

Toward Peace and Prosperity

Jeffrey Sachs

DURING THE PAST DECADE, THE WORLD HAS UNDERGONE more institutional economic change than in any other decade in its history. We are in the midst of a global revolution, in which countries with a combined population of perhaps three and a half billion have adopted market-driven economies. They have discarded completely different visions of the state, from extreme Stalinist-style socialism to a more moderate form of non-market, state-led industrialization. It is changing the world; it is changing these countries, and it is changing our environment as well, more rapidly and more decisively than at any other time in history. China, with its population of 1.2 billion, has been opening up since 1978, and India, with its 900 million people, since 1991. Central and Eastern Europe (150 million people) have tried to rejoin the world's economic system through institutional change, throwing open the doors of their countries to international trade and competition. Since 1991, a fragile new democratic system has emerged for the more than 300 million people in the fifteen new states of the former Soviet Union. In Latin America, with its 450 million people, military dictatorships returned to the barracks in the midst of financial chaos in the early 1980s. Almost every country has, one by one, thrown off a legacy of decades of statist economic policy in an attempt to rejoin the world economy. At times, these countries act in the most irreversible way, such as when Mexico joined NAFTA, or Chile, which is now knocking vigorously at the door to join formal institutional arrangements.

Africa is the only continent in the world where this is not yet an overriding phenomenon. Fortunately, even on that continent, some countries are adopting multi-party, democratic, and constitutional forms of government for the first time and are attempting to bring about economic change, but typically under conditions of horrendous social and human suffering. Overall, more than half of the world's population is fervently engaged in this struggle and if you look not just at the numbers or at the extent of this revolution, but at the intensity — the speed of change, the speed of institutional harmonization, the rapid construction of international

norms in areas such as trade or intellectual property rights (manifested in last year's Uruguay round agreement and the start-up of the World Trade Organization) — you can say that we are living in an unprecedented global revolution.

This economic revolution gives more fundamental hope to the prospects for economic development than anything we have seen in the world during the past 200 years. At the same time, political institutions in the world have lagged behind these dramatic economic and technological changes. Therefore governments, supranational and subnational institutions are under remarkable stress as this disjunction between economic change and much more gradual political change puts social and political and intellectual stresses on the world system.

The disjunction operates in two fundamental dimensions. One is in changing the nature of the function of government and the other in changing the nature of the level of government at which those functions can best be met. Both the change of function and the change of level are putting tremendous strains on the nation-state, which has been the organizing principle of the international system, according to at least one viewpoint, since the mid-seventeenth century, but certainly in the last fifty years. It is the stress on the nation-state which is the most profound manifestation of the current disjunction of economic and political change.

In many ways, history explains why we are having this global revolution. We need to understand why the world is shifting so dramatically right now, and what it portends for the political question.

1840—1990 IN A THOUSAND WORDS

Around 1840, the modern capitalist system, which was born following centuries of institutional innovation in Western Europe and primarily in England itself, went on to challenge the rest of the world. The industrial revolution became possible through this institutional breakthrough. At that time, the rest of the world was far from having capitalist institutions. While Canada, the US, Australia and

a few other former or current European colonies in the newly settled lands had capitalist economies, the great civilizations of India, China, Russia, and Islam were not market-based societies.

What is important about the period after 1840 was the incredible efficiency advantages of market capitalism that resulted in an unprecedented economic and military superiority of the market-based societies over the rest of the world.



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We have a fragile but truly global world market system.

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There had never been such a vast disjunction of power before, and that spilled over into a military and colonial process, which only now is finally unwinding. After 1840, Britain started to challenge China in the Opium Wars, and France began its colonization of North Africa. The Ottoman Empire came under stress. France and Britain defeated Russia in its own backyard in the Crimea in the 1850's, prompting Alexander II to initiate modernizing reforms in the 1860s.

Only one country in the non-Western world met the challenge by a decisive, radical, capitalist economic reform—Japan. In today's terminology, Japan's approach would be called "shock therapy". In 1868, Japan had a mostly peaceful revolution: the Meiji restoration. In the following 15 years, Japan systematically adopted capitalist institutions in a brilliant fashion. The Meiji restoration and the institutional reform that followed can probably be considered the most successful economic episode in history.

