HOUSE OF LORDS

SESSION 2002–03
1st REPORT

SELECT COMMITTEE ON ECONOMIC AFFAIRS

GLOBALISATION

Ordered to be printed 18 November 2002

PUBLISHED BY AUTHORITY OF THE HOUSE OF LORDS
LONDON – THE STATIONERY OFFICE LIMITED

£14.00 (inc VAT in UK)

HL Paper 5–1

CONTENTS

CD ROM (Containing the Report and two volumes of evidence).

Note

The evidence received by the Committee is published in two separate volumes: oral evidence (and accompanying written evidence) up to 13 March 2002 is published in HL paper 143 (Session 2001-02) and is referred to in the text of this report as (Ev I), and oral evidence (and accompanying written evidence) taken after 13 March 2002 and other written evidence is published in HL paper 5-II (Session 2002-03) and is referred to in the text of this report as (Ev II). (Q) refers to a question in the oral evidence and (p) refers to a page of written evidence.

FIRST REPORT

18 NOVEMBER 2002

By the Select Committee on Economic Affairs

ORDERED TO REPORT

GLOBALISATION

CHAPTER 1: INTRODUCTION AND LIST OF CONCLUSIONS AND RECOMMENDATIONS

Background

1. The Select Committee on Economic Affairs was appointed by the House of Lords on 7 March 2001. It was given the following terms of reference: "to consider economic affairs".

2. The membership of the Committee, together with their declarations of interest, is set out in Appendix 1.

Purpose and scope of the Committee's inquiry into globalisation

3. Meeting the challenge set by its wide-ranging terms of reference, the Committee announced on 22 March 2001 that it would undertake an inquiry into economic globalisation.

4. In undertaking this inquiry, the Committee recognises that it should not replicate the work done elsewhere by academic, governmental or other institutions which have the resources to conduct original research. The purpose of the Committee's inquiry is more general. It is to take forward the debate on globalisation – a debate described in the White Paper published by the Department for International Development *Eliminating Poverty: Making Globalisation Work for the Poor* as "a serious political debate about the equitable management of globalisation".[1]

5. Mike Moore, then Director-General of the World Trade Organisation (WTO), described "globalisation" in evidence to us as "a sort of slogan" which – unlike "internationalism" – has a "menacing ring" (Ev I, Q 1122). The prevalence of the popular belief that globalisation is a harmful phenomenon is illustrated by the recent and dramatic emergence of groups protesting against globalisation. The Committee, sensitive to this anxiety, seeks to examine and to clarify the diversity of opinion on the extent to which economic globalisation should be perceived as a threat or an opportunity, and to make recommendations for change where it seems to the Committee that the costs of globalisation can be ameliorated.

6. Globalisation is an elusive concept. Many of those giving evidence made this point. Dr Supachai Panitchpakdi, the present Director-General of the WTO, for example, advised that it was sometimes "best to avoid using the word 'globalisation' as a catch-all word and to be as explicit as possible" (Ev I, Q 562); and Gerry Rodgers of the International Labour Organisation (ILO) said: "When it comes to globalisation more generally I think we have to acknowledge that we are dealing with something which is rather fuzzy." (Ev II, Q 1238). The Committee is aware that globalisation is used to describe developments within a variety of different fields of human activity and interests – social, political, cultural, environmental as well as economic – and that these different manifestations of globalisation are inextricably interconnected. Although our remit is largely to do with economic matters, we do not take this to mean solely a concern with the economy as narrowly interpreted. In judging the effects of globalisation, we have no hesitation, for example, in bringing health, life expectancy, law and order, and education into the picture. We recognise that these issues are both indicators of, and precursors to, successful development.[2]

---

1 *Eliminating Poverty: Making Globalisation Work for the Poor*, Cm 5006, December 2000, p 14, para 10.

2 Referring to the range of issues included in the United Nations' Millennium Development Goals (income, education, health, gender issues, governance and the environment), Nicholas Stern of the World Bank suggested that they were "not only outcomes that are desirable in themselves, they create means to higher incomes" (Ev II, Q 1832).

Evidence gathering

7. Following the 2001 General Election, the Committee was reappointed on 28 June 2001 and on 24 July 2001 the Committee issued a Call for Evidence. The text of the Call for Evidence is given in Appendix 3.

8. The Committee received over 50 written submissions in response to the Call for Evidence and, between 17 July 2001 and 10 October 2002 took oral evidence from 56 organisations and individuals. A list of witnesses is given in Appendix 2. We also met Stanley Fischer, former First Deputy Managing Director of the International Monetary Fund (from 1994 to 2001) and Mervyn King, Deputy Governor of the Bank of England, who assisted us by providing informal background briefing.

9. During the course of taking evidence, the Committee visited a number of international organisations in Geneva (the World Health Organisation, the World Trade Organisation, the International Labour Organisation and the United Nations Conference on Trade and Development) and the European Commission in Brussels.

Acknowledgements

10. The Committee is grateful to those who gave evidence, written and oral, and recognises that the contribution which it is able to make to the globalisation debate depends critically on the quality and range of evidence which it has had the privilege to receive. The Committee regrets very much that the United States Government declined to provide evidence. Their reasons are set out in a letter dated 16 October 2002 which is reproduced in Appendix 4.

11. The Committee is also grateful to its Specialist Advisers: Professor Anthony Venables, Professor of International Economics, the London School of Economics, and Professor Michael Wickens, Professor of Economics, University of York. It would also like to record its thanks to Mr Martin Stewart who, with Professor Venables, provided a briefing document for the Committee at the outset of the inquiry (see Appendix 5), to Mr Adrian Lewis who assisted in summarising the evidence and to those who contributed to the organisation of the Committee's visits abroad.

Structure of the Report

12. The next chapter of the report (Chapter 2) sets out the range of definitions of globalisation – both globalisation generally and economic globalisation specifically – which have been given to the Committee in evidence. This is to set the scene of the globalisation debate. Chapter 2 also considers the question whether the current period of globalisation differs (and, if so, how) from previous periods of significant international economic integration and, as part of that examination, attempts to identify the driving forces behind current globalisation.

13. Whilst the majority of the evidence we received favoured globalisation, no witness presented it as a process which had no harmful effects. In the following chapters of the report we give an account of the evidence received by the Committee of some of the concerns about the impact, both internationally and nationally, of economic globalisation and in each chapter we draw conclusions and make recommendations. Thus, in Chapters 3 to 7, we consider, within the context of opening up markets of all kinds, issues under the following headings:

- Economic performance, poverty and inequality;
- Labour market conditions;
- The role of transnational corporations;3
- Management of the international trading system; and
- The international financial system.

14. We begin, however, by setting out an overview of concerns and a summary of conclusions and recommendations.

Overview of concerns

15. We have become accustomed to reading newspaper reports about protestors taking to the streets – in Seattle, Washington, Prague, Nice, Gothenburg and Genoa – to protest against globalisation. One of the principal motivations of the Committee in undertaking this inquiry is to examine and attempt to

3 In our Call for Evidence we use the expression "multinational corporation". It was drawn to our attention that a more commonly used, and less confusing, term is "transnational corporation". Throughout the report, therefore, we refer to "transnational corporations" (or TNCs). We take it to mean the same as "multinational corporation" (MNC).

clarify the reasons which have given rise not only to the anti-globalisation movement in recent years but also to a more widespread sense of anxiety that globalisation is harmful.

GENERAL REMARKS

16. A range of witnesses were asked for their views about why they believed globalisation has given rise, at the very least, to public disquiet and, on occasions, violent protest. Two general remarks can be made about the evidence at the outset: first, the opinions of witnesses varied and those who were critical of globalisation cannot be regarded as an homogeneous group; and, secondly, although some strands of protest are literally *anti*-globalisation, in most cases critics of globalisation favour *better* globalisation rather than *no* globalisation.

17. Dr Noreena Hertz, of the Judge Institute, Cambridge University, for example, told us when asked about the concerns of the anti-globalisation movement:

> "Most people are not anti-globalisation … In some senses it is hard to talk about it as a movement because it is a movement of movements; there are all these different groups who are aligned in it, but … by far the majority are not anti-globalisation … The way I would define it – and I am defining it in a very particular way – is as a continuum where, on the one extreme, you have people who go out on to the streets of Seattle, Genoa, Prague, Nice, Gothenburg, or the hundreds of thousands who go out and protest in Latin American countries or in Africa. Then you might have over here the students who do not want to buy Nike trainers because they are concerned about buying things from sweat shops. Then over here you might have the housewives and Women's Institute members who do not want to buy genetically modified food because they are concerned about the things they are giving their kids to eat. Then you have people like Joseph Stiglitz, the former Chief Economist of the World bank who resigned because he had come to believe that its programmes were exacerbating poverty, or even George Soros, who tells me that he sees himself as part of the anti-globalisation movement." (Ev II, Q 1651).

Dr Hertz continued: "it is a matter of making globalisation work in a much better way for many more people" (Ev II, Q 1652).

18. Professor Joseph Stiglitz of Columbia University, alluding to what is widely perceived to be "a real sense of hostility towards globalisation", suggested that "it is not hostility towards globalisation, but it is really hostility towards the way globalisation has been managed and to a particular set of economic doctrines that have accompanied globalisation on the part of some of the international economic institutions." (Ev I, Q 711).

19. George Monbiot of *The Guardian* said: "I feel the protest against what has been called globalisation … has brought together an extraordinary array of concerns, some of which are mutually contradictory … it is a very broad and very wobbly coalition indeed …" (Ev II, Q 1348). Mike Moore also commented this diversity when he described a protest march in Washington against the World Bank and the IMF, noting that he had seen "vegetarians … marching with meat farmers" (Ev II, Q 1122). Mr Moore also indicated his view that not only was there an absence of consensus amongst the protestors in developed countries, but that the generality of the protest against globalisation in the developed countries ran counter to the perception of globalisation in developing countries: "Half the rich world is protesting about globalisation and the poor world is protesting about marginalisation … It is hard not to get irritated by middle class indulgences." (Ev II, Q 1127).

THE VARIETY OF CONCERNS ABOUT GLOBALISATION

20. The Committee received a range of evidence about why people are critical of globalisation, some came from the critics themselves, some came from those who were the subject of criticism and some came from commentators. Given the complexity of the concept of globalisation, inevitably the criticisms were diverse (and, as George Monbiot noted, not wholly consistent). They included concerns about the economic consequences of globalisation (such as income inequality and global shifts in employment), about the way in which globalisation is managed at an international level and about broader issues such as cultural homogenisation or environmental degradation. We acknowledge that the evidence we received will not have included every criticism to be made of globalisation but we believe – or we hope – that we have identified the main objections.

LIST OF CONCLUSIONS AND RECOMMENDATIONS

We offer this list as a help to the reader. We emphasise, however, that a proper understanding of each conclusion and recommendation requires full consideration of the argument that precedes it in the text of each chapter.

CHAPTER 2: DEFINING AND DESCRIBING "GLOBALISATION"

1. The present period of globalisation represents a new departure in world affairs. (paragraph 55)

2. Although some of our witnesses claimed that what we observe is much the same as what has happened before, but on a large scale, we believe that recent experience is both quantitatively and qualitatively different. (paragraph 57)

CHAPTER 3: ECONOMIC PERFORMANCE, POVERTY AND INEQUALITY

Poverty

3. Although the general level of world poverty appears to be decreasing, this improvement is not evenly spread and some countries continue to suffer a very high concentration of poverty. (paragraph 64)

4. There remains, in our view, a shameful level of poverty in the world. We are appalled at the sheer waste of human potential that such poverty implies. (paragraph 64)

Inequality

5. It appears that between-country inequality is reducing (largely because of the economic growth of China and, to a lesser degree, India), but within-country inequalities (both in developing and developed countries) are in some cases increasing. (paragraph 72)

Relationship between poverty, inequality and globalisation

6. While there are negative aspects to globalisation, the weight of the evidence suggests that the opportunities created by globalisation outweigh the dangers. Effective integration in the global economy is a major part of the explanation why some developing countries, such as China and India, have enjoyed significant economic growth in recent years and a failure to integrate effectively is at least part of the explanation why other developing countries, such as sub-Saharan Africa, remain very poor. (paragraph 86)

7. The process of globalisation requires appropriate national policies (dealing, for example, with political and administrative reform) and a strengthened international governance infrastructure so that its potential may be maximised. Only then can markets operate optimally. (paragraph 88)

Exploiting globalisation to reduce poverty and inequality

8. We welcome the measures that are being taken internationally to assist developing countries to improve their investment climate. Although this is principally a responsibility of the developing countries themselves, efforts should be made through multilateral and bilateral agencies and agreements to facilitate developing countries in making such improvements. (paragraph 94)

9. We consider that efforts should be made through multilateral and bilateral agencies and agreements to encourage developing countries to diversify their production, while not undermining the areas of production where those countries have a distinct comparative advantage. (paragraph 96)

10. We welcome the United Nations' commitment in the second of its Millennium Development Goals to "achieve universal primary education" and the UK Government's support for this. An education strategy which takes school age children out of the labour market should be at the centre of any development plan. Far from creating an economic burden, this is a prerequisite to a successful economy. (paragraph 100)

11. Financial regulators, the international financial institutions, the World Trade Organisation, professional bodies and governments, either separately or together, should establish a centre of responsibility with the aim of tackling corruption (both in connection with development programmes and the operation of the global economy). We believe the UK Government has an important part to play here, preferably in co-operation with our European Union partners. Transnational corporations and other businesses must accept responsibility for scrutinising their agents and other business associates with regard to corrupt practices on their part. Reinforced action by business organisations would also be helpful. (paragraph 110)

CHAPTER 4: LABOUR MARKET CONDITIONS

Developed countries

12. Globalisation has brought about industrial restructuring which has caused some transitional unemployment in developed countries especially amongst the less skilled. The evidence suggests however that technological change has been more significant in reducing industrial employment amongst the less skilled. It is possibly a more significant force than competition from low-wage economies. (paragraph 117)

13. The evidence suggests that in those developed countries where there is increasing wage inequality, this cannot be attributable solely to globalisation but is also a consequence of a number of other factors including technological change. (paragraph 119)

Responding to changing labour market conditions

14. Given the fall in demand for unskilled and less skilled labour in the tradeable sector of the economies of developed countries, including the United Kingdom, successive UK governments have been right to take steps over many years to promote the skills training of the unskilled and less skilled workforce. We support the present Government's reinforcement of the policy to promote education and skills training. Similarly, as regards developing countries, increasing skills levels is an important element of a strategy to enable those countries to exploit more effectively the potential of globalisation. (paragraph 135)

15. Significant benefits arise from labour mobility (for both the countries involved and the individuals). Nevertheless, there is a concern about the effect of the "brain drain" on those developing countries which are losing skilled labour. To the extent that this impairs the development of these countries (in relation to both their public and private sectors), we share that concern. We welcome the UK Government's commitment to undertake further research on the "brain drain". Overseas aid policy should help to finance education and training in poorer countries, shifting the burden from taxpayers there to taxpayers in the countries of immigration. The level of aid might be geared to some extent to the number of skilled workers coming from a country. (paragraph 138)

CHAPTER 5: ROLE OF TRANSNATIONAL CORPORATIONS (TNCS)

TNCs and the economic effects of foreign direct investment

16. We believe that foreign direct investment is an effective mechanism for economic change in developing countries (although there is evidence that it could be more effective). (paragraph 150)

Complaints about the power of TNCs

17. Witnesses expressed a real concern about the influence of TNCs in democracies. We acknowledge that TNCs are powerful, but we believe that they are also subject to a range of constraints and, in particular, to the power of governments and of public opinion. (paragraph 157)

18. We acknowledge that there is a concern that some TNCs have the capacity to be "footloose", but we believe that, in practice, their mobility is constrained and that foreign direct investment by TNCs, once undertaken, is locked in to a significant extent. We think that this point is fundamental. (paragraph 162)

19. TNCs are not an homogeneous group and standards of conduct will vary between them. Some TNCs behave responsibly but others act against the interests of the country in which they

have located production. The evidence we have received suggests that often TNCs adopt standards which are higher than those adopted by local businesses. We are not complacent however. We are aware that businesses have a primary duty to act in the interests of their shareholders and that there is, therefore, a case for government measures to be taken to encourage them to take responsibility for a wider range of the interests which are affected by their activities. (paragraph 169)

Regulation of TNCs

20. There has been a welcome increase in transparency of governments and of public financial institutions in recent years. Although similar advances have been made by some TNCs, the corporate sector has a long way to go in this respect. We recognise the right of companies to a degree of commercial confidentiality, but believe that their claims to this could be regarded as excessive, making it almost impossible for the international financial institutions and governments, let alone a committee such as ours, to give them the scrutiny that good global governance requires. (paragraph 181)

21. We welcome international initiatives to promote corporate social responsibility amongst TNCs as a mechanism for enhancing transparency and accountability of TNCs. We recognise, however, that there is concern that a purely voluntary regime will not provide a sufficient safeguard against abuse of power by TNCs. We note with approval that, as part of its current review of company law, the UK Government is considering that some companies should be required to report on the impact of their activities on the environment and, more broadly, on the communities in which they operate. (paragraph 182)

22. There is a need to consider whether a powerful global competition authority is necessary. (paragraph 183)

23. The UK Government should review its data collection in respect of TNCs. Data collection at present is too limited and out of date and should be substantially improved. (paragraph 184)

CHAPTER 6: MANAGEMENT OF THE INTERNATIONAL TRADING SYSTEM

Governance of the WTO

24. We recognise that member countries of the WTO vary in size and economic power. They vary, therefore, in their capacity to influence decisions in the WTO and, more fundamentally, to maintain a presence at the WTO. It would be naïve to believe that an organisation like the WTO would not be dominated by a small number of rich countries. The important question, which applies to the International Monetary Fund and the World Bank as well, is whether this domination is excessive. We believe that it is in all three institutions, but the evidence we received placed most emphasis on the WTO. We urge the Government, with its European Union partners, to consider, first, how to improve the balance of power in the WTO and, secondly, how to ensure that decisions are more transparent. We acknowledge the commitment of the Government, contained in the White Paper on globalisation by the Department for International Development, in respect of both matters. (paragraph 199)

