensions were "taken away by parasites" (*ibid*, p. 54). According to Proudhon, achieving the Revolution's ideals required the purging of society's hierarchical economic structures, which were the basis of existing power and privilege surrounding the government, and that the economic independence of every man be placed on an equal footing. Accordingly, disposing of financial aristocracy that controlled credit and preventing the state from being a breeding ground for the privileged classes were fundamental to solving the credit squeeze in the 1847 crisis.[11]

To elucidate the state of the credit system, Proudhon juxtaposed the four abovementioned internal and external deficiencies, along with the ideals of the French Revolution. He stated that in a free and equitable post-revolutionary society "every privilege is public property" (*ibid*, p. 176). This meant that, by virtue of its privileges, the Bank of France needed to become a "public institution" (*ibid*). In addition, citizens should have the right to establish banks at will. If the Bank of France became a public institution, it would stop serving for-profit organizations and issuing discount bank notes at low or zero interest. This, in turn,

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the basis of the immaturity and uneven distribution of financial markets, and monopolized currency through speculation and high interest" (p. 60).

11 Proudhon learned ways of dismantling the state from the French Revolution. In the "Fifth Study" of "The General Idea of the Revolution in the Nineteenth Century," Proudhon proposed a method he described as a "social liquidation." This term referred to a policy of abolishing economically dependent relationships by repurchasing feudal privileges at low or zero interest. This followed the example of the abolition of compensation from feudal rents and the repurchasing of the rights to collect rent, implemented in the French Revolution. It may be said that dismantling the state was nothing more than remunerating various rights of the state and transferring these rights to the public.

would gradually push financial aristocracy away from credit transactions, through which they privatized the banking industry and extracted unfair profits on the basis of high interest. This would lead to changes in relationships from those of unilaterally extending credit to reciprocal relationships between equal position of lender and borrower.

However, this raises the question about the specific functions of the Exchange Bank and the People's Bank. The banks' primary activities were, for example, to discount interest-free commercial bills signed by the drawer and endorser (or collateralized interest-free loans) and the sales and purchase of consigned products. After the banks imposed requisite handling fees, they could then discount commercial bills at no charge, "removing all situational characteristics of the lendee, such as location, date, personality, payment date, and objects" (Morino 1998b, p. 55), and replacing those notes with general bank notes.[12] Bank notes used the best commercial bills representing delivered, rather than unsold, products as collateral (*ibid*, p. 58); thus, bank notes are "collateralized by products" (*ibid*, p. 54), instead of precious metals. Further, they are issued only in proportion to the value of products that can be seen as having realized value by virtue of their being sold for commercial bills. "Over-issuances are impossible" (*ibid*, p. 58). In the case of lending, the relationship with interest-free discounts of commercial bills could be changed so that producers deposited products in a bank, and banks used these deposited products as collateral for loans without interest. In the case of discounted notes and lending, equivalent exchanges between banks and producers could always be made, with the value being guaranteed and fixed as the cost at the time of exchange. This would facilitate "reciprocity" in the exchange.[13] In addition, if we assume that as commercial bills circulate among producers, the payers of these bills, and that bank notes of equal value are circulated back to the banks from the producers, at which point all market transactions are completed, then social allocation for labor are also smoothly completed. In this event, from the viewpoint of social standards, the amount of labor embodied for each producer is appropriate, and the "proportionality of value" is maintained.[14] The periodic circulation of bank notes in conjunction with the payment of bills is an argument against the possibility of excess circulation

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[12] The basic function of the Exchange and People's Bank was the "generalization of commercial bills" (Sato 1977, p. 322) or the "generalization of bills of exchange" (Morino 1998b, p. 54).

[13] "*Reciprocity*…consists of the sellers and buyers guaranteeing each other, irrevocably, their products at cost price" (Proudhon 1851, p. 91). Producer relationships include ethical stipulations that one must not shrewdly deprive others in pursuit of price differences like merchants, and follow the simple ideal of equality in exchanges. In other words, products have a fixed value when put on the market, and that value should not be affected by fluctuations in the market.