In the early 1870s, the Japanese sent missions to Europe and the US to bring back ideas for institutional reforms. Within 15 years of the start of the Meiji restoration, a previously closed feudal society was operating under open trade and capitalist institutions. Japan soon had a gold standard, a central bank law that was modeled on the Belgian central bank, educational institutions, newspapers, post office systems, police forces, and an army. By the 1890s, Japan had adopted a cabinet system of government, a constitution, and a comprehensive commercial law code. These reforms set in motion a century of dramatic economic development, propelling Japan to the second position in the world economy.

No other large nation succeeded in achieving what the Japanese had done. Some countries were so far behind and subject to such internal strife that they fell apart. Others, like India, fell under the complete control of a European imperial power. Some tried partial reforms. The story of Russia's partial reforms between the 1861 emancipation of the serfs and the First World War was one of half steps, confusion, and paralysis. Russia never managed the breakthroughs that truly would have made it a law-bound, market-based capitalist economic system. This left the tsarist regime enormously fragile, unable to absorb the profound shocks of the war, vulnerable and too weak to fight off its eventual overthrow.

Yet, by the end of the nineteenth century, one can say that a world system existed. It was a world capitalist system that even had its own form of the Internet — the telegraph, at the time was perhaps more remarkable than e-mail is today. There were transport and communications breakthroughs, railways, steamships, the Suez and Panama Canals, and above all, a global market system. The world had arrived at a global market system, and yet it ultimately collapsed because of the fundamental disjunction of economics and politics. Yes, there was a global market system, but it was based on colonial domination, not international rule of law. The balance of power within Europe, rather than the rule of law, was the fragile basis for the international system.

In 1914, a new phase of history began with the worst war in world history, followed by a decade of financial instability, the Great Depression, and the Second World War. At the end of the

Second World War, the post-colonial countries, now independent for the first time in this hundred-year span, looked out in the world and asked: "Do we choose capitalism?" What they saw in capitalism, they thought, was not the successful dynamism of the late nineteenth century, but rather predation, the rule of the jungle, imperialism, dependency, violence, instability and the like. And a conscious decision was made not to choose capitalism. The vast majority of the developing world opted for either hard-core socialism or, what was called, the "third way" of state-led industrialization. Both socialism and state-led industrialization strategies aimed at using the state to develop industry and to promote modernization behind closed barriers. The outside world was viewed as dangerous. Nehru and Gandhi, after all, had fought for Indian independence on the rallying cry of "self-sufficiency". So had Sukarno in

Indonesia and new national leaders in many other post-colonial countries. The way to develop, it was thought, was to have the state guide the development process while remaining aloof from the rest of the world. It is therefore no accident that almost all

of the developing world chose closed borders, and a heavy role of the state. The economic choices were similar, whether it was Atatürk, Nehru, Sukarno, Peron, or the other leaders of the post-colonial world. They chose a non-capitalist system.

What has been happening over the last ten years is the collapse of that choice. What these leaders chose did not work, because it was fundamentally flawed. There was no way to develop a country by closing oneself off from the outside world, depriving oneself of the world's thinking, technological advances, competition, capital and other factors fundamental to economic growth. The vast majority of governments in the developing world went bankrupt in the early 1980s as a result of having borrowed heavily in international markets—a strategy pursued in an attempt to keep the system of state-led industrialization alive after stagnation set in by the 1960s and 70s. Foreign borrowing turned into a mountain of debt rather than economic development. By the 1980s, the foreign debts could not be paid. At this point, financially bankrupt governments initiated fundamental institutional reforms.

From an economic point of view, recent developments have put us back to where we were one hundred years ago. We have, once again, a fragile but truly global world market system. If there is a fundamental lesson from one hundred years ago, it is, of course, that we are not at the end of history. The system remains fragile for essentially the same reasons that it did in the first wave of global capitalism: our political institutions are not yet capable of guaranteeing a peaceful existence based on the rule of law under a global market system. Yet, we are closer than we were one hundred years ago. There is a great amount of international law, there is codification of international rules of the game, there is national sovereignty (after the colonial era finally passed). The economic changes that have taken place are the most promising that we have seen in this century.