Developed country protectionism: agriculture and textiles

25. We consider that developed countries' protectionism (mainly in the United States and the European Union) with regard to agricultural and textile products in particular is wholly objectionable and unjustifiable. In coming to this view we were particularly struck by the evidence of Clare Short, the Secretary of States for International Development, and Mike Moore, former Director-General of the WTO, which we believe should inform future debate on the subject. Developed country protectionism places an unfair burden on developing countries and is in stark contrast to the protestations of the leaders of rich nations that they are committed to helping the world's poor. We urge the Government, within the European Union and the WTO, to take stronger steps to ensure that it is brought to an end. (paragraph 208)

WTO Agreements

26. We are convinced of the central role that Research and Development plays in the process of economic development, and the importance of intellectual property protection as helpful to that end. There is, however, widespread concern that the agreement on Trade-related Intellectual Property Rights (TRIPS), in some respects, is acting against the interests of developing countries

and placing a burden of compliance on developing countries. We share that view. (paragraph 223)

27. We support the initiatives both in the UK and the WTO that seek to review the operation of TRIPS and urge the UK Government to take the steps necessary to ensure that the interests of developing countries are properly considered in the amendment of the TRIPS agreement. (paragraph 225)

28. The UK Government should help to ensure that the implementation of the General Agreement on Trade in Services (GATS) does not place unreasonable pressures on the governments of developing countries prematurely to introduce competition into their service sectors. (paragraph 233)

CHAPTER 7: THE INTERNATIONAL FINANCIAL SYSTEM

The effects of capital market liberalisation

29. The evidence supports our view that there are advantages to capital market liberalisation. Economic theory and the evidence we have received show, in particular, that capital market liberalisation is broadly beneficial to the economic progress of developing countries. It is not without costs, however, and for developing countries to pursue it without adequate preparation of the right policies and institutions would be foolhardy. Our overall conclusion is that the international free flow of capital should be the aim, and become the norm. However, matching the timing of capital market liberalisation with the precise circumstances of the individual country is of the essence. (paragraph 256)

The international economic institutions

30. We started our inquiry from a position highly critical of the World Bank in its role as an international financial institution. While acknowledging the criticisms of the Bank, the evidence has led us to a more balanced and supportive view. In addition to welcoming the Bank's more client-focused approach in its operations, we are especially impressed by the World Bank as a source of data and research which provides the basis for a sensible and valuable approach to the growth process. (paragraph 265)

Tackling financial instability and crises

31. We believe that the IMF is the appropriate body to assist a country faced with an immediate financial crisis. We say this whilst recognising and sharing the criticism of some of the IMF's previous interventions. We are aware that in the past the IMF has been seen as being part of the problem rather than the solution. We are glad to note that they have for some time been subjecting their procedures to internal scrutiny, especially as they pertain to dealing with short-term financial crises. In the short term, what is obviously required is immediate assistance to deal with impending sovereign debt default. We recognise that the resources of the IMF are limited and that, therefore, financial support from the United States and other developed countries will have to increase and the role of the main central banks be enhanced. We also recognise the advantages of involving the world's capital markets in providing the necessary short-term finance, and the important role that the IMF can play in sovereign debt re-scheduling. Finally, it is our general view the IMF should pursue an open-minded approach to these problems and one that is carefully tuned to the circumstances of individual countries. (paragraph 292)

32. The Committee is not persuaded of the case for a Capital Transactions Tax as a mechanism for reducing capital market volatility. It would be difficult, if not impossible, to impose world-wide and could be very harmful to a country to do so on its own. We recognise that capital outflows can be damaging to an economy, but this is often a symptom of domestic macroeconomic problems, not the cause. Where, however, capital outflows are the result of excess volatility and the irrationality of international financial markets, the IMF, together with the major central banks, should assist in reducing that volatility. (paragraph 299)

CHAPTER 2: DEFINING AND DESCRIBING "GLOBALISATION"

21. Although globalisation may be a contested concept, there is no dissent from the view that we live in a period of globalisation. The first two questions which the Committee asked in its Call for Evidence were therefore: what is globalisation? and is it new? Both questions elicited a variety of responses.

Defining globalisation

22. It was noted by many witnesses that globalisation – generic globalisation – should be construed broadly as spanning a range of human activities. A cross-Government Departmental memorandum[4] suggested, "… in an economic context [globalisation] is normally understood to mean a process of increasing international interactions and accelerating international trade, capital and information flows" but that "globalisation can also be seen to have a political dimension, including the diffusion of global norms and values, the spread of democracy and the proliferation of treaties, such as international environmental and human rights agreements." (Ev I, p 1). The Trades Union Congress (TUC) noted that "today globalisation is applied to cultural, political and social changes as well as economic" but, as far as the economic definition was concerned, they thought that a reasonable approach was that adopted by the World Bank and others, namely that it is "the rapid increase in the share of economic activity traded across national boundaries", measured by international trade as a share of national income, foreign direct investment flows and capital market flows (Ev I, p 31).

GLOBAL INTEGRATION OF ECONOMIC ACTIVITY …

23. A number of witnesses described globalisation in terms of a process of increased global economic integration or interaction. For example, Patricia Hewitt, Secretary of State for Trade and Industry, endorsed the definition set out in the White Paper *Eliminating World Poverty: Making Globalisation Work for the Poor*:[5] "globalisation means the growing interdependence and interconnectedness of the modern world", which is, in turn, demonstrated by "the increased ease of movement of goods, services, capital, people and information across national borders" (Ev II, Q 1848). Dr Gro Harlem Brundtland, Director-General of the World Health Organisation (WHO), similarly referred to globalisation as the circumstances in which "there are interdependencies and … realities and rules that increasingly cross national borders" (Ev II, Q 1188). Dr Caroline Lucas, a Green Party MEP, whilst distinguishing between economic globalisation and "the wider issues that often get bundled up in that same term", defined the former as "an economic process whereby national economies are integrated ever more tightly into one global giant economy"(Ev II, Q 1393) and Anita Roddick of The Body Shop International plc endorsed the definition of economic globalisation formulated by Colin Hines of Greenpeace: "the integration of national economies into the global economy though trade and investment rules and privatisation, with the help of technological advances."[6] (Ev II, p 366). The Royal Academy of Engineering assumed globalisation to mean "progress towards an open and integrated world economy" (Ev II, p 369).

24. Nicholas Stern, World Bank Chief Economist and Senior Vice President, said that he preferred the language of "integration", because "when you think about integration, it is something that has a number of dimensions and you can go a long way or a short way or a medium way on each dimension … The dimensions you can think about are trade, which is one of the easiest to analyse and where the results are clearest, but we also see globalisation of capital, some modest globalisation of labour … and globalisation of communications, technology, transport, crime and disease and so on." (Ev II, Q 1820). Mr Stern thought that, of the various dimensions, trade was "key".

25. Dr Supachai Panitchpakdi characterised globalisation as "increasing linkages" – economic, social, cultural – "between various regions, various economies and various sectors around the world." (Ev I, Q 562). Dr Noreena Hertz said that she saw globalisation "… as the accelerating extent of interconnectedness in the world today …bear[ing] upon economics, politics, law, culture and migration", manifesting itself "in terms of trading arrangements and financial markets … environmental questions and questions of infectious diseases and health." (Ev II, Q 1637).

26. Ignazio Visco, Chief Economist of the Organisation for Economic Co-operation and Development (OECD), suggested that globalisation was "a process towards closer economic integration of markets", channelled through trade in goods and services, mobility of capital and

---

4 By officials from the Department of Trade and Industry, HM Treasury, the Foreign and Commonwealth Office and the Department for International Development. During the remainder of this report, this memorandum will be referred to as "the cross-Departmental memorandum".

5 See note 1 above.

6 Colin Hines, *Localisation. A Global Manifesto* (2000), p 4.

mobility of labour. (Ev I, p 170). Similarly, Sir Samuel Brittan of the *Financial Times* said that globalisation did not mean "anything different from an open integrated world economy" in which there was free movement of goods and services, capital and labour (Ev I, p 249) and Martin Wolf, also of the *Financial Times*, referred to the current period of globalisation as "the process of economic integration which has been underway in the last two decades or so" (Ev II, Q 1588).

27. The United Nations Conference on Trade and Development (UNCTAD) offered a definition in the same vein:

> "In general terms, globalisation describes the process of increasing economic integration among nations through cross-border flows of goods and resources together with the development of a complementary set of organisational structures to manage the associated network of economic activities." (Ev I, p 360).

And we note that in a report published by the European Commission, *Responses to the Challenges of Globalisation: A Study on the International Monetary and Financial System and on Financing for Development*,[7] globalisation is characterised as "a trend towards greater integration and interdependence between countries and regions of the globe". It continues: "These growing linkages are often economic and political, but globalisation also has important social, environmental and cultural aspects."[8]

28. The Financial Services Authority (FSA), whilst pursuing the integration theme, emphasised the institutional perspective and defined globalisation in terms of three elements: "… the interdependence of nations, governments and other authorities; … the geographical scope of institutions which operate in a large number of different countries; … and … the globalisation of capital flows and markets." (Ev I, p 318).

… OR THE DIMINISHING IMPORTANCE OF NATIONAL BOUNDARIES

29. A number of witnesses saw the diminishing importance of national boundaries as the key element of globalisation. Matthew Taylor MP, Treasury Spokesperson for the Liberal Democrats, expressed this most clearly when he said: "In some ways, the best definition of globalisation may be that we all play in each others' backyards, and the fences have been torn down between gardens" (Ev II, Q 1352).

30. Willem Buiter, Chief Economist of the European Bank for Reconstruction and Development (EBRD), like other witnesses emphasised – and elaborated on – the diversity of meanings applied to globalisation, but focused principally on the breakdown of boundaries. Globalisation was, he said:

> "… very broadly … a process of diminishing importance of distance, geography and national boundaries in shaping all kinds of human activities. It therefore refers to trade liberalisation, trade integration; it refers to increased capital mobility. It refers in certain regions to increased labour mobility; and it also refers to the enhanced mobility of just about everything and anything that is permitted by the combination of technological change, lower transportation costs and communication costs that have been going on for a long time." (Ev I, Q 189).

Mr Buiter added that there were incontrovertibly adverse elements of globalisation: increased mobility of terrorism, increased mobility of contagious diseases and contagion of crises brought about by the globalisation of capital and financial markets. Sir Andrew Large, then Deputy Chairman of Barclays Group plc, also characterised the globalised economy as one in which boundaries, "as fences to restrict capital movement, marketing initiatives, and information transfer", had declining relevance, acknowledging that "regrettably" this also had implications for the global reach of terrorism, drugs and crime. (Ev I, p 289).

31. The World Development Movement (WDM), a non-governmental organisation, saw economic globalisation in similar terms, describing it as "the removal of barriers to business activity across international borders and within societies", again noting that this development had been accompanied by the global spread of a variety of harmful activities including, for example, trafficking in women and children for sex or slavery, illegal trading and money laundering. (Ev I, p 340).

32. We have no difficulty with the broad view of the nature of globalisation. As an economic affairs committee it is not surprising that our main interest in what follows will be on the economy. But as will become apparent, we take some account of politics and administration, the cultural dimension and concerns about the environment in our discussion of the issue.

---

[7] SEC (2002) 185, 14 .2.2002.

[8] *Ibid*, p 17.

Driving forces of globalisation

33. Underlying this reduction in the importance of barriers are both technological and policy changes. Differences of opinion arise less from what these "driving forces" are – few, for example, would dispute that technological advances or the pursuit of trade liberalisation through the WTO are relevant – than from how these various components of the globalisation milieu interact and what their relative importance is. We list below some of the evidence we have received about the principal driving forces characterising current globalisation – without judgement as to priority.[9]

TECHNOLOGICAL CHANGES

34. Many witnesses stressed the importance of advances in transport and communications technology as distinctive features underpinning current globalisation. [10]

35. For example, Diane Coyle, Managing Director of Enlightenment Economics, emphasised the implications of technological advances on the structure of transnational corporations and the location of production. She suggested that the change in trade pattern since the Second World War – with the growth of trade in manufactures and, in particular, intermediate goods – reflected "… a truly global reorganisation of production by companies made possible by information and communication technologies and also declining transport costs." (Ev I, Q 662). Dr Noreena Hertz expressed the point even more strongly, identifying technological advance as the central feature of current globalisation:

> "I think what is new now and why the subject is so in the forefront is that the revolutions in communication and technology have just accelerated and escalated companies' abilities to operate all over the globe. So we have this kind of corporate-led globalisation operating in a way that is significantly different to before." (Ev II, Q 1639).

36. In the cross-Departmental memorandum, it is noted that "the recent acceleration in globalisation has been made possible by sharp reductions in transportation, telecommunication and computation costs", and this in turn has made "it easier for firms to co-ordinate production activities in different locations in cost-effective ways, allows new technologies or knowledge to spread more quickly and widely and generally reduces frictions to world commerce." (Ev I, p 11).

37. DHL, a company providing a global carrier service, gave a more specific instance of how technological change had enabled it to speed up the movement of goods across the world: "We have developed industry-leading inventory-control systems that interface directly with customs authorities clearance systems through Electronic Data Interchange, enabling immediate clearance in a virtual, paper-free environment." (Ev II, p 165).

38. Some witnesses emphasised the advance of information and communications technology in relation to the rapidity of market flows. Sir Andrew Large referred to the "instantaneous availability of information on a global basis" (Ev I, p 289) and Tito Mboweni, Governor of the South Africa Reserve Bank, commented on the growing interdependence of different countries in the world economy, "driven in particular by the power and influence of information and communications technology" which allowed capital movements "almost at the touch of a button" (Ev I, Q 574).

TRADE LIBERALISATION

39. Following the Second World War, in 1947, the General Agreement on Tariffs and Trade (GATT) was negotiated providing a framework for a policy of trade liberalisation. The GATT was replaced in 1995 by the World Trade Organisation (WTO) with the purpose of promoting trade liberalisation through negotiated agreements and a binding disputes mechanism.[11] A series of multilateral trade rounds under the auspices of the GATT succeeded in reducing trade barriers from their high inter-war levels.

40. In addition to multilateral and unilateral reductions in trade barriers, trade liberalisation has also been pursued in regional integration agreements. Some 150 of these agreements are currently in force, covering more than one third of world trade. Some of these agreements – notably in Europe – have gone beyond tariff liberalisation to include removal of border controls and harmonisation of a range of standards and regulations.

---

9 A fuller analysis is set out in the briefing paper reproduced in Appendix 5.

10 We note, however, Sir Samuel Brittan's reminder to us that significant technological changes occurred in the 19th century: "Has the development of information technology added a new element – because any change in any part of the world can be viewed instantly on computer screens? Surely the bigger breakthroughs were made in the middle of the 19th century when we leapt from horse-drawn transport and sailing ships to the railways and transatlantic cable, which transmitted to the New York stock exchange news of the 1873 Vienna financial crash?" (Ev I, p 249).

11 We consider the role of the WTO in more detail in Chapter 6.

CAPITAL MARKET LIBERALISATION

41. Capital market liberalisation is widely perceived as a distinctive feature of current globalisation. Peter Sutherland, Partner and Chairman of Goldman Sachs International, for example, described the extent of capital flows – assisted by technological developments which have enabled instantaneous transactions – as "truly amazing" (Ev I, p 202). Professor Bulmer-Thomas, Director of the Royal Institute of International Affairs, referred to the "qualitative leap in the scale of liberalisation" of capital flows in the 1980s, promoted by the International Monetary Fund, the World Bank and the Bank for International Settlements, as one of the "key dimensions" of globalisation (Ev I, p 51).

New phenomenon or new label?

PREVIOUS PERIODS OF GLOBALISATION

42. Our evidence contains a variety of views on whether or not the phenomenon of current globalisation is new. There appears to be widespread agreement amongst commentators that the first period of globalisation occurred between 1870 and 1914.[12] Michael Kitson of the Judge Institute of Management Studies, Cambridge University, and of the Cambridge-MIT Institute described this period as "the era of the classical Gold Standard", when "in effect, the growing world economy was becoming more open and more dependent on international trade", with the annual average growth of world output and world trade at 2.7% and 3.5% respectively (Ev I, p 109).

43. The World Bank describes the following period from 1914 to 1945 as "the retreat into nationalism" and "rising protectionism", noting, for example, that by 1950:

- exports as a share of world income were about 5%, about the same level as in 1870;
- the foreign capital stock of developing countries was about 4% of income, far below the level in 1870;
- that immigration in to the United States fell from 15 million in the period 1870 to 1914 to 6 million in the period 1914 to 1950.[13]

It then divides the post-Second World War period into two: 1945 to 1980 ("the second wave of globalisation") and post-1980 globalisation ("the new wave of globalisation").14 The latter, current, period of globalisation is distinguished in the following way:

> "First, and most spectacularly, a large group of developing countries broke into global markets. Second, other developing countries became increasingly marginalized in the world economy and suffered declining incomes and rising poverty. Third, international migration and capital movements, which were negligible during second wave globalization, have again become substantial."[15]

44. Michael Kitson suggested that the post-Second World War years could be analysed in three phases. First, there was "the Bretton Woods period" which spanned 1950 to 1973 and was characterised by a rapid expansion of the openness of the world economy (with annual average growth of world output and of world trade at 4.7% and 7.2% respectively). Secondly, following the 1973 oil crisis, a period of slow down occurred until 1990 (with annual average growth of world output and of world trade at 2.8% and 3.9% respectively), since when there has been a period of significant increase in world trade (annual average growth, 1990 to 1999, of 6.2%) although growth in output has remained modest (3.0%) (Ev I, p 109).

45. A number of witnesses gave evidence about how the current period of globalisation could be distinguished from previous periods of significant world economic integration. The Department for International Development said: "We probably all agree with you that qualitatively we are dealing with a very similar phenomenon at the end of the 20th century to that which occurred at the end of the 19th century." (Ev I, Q 11). There were, however, differences between the periods: whereas the first had seen significant migration (especially across the Atlantic), features of the second have been, first, a rapid advance in communications technology and, secondly, a more substantial country coverage. Diane Coyle expressed a similar view: "There is obviously nothing new about globalisation per se. There have been many episodes in history, including the late 19th century and beginning of the 20th

[12] This view is taken by the World Bank on the basis that globalisation is measurable in terms of trade, migration and capital flows and that prior to 1870 "none of these flows was sufficiently large to warrant the term globalization" (World Bank, *Globalization, Growth, and Poverty* (2002), p 23).