[14] Proportionality of values is (A) proportionality in proper exchanges that follows exchange values measured by labor time and cost spent by producers in production, and (B) the set correlation between the use value and exchange value set for each product. In this case, it has a dual meaning as reverse proportionality (Fujita 1993, p. 14).

of bank notes. The market principles of ‘equivalent exchanges between products’ are realized through the market transaction process.

The Exchange and People’s Banks, however, were thought to have two problems in their issuing methods. First was the issuance of bank notes with excellent bills as collateral; the criterion of excellence was based upon the future delivery performance of products. However, without considering the ability to make future payments, if one views a sale as having been transacted when a product is delivered, then this discount would likely be imprudent. Recipients (payers) must make a successful sales transaction using either bank notes or cash to pay back a bill. The second problem deals with the method of depositing goods in banks and issuing notes. Products were deposited into banks as collateral for loans, but the handling of these products needed to be dealt with in the same manner as the settlement of a commercial bill. In other words, just as producers pay arrears at certain intervals on their own bills using bank notes or cash, they also need to buy back the deposited products. In any case, the only effect was delaying uncertainty in a sale. Bank notes from the Exchange and People’s needed to be collateralized, which depended on successful sales by the payer of the commercial bill and the products deposited in the banks.

While Proudhon’s Exchange and People’s Banks posed the aforementioned problems, they also proposed to fulfill the following social roles: On one hand, the value of products in individual transactions would be mutually guaranteed by both parties through the issuance of notes by the Exchange and People’s Banks, which would serve to convert mutually acknowledged value. Thus, bank notes would become credit notes representing relationships of mutual guarantees and promises. On the other hand, commercial bills would be payment promises agreed upon in private relationships, which are converted to group payment promises of the parties involved. Therefore, in issuing bank notes, the Exchange and People’s Banks would effectively convert private receivables and payables relationships, in the form of commercial bills, into bank notes that represented contractual relationships acknowledged by society. In addition, currency monopolies would be resolved through a series of processes, and the equality of the parties involved in the transaction would be preserved. In this case, the manner in which commercial bills would be settled was still uncertain, yet the receiver would bear the responsibility for conducting a firm transaction. Thus, it would be possible to stop the moral hazards of drawing bills. Also, credit to producers, who were parties to associations, such as the Exchange and People’s Banks, led to the outset of the issuance of bank notes by the People’s Bank. This then became the mechanism to stop the monopolization of currency issued by the central bank. Eventually, interest-free credit would be supported by the certainty of payment by producers. Thus, depositors and banks would work in collaboration for these operations while adhering to strict audits.

As discussed, Proudhon's ideal for an economic revolution was the realization of a market economy in which producers dealt with each other as equals during exchanges. According to Proudhon, this could be achieved through the removal of large-scale ownership and monopolies typified by the large feudal land holdings and high interest that impeded exchanges among producers. Therefore, the ideal market envisioned by Proudhon was one in which there were no currency, interest, or state impediments to exchanges. The ideal primary subjects in economic activity were small independent producers who had their own means of production, made independent decisions, maintained economic independence regarding production, and whose ownerships were limited in scope such that they did not impinge on others ownerships.

By presenting these concepts, Proudhon indicated his next, modern direction. This was the awareness of current markets being distorted by "currency, interest, and the state," and the search for true markets to replace the current ones. Proudhon attributed various causes to these market distortions; however, different understandings of his interpretation led to several movements. Nevertheless, at their core, these movements shared a similar vision of the market.

## II Marx's Difinition of the Labor Money Theory

As shown, Proudhon's theory of free credit was a concept that advocated the abolition of interest and metal currency. In this section, we confirm Marx's definition of the labor money theory and examine how Proudhon's theory of free credit and his plans for the Exchange and People's Banks, and Marx's critique of the theory of labor money are related.