STRESSES ON THE NATION-STATE

We have, as mentioned above, a fundamental disjunction in two dimensions: first in function and second in the level of gov-

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ernment. Both need reform. We used to view government as promoting industry, guiding industrialization, stabilizing economies through Keynesian methods. Now it is quite clear that the list of functions has to be vastly altered. Many of those functions were extremely naive in their conception. Some of them made sense fifty years ago, such as the public provision of social security. However, they no longer make sense because private markets can do better without putting the stresses on the fiscal and political system. When national governments introduced state-guaranteed pensions about half a century ago, there were no private capital market institutions that could do this job. Now there are new, market-based ways to secure the provision of pensions.

The government's appropriate functions are once again the classic ones. The first is security, and that operates on two levels: one is national security and defense, and the other is internal security in the sense of preserving the rule of law and protecting property rights. While that is easy to state in one sentence, it requires about eighteen federal volumes of law to make it real. So the task of government is not simple. The protection of property rights is extremely complex. A second fundamental function is managing global resources, because there are areas where property rights do not exist. While economists may say "all that you have to do is define the property rights to the air, to the sea, to outer space," it is vastly easier said than done. We are just facing the beginning of institutional challenges in global environmental management. So the role of collective action remains fundamental.

The third fundamental role of government, the support of the generation of basic knowledge, is also a collective action problem. As our economies are more knowledge-driven today than at any time in history, the role of knowledge in our economic development grows. We know that markets can generate fantastic amounts of basic knowledge, but they cannot do it by themselves. The biotechnology industry, for instance, generates basic knowledge on the basis of intellectual property rights that have emerged over time, but it also depends on large amounts of public help and support for basic knowledge because the market incentives are not sufficient.

The fourth function of government is the "social" one. However, there should be a question mark beside it, because most of what states do right now is transfer income, which places them under the rubric "social welfare state." Today, most of these social transfers are no longer what we would regard either as "social" or necessarily "state" because they are trans-

fers from the middle-class to the middle-class, at least in the rich countries. That simply is not serving the kind of social function that we think of when referring to the basic social safety net.

The next challenge is deciding at which level of government these functions can be carried out. What is clear is that the nation-state as the central organizing level for the provision of security and the other factors is not adequate. The state is under profound stress in two directions.

The nation-state is far too small to be the level for organizing economic life. Without international trade no economy can be productive, not even the US. Under mercantilist theory, the nation-state defined the extent of the market, but now prosperity requires participation in the global market. Nor should the nation-state define the activity of the national financial market as too small to spread the risk and channel resources for profitable investment. Therefore, the international markets for goods, services, knowledge, technology and finance have supplanted the national market.

On the other hand, the nation-state is too large to provide the communal services of education, culture, and the arts, that smaller communities desire in order to protect their heritage.

Since we are all living in the global economy, there is even greater urgency in allowing communities to find their own space in which they can manifest their distinctiveness and cultural heritage. Thus, there is a great pull in both directions away from the nation-state. Every large country in the world is undergoing a fundamental devolution of power right now, and this will remain true as world peace and open markets prevail. As long as there is peace and an international marketplace, the nation-state simply does not carry out the basic functions defined above.

In India, China, Brazil, the United States, Canada, and in every continental society, a radical devolution of power to local governments or to regional governments occurs at the same time at which there is a search for supranational solutions to some of these challenging problems. At the supranational level, we are desperately in need of an international rule of law,

but at the same time, we lag far behind in obtaining a common understanding and basis for legitimating an international legal order. In the US, the United Nations does not have the legitimacy and the support of the people that it needs in order to carry out its function. Institutions like the World Trade Organization, the International Monetary Fund, the World Bank, which are vital for providing international norms and legal standards to create a stable world system, are basically on page

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D-17 of our newspapers. These organizations are poorly understood. They lack support and legitimacy while being under enormous pressure of budget cuts, in a climate of financial stress affecting all of the leading countries.

WHERE TO GO FROM HERE?