[13] *Ibid*, pp 26-27.

[14] *Ibid*, pp 24-38.

[15] *Ibid*, p 31.

century – but they differ in their characteristics …" (Ev I, Q 662). Ms Coyle then listed the differences: the absence of migration as a feature of the present period of globalisation, changes in the pattern of trade (with a relative decline in trade in commodities and an increase in the trade in intermediate goods, manufactures and services), and the development of information and communication technologies (which Ms Coyle describes as "genuinely new").

46. Similarly, Lord Desai, Professor of Economics and Director of the Centre for the Study of Global Governance at the London School of Economics, suggested that the world had "arrived back at the 19th century but on a higher level of technology" (Ev II, Q 1723). It was, he said, wrong to call it a "circle" but rather it was a "spiral": "We have not arrived at the same position as 100 years ago. For one thing, technology is different". He went on to suggest, however, that technology was not the only (or the most important) difference: "secondly, … there are many more nation states now than there were then", but most importantly – "the one major difference compared to the 19th century" was "the movement of people." (Ev II, Q 1724).

47. Professor David Greenaway, Director of the Leverhulme Centre for Research on Globalisation and Economic Policy at Nottingham University, suggested that, to the extent that the openness ratios (that is, the level of trade compared to GDP) of the late 19th century resembled those of the post-Second World War period, globalisation was "not an entirely new phenomenon". The current "vintage", however, had "three new dimensions": its greater global reach ("more countries are part of the international economy and to a greater extent, than in the second half of the 19th century"); the more extensive and more pervasive levels of cross-border investment by transnational corporations; and, the presence of deeper and more integrated capital markets (Ev I, p 97). The WDM similarly focused on the level and nature of foreign investment and the availability of capital as the hallmarks of current globalisation:

> "… the phenomenon of globalisation as currently experienced is different from former periods, such as the start of the 20th century, by:
>
> - Foreign trade and investment being undertaken by the private sector pursuing profit, rather than by a mix of private and public sector.
> - Higher levels of foreign investment.
> - Vastly increased levels of financial capital." (Ev I, p 340).

48. Mr Kitson was keen to stress that globalisation should be seen as a dynamic and evolving process and that the world economy should be regarded in terms of progressing towards (but not having achieved) full globalisation: "… it is a process that is continuing; we are not in some end state of a fully globalised economy …" (Ev I, Q 295). The historical perspective of globalisation as a developing feature of the world economy was expressed by others witnesses as well. Ignazio Visco, for example, described globalisation as "an on-going process that has been … accelerating over the past decades" (Ev I, p 170) and the Royal Society of Edinburgh referred to globalisation as "a continuous process" that had been "around a long time" (Ev II, p 374).

49. We agree with the view that the process of globalisation has a long way to go before anything like a fully open and integrated world economy is reached. In the case of the poorest countries we must think in terms of many decades before this may be achieved, but even the most developed countries are far from fully open.

OBJECTIVE MEASURES OF GLOBALISATION

50. Globalisation can be measured, albeit imperfectly. The commonly accepted indicators of the extent of globalisation are: trade flows, capital flows and migration.

Trade flows

51. The evidence shows that during the current period of globalisation trade flows are high compared to the inter-war period but that levels during pre-First World War globalisation had also increased. During the period 1820 to 1914, the value of world exports rose by a factor of 33 (from US $7 billion to US $236 billion at constant 1990 prices); between 1950 and 1992, they increased by a factor of 10 (from US $376 billion to US $3,786 billion at constant 1990 prices). The ratio of world exports to Gross Domestic Product has increased from 1% in 1820 to 19.1% in 1999.[16] Professor Greenaway drew attention to trade flows as a feature of the present world economy, noting the comparison with the 19th century economy:

[16] Figures supplied in the cross-Departmental memorandum (Ev 1, pp1-2).

> "Over the post-World War II period, trade volumes have grown at unprecedented rates, averaging almost 6 per cent per annum for 50 years. … More significantly, however, these growth rates have consistently outstripped the comparable growth rates of real output and average openness of economies, both developing and developed, has increased sharply. But this is not the first time this has occurred. … In the late nineteenth century, openness ratios were also very high and the international economy showed some similar features of globalisation."[17] (Ev I, p 97).

A number of witnesses gave evidence about the comparative level of trade between the post-First World War period of globalisation and the current period. We note, for example, the cross-temporal and cross-national analysis provided in the cross-Departmental memorandum (Ev I, pp 1-2).

Capital flows

52. There are different ways of measuring capital flows. It can be measured by comparing over time the average absolute value of a country's national current account as a percentage of GDP (since the current account is "by definition a measure of [a nation's] net capital inflow or outflow"),[18] or by examining the correlation between domestic saving and domestic investment (the argument being that "in a world of perfect capital mobility, there should exist no systematic relation between domestic saving and investment since domestic saving would search the world for the highest return irrespective of the state of domestic investment").[19] On either measurement, it appears to be the case that capital flows, although they increased significantly during the 1990s, remain lower than they were during the pre-First World War period of globalisation.[20] As with trade flows, it is useful to go behind the veil of the broad figures and consider the detail. The European Commission report – *Responses to the Challenges of Globalisation* – for example, notes that "the structure of capital flows … has been evolving over time", and that the hallmark of current globalisation (since 1990s) has been the growth in foreign direct investment (FDI) by transnational corporations.[21] (We consider this in more detail in Chapter 6 of this Report.)

Migration

53. Migration has been described as "the most obvious difference between the two waves of globalisation".[22] A number of witnesses raised this point (see paragraphs 45 and 46 above). Whereas trade and capital mobility have reached new levels in the current period of globalisation, labour mobility is far lower than during the pre-First World War period.

NEW KEY PLAYERS

54. The present period of globalisation can also be distinguished by its key players. In their memorandum, Save the Children describe developments such the communications revolution and the decline in costs of transport as "contextual" or "passive" factors underlying current globalisation, factors which "are not in themselves responsible for globalisation as we know it today". In their view "the main forces actively driving globalisation are human and political" (Ev I, p 335). They list these forces as governments (of wealthy countries), international institutions (in particular, the WTO, the World Bank and the International Monetary Fund) and transnational corporations. We would add two other key players as being distinctive features of the landscape of current globalisation: the "new globalisers" – the emerging countries which seem to be succeeding in the globalised economy (such as China, India, South Korea) – and non-governmental organisations (NGOs).

Conclusion

55. We do not offer a simple definition of globalisation, but it is our view that **the present period of globalisation represents a new departure in world affairs.** Partly this is to do with what has been called "the death of distance", assisted by the absolute and relative decline in transport costs. Coupled

---

17 Footnotes not included.

18 Richard E. Baldwin and Phillipe Martin, *Two waves of globalisation: superficial similarities, fundamental differences*, NBER Working Paper 6904, January 1999, p 8.

19 *Ibid*, p 9, citing Feldsein, M and C Horioka (1980), "Domestic savings and international capital flows", *Economic Journal* 90:314-329.

20 *Ibid*, pp 8 and 9, and see the cross-Departmental memorandum (Ev I, pp 3 and 4).

21 European Commission, *Responses to the Challenges of Globalisation: A Study on the International Monetary and Financial System and on Financing for Development*, SEC (2002), 14 Feb 2002, p 20.

22 Baldwin and Martin, *op cit*.

with this has been the decline in costs of communication, the counterpart of which is the vast increase in the speed and reliability of communication in words and images. There were similar advances in the 19th and earlier part of the 20th century, but on nothing like the scale of recent years.[23] We have one world, in an economic and cultural sense, which has not existed before.[24]

56. This is, of course, partly a matter of the expansion of market forces, especially those of an international character. There are very few countries indeed which are insulated from such forces. What is also of importance is the spread of branded products which are truly international in character.[25] These have economic significance not least in connection with the exercise of monopoly power. But they have a cultural impact too. It is apparent, especially given the extent of United States ownership of such brands,[26] that much anti-globalisation protest is prompted by the existence and dominance of these brands.

57. There is closer interconnectedness between countries than ever before. They have much more in common and short-term shocks, whether economic or non-economic, are transmitted more rapidly. Moreover, the forces at work show no signs of abating. **Although some of our witnesses claimed that what we observe is much the same as what has happened before, but on a large scale, we believe that recent experience is both quantitatively and qualitatively different.**

---

23 See, for example, the written submission of the Royal Academy of Engineering: "The majority view amongst those Academy Fellows who contributed to this discussion is that globalisation is a new phenomenon. Developments such as the communications revolution, air travel, containerisation and bulk transport have generated an unprecedented increase in the volume and speed of trade." (Ev II, p 369). See also the written submission of the World Humanity Action Trust: "[Globalisation] is a manifestation of a greatly increased degree of interconnectedness across the world. It may not be a new phenomenon. However, its present scale … presage substantial impact on national policies of many kinds." (Ev II, p 392).

24 Professor Stiglitz gave an example of this. He told us how, in one remote Indian village, the mayor talked to him about biopiracy and the patenting of traditional medicines under new WTO provisions, and in another the mayor spoke about the euro (Ev I, QQ 722-23).

25 See paragraphs 172-73 below.

26 The Confederation of British Industry give evidence that the parent companies of the top nine global brands are US based (Ev I, p 134).

CHAPTER 3: ECONOMIC PERFORMANCE, POVERTY AND INEQUALITY

58. The impact of globalisation on economic performance varies across countries. We begin by focusing on the poorer countries and considering the evidence in relation to globalisation and its effect on poverty and inequality.

59. Many witnesses expressed concern about the level of poverty and income inequality that remains in the world. Dr Noreena Hertz, for example, said:

> "… in this period of globalisation we are seeing greater inequality between countries in seven out of the eight measures on inequality. We see, and this is pretty much undisputed, that inequality has increased over this period between countries…. The distance between richer and poorer countries over the past 30 years, in terms of GNP, has more than doubled, so rather than seeing inequality between countries decrease we are seeing it increase over this period …" (Ev II, Q 1638).

Furthermore, "the poorest percentile in many societies are actually worse off today than they were" (Q 1642). And the Catholic Agency for Overseas Development (CAFOD) suggested:

> "In general, NGO[27] and civil society concerns [about globalisation] stem from the realisation that while globalisation has led to benefits for some, it has not led to benefits for all. The benefits appear to have gone to those who already have the most, while many of the poorest have failed to benefit fully and some have even been made poorer." (Ev I, p 338).

60. In this chapter we consider the evidence about the current levels of global poverty and inequality. We then turn to the more difficult question of whether there is a causal relationship between globalisation, on the one hand, and poverty and inequality on the other. Finally, we consider what actions might be taken to assist those countries which remain very poor.

Poverty

61. The commonly used poverty measure is population living below \$1 a day (although reference is sometimes made to a poverty measure of \$2 a day).[28] A distinction can be drawn between *the poverty rate* and *the poverty headcount*: the first is relative to the size of the total world population and is, therefore, the proportion of the world's population who live below the \$1 a day poverty line; and the second is the absolute number of people in the world that live in poverty. It is an important distinction because the increase in world population means that a decline in the poverty rate will not necessarily be accompanied by a decline in the poverty headcount.

62. According to World Bank figures,[29] during the 1990s the proportion of people living on less than \$1 a day – the poverty rate – fell significantly (from 29% of world's population to 23%). As regards the poverty headcount, Nicholas Stern of the World Bank told us:

> "… the absolute numbers in poverty have gone down in the last 20 years or so. Those living at less than one dollar a day were in number around 1.4 billion or so in 1980 and the number is around 1.2 billion now. That is in a period when population in developing countries grew by around 1.5 billion people, so that reduction is a big change." (Ev II, Q 1820).

63. A recent study by Xavier Sala-i-Martin of Columbia University drew the same conclusion: "world poverty has declined substantially over the last thirty years. This is true if we use the one-dollar-a-day or the two-dollar-a-day definition and whether we use poverty ratios or poverty counts". His figures varied, however, from those given by Nicholas Stern. According to Xavier Sala-i-Martin, "using the one-dollar-a-day definition, the overall number of poor declined by over 400 million people: from close to 700 million citizens in the peak year of 1974, to less than 300 million in 1998".[30]

64. **Although the general level of world poverty appears to be decreasing, this improvement is not evenly spread and some countries continue to suffer a very high concentration of poverty**. Xavier Sala-i-Martin makes this point in his study: "the fact that the world is improving does not mean

---

27 Non-governmental organisation.

28 These rates are set in constant 1985 US \$, so as to be unaffected by inflation. They therefore correspond to levels of more than \$1 or \$2 in current US \$. To apply them in particular countries requires conversion from US \$ to local currency, and this is typically undertaken using purchasing power parity exchange rates. We are bound to say that the "\$1 a day" criterion is more a symbol or a metaphor than a rigorous measure of poverty in any sense. The evidence we cite is more fundamental than that, but the main conclusion (in paragraph 64 below) – that there have been a fall in the numbers in poverty but that there are many people still desperately poor – certainly holds.

29 World Bank, *World Development Indicators 2002* (2002), p 6.

30 Xavier Sala-I-Martin, *The Disturbing "Rise" of Global Income Inequality*, NBER Working Paper 8904, April 2002, p 19. (See also NBER Digest, October 2002, p 5.)

that all is good. Actually, one disturbing fact … is that more than 95% of the 'one-dollar poor' live in Africa". He draws the conclusion that "the massive concentration of poverty in the African continent suggests that the lack of economic growth of Africa is the most serious economic problem we face today".[31] **There remains, in our view, a shameful level of poverty in the world. We are appalled at the sheer waste of human potential that such poverty implies.**

Inequality

65. "Inequality" is a more complicated concept than "poverty". Whereas poverty and increases in poverty are incontestably bad, not only is some level of inequality inevitable but an increase in inequality does not necessarily imply harm (as when all individuals become better off but the rich disproportionately so). It also appears from the evidence we received that the measurement of global inequality – as opposed to global poverty – is contentious.

MEASUREMENT OF GLOBAL INEQUALITY

66. There are a number of ways of measuring and describing inequality, each measure tending to produce different results. Lord Desai, although clear that the numbers in poverty had reduced over the last 30 years, thought that assessing whether inequality had increased or decreased was a more difficult question to answer because of these different measurements: "… on inequality I have still not been able to make up my mind. The way people cite statistics, they are either in terms of inequalities between countries' per capita income or the richest 50 people have so much wealth compared to the income of so many nations and so on. I have not seen any hard and fast evidence about this." (Ev II, Q 1727). Professor Bulmer-Thomas suggested that, "on the crucial question of the gap between rich and poor countries, the jury is still out" (Ev I, p 52).

67. An important distinction in this debate is made between *between-country* inequality and *within-country* inequality. They are not necessarily related. Between-country inequality is based on international comparison of average income levels in each country, whereas within-country inequality looks within each country separately. It is possible that between-country inequality measures show improvement at the same time as some or all within-country measures are deteriorating. We note also that an increase in within-country inequality frequently accompanies a period of rapid economic development. A global inequality measure combines within- and between-country information to give an indication of inequality across individuals in many countries.

68. Martin Wolf suggested that "there has been some reduction in global inequality because of the relative growth of a few very successful countries" (Ev II, Q 1589). On his analysis, between-country inequality, measured by comparing the relative average income of countries, is reducing (because of the relative growth of China and, to a lesser extent, India) (Ev II, Q 1588).[32] On the other hand, as regards within-country inequality, he argues that "income inequalities in the developed world have increased" and "there has been an increase in inequality in developed countries" (Ev II, Q 1589). He went on to suggest, however, that neither of these descriptions of inequality – within- and between-country – reflected the popular notion of inequality: "… when most people talk about inequality what they really mean … is the proportionate or absolute gaps in absolute income between the very poorest countries in the world and richest countries in the world", and he asserts that "there is absolutely no doubt at all that … those gaps have continued to rise in the last 20 years, as they have done absolutely consistently for two centuries." (Ev II, Q 1589).

69. A number of other witnesses gave their views on the inequality debate. Save the Children expressed a concern that in the current period of globalisation there was not only a concentration of the gains from globalisation producing an imbalance between countries (in favour of developed countries) but that there has also been a concentration producing an imbalance within (both developed and developing) countries: quoting UN Special Rapporteur Jose Bengoa, they said, "this twofold process of concentration is one of the characteristics of the current process of globalisation".[33] UNCTAD shared this view:

---

[31] *Ibid,* pp 19- 20.

[32] Professor Bulmer-Thomas thought that if China – "with its huge population and spectacular growth rate" – were excluded from a calculation of world inequality, "there is circumstantial evidence that the income gap has in fact widened" (Ev I, p 52).

[33] *The relationship between the enjoyment of human rights, in particular economic, social and cultural rights, and income distribution*, Final Report of Special Rapporteur José Bengoa to the 49th session of the UNHCHR Sub-Commission on Prevention of Discrimination and Protection of Minorities, 30 June 1997, quoted in the written submission of Save the Children (Ev I, p 336).

> "The promise of fast and stable growth in the South along with greater equality within developing countries and diminishing income gaps with the North has not materialised. …The world economy has, since the early 1980s, been characterised by rising inequality and slow growth. Income gaps have widened between North and South with only a handful of East Asian economies managing to sustain growth rapid enough to narrow the gap, or even in some cases to catch up, with the North. … Polarisation among countries has been accompanied by increasing income inequality within countries. ... In more than half of the developing countries the richest 20 per cent today receive over 50 per cent of the national income. Those at the bottom have failed to see real gains in living standards, and in some cases have had to endure real losses." (Ev I, p 361).

70. The World Bank, in *Globalization, Growth and Poverty*, distinguishes between the developed countries, the new globalisers and the weak globalisers: "During the second wave of globalisation the rich countries diverged from the poor countries, a trend that had persisted for a century. During the third wave the new globalisers have started to catch up with the rich countries, while the weak globalisers are falling further behind."[34] The report concludes:

> "Among rich countries there has been convergence: the less rich countries have caught up with the richest, while within some rich countries there has been rising inequality. Amongst new globalisers there has also been convergence and falling poverty. Within China there has also been rising inequality, but not on average elsewhere. Between rich countries and the new globalisers there has been convergence. Between all these groups and the weak globalisers there has been divergence."[35]

Nicholas Stern gave us an indication of the numbers of people involved. Countries which the Bank termed "new globalisers" accounted for a total population of about 3 billion and since 1980 income per capita of these countries had grown by about 5% a year. Those countries which the Bank describes as "weak globalisers" account for a total population of about 2 billion and these have seen a fall in income per capita (Ev II, Q 1820).