Prior to Proudhon's publication on the theory of free credit, Marx made the following assertions regarding the attributes of Proudhon's theories in the "System of Economical Contradictions, or the Philosophy of Poverty" (1846). Marx questioned whether Proudhon was the first to conceive the notion of social revolution by changing mankind into direct laborers and making exchanges with each other for equal amounts of labor. Marx responded to his own question by stating that anyone conversant with economics "should know that socialists in England advocated almost everything about the egalitarian application of Ricardo's theory in various ages." Marx viewed Proudhon as the so-called "Ricardian socialist."[15] From this dialog

[15] In the Introduction to the first German edition of the "The Philosophy of Poverty", Engels (1885) commented on "the utopia of labour money", saying "And the petty bourgeois especially, whose honest labour – even if it is only that of his workmen and apprentices – is daily more and more depreciated in value by the competition of large-scale production and machinery, this small-scale producer especially must long for a society in which the exchange of products according to their labour value is at last a complete and invariable truth. In other words, he must long for a society in which a single law of commodity production prevails exclusively and in full, but in which the conditions are abolished in which it can prevail at all, viz., the other laws of commodity production and, later, of capitalist production."

we see that Marx sought after Proudhon's "regenerating formula of the future" in "the determination of value by labor time," and defined this formula as an idea for exchanging equivalent amounts of labor based on small producers (Marx 1847, p. 138).

Sato (1977) and scholars, however, have raised objections to Marx's given definition; the author of this paper also has some concerns. As with Marx, was Proudhon's theory of free credit something that "directly pursued exchanges based on labor time?" (Sato 1977, p. 319). As shown in Section I, interest-free, equivalent exchanges were made on the basis of Proudhon's Exchange and People's Banks. If supply and demand were aligned as a result of market transactions, then a "proportionality of values" could be maintained. It is possible that the underlying labor amounts included the possibility for exchanges of equal amounts of labor, but they did not proactively guarantee these equal exchanges. In Proudhon's plan, built on the assumption of market transactions, the relationship to the amount of labor is determined "*ex post*" and invisibly, while in the labor time theories of Owenite or in Ricardian socialism, products are exchanged after determining labor time "*ex ante*," on the basis of the products. To this effect, the two are decisively different.

For example, Marx states the following in his "A Contribution to the Critique of Political Economy": "*John Gray* was the first to set forth the theory that labour-time is the direct measure of money in a systematic way. He proposes that a national central bank should ascertain through its branches the labour-time expended in the production of various commodities. In exchange for the commodity, the producer would receive an official certificate of its value, i.e., a receipt for as much labour-time as his commodity contains, and this bank-note of one labour week, one labour day, one labour hour, etc., would serve at the same time as an order to the bank to hand over an equivalent in any of the other commodities stored in its warehouses." (Marx 1859, pp.320-21). This is "the basic principle" of labor money theory (*ibid*). Namely, the national central bank would give producers a certificate for labor time spent on production in advance of exchanges. At the same time, the bank guarantees the value of products as current value.

Under Proudhon's system of the Exchange and People's Bank, receipts would be given for products guaranteed by current value, thereby realizing an exchange for an equivalent amount of labor. If one considers Gray's model as a typical labor money system, then realizing proportionality according to labor time and cost is clearly different from Owen's concept of labor money, since it does not pursue realization itself, as can be seen in Proudhon's plans to establish the Exchange and People's Banks (Fujita 1993, p. 30). In other words, Marx misconstrued the theories of labor money in England as being similar to Proudhon's principles.

Nevertheless, Marx continued the argument, using his criticism of labor money theory, which erroneously combined the two ideas, as a criticism of Proudhon's work. However, not all of Marx's criticisms missed the mark. According to Marx, despite the fact that labor money theorists must assume a production system that requires producer's labor to be expended directly as social labor, by having labor money-issuing banks intercede on the basis of the production of products, these theorists fall under the illusion that individual labor is treated directly as social labor. Put differently, the question of why products must take the form of commodities in a commodities economy is overlooked.

"Commodities are the direct products of isolated independent individual kinds of labour, and through their alienation in the course of individual exchange they must prove that they are general social labour , in other words, on the basis of commodity production, labour becomes social labour only as a result of the universal alienation of individual kinds of labour" (Marx 1859, pp.321-22). Even if one posits that Marx asserts "value proportionality" as a result of market transactions in Proudhon's theory of free credit, the assumption of an exchange of products at a fixed value through banks offering free credit in the circulation process treats currency as an emblem of circulation; in addition, this is done with no understanding of the peculiarities of a commodities production system, which in turn invites contradictions between individual labor and social labor. No matter how much free credit is given, rational economic activity requires a third commodity as a measure of social labor for the other two commodities. In other words, commodities in the form of money are required. According to Marx, Proudhon believed that only precious metals were commodities in monopolizing currency. But ridding precious metals of their currency status would only lead to the substitution of another commodity in place of currency for as long as production continued. Proudhon was never clear on the distinction between precious metals, particularly gold, being accepted as money and other form of money. This point will be revisited in Section III. Although Marx's criticism of Proudhonism may, at times, miss the mark on these two concepts, Marx's own market vision is noteworthy. However, (1) Marx made the mistake of combining free credit theory and labor money theory, (2) and accepted and made anti-criticism policy recommendations grounded in France during the specific age. This being said, these two points have become Marx's policy assessments regarding the theory of free credit.