This leads to the question of how to strengthen our supranational institutions. We are faced with the challenge of creating a supranational legal system that can gain our assent to carry out the basic functions of financial regulation and oversight in a world financial market. We need to create an open trading system that will take away the tensions and the pressures that could lead to the renewed nationalism that undermined global capitalism 100 years ago.

First, the G-7 is the wrong group. In this world, right now, it does not make sense to think that this group of seven countries can really manage the world economy. What is best about the G-7 is not just its economic strength, but the fact that these are the leading democracies. However, it is vital to add other leading democracies to this group. There is a case for a gathering of countries that is smaller than the United Nations General Assembly, but the G-7 is not the group that can write the script for the world any more. As leading democracies that have chosen to reintegrate into the world's system, Brazil, India, and Russia (if it remains democratic) need to be part of this group if the group is really to address global legal and financial concerns. To form the right expanded group would be quite an important venture for the current G-7.

Second, our political and economic leaders must appreciate the fragility of the world's system more than they do. Democracy and the market economy really are the most brilliant institutions, but they are fragile, as history has proved. We have a good chance to consolidate a global market system, but there are still great risks. For example, it is reckless for the US to be pursuing its unilateral attack on Japan's trade policies outside the World Trade Organization. The WTO is a fragile institution that requires our nurture and support.

Third, we need to define the function of international institutions so they can carry out their job. The World Bank, for example, needs radical restructuring and downsizing, because private capital markets can do much of what the World Bank now does for the middle-income developing countries. The private capital markets can fund the infrastructure and it is much better to press the private markets to do so, because there will be more competition, more discipline, and better investment judgements. The World Bank is needed precisely in those areas where there are collective action problems. It can help govern the global commons, foster sound environmental management, and work with the World Health Organization to help promote worldwide public health, so we are not overtaken by yet new strains of unknown viruses, which have horrified and terrified us in the past decade. These are the functions of the World Bank: basic research and devel-

opment, the global environment, world health, assistance for the poorest countries which are outside of the market right now because of their desperate conditions. The World Bank need not be in the business of project lending to middle-income countries.

This is an example of a reform that would be both within the spirit of budget cutting and promoting the real functions that need to be carried out. The same applies to the IMF. We have to think creatively. Giving the IMF more money to carry out its policing functions, as agreed during last year's Halifax summit, lacks imagination. What we really need is not just a policeman

with money to throw to Mexico, but a deepening of the international rule of law and financial regulation. The IMF could function with less money but more effectiveness if it were modeled on the basis of national financial regulation such as the financial workouts under US bankruptcy law. This would

be far better than merely handing out money to countries in distress. We need creative thinking about the functions of the IMF as well as the level of IMF finance. These international institutions are vital, but only if they perform effectively.

Last year was not only the 50th anniversary of the United Nations and the end of the Second World War, but it was also the two hundredth anniversary of one of the most remarkable documents of human thought ever published—Immanuel Kant's essay on *Eternal Peace*. It is one of the boldest and most brilliant expositions of the Enlightenment that has come down to us. Kant asked himself a remarkable question two hundred years ago: how do we create a system of eternal peace where we can avoid war and live in international harmony? He gave an absolutely remarkable answer, considering the time in which he lived. He said it should be based on two things: first, it should be founded on a community of republican (non-monarchical) governments that we would now call the community of democracies. He pointed out, as one of the world's first political scientists, that the republican governments would be much less likely to wage war than would monarchical governments. The second thing Kant noted was that we need free international commerce because free trade is a civilizing instrument that promotes prosperity, interdependence, and mutual understanding among peoples.

The point is that economics and politics must go hand in hand. Kant not only made a brilliant observation, he gave us an agenda. One hundred years ago, we reached a world market system, but not the community of republics that Kant had urged. Yet another hundred years later we are on the threshold of a world market system and perhaps even a community of democracies. Democracies may not yet be universal, but the reach of democracy is expanding. The number of democracies has approximately doubled from around 50 ten years ago to around 110 today. We have a chance to create an international system based on market principles and the international rule of law. For our security, our prosperity and our children's happiness we must grasp this chance. ♦

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