71. Xavier Sala-i-Martin, in his study on global income inequality, reviewed seven income inequality indexes.[36] He concluded that "income disparities during the last two decades have declined substantially" as a result of the decline in inequality between (rather than within) countries (which is largely a result of the significant growth rates in China and to a lesser extent India),[37] but that within-country inequalities have increased slightly over the last 30 years (although "this increase has been so small that it does not offset the substantial reduction in across-country disparities").[38]

72. **It appears, therefore, that between-country inequality is reducing (largely because of the economic growth of China and, to a lesser degree, India), but within-country inequalities (both in developing and developed countries) are in some cases increasing**.

Relationship between poverty, inequality and globalisation

73. We now turn to the question whether there is a causal link between globalisation and the changes in the levels of poverty and inequality: has globalisation *caused* the significant economic growth of China and India? Is globalisation responsible for the poverty of sub-Saharan Africa?

74. Richard Kozul-Wright of UNCTAD, noting that "large parts of the developing world seem to be more marginal today than they were 20 years ago", asked "[but] what would have happened if you had not moved into this world of liberalisation? Would things have got worse? It is a difficult debate to enter." (Ev II, Q 1162). Martin Wolf similarly commented on the difficulty of comparing the present world to one in which none of the developments associated with globalisation had happened; it was he said "almost impossible to imagine" – although he speculated that "… quite a significant number of developing countries would have grown more slowly than they did, particularly some very big ones like China and India." (Ev II, Q 1588).

---

34 World Bank, *Globalization, Growth and Poverty* (2002), p 50.

35 *Ibid*, p 50.

36 The Gini coefficient, the variance of log-income, two of Atkinson's indexes, the Mean Logarithmic Deviation, the Thiel index and the coefficient of variation.

37 "The reason for the decline in global income inequality after 1978 is that the most populated country in the world, China, experienced substantial growth rates. Hence, the incomes of a big fraction of the world' population (approximately 20%) started converging towards the rich economies after 1978": Sala-i-Martin, *op cit*, p 29.

38 *Ibid*, p 30.

75. The debate about the consequences of globalisation on the economic success of countries is a complex one. We found it helpful in our deliberations to consider the debate in terms of the following four propositions:

- Globalisation has created opportunities that some countries have successfully exploited.
- Countries that have not been successful would not have performed better if they were closed economies.
- Many countries that have not been successful have failed to adapt to the globalised economy.
- There are aspects of globalisation that have harmed some countries.

We now turn to the evidence that we received in relation to these propositions.

Globalisation has created opportunities that some countries have successfully exploited.

76. The analysis of the World Bank (see paragraph 70 above) of why some countries are successful and others are not supports the view that those developing countries which are now seeing convergence in average incomes with developed countries are doing so because of integration with the global economy. Nicholas Stern said to us:

> "Let us look at what we may call the globalisers, for want of a better word. In our recent work we defined these countries in a very specific way. They are the top third of developing in terms of increases in trade to GDP ratios since the 1980s. Since 1980 … you get 24 countries with a population of around three billion. In the last 20 years that three billion has grown in terms of income per capita by about five per cent per annum, which is phenomenally fast by historical standards." (Ev II, Q 1820).

Turning to the developing countries which have not done well, he said: "Then you have got the … two billion people in countries which have not globalised so rapidly and where income per capita is declining. Those countries have not seen these increases in trade to GDP ratios …" (Ev II, Q 1820).

77. We received a range of evidence that supported the proposition that for some countries at least globalisation had presented opportunities which had led to their economic success. Professor Paul Krugman, Professor of Economics at Princeton University, for example, noted the breakdown in the traditional division between the developed and developing world. He suggested that this change was driven by trade, as a result of which developing countries now fell into two categories: those which were converging with the developed world and those which remained very poor:

> "… a lot of the protests presume that before we had this increase in financial trade, before the great increase in international investment, we had, basically, good conditions in the developing countries, and they compare that idealised state with what you actually see. I am old enough now to remember what development economics was like in the mid-1970s and it was, essentially, non-development economics; it was the study of countries that failed to develop. There had been no cases of transitions from third world to first world since, maybe, Japan. There seemed to be a permanent division of the world into a club of richer countries and a club of poor countries, and in much of the developing world the question was not 'would they develop?' but 'how long until the Malthusian crisis?' Now, we at least have seen since then a number of graduation cases: South Korea would be the outstanding case of a country that went from subsistence level to, essentially, first-world living standards. A number of countries have made significant progress – enough so that at least we can say that that permanent division of the world into rich countries and the other quarter is not, in fact, the case … *All of the success stories are export-led growth. All of them are by getting into the global economy*." (Ev II, Q 1880. Italics added).

78. Professor Joseph Stiglitz, although critical of the way in which globalisation has been managed by the international financial institutions to the detriment, he argued, of many developing countries, none the less took the view, "very strongly", that globalisation had had "a very positive effect on a number of countries in the developing world" – "If you look around the most successful countries, far more successful than anything we had ever anticipated, are the countries of East Asia. Their growth has been based on taking advantages of exports, it has been export-led growth." (Ev I, Q 711). Professor Bulmer-Thomas also referred to the "opportunities for export-led growth" (along with "the rise in real wages associated with the absorption of labour") as "the main benefit" of globalisation for developing countries (Ev I, p 52). Donald McKinnon, Commonwealth Secretary General, told us that, in the view of the Commonwealth, "global trade expansion" provided "the most viable route out of poverty for the world's poor" (Ev I, Q 778).

79. A recent study by Centre for Economic Policy Research, *Making Sense of Globalization*, attributes the success of China as "partly a consequence of opening to trade and FDI" and "thus partly a result of the globalization process."[39]

Countries that have not been successful would not have performed better if they were closed economies.

80. We received no evidence to support the proposition that countries which remain very poor would have faired better had they become closed economies. Neither would such a proposition be supported by economic theory. The Secretary of State for International Development, Clare Short, said that she had no doubt that openness was beneficial to a country's development and that the closed economies (such as North Korea) "get left behind" (Ev II, Q 2016). Martin Wolf said: "It seems to me quite difficult to argue and I am not convinced there are any clear cases where you can show that as a result of policies of clear attempted integration countries are unambiguously poorer, on average (as opposed to some people within them which is certainly true), than they would have been if they had remained autarchic which many of them were." (Ev II, Q 1590). And Dr Hertz similarly took the view that "countries that have de-linked from globalisation completely – like Cuba or North Korea – are worse-off" (Ev II, Q 1647). When asked whether the issue was not so much globalisation but, instead, "better globalisation", Dr Hertz agreed (Ev II, Q 1649).

Many countries that have not been successful have failed to adapt to the globalised economy.

81. For more countries the problem has not been deliberate delinking but rather a failure to succeed in participating effectively by adapting to the globalised economy. There is an important distinction to be recognised between countries who have failed to adapt because of decisions they have taken themselves, and countries who have suffered because of forces outside their control. Peter Sutherland of Goldman Sachs International referred to globalisation as having passed sub-Saharan Africa (and other economies) by – "perhaps through the deliberate fault of their own governments who have simply failed to become part of it" (Ev I, Q 500). He argued that the response to the marginalisation of sub-Saharan Africa was not to attack the concept of globalisation but rather to enable Africa "to partake in it" (Ev I, p 203). Dr Supachai Panitchpakdi also referred in his evidence to the marginalisation of low-income countries and similarly argued that their marginalisation was "not because of the globalisation process, but mainly because low-income countries are not adequately involved in the process of globalisation":

> "… [low-income countries] are left out of the [globalisation] process because they cannot gain access for their products in the more advanced countries, they cannot gain access to sources of finance, of foreign direct investment. They are being left out of or being marginalised. It is not really because globalisation has not given the opportunities, but it has not reached them in a way that they should be able to take advantage of." (Ev I, Q 562).

The Royal Academy of Engineering suggested that the "losers" from globalisation included "those developing countries that have poor financial, political and commercial infrastructure and are unattractive for inward investment and the manufacture of labour intensive components" (Ev II, p 372).

82. Barry Coates, Director of the WDM, argued that many of the poorest countries – such as sub-Saharan Africa – were, in fact, "deeply engaged in trade", with sub-Saharan Africa exporting a total of around 30% of its GDP (compared with about 19% amongst countries belonging to the Organisation for Economic Co-operation and Development). However, these countries suffered because their exports were concentrated in the commodities market, a market in which prices were falling (Ev I, Q 892). Lord Desai made a similar point: "It is not that African countries do not trade, but they have been stuck in the primary commodities trade." (Ev II, Q 1728). Dr Caroline Lucas suggested that this demonstrated that integration in the world economy was not sufficient for economic success but, rather, it depended on the "terms of that integration" (Ev II, Q 1421).

There are aspects of globalisation that have harmed some countries

83. We received some evidence that suggested that the globalisation process has acted to the detriment of some countries. The World Bank, in *Globalization, Growth and Poverty*, posed the question: "Could globalisation itself have contributed to the economic marginalisation of some countries?" One way in which it suggests that it could is through capital flight resulting from

[39] Centre for Economic Policy Research, *Making Sense of Globalization: A Guide to the Economic Issues*, Policy Paper No 8, July 2002, p 60, section 4.2.

liberalisation of the capital markets: "By 1990 Africa, the region where capital is most scarce, had about 40 per cent of its private wealth held outside the continent, a higher proportion than any other region. This integration was not a policy choice: most African governments erected capital controls, but they were ineffective".[40] Destabilising movements of short-run capital have also damaged other countries, a recent example being Argentina. We consider this issue in more detail in Chapter 7.

84. Willem Buiter of the EBRD identified five strands to what he describes as "pathological globalisation" – "the unambiguously negative dimensions of globalisation": international spread of contagious diseases;[41] the threat of international contagion in financial markets; crime; terrorism; and threats to national or regional cultures (Ev I, p 84).

CONCLUSION: IS GLOBALISATION A THREAT OR AN OPPORTUNITY?

85. Although no witnesses suggested that globalisation has no harmful features or effects at all, most thought globalisation had the potential to do more good than harm. Peter Sutherland, for example, said that "there is little doubt that the results of globalisation overall are overwhelmingly good" (Ev I, p 203). A number of witnesses used the language of "positive-sum game". Willem Buiter described globalisation as potentially "a blessing": "[Globalisation] is first and foremost about increasing opportunity, choice and freedom. The simple but fundamental proposition that is the cornerstone of this positive judgement, is that trade – voluntary exchange – is not a zero-sum but a positive-sum game." (Ev I, p 84). Professor Greenaway told us that, although there would be losers – in the short run especially – "… in the long run, for any economy, globalisation is not a zero-sum game: international exchange improves living standards through some combination of higher wages, better employment prospects and access to a wider array of cheaper goods and services." (Ev I, p 98). Gerry Rodgers of the ILO also described globalisation "as a positive-sum game", and said that the issue was to ensure "that those who lose are either compensated or helped to become winners" (Q. 1240). And Andrew Crockett, General Manager of the Bank for International Settlements (BIS) and Chairman of the Financial Stability Forum, in the same vein, said that "the globalisation process is not a zero-sum game. The world as a whole stands to benefit from it" (Ev I, p 156). A dissenting view was expressed by the Green Party for England and Wales which suggested that international competitiveness is "a zero-sum game – it depends on there being losers" and this "is an essential feature of globalisation" (Ev II, p 84).

86. **While there are negative aspects to globalisation, the weight of the evidence suggests that the opportunities created by globalisation outweigh the dangers. Effective integration in the global economy is a major part of the explanation why some developing countries, such as China and India, have enjoyed significant economic growth in recent years and a failure to integrate effectively is at least part of the explanation why other developing countries, such as sub-Saharan Africa, remain very poor.**[42]

MANAGED GLOBALISATION

87. The evidence also suggests, however, that, to be effective, globalisation requires management at the national and international level. In the White Paper on globalisation – *Eliminating World Poverty: Making Globalisation Work for the Poor* – it is stated that whether globalisation works well or works badly will depend on policy intervention:

> "Managed wisely, the new wealth being created by globalisation creates the opportunity to lift millions of the world's poorest people out of their poverty. Managed badly and it could lead to their further marginalisation and impoverishment. Neither outcome is predetermined; it depends on the policy choices adopted by governments, international institutions, the private sector and civil society."[43]

A similar point was made by the TUC. They concluded that "the balance of economic evidence suggests … that greater participation in world trade and direct investment can help reduce poverty in developing countries", but went on to say that "this does not mean that trade and investment should take place on any terms … the right policies and regulatory framework need to be in place to help ensure that the benefits are fairly shared" (Ev I, p 38). Willem Buiter also emphasised the need for intervention:

---

40 World Bank, *Globalization, Growth, and Poverty* (2002), p 41.

41 In a report to the World Health Organisation by the Commission on Macroeconomics and Health, *Macroeconomics and Health: Investing in Health for Economic Development* (December 2001), it is suggested that globalisation presents a number of policy challenges. These include the increased pace of the international transmission of diseases (p 76).

42 Professor Krugman's comment cited in paragraph 77 above is decisive in this regard.

43 *Eliminating Poverty: Making Globalisation Work for the Poor*, Cm 5006, December 2000, p 15, para 19.

> "The key political issue of our time is to ensure that institutions are created, at all levels, local, national, regional and global, to ensure that [the] potential aggregate gains are realised and shared widely and fairly. … The gains from globalisation will not be reaped without active institution-building efforts at all levels." (Ev I, p 85).

Andrew Crockett suggested that the benefits of globalisation were "by no means automatic" – there would be losers in the process and "this calls for appropriate policy initiatives to manage the process" (Ev I, p 156). And Diane Coyle made the point to us that the reason why globalisation was viewed with such suspicion was that "global flows, of goods, capital or people, can … have adverse results whenever there are market failures of regulatory weaknesses", and therefore, "policy needs to help limit or reduce the costs of globalisation" (Ev I, p 268).

88. **The process of globalisation requires appropriate national policies (dealing, for example, with political and administrative reform) and a strengthened international governance infrastructure so that its potential may be maximised. Only then can markets operate optimally.**

Exploiting globalisation to reduce poverty and inequality

89. Many witnesses gave evidence about why very poor countries have failed to integrate effectively in the global economy. A number of reasons were put forward. Some focus on the international environment (and, in particular, the operation of the international financial institutions and the financial markets) and on the regulation of the global trading system. (We consider these in Chapters 6 and 7 below.) Other explanations were specific to a country (for example, governance problems, the absence of an adequate civic infrastructure and a poor investment climate). We consider this second set of reasons in this section.

GOVERNANCE , INFRASTRUCTURE AND INVESTMENT CLIMATE

90. In its report, *Globalization, Growth and Poverty*, the World Bank emphasises the importance of developing countries strengthening their domestic institutions and policies:

> "Those developing countries that are successfully integrating with the global economy are doing so not just because of relatively open trade and investment policies, but also because of effective policies and institutions in other areas. Whether closed or open, developing economies need such policies and institutions. … The investment climate for firms, and labour market and social protection policies for workers … will effect the extent to which a developing economy integrates with the world and the benefits it receives from this integration".[44]

And Nicholas Stern suggested to us in evidence:

> "It is important to ask why [sub-Saharan Africa] has suffered. I do not think that it has got much to do with openness to trade, although they are, in fact, quite open to trade. It has more to do with governance issues, with conflict, with weakness of infrastructure, corruption, the tragedy of HIV/AIDS, malaria and TB and so on." (Ev II, Q 1820).

Professor Krugman argued that "relatively small amounts (from our point of view) invested in health and in some very basic infrastructure could make a huge difference" in sub-Saharan Africa (Ev II, Q 1882). And Ignazio Visco of the OECD said that, in addition to aid flows, "… adequate domestic policies in [poor countries] to create a stable macroeconomic environment and structural policies to spur private sector development are essential to achieve the much needed growth in output and living standards." (Ev I, p 172).

91. "Investment climate" is defined by the World Bank as "the regulatory framework for starting up firms and expanding production, the quality of supporting infrastructure (including financial services, power, transport, and communications), and the overall economic governance (such as contract enforcement, fair taxation, and control of corruption)".[45] We received a range of evidence about the importance of promoting a good investment climate as a means to enable poor countries to improve their indigenous production and attract foreign direct investment by transnational corporations. (We consider the effects of FDI in more details in Chapter 5.)

92. Andrew Crockett suggested that:

> "There is a general consensus that structural preconditions are necessary to reap the benefits of both trade and financial integration. Obvious examples include a system of well-defined property rights and the rule of law, but there are other more specific requirements relating to

[44] World Bank, *Globalization, Growth and Poverty* (2002), p 85.

[45] *Ibid*, p 95.

market practices and regulatory oversight. Unless all these preconditions are in place, a country risks either being marginalised, or else succumbing to dislocations brought about by market malfunctioning." (Ev I, p 156).

Peter Sutherland, in his agenda for reform of the globalised economy, put "address[ing] the marginalisation of the world's least developed countries" at the top. He suggested that the focus should be to help these countries "build the capacity to participate in global commerce" by assisting them to create the institutional and physical infrastructure necessary to enable them to attract foreign direct investment (Ev I, p 206).

93. In its submission, the Department for International Development indicated its awareness of the need to build up the infrastructure of poor countries by setting out the measures that the Government is taking to improve the domestic institutions and policies of developing economies as a means, in turn, to improve private investment flows. These include, for example, support for the Financial Sector Reform and Strengthening Initiative which was launched in April 2002 (by a group of bilateral donors, the IMF and World Bank) and which provides technical assistance to low- and middle-income countries to implement internationally agreed financial standards and codes. In relation to "the massive need for" infrastructure investment, the Government is also supporting a $305 million Emerging Africa Infrastructure Fund which was launched in January 2002 and which provides long-tern debt financing for private sector infrastructure companies in sub-Saharan Africa by using public funds to lever private finance.[46]

94. **We welcome the measures that are being taken internationally to assist developing countries to improve their investment climate. Although this is principally a responsibility of the developing countries themselves, efforts should be made through multilateral and bilateral agencies and agreements to facilitate developing countries in making such improvements.** We were pleased therefore to receive the evidence of Commissioner Solbes, EU Commissioner for Economic and Monetary Affairs, who told us that in their agreements with developing and emerging markets, they "try to introduce [the] idea of improving governance as a key element of future relations", a policy complemented by efforts also to encourage transnational corporations to reinforce improvements in the investment climate of the developing countries in which they operate (Ev II, QQ 2003 and 2006).