In Chapter 2 (On Money) in "Grundrisse", Marx criticized the "Proudhonian" Darimon (Marx 1857-8, pp. 51-2). This development corresponded with his criticisms of Proudhon's theory of free credit. Next, Marx's criticism of Darimon is considered.

Marx's criticism of Darimon covered several points, among which we discuss whether the passages on the conflict between individual labor and social labor are theoretically meaningful. Marx's criticisms arose from the following questions: (a) whether individual labor time, included for each commodity, was a measure that could be equated, or whether it was a unified measure reflecting differences in productivity among producers and temporal changes in labor productivity regarding production of commodities of the same type, and (b) whether labor time was an appropriate measure of a commodity's value, or whether producers could use it as a perceivable metric to ascertain trends in supply and demand.

With question (a), Marx criticized labor money theorists' assumptions that the individual labor time of products was homogeneous and equatable. Is product labor time equatable? Let us consider an example: Labor money theory is also a critique of metal currency, thus labor money referred to herein is assumed to be paper money with no value in and of itself. When given a certain level of labor productivity, producers will accept labor money, wherein X number of labor hours are noted as corresponding to the labor time spent in production. In doing so, various commodities are given a value that is equal to the labor time spent in production. Naturally, in this example of an exchange, the labor time noted on the labor money held by producers will match the commodity's labor time. As a result, all producers' labor time can be equated according to labor productivity, and the theoretical conditions are given for realizing an exchange of equal amounts of labor and rights to whole labor. However, when the additional issue of spatial differences in labor productivity for similar commodities is considered, it is clear that if there is a difference in productivity, individual labor time cannot be equated. At some point, producer *A* will accept labor money marked for 10 labor hours of production for one unit of desks. But consider the case where producer *B* has twice the productivity, requiring only five hours to produce one unit of desks. If producer *B* makes the same number of desks as producer *A*, he can only accept five hours worth of labor money. As a result, labor money showing the same 10 hours worth of time may have two values: one unit and two units of desks. When measuring based on labor amounts for one unit of desks, the labor time for the producer with lower productivity will receive twice the amount as the producer with higher productivity. Other than cases wherein productivity is equal, equating labor time for differing levels of productivity requires another measure of labor time for each party. In addition, the consequences are the same for temporal changes in productivity. Market economies, in which the pursuit of profit is a motive for production, brings about spatial differences and temporal changes in productivity. In the production of similar commodities, labor money that uses labor time as a measure of value that does not reflect differences in productivity is remarkable. Further, relationships that buy back commodities on the basis of a valuation system of labor time spent in production and the amount produced per one hour of labor time per producer (in other words, the relationship between invested labor and commanded labor) cannot be managed, as this will vary by producer. Labor money that should steer toward fair exchanges will, instead, engender feelings of unfair treatment between producers (*ibid*, pp. 72-4).

In the criticism (a), it was noted that individual labor time was insufficient as the measure of commodity value. Thus in (b), Marx criticized labor money theory that viewed value and price as the same. He argued that, assuming an anarchical production system based on private ownership, money price must be considered as a measure replacing labor time. "The *value* (the real exchange value) of all commodities (including labour) is determined by their production costs, in other words, by the labour time required for their production. Their *price* is this exchange value of theirs expressed in money." Undoubtedly, "but this would be attained only on the assumption that *vale* and *price* are only *nominally* distinct," labor money can be directly expressed through labor time as commodity value. Within market economies, however, individual exchanges are based on the system of private property, and supply and demand vary; therefore, social conditions that equate value and price do not exist. Although "Demand and supply continually determine the prices of commodities; they never coincide or do so only accidentally; but the costs of production determine for their part the fluctuations of demand and supply." Eventually, the relationship between supply and demand determines price. Further, "the value of commodities determined by labour time," as imagined by labor money theorists, "is only their *average value*," and in actual market transactions, "But this average is very real if it is recognized as both the driving force and moving principle of the fluctuations which occur in the prices of commodities during a particular period of time." The average prices of commodities are used as "the basis of commercial speculation" to calculate the probability of speculation. The market value of commodities is always different than the average value of those commodities, and emphasizes that speculative transactions based on fluctuations of prices standardized on average commodities prices are a distinctive trait of market economies. Thus, Marx presents the vision of a real market overlooked by Proudhon, who had an ideal vision of markets. (*ibid*, pp. 74-5)[16]