DIVERSIFICATION

95. A number of witnesses expressed concern about developing country economies which are dependent on commodity exports. Sir Andrew Large, for example, noted the difficulties of those countries "that have been particularly dependent on commodities of one sort or another" (Ev I, Q 775) and suggested that the "losers" from globalisation included "countries which are heavily reliant on commodity products without the benefit of economic value adding activity, such as Zambia for copper and Ghana for cocoa" (Ev I, p 292). He referred, on the other hand, to Malaysia as an example of a country which had responded by diversifying into the service and high-technology sectors (Ev I, Q 775). Nicholas Stern also suggested that the falling commodity prices "are part of the story" underlying the continuing poverty of sub-Saharan Africa (Ev II, Q 1820).

96. Although few witnesses argued that falling commodity prices have been caused by globalisation,[47] it is, none the less, the case that falling commodity prices have created a harsher world for those economies dependent on commodity exports. **We consider that efforts should be made through multilateral and bilateral agencies and agreements to encourage developing countries to diversify their production, while not undermining the areas of production where those countries have a distinct comparative advantage.**

AN EDUCATED AND HEALTHY WORKFORCE

97. We asked Niall FitzGerald, Chairman and CEO of Unilever plc, what factors determined whether a transnational corporation would invest in a country. He suggested four: political stability, good macroeconomic management, attractive financial returns and "finally, but most important of all, a healthy, educated and skilled population" (Ev II, Q 1552). The Report of the Commission on Macroeconomics and Health also argued:

---

[46] Ev II, p 188.

[47] In a memorandum submitted by the Green Party of England and Wales, it is suggested that transnational corporations are responsible for the adverse terms of trade affecting developing countries dependent on trade in primary commodities such as tea, coffee and bananas (Ev II, p 43).

> "investments in health work best as part of a sound over-all development strategy. Economic growth requires not only healthy individuals but also education, and other complementary investments, an appropriate division of labour between the public and private sectors, well-functioning markets, good governance, and institutional arrangements that foster technological advance. … We are not claiming that investments in health can solve development problems, but rather that investments in health should be a central part of an overall development and poverty reduction strategy".[48]

On the practical reasons why a healthy workforce is so important for economic (as well as humanitarian) reasons, the report went on:

> "Healthier workers are physically and mentally more energetic and robust, more productive, and earn higher wages. Their productivity makes companies more profitable, and a healthy workforce is important when attracting foreign direct investment. They are also less likely to be absent from work due to illness (or illness in their family) and to be more productive on the job. The effect is especially strong in developing countries, where a higher proportion of the workforce is engaged in manual labor".[49]

Child labour

98. One aspect of globalisation and poverty which was drawn to the Committee's attention in particular is the problem of employment of school age children.[50] In a recent ILO report, *A future without child labour*, it was estimated that in the year 2000, 186 million children aged 5-14 and 59 million children aged 15-17 were engaged in child labour.[51] Although child labour is not solely a feature of developing countries, "the problem is most critical in developing countries".[52] Gerry Rodgers of the ILO referred to villages in poor developing countries where "you have the absurd situation where the parents are unemployed and the children are working" (Ev II, Q. 1246). A satisfactory explanation of why this is so has not emerged from the evidence. As a matter of theory the reason must be that, given what they are paid relative to their productivity, it is more profitable to employ children than adults. We have to ask: are the children actually more productive? Or is it that adults demand more pay than children? And if the latter is the case, is that a matter of convention (because otherwise it would look wrong)?

99. In the modern world, not only is an economy based on working children and unemployed adults ethically unacceptable, it does not make economic sense. Economic advance demands an educated and trained labour force. That means that children must be in school, both for a basic education and, for many of them, a good deal more than that.

100. Our conclusion is straightforward. **We welcome the United Nations' commitment in the second of its Millennium Development Goals to "achieve universal primary education" and the UK Government's support for this.**[53] **An education strategy which takes school age children out of the labour market should be at the centre of any development plan**. **Far from creating an economic burden, this is a prerequisite to a successful economy.** We note with interest the views of Dr Supachai Panitchpakdi, who said, referring to his experience in Thailand, that "the most effective means against child labour, which is one of the key areas of labour rights violation, is to extend compulsory education …" (Ev I, Q 565).

101. We believe the labour market works and, therefore, in many cases adults will be employed to replace working children, albeit at a higher wage. Since all the employers who have spoken to us have expressed their commitment to good business practice, the payment of decent wages, and the enhancement of the quality of the workers they employ, we feel they deserve the strongest encouragement from our own government and from governments in the host countries. An aid programme to assist in keeping children in school is the best path to economic development which can eventually generate its own momentum and be self-financing.

---

48 Report to the World Health Organisation by the Commission on Macroeconomics and Health, *Macroeconomics and Health: Investing in Health for Economic Development* (December 2001), pp 25-6.

49 *Ibid,* p 34.

50 See, for example, the ILO at QQ 1245-53 and the written submission of the UK Section of the Women's International League for Peace and Freedom (Ev II, p 390).

51 International Labour Organisation, *A future without child labour: Global report under the Follow-up to the ILO Declaration on Fundamental Principles and Rights at Work 2000* (2002), p 16.

52 *Ibid*, p 21.

53 See *Eliminating Poverty: Making Globalisation Work for the Poor*, Cm 5006, December 2000, p 29.

POLITICAL STABILITY AND COMBATING BRIBERY AND CORRUPTION

102. In *George Soros on Globalization* it is argued that bad governance is a significant cause of poverty in developing countries: "By far the most important causes of misery and poverty in the world today are armed conflict, oppressive and corrupt regimes, and weak states – and globalization cannot be blamed for bad governments."[54] In evidence, Mr Soros developed this point further: "… it is a remarkable fact that countries which are rich in natural resources are among the poorest and most miserable because they are disrupted by civil war, strife, oppressive and corrupt governments" (Ev II, Q 1927). This was, he suggested, true both of Africa and Central Asia. Clare Short also referred to how conflict "delays investment and breaks up infrastructure" and to the "very corrosive" effect of corruption (Ev II, Q 2042).

103. Whilst not alleging that corruption is a phenomenon of globalisation per se,[55] the view was expressed by a number of witnesses that corruption is a factor which has contributed to the failure of some developing countries to achieve potential benefits of globalisation.[56] Willem Buiter told us: "I have become very impressed with the cost inflicted on society by the creation of opportunities for corruption and bribery" (Ev I, Q 200). The point is also made in the White Paper *Eliminating World Poverty: Making Globalisation Work for the Poor*:

> "More effective government and greater benefits from markets require tougher action – by developing and developed countries – to deal with corruption. The evidence suggests that investment levels are lower in countries with high levels of corruption, due to the uncertainty created, the cost of bribes and time-consuming bureaucracy".[57]

104. Corruption involves two parties: the one who pays the bribe and the one who receives it. It is, by its very nature, a hidden activity. It is, therefore, difficult to comment conclusively on the issue. Many of our witnesses, however, had no doubt that corruption exists – on the part of both governments and companies – and that it exists to a non-trivial extent.

105. Professor Victor Bulmer-Thomas, for example, referred to oil companies paying large amounts of tax to governments which are "very often corrupt" and "therefore money is diverted to private bank accounts"(Ev I, Q 83). George Soros gave the example of British Petroleum wanting to disclose payments to the Angolan Government on a voluntary basis, only to be threatened by Angola with expulsion. Dr Axel Gietz, Corporate Affairs Director of DHL, also referred to government corruption:

> "A lot of challenges you face are not brought in by the multinationals: they are indigenous challenges that result from under-developed economic structures, practices and traditions. Corruption is an example; it is not brought into developing countries by the multinationals; it is the result of the state of development of a given country." (Ev II, Q 1812).

And we note that, in the United States, the National Bureau of Economic Research (NBER) Programme on the Development of the American Economy this year launched a new initiative on "the roots of reform in America", an initiative "motivated by current concern with corruption in transition and developing economies."[58]

106. Matthew Taylor MP suggested that TNCs "had a very dubious track record" as regards corruption (Ev II, Q 1375). And Barry Coates of the WDM told us that: "… on the World Bank's 52 black-listed companies for corruption, 34 are British. We have to understand that this form of corruption/destabilisation often has some element of involvement from Britain" (Ev I, Q 922). In May 2002, Transparency International, the global anti-corruption organisation, published its Bribe Payers Index which measures perceptions within the business community in 15 emerging market countries about the use of bribery by corporations from OECD member states. It found that "corporations from OECD member nations are seen to continue to use bribes even though all OECD countries have passed laws prohibiting foreign bribery", especially in the construction and arms industries. It also

---

54 *George Soros on Globalization* (2002), p 16.

55 Commissioner Solbes, European Commissioner for Economic and Monetary Affairs, argued that the greater competition encouraged by globalisation was, in fact, "helping to reduce corruption" (Ev II, Q 2009).

56 See also, for example, Caroline Lucas MEP at Ev II, Q 1419.

57 *Eliminating Poverty: Making Globalisation Work for the Poor*, Cm 5006, December 2000, p 25, para 60. Source: Worldaware/Commonwealth Business Council Report *Priorities for Action to Promote Investment in the Commonwealth*; Smarzynska B and Wei, Shiang Jin, March 2000, *Corruption and Composition of Foreign Direct Investment* US National Bureau of Economic Research Report.

58 *NBER Reporter*, Summer 2002, p 3. We note rather wryly their comment that "corruption was rampant in late nineteenth century America and in 1900 most Americans were inured to political graft". The NBER's Programme on the Development of the American Economy investigates long-run economic development and growth, with specific attention to the United States.

found, however, that the problem is perceived to be even greater outside the OECD, with companies from Taiwan, China and Russia being seen as more likely to use bribes than OECD members. Furthermore, there is a perception that domestic companies are more likely to use bribes than foreign firms.[59]

107. We asked those of our witnesses who represented TNCs about the prevalence of corruption. Not surprisingly, each of them – Niall FitzGerald of Unilever, Lord Browne of BP and Dr Gietz of DHL – stressed their opposition to their companies engaging in corrupt practices (Ev II, QQ 1551, 1278 and 1812). Patricia Hewitt said that in her experience "most of our companies do not pay bribes" (Ev II, Q 1863). Clare Short was asked however about the general allegation that some TNCs are engaged in corrupt practices in developing countries and elsewhere. Referring to the recent implementation of the OECD convention on corruption,[60] making it a crime to offer a bribe to a public official abroad, she said: "You can be sure if we need a convention like that there must have been malpractice." (Ev II, Q 2042).

108. It is not our wish to point fingers, and we are certainly impressed by the commitment to good business behaviour and ethical practice expressed by the firms who gave evidence to us. But the matter cannot rest there. Part of the solution lies in greater transparency of business operations, the financial side of which also involves the banks. If bribes are paid, these must go through the accounts which are, in turn, supposed to be audited. George Soros also focused on the need for greater transparency, particularly in relation to payments by TNCs to developing country governments.[61] He has proposed a scheme called "publish what you pay", a measure which would require oil companies and mining companies to disclose, by country, how much they have paid so as to counter the siphoning-off of funds mentioned by Professor Bulmer-Thomas (in paragraph 105 above). We note that the Prime Minister, Tony Blair, endorsed this proposal in a speech following the Johannesburg Summit on Sustainable Development in September this year.[62] The Chancellor of the Exchequer, Gordon Brown, also indicated his support for both the international financial institutions and businesses working towards greater transparency (Ev II, Q 2092).

109. Donald McKinnon referred to the role of government in any strategy to combat corruption. It had, he said, to "begin at the top in every country and it had to be a very strong commitment". He went on: "… international institutions are looking more rigorously at corruption and how it affects development in all countries. It is a slow, steady pressure that is going to work here but the commitment of leaders principally is what is needed." (Ev I, Q 820). Commissioner Solbes, European Commissioner for Economic and Monetary Affairs, argued that transparency was at the core of tackling corruption in developing countries, but advanced the more general point that "the best system to fight corruption is to have good governance and good democratic institutions and a good system of democratic control". For this reason, he said, improving governance was "a key element of future relations" in EU agreements with developing and emerging markets – "trying to prohibit corruption by law is nice but it is not enough" (Ev II, Q 2003). In its submission, the Conservative Party advised "bearing down on corruption, with a rigorous approach to withdrawing development assistance where there is evidence of misuse …" (Ev II, p 292).

110. **Financial regulators, the international financial institutions, the World Trade Organisation, professional bodies and governments, either separately or together, should establish a centre of responsibility with the aim of tackling corruption (both in connection with development programmes and the operation of the global economy). We believe the UK Government has an important part to play here, preferably in co-operation with our European Union partners. Transnational corporations and other businesses must accept responsibility for scrutinising their agents and other business associates with regard to corrupt practices on their part. Reinforced action by business organisations would also be helpful.**

---

59 Press release: Transparency International, 14 May 2002.

60 Convention on Combating Bribery of Foreign Public Officials in International Business Transactions.

61 " … transparency would be extremely helpful and knowing what the governments are receiving would then enable both the civil society, citizens, and indeed the national institutions to hold governments accountable…" (Ev II, Q 1927).

62 Mr Blair said: "We want to work with developing countries to ensure that revenues from natural resources are used effectively to reduce poverty. So the UK is taking a leading role in bringing together countries, businesses, development agencies and NGOs to tackle the current lack of information available, and ensure that all payments by companies are published openly."

CHAPTER 4: LABOUR MARKET CONDITIONS

111. Whereas concerns about poverty and inequality focus principally on developing countries, fears about the impact of globalisation on labour market conditions relate to workers in developed countries as much as those in developing countries. We turn first to developed countries.

Developed countries

112. The main worry in developed countries with regard to labour market conditions is that competition from cheap imports from low-wage economies (which may threaten domestic manufacturing industries) and the capacity of transnational corporations to move production to low-wage economies (or to outsource to low-wage economies) may cause

- higher unemployment amongst the unskilled labour force (particularly in the manufacturing sector);
- greater wage inequality; and,
- greater job insecurity.

We note at the outset that discussion about the effect of globalisation on these phenomena must be placed in the context of all the other economic forces at work. Technological advance, the emergence of new products, demographic change, employment laws, an increased emphasis on lower inflation as the target for macroeconomic policy, and a move to greater reliance on the market mechanism within an economy – all have a part to play.

UNEMPLOYMENT

113. A number of witnesses referred to the effect of competition from low-wage economies on developed countries' employment (although not suggesting that high levels of unemployment in some developed countries should be attributable to globalisation). Patricia Hewitt, for example, said about the impact of globalisation within the low-skilled, tradeable sector: "We are not going to have a future making cheap cotton tee-shirts. That and a lot else besides will move to the countries which have low wages or other sources of comparative advantage …" (Ev II, Q 1854).

114. Ignazio Visco of the OECD told us that: "Eventually, globalisation leads to a substitution of low-skilled jobs by high-skilled jobs in high-income countries, and an increase in the employment level in low-income countries. … Even though the net impact on employment is likely to be modest, the skills required of workers could change substantially as the composition of employment shifts." (Ev I, p 172). Similarly, the TUC argued that although "overall, the rapid growth in trade in the 1990s has not been associated with deterioration in labour markets in the OECD", "the entry of new producers will undoubtedly put pressure on some sectors in established markets and cause some industrial restructuring" and, as a result, "concerns remain that growing competition from low-wage competition has lost jobs in the manufacturing sector, especially for less skilled workers in the more labour intensive lower value added industries". The TUC continued:

> "There is clearly some truth in that charge, although exports from the industrialised world to low wage economies will at the same time create new jobs. Nonetheless, the argument goes that job losses will tend to be much greater than job gains because the industries under threat from cheap imports tend to be labour intensive, while industries exporting to the developing world tend to be capital intensive." (Ev I, p 35).

The Royal Academy of Engineering anticipated that "the share of the UK GDP generated by traditional 'metal-bashing' and heavy manufacturing will continue to decline" (Ev II, p 371).

115. Michael Kitson also referred to the shift of less skilled jobs to "low cost sectors and less developed countries", causing greater unemployment, job insecurity and wage inequality amongst the less skilled in developed countries (Ev I, Q 274). Similarly the Engineering Employers' Federation (EEF) took the view that "inevitably, we will lose some of our manufacturing activities to lower cost countries" – this would generally be "at the lower end" – that is, the less skilled sectors – of manufacturing and engineering (Ev I, Q 478).

116. Although globalisation has led to some unemployment through industrial restructuring, a number of witnesses drew attention to the fact that the technical innovation that characterises this period of globalisation has influenced the nature and rate of industrial restructuring. According to a study[63] to which reference is made in the TUC written evidence, "80% of the fall in industrial

[63] Rowthorn and Ramaswamy, *Growth Trade and Deindustrialisation*, IMF Staff Papers, March 1999.

employment in the advanced economies between 1964 and 1994 can be explained by internal factors and only 20% by competition from low wage economies." (Ev I, p 35). John Monks told us, in relation to the cause of unemployment amongst unskilled workers, that "it is extremely difficult to measure [globalisation] against the other factors, of which technological change and development is such a powerful driving factor" (E v I, Q 56). Patricia Hewitt also suggested that "it is very difficult to distinguish the adjustment costs that come from engagement in world trade and globalisation and those that would come anyway from technological change …" (Ev I, Q 1849). Ian Brinkley, a TUC Senior Policy Officer, however, suggested that they were "… more persuaded that the big effects have come through technology and technical advance in terms of the impact on the unskilled worker. Trade and competition from low wage economies clearly has had a role, but it is rather less important than other factors." (Ev I, Q 56).

117. **Globalisation has brought about industrial restructuring which has caused some transitional unemployment in developed countries especially amongst the less skilled.**[64] **The evidence suggests however that technological change has been more significant in reducing industrial employment amongst the less skilled. It is possibly a more significant force than competition from low-wage economies.**

WAGE INEQUALITY

118. Although there has been a decline generally in the demand for unskilled labour in developed countries, the TUC notes that there has not been a corresponding general increase in wage inequality. Whereas there have been significant increases in wage inequality in economies such as the United States, the United Kingdom and New Zealand, other OECD countries have not had a similar experience. The TUC suggests that the implication is that "institutional and other factors – strong trade unions, social benefits and employment protections – also have an important role to play" (Ev I, p 36). Professor Greenaway also notes the "skill premium" – the increase in wage inequality – in the UK and the US in the last quarter of a century but suggests that the difference between the UK and US, on the one hand, and continental Europe, on the other, is that "the decline in labour market outcomes for the less skilled in those economies seems to manifest itself on the employment front" rather than through wage inequality. As regards the cause of increased wage inequality in the UK, he argues that trade with low-wage economies is only a "minor player": other factors such as wage compression in the public sector and the proliferation of skill-biased new technologies are "at least as, if not more, important than the globalisation process" (Ev I, Q 232).[65]

119. **The evidence suggests that in those developed countries where there is increasing wage inequality, this cannot be attributable solely to globalisation but is also a consequence of a number of other factors including technological change.**

JOB INSECURITY

120. Job security, in terms of the perception of members of a workforce about their individual security, is, as the TUC rightly points out, "difficult to measure" (Ev I, p 37). However a survey was carried out by the OECD in 1996 and 2000 across a large number of OECD countries which at the very least offers some information about changes in concerns about job insecurity. The survey showed a general fall in concern about job insecurity during that period although the 2000 survey indicated a comparatively high level of insecurity in the United Kingdom.[66] Patricia Hewitt, however, had a different impression:

> "There is undoubtedly … a greater feeling of insecurity, if you look at the survey evidence over time. I think that part of that does some from the sense that this is an intensely competitive world; increasingly competition comes from international companies and from other countries, but coupled with that and intertwined with it is the incredible speed of technological change. So that the prospect of staying in pretty much the same job using pretty much the same skills in a sector that does not look very different has really disappeared." (Ev II, Q 1858).

121. Whatever the perceptions of members of the workforce about their security, Professor Greenaway suggested that globalisation will tend to create actual job insecurity: "Increased

---

64 As the TUC suggested, however, "there is little new in this process of industrial change" – competition from low wage economies has been going on for decades or longer and "[industries] have had to respond as a result." (Ev I, p 35).

65 Professor Greenaway added two caveats to this conclusion: first, there is a link between trade and skill-biased technical change; and, secondly, a significant increase in trade with some of the very large low-wage economies such as China and India is likely to have an impact on UK wage inequality (Ev I, Q 232).

66 International Survey Research, OECD 2001, quoted in the written evidence of the TUC (Ev I, p 37). When asked whether they were unsure of a job even if they performed well, 41% of respondents in the UK said they were.

globalisation creates more opportunities and therefore the potential for greater job turnover. Although the latter is a desirable characteristic of a dynamic well functioning economy, it also brings with it less job security." (Ev I, p 98). It is important not to assume, however, that job insecurity must result from labour mobility. It is argued that countries such as ours or, even more so, countries in the EU would benefit economically from increased labour mobility (see paragraphs 128 and 136 below). This is sometimes confused with a fear of increased insecurity. If, however, there is full employment, more mobility does not necessarily imply more actual insecurity because workers may be able easily to get suitable new jobs.

SKILLED WORKERS

122. Although the focus of the concern of developed countries about the impact of globalisation on labour markets has been on the unskilled workforce, according to the TUC, the skilled workforce of the United Kingdom does not remain unscathed by worries about unemployment and job insecurity. They reminded us that our major competitors are other European countries (Ev I, Q 49) and that the impact of this European trade is to encourage companies to go "up market all the time" – the implication of this is "very different from competition from low-wage economies, which is more likely to result directly in unemployment" (Ev I, Q 51).

Developing countries

UNEMPLOYMENT AND WAGE EFFECTS

123. In general, witnesses argued that fears about the impact of globalisation on labour market conditions were principally about unskilled labour in developed countries. We received some evidence, however, which indicated that structural changes in production in developing countries have also had harmful transitional effects in relation to employment and wage levels. Donald McKinnon suggested that:

> "Trade liberalisation has resulted in the loss of employment in sectors that had previously been protected and had difficulties in driving down unit costs. The loss of trade preferences is having a particularly pernicious impact on vulnerable small states … The loss of these preferences is undermining the competitiveness of these economies and threatening their viability." (Ev I, p 304).

He urged that measures should be taken to assist these vulnerable countries.67 Duncan Green, Public Policy Analyst, CAFOD, argued that globalisation could create unemployment because of a high proportion of foreign direct investment being in the form of mergers and acquisitions rather than 'greenfield' investment (Ev I, Q 901).

124. Ignazio Visco, whilst arguing that globalisation would generally lead to the creation of employment opportunities in developing countries (as unskilled work shifted from developed to developing countries), also acknowledged the likelihood of "distributional consequences" which would require some form of "social insurance" (Ev I, Q 438).

125. As regards wage levels, again the evidence we received was largely to the effect that globalisation would benefit wage levels in developing countries. (In Chapter 5 we refer to the effect of TNCs on wage levels in developing countries.) Duncan Green, however, argued that his experience of the textile industry in particular indicated that where an industry was highly mobile, "the threat of relocation is almost as bad as the actuality of relocation in terms of holding down and reducing wages and conditions …" (Ev I, Q 901).

DEVELOPED COUNTRY "POACHING"

126. The new technologies, coupled with globalisation, have placed a premium on skilled labour in developed countries. There is also a premium on skilled labour in developed countries arising from indigenous shortages in certain areas such as the medical and teaching professions.[68] This has led to recruitment by developed countries of professional staff who have been trained in developing countries. In the Report of the Commission on Macroeconomics and Health to the World Health

[67] It is, of course, the case that a change in trade preferences can have a neutral, rather than negative, effect: the removal of trade preferences from one country can be offset from a gain in another country.

[68] See, for example, John Monks (Ev I, Q 58) and Professor Bulmer-Thomas (Ev I, Q 109). Sabine McNeill of the Forum for Stable Currencies also refers to the flow of "essential skills" from developing to developed countries (Ev II, p 297).

Organisation, the problem of the "brain drain" from developing countries is identified as one of the four key policy challenges of globalisation.[69]

127. In a general sense it is contradictory to argue that international capital mobility is economically beneficial and international labour mobility is not. The case for it is based on the elementary proposition that the world gains if factors of production are used where they are most productive. As we indicate below, that does not mean that serious problems do not emerge in connection with such mobility. Policy intervention is needed to mitigate the ill effects of the international movement of capital and labour. International labour mobility – which at present is relatively restricted – has major benefits however. Andrew Crockett, for example, took the view that, although the movement of labour imposed certain costs, "any broadened opportunity for willing buyers and sellers to come together, whether for products or for factors of production, is desirable" (Ev I, Q 396). He also referred to the importance of remittances by migrant workers to their home countries (especially in relation to high population countries in the Middle East (Ev I, Q 399)).[70] Willem Buiter thought that: "On the whole ... the movement from countries where labour is plentiful and productive jobs are few and far between relative to the endowment of labour to countries which are greying, where labour is scarce, makes sense both for those who move and in principle for those left behind ..." (Ev I, Q 201). Diane Coyle gave the example of the recruitment by firms in the United States Silicon Valley of computer experts from Taiwan and India and suggested that "… the US opening its doors to those immigrants could turn out ... to be one of the best things that developed countries have ever done for developing countries because they have built leading edge industries in their own countries, it is not all one way." (Ev I, Q 665). Donald McKinnon similarly cited the Indian diaspora as a benefit to Indian economic growth (it has "become a major source of foreign capital inflows into Indian, with an estimated US $30 billion in net foreign currency deposits in India, contributing substantially to the balance of payments and foreign debt financing needs") and suggested that the Chinese diaspora was similarly contributing to China's recent "remarkable economic performance" (Ev I, p 306).

128. On the other hand, there are also harmful effects on developing countries: not only, as Professor Bulmer-Thomas suggests, have these countries "invested scarce resources" in the training of such staff (Ev I, Q 109), but the knock-on effect will be that the developing countries themselves will suffer a shortage in professional staff. Andrew Crockett gave an example:

> "… the so-called green card scheme in Germany … is intended to attract large numbers of IT professionals from India to Germany. That is obviously beneficial from the German point of view, it is obviously beneficial from the point of view of the individual who earns more. Whether it is so beneficial from India's standpoint, losing skilled labour, is another question." (Ev I, Q 397).

129. Donald McKinnon also emphasised this (somewhat unwelcome) connection between globalisation and labour mobility:

> "The 1970s debate about the brain drain of skilled labour of developing countries into the OECD is still a concern to certain countries which are suffering particularly high losses of skilled professionals, for example South Africa. (The Canadian Medical Association Journal has noted in an article that nearly one in five doctors in Saskatchewan province earned their first medical degree in South Africa.) …
>
> In what can sometimes be seen as constituting a form of harmful competition millions of highly skilled workers, trained in developing countries, in key professions such as doctors, nurses, IT professionals and accountants are recruited by the OECD area." (Ev I, p 305).

130. The Department for International Development, in its White Paper on globalisation, indicated its awareness of the problem of poaching of skilled labour by developed countries:

> "The UK believes that developed countries need to be more sensitive to the impact on developing countries of a skills drain. They need to ensure that policies in this area do not unfairly restrict the ability of developing country service suppliers to sell into their markets, yet

69 "It is estimated that in the case of 20 African countries – Algeria, Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Gambia, Ghana, Guinea, Guinea Bissau, Liberia, Mali, Mauritania, Morocco, Nigeria, Senegal, Sierra Leone, Somalia, Sudan, Togo, and Tunisia – more than 35 percent of nationals with a university education are now living abroad (International Organization for Migration 2001)": report to the World Health Organisation by the Commission on Macroeconomics and Health, *Macroeconomics and Health: Investing in Health for Economic Development* (December 2001), pp 75-76.

70 In a Special Report on Emigration by the *Economist*, 28 September 2002, p 28, it is stated that migrants send home $60 billion though official channels with an estimated additional $15 billion in other, unreported, ways. As to the benefit of remittances, the report states: "One of the few attempts to estimate whether remittances by the skilled offset the loss of intellectual capital to the sending country concluded that they did not."

also do not worsen skill shortages in developing countries. In line with this principle the National Health Service has developed a set of ethical guidelines which rule out recruitment from a particular country of this has a negative effect on that country's healthcare services".[71]

The Department indicated that it is carrying out research in this area.72

131. Given this, we were interested to receive the evidence of Patricia Hewitt. She told us that the Government had taken steps to make it easier for those who had skills falling within a list of skills shortages to migrate to the United Kingdom, a list which had been expanded to include information and communication technology and other engineering skills (Ev II, Q 1869).

132. In sum, there are two important considerations to bear in mind here. One is the economic proposition that all factors of production should be used where they are most productive. In that way output is maximised. The second is that much labour contains a capital element which is the education and training invested in it. It is that embodiment of human capital which raises its productivity and causes a wage premium for the skilled. The problem is that the cost of that education and training is largely paid for by the general taxpayer. The labour may then move in response to higher wages and better employment prospects. The individual concerned will gain, but what of the general taxpayer who has borne some of the cost? Where governments restrict the movement of labour and, in particular, admit mainly those with special skills of which they are short, the problem of the cost to the sending country is exacerbated. The difficulty, which we raise in paragraphs 136-38 below, is whether it is possible to encourage the free movement of labour while co-operating with those who paid for the investment in skills. In doing so we note that the problem is not just one of movement from poor countries to the rich. In principle, it will apply, for example, to movement of the highly skilled and highly educated from the UK to US.

Responding to changing labour market conditions

PROMOTING SKILLS

133. In Chapter 3 we considered, as part of a broader strategy for dealing with poverty in developing countries, the importance of promoting the skills of the workforce in those countries. It is not surprising that in a changing labour market in developed countries where there is an employment shift in favour of skilled labour, a number of those who gave evidence suggested a similar prescription for developed countries. Professor Greenaway, for example, suggested that the policy response in developed countries could either be to increase job security (through legislative measures to reduce job turnover and transitional unemployment) or to increase adaptability through education and on the job training. Since, he argued, policies to increase job security are likely to reduce adaptability, they tend to be associated with greater structural unemployment. He advised, therefore, measures which would foster adaptability (Ev I, p 98) and went on: "The benefits from such policies extend well beyond adjusting to globalisation and include adjusting more smoothly to changes in technology which, given computerisation and the communications revolution, are also accelerating." (Ev I, p 98).

134. The Royal Academy of Engineering advised that "it will be essential to maintain a high level of skills in the workforce" (Ev II, p 371) and the Royal Society of Edinburgh stressed the importance of investment to "progressively 'up-skill'" (Ev II, p 377). Michael Kitson similarly suggested that investing in competencies, skills, infrastructure and R&D (research and development) was important if the United Kingdom were to "compete effectively … in a globalising economy" (Ev I, Q 310). Patricia Hewitt told us that "the big challenge" was to ensure that those "who lack basic skills" should be assisted in acquiring them (Ev II, Q 1854). There was, she suggested, a basic skills deficit which had been "neglected for a very long time" and which would require "a very substantial investment to overcome" (Ev II, Q 1858).

135. **Given the fall in demand for unskilled and less skilled labour in the tradeable sector of the economies of developed countries, including the United Kingdom, successive UK governments have been right to take steps over many years to promote the skills training of the unskilled and less skilled workforce. We support the present Government's reinforcement of the policy to promote education and skills training. Similarly, as regards developing countries, increasing skills levels is an important element of a strategy to enable those countries to exploit more effectively the potential of globalisation.**

---

[71] *Eliminating Poverty: Making Globalisation Work for the Poor*, Cm 5006, December 2000, p 43, para 134.

[72] *Ibid*, p 43, para 133.

COMPENSATION AND THE "BRAIN DRAIN"

136. John Monks suggested to us that part of the response to a shortage of skills in the British labour market should be "to improve our own skills, educational skills and training to ensure that we seek to meet our own needs as far as we can" rather than "to look abroad and poach other countries' skills" (Ev I, Q 58). Whilst adapting the skills set of the home workforce to meet the needs of the economy is clearly important, migration can be beneficial both to the individual worker and more generally: it can enhance cultural exchange, promote the dissemination of skills and enables migrants to send remittances back to their home countries. On the other hand, policies need to be put in place to offset the harmful effect of publicly-financed skilled workers leaving developing countries.

137. A number of witnesses argued in favour of a scheme where if skilled labour is lost to a country, that country should be compensated for the costs of training. Diane Coyle, for example, said that she could "envisage many mechanisms for making sure that the taxpayers of already very poor countries are not penalised for losing their best and brightest" (Ev I, Q. 672). Willem Buiter suggested more specifically that where education is publicly financed there should be a form of exit tax "related explicitly to the costs incurred by society" in training and educating, collected by the host (or recipient) country and paid to the home (or sending) country (Ev I, Q. 201). Donald McKinnon also endorsed the idea of a compensation scheme although he suggested that it should be the host country which should be charged rather than the migrant worker. Whilst supporting the basic right of individuals to choice where to live and work, Mr McKinnon thought that "… may be … some form of compensation needs to be paid by OECD countries to correct [the] market externality caused by OECD organisations 'free-riding' on developing country investment in human capital". He also made a "concrete suggestion" which was "for rich industrial countries to support technical skills training institutes such as nursing schools, medical schools and IT training institutes in developing countries …" (Ev I, p 305). These are all interesting suggestions. We would be worried, however, about the implication for freedom of movement if an exit tax were introduced. In addition, where a person moves from country A to country B and then to country C, it becomes exceedingly difficult to determine where the benefits and costs lie.

138. **Significant benefits arise from labour mobility (for both the countries involved and the individuals). Nevertheless, there is a concern about the effect of the "brain drain" on those developing countries which are losing skilled labour. To the extent that this impairs the development of these countries (in relation to both their public and private sectors), we share that concern. We welcome the UK Government's commitment to undertake further research on the "brain drain". Overseas aid policy should help to finance education and training in poorer countries, shifting the burden from taxpayers there to taxpayers in the countries of immigration. The level of aid might be geared to some extent to the number of skilled workers coming from a country.**

CHAPTER 5: ROLE OF TRANSNATIONAL CORPORATIONS

139. A significant feature of globalisation is the increasing internationalisation of production. There are distinct but related aspects. One is the growth of "production networks" in which stages of production are outsourced to low wage economies.[73] The other is the role of the transnational corporation (TNC) and foreign direct investment (FDI). First, however, we consider the issue of measuring the power of TNCs.

Measuring the power of TNCs

140. Many witnesses focused on the presence and power of TNCs in the global economy as the defining characteristic of the current period of globalisation. According to Christian Aid, "over the last 30 years, the number and size of TNCs has increased dramatically. In 1970, there were 7,000 TNCs, whilst today there are 63,000 parent companies operating with about 690,000 subsidiaries in almost all sectors, countries, industries and economic activities in the world."[74] Donald McKinnon referred to TNCs as the "main drivers of and beneficiaries from globalisation" (Ev 1, p 305). CAFOD saw the "increasing size and dominance of transnational corporations" as one of the main concerns about globalisation (Ev 1, p 339).

141. A theme which emerged from the evidence we received is that TNCs are powerful and becoming ever more powerful. It is not, however, at all clear how the power of TNCs is to be measured or, for that matter, of what it actually consists. To demonstrate the size of the most significant TNCs, some commentators compare them to countries' economies. Christian Aid, for example, asserted that "many TNCs are bigger than most countries in which they operate. In 1998, the annual turnover of BP was larger than the GDP of all the least developed countries combined".[75]

142. Lord Browne, Group Chief Executive of BP plc, was critical of this comparison between company turnover and a country's GDP: he referred to it as an "abuse of data" (Ev II, Q 1270). Sir Samuel Brittan similarly said: "It is often said that large American companies ... [have] a higher turnover than the GDP of Luxembourg or even Belgium, but these are completely different entities." (Ev I, Q 593). Michael Kitson expressed the same view (Ev I, Q 296).