According to Marx's "Grundrisse," the monetary function of measure of value, or money itself, is required when individual labor time for commodities cannot be equated.[17] Whether commodity quality and amount is in accordance with demand, and whether labor time for commodities is expended on the basis of managed productivity, cannot be assessed as a direct metric of each commodity's labor time. "Labor time as a measure of value (behind the price relationship –author) exists only ideally" and "Price as distinct from value" is a metric that can also be referred "*money price*."[18] Labor money used as a direct measure of labor time value

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[16] Obata (1986, p. 114) critically examined labor money theory cited in Marx's "Grundrisse," (1857-8, p. 75) and outlined Marx's understanding of markets. Obata commented that "Marx declared that '*Pric*e, therefore, differs from *value*, not only as the nominal differs from the real; not only by its denomination in gold and silver; but also in that the latter appears as the law of the movements to which the former is subject', showing the image of an undisciplined market encapsulating movements as 'precisely through continual inequity to itself.'" Obata herein clearly explains Marx's peculiar market awareness.

[17] Measure of value includes both showing the value amount and measuring the value of a commodity being purchased. In this paper, the former is referred to as "measure of value" and the latter as "the (monetary) function of measure of value."

[18] In the Introduction to the first German edition of "The Philosophy of Poverty," Engels (1885)

must be "with all the properties of our present money without performing its services." The system of private production capabilities give rise to anarchical production, which always results in excess or insufficient production in the adjustment process. Markets acting as anarchical production adjustment mechanisms, on the one hand, form standards of supply and demand productivity, and on the other hand, they provide room for mercantile speculation surrounding price differences arising from productivity differences or excess or insufficient production. By answering the question of what markets are, Marx became a critic of Proudhonists and their vision of the ideal market. In other words, Marx's viewed markets as encapsulating the absence of exchanges for equal amounts of labor and ideal averages through intrinsic anarchy; put differently, they evidenced difficulty in making adjustments for supply and demand (*ibid*, pp. 77-8).

## III Criticisms of Proudhon in "Capital"

In "Grundrisse", the discussion on criticism about labor money theory, as developed in Section II, focused on whether labor money as a unit of labor time functioned as money. In other words, this proved the need for money price, and a criticism of the theory of measure of value in particular. Assuming a market economy based on private property, labor time cannot be a standard for determining the appropriateness of commodity values on the basis of social standards, and money price is necessary to show value. In addition, labor money that does not appropriately reflect commodity value cannot become a metric of the social allocation of labor time in a commodity economy.

Further, in Chapter 4 of "Capital" I, "the transformation of money into capital" is referred to income for producers, including surplus value (or surplus products) from exchanges of equal amounts of labor. Thus, in response to Proudhon, who posited that exploitation would not occur, and the assumptions of labor money theorists, this was a theory of surplus value, with a noted possibility for exploitation in surplus value during the production process, even in market economies with exchanges of equal amounts of labor.[19] Marx's definition of exchanges of equal amounts of labor necessitates a stage for surplus value theory to criticize labor money as a theory of unfair exploitation. Even if this were the case, in "Commodities," Chapter 1 in

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commented on Rodbertus' labor money theory, declaring that "if price appreciation, or informing producers of world markets in decline in response to competition is forbidden, producers will close their eyes completely." Engels emphasizes that price, for producers, acts as the "sole adjustment" made to determine whether production volume is proportional to social demand.