143. A country's Gross Domestic Product is an aggregate of value added – income payments to labour, capital and land – whereas the sum total of a company's sales figures also includes payments to other firms for intermediate goods. The two are not, therefore, comparable. It is nonsensical to talk in such terms, and to compare business turnover with value-added. It is likely, therefore, that Martin Wolf is correct when he asserts that "corporations are neither as big or as powerful as critics claim".[76] We note, however, that UNCTAD has recalculated TNCs sales in terms of value added. They conclude that the value-added activities of the 100 largest TNCs have grown faster than those of countries in recent years, accounting for 4.3% of world GDP in 2000, compared with 3.5% in 1990, and that 29 of the world's 100 largest economic entities are TNCs, compared with 24 in 1990.[77] As Michael Kitson states, TNCs are "more powerful now than they have been" (Ev I, Q 296) – they are powerful players in the globalised economy and powerful forces in many national economies. To anticipate our conclusion in paragraph 157 below, what emerges from the evidence is that TNCs are powerful, but their power is constrained.

TNCs and the economic effects of FDI

144. Foreign direct investment flows have grown significantly in recent years. According to the World Bank's world development indicators, FDI by firms as a share of GDP increased between 1989 and 1999 from 2% of world GDP to 4.6%.[78] Sir Andrew Large referred to both the recent increase in trade which, he said, over the last 10 years had increased fourfold to $3 billion and to the even greater increase in FDI flows which were $2 billion a year in the 1970s, increasing to $130 billion in 2000 (Ev 1, p 293).

---

[73] It is estimated that at least one third of world trade in manufactures is a consequence of this activity – for example, trade in parts and components for further assembly – and the activity is particularly important for many Asian economies. The labour market implications of this are considered in Chapter 4 above.

[74] Christian Aid, *Trade for Life: Making Trade Work for the Poor* (2001), p 114, citing Sarah Anderson and John Cavanagh, "Top 200: The rise of corporate global power", Institute for Policy Studies, Washington, 2000, p 1.

[75] *Ibid*, p 114, citing UNCTAD, *World Investment Report 2000*, Geneva, 2000.

[76] Martin Wolf, "Countries still rule the world", *Financial Times*, 6 February 2002.

[77] UNCTAD Press Release, *Are transnationals bigger than countries?*, 12 August 2002.

[78] Quoted in the written submission of the TUC (Ev 1, p 31).

145. A benefit of FDI is that it makes the surplus savings of some countries available to others where it will be more productive and yield a higher return. It also promotes economic development by acting as a mechanism for the transfer of technology and skills from developed to developing countries. We received a range of evidence in support of these views. The Confederation of British Industry (CBI), for example, said: "… compelling evidence that FDI has helped developing countries to achieve sustained poverty reduction can be found in the contrast of the Asian Tigers, which opened themselves to trade and investment, with the experience of many African countries. Characterised by very low levels of FDI, they continue to be dogged by persistent levels of poverty." (Ev 1, pp 134-35). Clare Short was emphatic about the benefits of FDI to developing countries: "In terms of the interests of developing countries, responsible, foreign direct investment, bringing technology transfer and improved infrastructure is absolutely the key to them speeding up their economic development." (Ev II, Q 2039). Nicholas Stern described FDI as "a powerful force in support of growth" and "a powerful force in terms of ideas, management, technology and so on." (Ev II, Q 1826).

146. The Department for Trade and Industry also referred to the benefits – especially to developing countries – of the technological spread facilitated by foreign direct investment and the link between FDI and economic growth:

> "… the economics of this debate is the extent to which it is true that multinationals … bring with them to host countries things which are likely to improve the long-term rate of growth of that country's economy. The evidence seems to be stronger for developing countries. The proposition there is that they (developing countries) have a greater chance of catching up … than if they did not have this new technology." (Ev I, Q 20).

147. Peter Aven, President of the Alfa Bank in Russia, and Kakha Bendookidze, Director General of United Heavy Machinery, offered a Russian perspective. Mr Aven acknowledged that there is an anxiety, expressed by the anti-globalisation movement, that TNCs wield unaccountable power (Ev II, Q 1718). As far as the Russian economy was concerned, however, such corporations were, in his view, a force for good: "… technology did not exist until transnational corporations came into the country ... For Russia, especially after the collapse of the Soviet Union, more openness and stronger presence of transnational corporations are positive factors." (Ev II, Q 1678). Mr Bendookidze referred to the contribution of TNCs in the way in which they promoted the spread of knowledge and experience about organising and managing companies and the transfer of new technologies (Ev II, Q 1959). Tito Mboweni of the South Africa Reserve Bank was similarly positive about the effect of TNCs in South Africa: "Have they exploited South Africa or have they assisted South Africa to develop? The answer is most definitely that they have assisted South Africa to develop, without a doubt" (Ev I, Q 583) – in fact, he said, it was certain domestic companies which could be described as exploiting South Africa because of their pollution of the environment.

148. Dr Yilmaz Akyuz of UNCTAD stressed the importance, however, of getting the right sort of foreign direct investment. It was not, he suggested, sufficient that the TNCs should be entering a country in order to employ unskilled labour: "We want them to bring technology; we want them to bring know-how. We want them to establish linkages with domestic industry and eventually we want them to pass on some of the advantages that they enjoy." (Ev I, Q 962). And Michael Kitson suggested that "FDI … may be an effective vehicle for increasing the globalisation of technology" but "much will depend on the objectives of the MNC: is it seeking the lowest cost of production or is it seeking to utilise national or sub-national expertise and research?" He went on: "… many MNCs may tend to be loyal to their own home-based country when they have to locate a strategic asset such as technology although others may be seeking out competitive clusters abroad." (Ev 1, p 111).

149. Donald McKinnon recognised that TNCs were "a powerful force for global technology transfer, skills development and international investment flows" but thought that there was a perception amongst recipient countries that significant benefits were not flowing to their citizens: "… there is a perception that they are not doing enough in terms of promoting training; transferring technology/addressing the digital divide; widening the country coverage and depth of investment flows; bringing about a more equitable multilateral trading system; and protecting the global commons." (Ev 1, p 305). Lord Browne acknowledged this point. Reflecting on the achievements of globalisation, he commented that there is "… an awful lot still to do. It is not evident to me, when I go to a place like Angola, or I go to South Africa or I go to Indonesia, that the benefits of what we do are directly coupled to those who are affected by it – not yet." (Ev II, Q 1268).

150. **We believe that foreign direct investment is an effective mechanism for economic change in developing countries (although there is evidence that it could be more effective).** To put this in context, however, we note that although FDI flows far exceed the level of aid from developed to

developing countries,[79] they remain highly concentrated amongst developed countries. The CBI provided some clear evidence (drawn from the UNCTAD *World Investment Report 2000*) of this: "Between 1985 and 1995, 71 per cent of inward flows of FDI were concentrated in the developed world, rising to 73 per cent by 1999. Similarly, 90 per cent of outward flows originated in the developed world between 1985 and 1995, increasing to 91 per cent by 1999." (Ev I, p 128). The reason for this concentration is explained by the TUC: "The increase in [gross foreign direct investment and private capital flows] as a share of GDP over the past ten years is largely confined to the OECD economies, with especially big flows involving the Eurozone economies and the UK. This is not very surprising – private investment and private capital tends to be drawn to the richer and bigger economies because this is where the market demand for funds and the opportunities to invest profitably are greatest." (Ev 1, p 33). Of course, much of this investment is beneficial too. International technological transfer accompanied by improved managerial skills is an important source of improvement in advanced countries where productivity is still below the best.

151. We also note that much FDI involves mergers and acquisitions (M&A) rather than creating a new or expanding an existing enterprise. However, while 80-90% of FDI flows into developed countries are due to M&A, less than one-third of flows into developing countries take this form: the remainder is 'greenfield' investment, associated with the construction of new facilities in these countries. Furthermore, as Michael Kitson, told us, there can be benefits from M&A: "M&A may obviously create benefits because it brings in new managerial techniques, new technologies and so on. New capital may produce this as well but it will also add to the domestic capital stock …" (Ev I, Q 289).

Complaints about the power of TNCs

152. The complaints which emerged from the evidence about the power of transnational corporations fall into the following broad categories:

- the democratic deficit arising from the power of TNCs to influence policy-makers at national and international levels; and
- the consequences of the exercise of that power on employment standards, the capacity of governments to pursue social welfare programmes, on the environment and culture.

DEMOCRATIC DEFICIT

153. A number of witnesses raised questions about the relationship between TNCs and democracy.[80] Professor Bulmer-Thomas, for example, suggested that one of the costs associated with globalisation "… is the transfer of power – from governments, other firms and to some extent labour – to MNCs. … There are still too many cases of MNCs misusing their power to extract tax concessions from weak governments or to impose unsafe working practices on their labour forces" (Ev 1, p 52). The Green Party of England and Wales (Ev II, p 85) took a similar view, as did Friends of the Earth England, Wales and Northern Ireland (Ev II, p 273), the Foundation for the Economics of Sustainability (Feasta)(Ev II, p 258) and the Royal Academy of Engineering (Ev II, p 372). Michael Kitson thought that one of the greatest areas of concern in relation to TNCs was "the way they may be having an influence on policy making and on the policy agenda", given that the objectives of TNCs "are not necessarily aligned with the objectives of societies and nation states" (Ev I, Q 296). Dr Noreena Hertz's view was that governments have ceded too much power to corporations – "their capacity to rule … is increasingly shaped and constrained by the interests of big business": "Governments are torn between wanting investment, wanting the multinationals there and having to take into account what price they have to pay to get them in and keep them in." (Ev II, QQ 1653 and 1656).

154. Aside from allegations relating to the role of TNCs at national policy level, we also received evidence of their influence in international fora. In Chapter 6, we give an example where it is alleged that the pharmaceutical companies played an influential role in bring about the World Trade Organisation agreement on Trade-related Intellectual Property Rights (TRIPS).

155. In contrast, other witnesses have argued that TNCs are subject to constraints from a variety of sources: government, competitors, consumers, campaigning organisations and consumer pressure.

---

[79] Between 1991-2000, aid to developing countries fell from $60.9 billion to 38.6 billion, whereas FDI rose from $35.7 billion to 178 billion: Centre for Economic Policy Research, *Making Sense of Globalization: A Guide to the Economic Issues*, Policy Paper No 8, July 2002, p 44, Table 5.

[80] More traditionally, of course, TNCs are alleged to prefer dictatorships to democracies. It is not, however, obvious to us of where, in recent years, it can be said that TNCs or globalisation can be held responsible for the subversion of multi-party democracy in favour of a dictatorship. Countries seem to have undergone that subversion without outside assistance.

Lord Browne suggested that TNCs are constrained both by governments ("They set the rules, sometimes imperfectly but nonetheless the rules, on property to a degree, on taxes, revenues, on the way in which the environment is creative for business.")[81] and by competition (Ev II, Q 1270). The World Bank, in *Globalization, Growth and Poverty*, endorses the latter point (although argues that "even here globalisation is not an unmitigated good" because an industry might be dominated by a monopoly or a cartel at a global level exposing the weakness of an international economy where competition is regulated at the national level).[82]

156. A second constraint suggested by the World Bank is "the globalisation of information": "companies are now far more vulnerable to international public opinion because people have learned how to harness their potential power as consumers."[83] Peter Aven, in describing his experience in the oil industry and of a partnership between his company and BP, provided an example of the power of popular opinion: "[BP] are much more strict on ecological issues than ourselves … I am sure that labour standards for transnational companies in Russia is higher than for Russian ones." Mr Aven suggested that the reason for BP's ecological stance was that "they are so much afraid to be accused of wrongdoing with the environment" (Ev II, Q 1710). Dr Hertz, whilst critical of the power of transnational corporations, also describes their weaknesses in terms similar to those applied by the TNCs themselves:

> "… never have companies been so powerful and never have they been so vulnerable, because companies now are under this amazing kind of pressure from all these new investors. They are under pressure from the anti-globalisation movement. They are under pressure from political shoppers. ... They are under pressure from governments. ... They are under pressure from disenfranchised constituents and under pressure from activist groups who will keep demanding the earth." (Ev I, Q 1656).

157. **Witnesses expressed a real concern about the influence of TNCs in democracies. We acknowledge that TNCs are powerful, but we believe that they are also subject to a range of constraints and, in particular, to the power of governments and of public opinion.**

CONSEQUENCES OF THE EXERCISE OF POWER BY TNCS

"Footloose" capital

158. It was argued by some witnesses that capital market liberalisation and the technological developments which are such important features of current globalisation allow TNCs to be "footloose" and enable them to pressurise investment-hungry developing countries to engage in a regulatory and tax "race to the bottom". This, in turn, has the damaging effect of encouraging poor standards (for example, in terms of labour conditions and the environment) and, because of the competition to provide a TNC-friendly tax environment, depleting a government's capacity to raise revenue to provide for an adequate social infrastructure.

159. CAFOD, for example, said that "the danger is that competition between countries wishing to attract foreign investment and technology could lead to a 'race to the bottom' in terms of tax incentives and labour market suppression, thereby minimising the potential social benefits offered by the private sector." (Ev I, p 339). Christian Aid, in *Trade for Life: Making Trade Work for the Poor*, were more emphatic:

> "The mobility of capital means that TNCs can increasingly move freely around the globe in search of the least restrictive conditions in which to operate and sell to make profits. … TNCs can play countries off against each other or take advantage of weak or absent national governance. … as TNCs' share and control of global activity increases, developing countries have to make more and more concessions to them, skewing national development priorities to the demands of TNC-driven global markets."[84]

160. George Soros appeared to concur – "I think that the ability of individual countries to constrain the transnationals … has diminished because the companies can move their business elsewhere. So the ability of capital to move around does limit the capacity of individual governments to tax them or to remunerate them." (Ev II, Q 1931). He went on: "… there is a competition to attract capital and

81 We note a review of *Open World: The Truth About Globalisation* by Philippe Legrain in the *Economist*, 12 October 2002, p 110, where it states: "The book shows that governments have great sway over both the extent and the form of economic integration. As for the idea that companies are more powerful than governments, it dissolves the moment you examine it".

82 World Bank, *Globalization, Growth and Poverty* (2002), p 124.

83 *Ibid*, p 124.

84 Christian Aid, *op cit*, p 115.

therefore there is a pressure to make conditions as favourable as possible, to tax as little as possible, to impose as little regulation as possible … which means that if you look at the world as a whole, the governments are less well situated to provide public goods as they were because they cannot tax capital as they used to.” (Ev II, Q 1932). He followed this, however, with the reservation that FDI, unlike highly mobile financial capital, once invested, could not be easily moved and to that extent a TNC would then become “a hostage to the government of the country” where it had invested (Ev II, Q 1931).

161. We received evidence from a small number of large TNCs. All dismissed the allegation that their investment decisions were short-term – or “footloose”. Lord Browne said: “you do not go into business and go into a country for a year, it is just not possible, it is very long term” and he gave the example of BP’s interests in Vietnam. BP went into Vietnam in 1990 and “the cycle of business” is expected to be completed in 2020 (Ev II, Q 1272). Sir Richard Sykes, Chairman of GlaxoSmithKline plc, gave a similar – although perhaps hyperbolic – response: “We are not in the business for a week. We are in the business for hundreds of years”; GSK, he said, “do not worry about losses here and there”: their “job is to be a good corporate citizen, to operate in all countries of the world and to … behave in an honest manner … ” (Ev II, Q 1480). Niall Fitzgerald of Unilever said: “We take a very long term view of business. Most of the countries in which we have operated, particularly developing markets, we have been in for 50, 70 or 100 years and we very much hope we will be there for another 70 or 100 years plus.” (Ev II, Q 1548).

162. **We acknowledge that there is a concern that some TNCs have the capacity to be “footloose”, but we believe that, in practice, their mobility is constrained and that foreign direct investment by TNCs, once undertaken, is locked in to a significant extent. We think that this point is fundamental**

“Race to the bottom”

163. The World Bank, in *Globalization, Growth and Poverty*, acknowledges that globalisation and the mobility of capital have empowered capital “at the expense of government and workers” and that, as a consequence, there may be competition between governments to offer an attractive tax environment. The Bank concludes, however, that “such competition is limited”. This is because companies will tend not to be concerned about tax policy but rather the broader climate for investment which a country can offer.[85] Commissioner Solbes also thought that the evidence showed that TNCs did not invest in countries solely because of any advantages being held out by the governments of those countries (Ev II, Q 1992).

164. In contrast, Anita Roddick characterised economic globalisation principally in terms of “… unscrupuluous companies … maraud[ing] around the world seeking the cheapest labour to exploit, the lowest pollution standards to operate to, the least protected natural resources to plunder.” (Ev II, p 366). Stephen Pursey of the ILO, however, took a different view. He suggested that TNCs were looking for a broad range of factors when deciding whether to invest – rather than just labour costs: “When you look around you find very little evidence that big multinational companies pay much attention to the labour costs in their choices. There are usually lots of other things that outweigh that.” (Ev II, Q 1239). Although smaller companies, on the margins of survival, might be tempted to cut labour costs, the larger TNCs (such as those from whom we took evidence) were able to take a longer term view which would not only benefit the host country but would also be in the long-term interest of the company. Diane Coyle endorsed this view in her observation that “the fact that foreign direct investment flows to a small group of middle-income countries I think shows that what companies are looking for is not the cheapest possible labour, they are looking for a bundle of characteristics …” (Ev I, Q 668). And Lord Browne suggested that the decision to invest in a country would involve asking: “do they have the capability in terms of people, most importantly, do they have an understanding of the place and can they … build a point of mutual advantage … ?” (Ev II, Q 1272).