[19] Obata (2004) states that "surplus value theory is mostly meaningless when divorced from the object of theoretical criticism of mainstream socialism at the time, such as Ricardian socialism tied to rights to whole products from labor, and Proudhon-style market socialism" (p. 4). Perhaps this comment shows a particular aspect of markets similarly assumed in "Capital" with exchanges of equitable value such as were assumed by Proudhon.

“Capital”, assuming simple commodities circulation and exchanges of equal amounts of labor, in some ways, the content on the theory of value form criticizes “Proudhon’s socialism,” deeming labor money theory difficult to comprehend. In keeping with the historical considerations of the criticism of Proudhon’s socialism within Marx’s “Capital”, a rethinking of the theory of value form and the exchange process theory allows a different aspect of labor money theory criticism to come into view compared with works written prior to “Capital”.

In the theory of free credit, Proudhon criticized precious metals as morphing into the authority to collect interest in exchanges because of its being regarded as currency, thereby obstructing equal relationships in exchanges. With the Exchange and People’s Banks providing free credit, Proudhon envisioned raising commodities to a status at the same level as precious metals. However, Marx’s theory of value form can also be seen receding from these types of assertions by Proudhon.

Let us first summarize Proudhon’s theory of free credit as interpreted by Marx. According to Proudhon, the Exchange and People’s Banks would lend without interest, using free discounts of commercial bills and commodities as collateral. In doing so, the value of all products and bills would be fixed; Marx criticized this point stating that the process for fixing this value was not acceptable. Fixing a value means acknowledging a fixed value without comparing the results of individual labor to the standards of social labor. Thus, even though it might be said that the Exchange and People’s Banks used market mechanisms, they disposed of the ability to escape from the inconsistencies of individual and social labor. For markets to function as a platform for individual labor to turn into social labor, the value of commodities must be able to change. In addition to the previous criticism that the theory of value form adjusts labor amounts, discussions in subsequent paragraphs provide a viewpoint on the difficulty in realizing value or constrained by the use value. To re-summarize Marx’s criticisms of Proudhon regarding the theory of value form, two questions are addressed: Why can commodities not simultaneously take the form of general exchangeability? Can markets truly take shape without money obstructing buying and selling when metal currency is removed from the equation?

In Chapter 1 of “Capital” I, in the notes to the third section of “the general form of value,” Marx comments on Proudhon’s socialism and states the following: “It is by no means self-evident that this character of direct and universal exchangeability is, so to speak, a polar one, and as intimately connected with its opposite pole, the absence of direct exchangeability, as the positive pole of the magnet is with its negative counterpart. It may therefore be imagined that all commodities can simultaneously have this character impressed upon them, just as it can be imagined that all Catholics can be popes together. It is, of course, highly desirable in the eyes of the petit bourgeois, for whom the production of commodities is the *nec plus ultra* of human freedom and individual independence, that the inconveniences resulting from this character of commodities not being directly exchangeable, should be removed" (Marx 1867, p. 79).

In other words, commodities with general exchangeability monopolize the status of the general form of value, and for this reason alone must exist in juxtaposition to a set of commodities with indirect exchangeability that is deprived of a form of general, direct exchangeability, or in other words, a form of relative value. On one hand, commodities take the form of relative value, and on the other, money takes the general equivalent form of value. Clearly, this is a criticism of the assumption that all commodities offer a form of general exchangeability, as Proudhon's theory of free credit eliminates metal currency. However, it is also a criticism of the market view that markets can return to an inherent stable state, with all commodities being exchangeable at any time, if only the introduction of money can be done away with. Disposing of money from circulation and wishing for the direct exchange of products, while still assuming small independent producers and a commodity economy, leads to the loss of an objective basis for determining an appropriate rate of exchange.

Regarding the relationship between a money form and gold, Marx declared that, in the move from a general form of value to a money form, "the progress consists in this alone, that the character of direct and universal exchangeability – in other words, that the universal equivalent form – has now, by social custom, become finally identified with the substance, gold" (*ibid*, pp. 80-1). This shows the possibility that, through social customs, the universal equivalent form, that is, "a form of value in general…can, therefore, be assumed by any commodity" (*ibid*, p. 80). Although one can say that commodity markets inevitably demand a money form, having gold attain the status of a general form of value is inevitable under specific social conditions. The question of what types of commodities will attain monetary status is settled by the dependence on society's historical context and customs. Nevertheless, Marx's view was that Proudhon, with his understanding of money being tied to gold, was being foolish through his inability to view France's situation as self-evident rather than in relative, historical context. Thus, the theory of free credit, shown to view the money form and gold currency as equivalent, could not realize the 'equivalent exchange of products' even after dethroning gold as a money form. The utility of one's commodity can only be known by an exchange ratio of the use value of other commodities. Further, a commodity must overcome the constraints of its own use value to realize its value. Although retroactive as a development of the theory of value form, Proudhon's theory of free credit concludes by saying "The whole mystery of the form of value lies hidden in this elementary form" (*ibid*, p. 58), questioning the primordial form of commodity economy.

Within elementary forms of value that begin with an exchange between two individuals, the values of the commodities owned by the two individuals are not equated from the outset, as with the homogeneity of human labor obtained as a result of social abstractions. Thus, the other person's commodity's body must be expressed as a mirror of one's own commodity's value. For the owners of commodities, the sociality of the value residing in one's commodity cannot be acknowledged; therefore, a process is required to express this value. Commodities of equal forms of value not only act as mirrors of the value but also are in a position to determine exchanges with commodities having a form of relative value. This relationship expresses the advantage of money in a general form of equal value. If we focus on this point, the value realization theory comes to fruition; it notes the conflict between money in the general forms of equal value and commodities in the relative forms of value. In particular, in individual commodities transactions, exchanges do not occur without matches between the coincidental desires of both commodity owners, and do not merely reflect the labor quantity relationship lurking in the commodities' background. This makes it difficult to say that the realization of value is guaranteed only by equal value. Finally, at issue once more is the method of issuing notes by Proudhon's Exchange and People's Banks.

In the Exchange and People's Banks, it was assumed that the value of products would be fixed and they would be exchanged for equal value. Accepting this assumption at face value, and assuming that prices for products and bills at the time of exchange would be constantly maintained, Marx's criticism of the theory of measure of value does not need to be an issue at the moment. In the case of free credit, even when considering commercial bills discounted without charge or loans with collateral of deposited goods, the value of deposited products or bills held by banks is fixed; thus, these can be seen as safe assets. But was that truly the case? Within the theory of free credit, there was no change in the fact that recipients were to settle a transaction using bank notes by the date of a bill, and thus, no matter how much free credit was extended, establishing a smoothly running economy depended on successful sales under the constraints of use value. Free credit was to create conditions that would enable the exchange of products at equal value. However, it did not promise the realization of that value. In other aspects, Proudhon overemphasized the stability of actual asset values (discounted commercial bills and deposited products), and overlooked uneven changes in asset value due to supply and demand trends and those in productivity. Eventually, bank credit would be given cheaply, and although it may have provided purchasing power without constraining commercial credit, there would be no change in the opportunity to sell to the owners of bank notes, nor would there be any proof that a form of money would not be necessary, as was posited by those who said metal currency could be eliminated from circulation.

Marx argued with Proudhon over a vision of the market and stressed that anarchy in production would disturb markets. Further, it can be said that Marx made a policy evaluation of realism, whereby the undisciplined nature of markets born from motives other than production anarchy made the theory of free credit impossible in principle. This is because additional merchant speculation drives temporary and repetitive discrepancies in the average price of commodities. In anarchy movements in the modern day, however, Marx's assessment is, for the most part, not accepted, and Proudhon's ideas are becoming understood as ideals of a movement and practical guidelines. As discussed in subsequent paragraphs, this has much to do with the ideals of market creation that embodied ideals similar to those of the French Revolution, which were Proudhon's aim, and "genuine globalization" (Graeber 2002, p. 65).

## In Lieu of a Conclusion: Anarchism and the Modern World

We now consider Proudhon's intentions, which Proudhon himself never sufficiently made a case for. First, the purpose of the theory of free credit is the provision of money to small- and medium-sized producers who cannot freely procure financing. At the same time, this was criticized because of the privileged role of money grants interest-collection authority that was given to money holders. Proudhon believed that a true free market economy could be realized and inequality in exchanges based on a money advantage could be eliminated; he believed this was possible by enabling producers to obtain money on an equal basis through free credit. The markets envisioned in this case were not real markets that continued anarchical production, but collaborative markets with mutually independent producers that relied on one another. These markets were not realistic markets that pursued profit amidst uncertainty and dramatic fluctuations, as was emphasized by Marx. Rather, they were ideal markets with little change and fixed transactional relationships repeatedly maintained in a narrow range of circulation. Reciprocity of value was nothing more than an ideological representation of this type of market vision. In other words, while Marx emphasized that value in actual markets is not fixed, Proudhon maintained that market deficiencies should be corrected to create relationships where value can be fixed. Marx's focus was the world of capitalistic markets. But Proudhon pursued the ideal image of a local market economy with small producers comprising artisans and farmers. There was a stark contrast in both market visions. While both Marx and Proudhon explored the question of how markets should be understood as a common issue, both sides competed over a market vision of truth; These market visions were clearly presented as fundamental investigations of a vision of money that dealt with how money should be understood. Arguments around labor money theory have developed a dual worldview of market visions defined by a vision of money.

We see commonalities in Proudhon's vision of market and his credit reform theories as well as the anarchism movement of the modern day. For example, according to Graeber, the anarchist movement is more of a "globalization movement" than an "anti-globalization movement." This means it is a movement of "the effacement of borders and the free movement of people, possessions and ideas" (*ibid*, p. 63). Because local currency is regionalistic, globalization moves in the opposite direction. Despite the denying of positive interest rates and the central bank's monopoly on the issuing of notes made it possible to create media (for example, local currencies) that include personal assertions and values. As a whole, it can be said that both sides act on the basis of the same ideals of creating free and equitable market networks via capitalistic market economies. This is shown in the organizational forms of groups in the globalization movement. In other words, "it is about creating and enacting horizontal networks instead of top-down structures like states, parties or corporations; networks based on principles of decentralized, non-hierarchical consensus democracy." (*ibid*, p. 70). These ideals exist outside of history and share common ground with those of Proudhon.

There are two aspects to Marx's theory of the value form of money and his criticism of labor money theory. The first aspect follows the criticism in "A Contribution to the Critique of Political Economy", which states that labor is the substance of commodity value. However, this cannot be shown by individual labor time, and is a theory of measure of value that does nothing more than express money price. Second, production anarchy in market economy inevitably gives rise to the advantage of money, and the difficulty or eventuality of sales (or realizing value) in market transactions. Labor money theorists, including Proudhon, overlook both of these aspects. This being said, Marx's theory leaves room for reconsideration. Proudhon's narrow understanding of market relationships, and that social relationships are not encapsulated in market relationships alone, are issues with similar roots. This is because Marx's theories of measure of value and the inevitability of money are constrained by problem setting that criticized Proudhon and by assuming a rigid commodity producing system. This leads to marginalization of the historical viewpoint inherent in Marx's theory. For example, Marx's theories would not demonstrate an understanding of the idea that the market cannot include the entire social reproduction process, constantly leaving behind fragments. In addition, exogenous natures of market that have developed through history, such as trade relationship between communities, are not theoretically incorporated. Discussions of the problems of realizing value and the quantitative relationships of labor assumed in market economies, without addressing these issues, show the limitations of Marx's criticisms of Proudhon from a Marxist theoretical viewpoint. At the same time, can we say that there is insufficient theoretical explanation given for local currencies and other movements to expand their activities in the non-market areas outside of both Proudhon and Marx's theories?

If one considers the current circumstances, the metabolic cycles of regional economies have been broken down due to bloated financial markets, and the burden of interest rates on small producers and laborers has been growing. Despite this, neither Keynesian doctrine nor

Soviet-style socialism are able to function as alternatives. Attention has been paid to Proudhon ideals, such as the elimination of increased unearned income including interest, which brings about fair market economies, coupled with an aversion to implementing state policies or making large-scale changes in economic systems. The approach of setting market principles and criticizing real markets has been used by various timeless movements within anarchism such as the modern-day WTO demonstrations and local currencies. More than being an inherent market ideal, it may be more properly said that certain ideals are being incorporated into markets. In that sense, is it appropriate to maintain this as a method of counter positioning ideals to reality within a normative theory? The idea of ideal markets functioning as alternatives is one that merits further research.

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