165. We asked the TNCs who gave evidence whether TNCs encouraged a “race to the bottom” in terms, for example, of labour and environmental standards. We were not surprised that they argued the reverse: that the presence of TNCs improved local standards. Niall FitzGerald gave the example of Vietnam: “ … you see the benefit not only to consumers but to the local suppliers with whom we operate because they need to operate at a standard which is compatible with ours. Therefore, we have to put in both the investment and the time and the technology to help them get to those standards.” (Ev II, Q 1548). Lord Browne agreed that it was fundamental to BP that it would not be a party to lowering labour standards in the countries in which it was operating: for example, he said, BP policed very carefully the issue of child labour. Pay, however, was different: pay was “dependent on the

[85] World Bank, *Globalization, Growth and Poverty* (2002), p 123.

competitive environment in the country" and although BP paid "at the upper edge", it was not appropriate nor expected that they should pay "on a global basis" (Ev II, Q 1278).[86] [87]

166. Ignazio Visco of the OECD summed up his views on the influence of TNCs as follows:

> "Critics of globalisation often accuse multinational firms investing in developing countries of reaping undue advantages. They are blamed for exploiting workers, damaging the environment and dictating their own rule. Often, however, multinational firms invest in developing countries not only attracted by the lower costs of labour but also to get closer to customers and to diversify their assets. The evidence of inappropriate behaviour in developing countries is scant, even if there might be some notorious cases. In general foreign firms have to follow the same local laws and rules as domestic firms, and in fact often face more stringent ones. They pay workers less than in developed economies, reflecting differences in skills and overall purchasing power, but there is well established evidence that foreign affiliates pay better wages than domestic firms." (Ev 1, pp 172-3).

167. Clare Short expressed a similar view: "If you look at labour standards and respect of the environment, overwhelmingly transnationals … have higher standards than the going rate in the country." (Ev II, Q 2039). And she was optimistic that transnational corporations would continue to improve standards – because they were aware of public expectations about high corporate standards (Ev II, Q 2043).

168. Christian Aid, in *Trade for Life: Making Trade Work for the Poor*, acknowledged that the TNCs could be beneficial although warned about the detrimental effects as well:

> "TNCs can and do often provide benefits to the economies of developing countries and enhance poor people's economic opportunities. They can build or finance infrastructure, and provide employment and technology. Their investments can support local businesses and stimulate domestic economic activity. But in many developing countries TNC-led globalisation has led to greater environmental degradation, the undermining of human rights and threats to the livelihoods of the most vulnerable."[88]

169. **TNCs are not an homogeneous group and standards of conduct will vary between them. Some TNCs behave responsibly but others act against the interests of the country in which they have located production. The evidence we have received suggests that often TNCs adopt standards which are higher than those adopted by local businesses. We are not complacent however. We are aware that businesses have a primary duty to act in the interests of their shareholders and that there is, therefore, a case for government measures to be taken to encourage them to take responsibility for a wider range of the interests which are affected by their activities.**

Cultural and environmental issues

170. When we began this inquiry, we were aware that a number of issues relating to globalisation would be raised which although important could not be encompassed within the scope of our investigation. These included allegations – against TNCs in particular (although not exclusively so)[89] – of promoting cultural homogeneity and of causing environmental degradation.

171. Dr Supachai Panitchpakdi, for example, said: "People sometimes equate globalisation with the predomination of one culture over another or by some countries over another. They talk about globalisation as the proliferation of the multinational corporations around the world, with the blessing of international organisations such as the World Bank, the IMF and the WTO …" (Ev I, Q 562). Donald McKinnon similarly described "the stifling of cultural diversity" as one of the elements of the concern about globalisation, albeit the last on his list of concerns (Ev I, Q 778)[90] and Feasta referred to

---

[86] Mr Bendookidze, in evidence to us, gave a robust account of the difficulty of imposing higher pay where the trade-off is between employment and better employment conditions, referring by way of example to the breaking up of ships for scrap in developing countries (Ev II, Q 1966).

[87] We assume that they mean by this that they do not pay the same rate for the job in all the countries they operate in. Instead they adapt remuneration to local labour market conditions.

[88] Christian Aid, *op cit*, pp 33-4.

[89] See, for example, the comments of Tito Mboweni in paragraph 147 (above) of this report.

[90] In contrast, Dr Gietz of DHL suggested that his company in fact promoted diversity: "… we are very conscious of the need to strike a balance between the global aspect of running a business in more than 220 countries and territories, and meeting local requirements and being sensitive to and understanding of local cultures and values." (Ev II, Q 1817). In the same vein, when it was put to Niall FitzGerald that a McDonald's hamburger was the same the world over, he observed that although the logo was the same everywhere, the product in China, say, was fundamentally different from that in Russia (Ev II, Q 1568).

the rise of a "global monoculture" with the global spread of products and education systems to support the production of those products (Ev II, p 302).

172. Two issues, in particular, emerged from the evidence we received about cultural homogeneity: the proliferation of global brands and the global prevalence of the English language. The Foreign and Commonwealth Office saw the presence of global brands as perhaps a defining feature of current globalisation (Ev I, Q 12). The CBI, in its written submission, referred to a study on global brands[91] which anticipated that the number would increase "dramatically over the course of the next few years as companies further increase their global presence" (Ev I, p 133). This view, however, contrasted with that expressed by Richard Tomkins in the *Financial Times*[92] where he argued that "big consumer brands were under pressure" because of what he describes as the fragmentation of the media: "today there are hundreds of [television] channels to choose from and people are much more individualistic in their tastes, so brand owners are left trying to sell to a mass market that barely exists".

173. A similarly optimistic view of the future of cultural diversity was expressed by witnesses in relation to the dominant position of the English language. Niall FitzGerald confirmed that English was the language of commerce, as did Dr Geitz of DHL (Ev II, QQ 1809-10), but did not think that this should cause us to worry about language diversity: not only was English the second language in a large proportion of the world but, although it was the language of commerce, it was not the "language of the street" (Ev II, Q 1573). Sir Andrew Large acknowledged the emergence of an "homogeneous business culture" (which included the fact that business was largely conducted in English) but, like Mr FitzGerald, was sanguine about the implications for cultural diversity more generally: "I do not think I see that the existence of an homogeneous business culture … destroys the social and political aspects of cultures." (Ev I, Q 761).

174. Whilst the cultural impact of globalisation is important, allegations relating to the despoliation of the environment, whether by TNCs or indigenous companies, have given rise to more immediate fears about the welfare of those developing countries which suffer environmental damage as a side-effect of economic development. Anita Roddick referred to the "alarming trends in environmental degradation" which had had the most severe impact in developing countries in the southern temperate or tropical regions (Ev II, p 368). Ronnie Hall of Friends of the Earth gave an indication of the breadth of the debate about the tension between economic development and environmental sustainability:

> "The policies that countries in sub-Saharan Africa are being asked to adhere to at the moment assume that trade will lead to global integration, will lead to development, and that is something that is being questioned at the moment.
>
> In terms of environmental impacts, there is a whole range of impacts, including increased use of natural resources to increase trade … we have seen this very clearly at the World Summit for Sustainable Development in the last few weeks where there has been quite a battle over the status of multinational environmental agreements in relation to trade." (Ev II, Q 2124).

Dr Supachai Panitchpakdi also referred to the rise in conflicts between trade and environmental rules (Ev I, Q 569). Professor Joseph Stiglitz expressed the concern that, under the WTO trading system, despite the environmental implications of trade decisions, "it is the trade ministers who set the rules of the game" without – as there is at the national level – the counterbalance of participation by environment ministers (Ev I, Q 735).

175. While cultural and environmental issues are important and contentious areas of the globalisation debate, we have not explored them in detail as part of our inquiry and do not think, therefore, that it is right for us to offer conclusions or recommendations in respect of them. In adopting this approach, we emphasise that we do not intend to diminish their importance in any way.

---

91 "Global brand" is defined as a brand which has achieved cumulative sales of at least $1 billion for the last 12 months ending Q1 2001 with a measurable presence in each of the four major geographic regions of Latin America, Asia Pacific, North America and Europe, Middle East and Africa. The study to which the CBI referred was undertaken by A C Nielsen. (Ev I, p 133).

92 31 October 2002.

Regulation of TNCs

CORPORATE SOCIAL RESPONSIBILITY[93]

176. In its written submission, the CBI suggested that "any discussion involving business and globalisation cannot but help get drawn into the wider debate surrounding the role that business has to play in terms of corporate social responsibility" (Ev I, p 135) and a number of witnesses raised this issue in evidence.

177. There are at present a number of voluntary codes on corporate social responsibility (CSR). These include:

- the OECD Guidelines on Multinationals (adopted in 1976 and revised in 2000) which provides a voluntary framework of "principles of good conduct";
- the United Nations Global Compact (launched in July 2000) which encourages businesses to espouse nine "universal principles" based on the Universal Declaration of Human Rights, the Rio principles on environment and development and the ILO's Fundamental Principles on Rights at Work;
- the Ethical Trading Initiative, an organisation comprised of business members, NGOs and trade unions which seeks to identify and promote good practice in the implementation of codes of labour practice;
- the Global Reporting Initiative (formed in 1997) which has the aim of developing globally applicable guidelines for businesses to report on environmental, economic and social performance; and,
- a proposed European Code of Conduct for European Enterprises Operating in Developing Countries.

178. In the United Kingdom, more than 60% of the top 500 companies have adopted a code of conduct,[94] and we received evidence from one of them – Unilever plc – about their adherence to a CSR code. Unilever plc emphasised the importance of CSR: "We regard the very business of 'doing business' in a responsible and sustainable way as the core of our corporate social responsibility: selling products that meet local consumers' needs, investing in productive capacity, spreading our technical know-how, working in partnerships through the value chain and in local communities, and making environmental responsibility a central business practice." (Ev II, p 110).

179. Clare Short, referring to the various voluntary codes (in particular the OECD code and the Ethical Trading Initiative) suggested that their effectiveness was a result of "the power of public opinion and consumer" and also because companies were aware that members of their workforce were likely to work better if they were able to take pride in the ethical stance of their employer and if they were treated well by their employer (Ev II, Q 2040). Lord Browne endorsed the point about reputation: "the ability of a corporation to exist in today's world is a function of the way in which it is respected and regarded …" (Ev II, Q 1286).

180. The European Commissioner for Trade, Pascal Lamy, referred to the role of the European Union in pursuing CSR and told us that the EU, through the Commission, had been instrumental in getting the OECD guidelines agreed. He supported the promotion of CSR – but through soft regulation rather than through legislation (Ev II, Q 1918). Other witnesses, however, took the view that the present voluntary codes governing CSR should be tightened up and made enforceable. Barry Coates of the WDM suggested the following prescription for regulating TNCs: first, voluntary codes of conduct and voluntary regulation by the companies themselves; second, the enforcement of an international code through national legislation; and third, in addition to regulation of CSR, a strengthening of corruption legislation and competition policy (Ev I, Q 903). Friends of the Earth England, Wales and Northern Ireland also called for mandatory CSR so as to enable stakeholders to challenge corporations (Ev II, p 273).

181. **There has been a welcome increase in transparency of governments and of public financial institutions in recent years. Although similar advances have been made by some TNCs, the corporate sector has a long way to go in this respect. We recognise the right of companies to a degree of commercial confidentiality, but believe that their claims to this could be regarded as**

---

93 Corporate social responsibility can be defined in a variety of ways. In the European Commission Green Paper, *Promoting a European Framework for Corporate Social Responsibility*, COM(2001)366, 18.7.2001, it is defined as "a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis".

94 Christian Aid, *Trade for Life: Making Trade Work for Poor People* (2001), p 126.

excessive, making it almost impossible for the international financial institutions and governments, let alone a committee such as ours, to give them the scrutiny that good global governance requires.

182. **We welcome international initiatives to promote CSR amongst TNCs as a mechanism for enhancing transparency and accountability of TNCs. We recognise, however, that there is concern that a purely voluntary regime will not provide a sufficient safeguard against abuse of power by TNCs. We note with approval that, as part of its current review of company law, the UK Government is considering that some companies should be required to report on the impact of their activities on the environment and, more broadly, on the communities in which they operate.**[95]

Competition policy

183. International capital flows are often connected with the formation of mergers. That in turn relates to the question of whether global markets have become more or less competitive. More generally, there is the problem of what effect globalisation of business has on competition policy at both national and (say) EU level. Following Peter Sutherland's comment on global problems requiring global solutions and possibly new global institutions (Ev I, p 204), **there is a need to consider whether a powerful global competition authority is necessary**. At a more parochial level we are certainly sympathetic to the European Commission's proposal to look again at the regulatory framework for mergers within a European context.[96] While our bias would be in favour of doing as much as possible at the national level, we agree that in some cases the "best placed competition authority" would sometimes be part of the European Commission itself.

Information about TNCs

184. Finally, we have been struck by how little factual information we have on some aspects of transnational corporations. For example, in the cross-Departmental memorandum, we were told that "there are no recent official data on trade by UK-based or owned transnational corporations", that the latest data in respect of the percentage of United Kingdom exports of goods accounted for by transnational corporations was for 1981, and that there was no data available in respect of trade in services (Ev I, p 12). More generally, much of the data we were given by the Departments related to several years ago. **The UK Government should review its data collection in respect of TNCs. Data collection at present is too limited and out of date and should be substantially improved**

[95] The Department of Trade and Industry published a White Paper *Modernising Company Law*, Cm 5553, on 16 July 2002. The White Paper proposes a significant change in the reporting requirements of large companies.

[96] Green Paper on the Review of Council Regulations (EEC) No 4064/89, COM (2001) 745/6, 11.12.2001.

CHAPTER 6: MANAGEMENT OF THE INTERNATIONAL TRADING SYSTEM

The GATT and the WTO

185. Although membership of the World Trade Organisation (WTO) does not extend to every country,[97] in effect, it governs the international trading system. Following the Uruguay Trade Round (1986-94), the WTO was created on 1 January 1995. It succeeded the General Agreement on Tariffs and Trade (GATT) which had been agreed in 1947 as part of the Bretton Woods settlement.

186. The stated purpose of the WTO is:

> "… to help trade flow as freely as possible – so long as there are no undesirable side-effects. That partly means removing obstacles. It also means ensuring that individuals, companies and governments know what the trade rules are around the world, and giving them the confidence that there will be no sudden changes of policy. In other words, the rules have to be 'transparent' and predictable".[98]

The underlying principles of the WTO are that "the trading system should be:

- without discrimination—a country should not discriminate between its trading partners … ; and it should not discriminate between its own and foreign products, services or nationals … ;
- freer—with barriers coming down through negotiation;
- predictable—foreign companies, investors and governments should be confident that trade barriers (including tariffs, non-tariff barriers and other measures) should not be raised arbitrarily …;
- more competitive—by discouraging 'unfair' practices such as export subsidies and dumping products at below cost to gain market share;
- more beneficial for less developed countries—by giving them more time to adjust, greater flexibility and special privileges."[99]

187. GATT dealt only with trade in goods and, at first, focused on lowering tariffs on imported goods. After 1947, there were a further seven trade rounds under GATT.[100] These extended to negotiations on anti-dumping and non-tariff measures as well as tariff reduction. The Uruguay Trade Round, as well as establishing the WTO, also brought a number of controversial new areas within the multilateral trading arrangement. These included: trade in services, intellectual property, agriculture and textiles. In November 2001, at the fourth WTO Ministerial Conference in Doha, Qatar, a new round of trade negotiations – described as the Doha Development Agenda – was launched. They include earlier negotiations on agriculture and services which were begun in early 2000. A completion date of 1 January 2005 has been set. Progress will be reviewed at a fifth Ministerial Conference in Cancun, Mexico, in September 2003. The Ministerial declaration adopted in Doha on 14 November 2001 gave prominence to the need to promote economic development and the alleviation of poverty in developing countries. Whilst asserting the objective of trade liberalisation and the abolition of protectionism, the declaration stated that the new round would be "… committed to addressing the marginalisation of least-developed countries in international trade and to improving their effective participation in the multilateral trading system."[101]

A "rules-based" trading system

188. The WTO administers trade agreements between members and offers a binding disputes mechanism.

189. During the course of this inquiry, the Committee visited the WTO in Geneva. Mike Moore, then Director-General of the WTO, told us that the "simple duty" of the WTO was "to facilitate negotiations between members and then, where members disagree, supply to them something unique in the international architecture, that is, a binding disputes mechanism". He described the disputes mechanism as "the jewel in our crown" (Ev II, Q 1102). Pascal Lamy, European Union Commissioner

---

97 There are, at present, 144 members – covering over 97% of world trade. A further 28 countries are negotiating accession.

98 WTO, *Trading into the Future* (March 2001), p 4.

99 *Ibid*, p 5. Given the extent of protectionism to be observed throughout the world accompanied by an array of restrictive business practices, we interpret these principles as an aspiration and not as an approximation of trading reality.

100 The trade rounds are as follows (number of countries involved indicated in brackets): 1947 Geneva (23); 1949 Annecy (13); 1951 Torquay (38); 1956 Geneva (26); 1960-61 (Dillon Round) Geneva (26); 1964-67 (Kennedy Round) Geneva (62); 1973-79 (Tokyo Round) Geneva (102); and 1986-94 (Uruguay Round) Geneva (123). *Ibid*, p 9.

101 Doha Ministerial Declaration, 14 November 2001, para 3.

for Trade, distinguished between the legislative part of the WTO – the part that is involved in the formulation of agreements – and the dispute settlement mechanism (DSM). Whereas he praised the efficiency of the DSM, the process for the formulation of agreements was, he suggested, "cumbersome and UN-like" (Ev II, Q 1908). Professor Greenaway thought that the DSM represented one of the key functions of the WTO: "Trade related disputes inevitably arise. To avoid them triggering unilateral action and possible trade wars, effective dispute resolution mechanisms are essential, especially for small counties and developing countries." (Ev I, p 99).

190. Mark Curtis, Head of Global Advocacy Team at Christian Aid, although critical of the WTO, supported a rules-based system of international trade – but cautioned that "the key is what the rules are and who sets them" (Ev I, Q 900). Dr Noreena Hertz took a similar view (Ev II, Q 1667).

Governance of the WTO

191. The WTO is an ostensibly democratic organisation based on the principle of one country, one vote and underpinned by a consensual decision-making process.[102] Mike Moore suggested that this arrangement, although a source of strength, could, at times, be difficult to manage: "It is like having a parliament of 144 members with no parties, no whips, no speakers and no limit to speaking time." (Ev II, Q 1102). The Department for International Development praised the system: "The Government … believes that the WTO provides the best forum in which to achieve democracy in international trade negotiations"; this was because "rich and poor countries have an equal say, with access to all meetings. Since developing countries make up two-thirds of the 144 members of the WTO, they are in strong position for negotiations. Moreover, decisions are only made through consensus – if any country objects agreements will not be reached." (Ev II, p para 11). Lord Desai was similarly supportive: "The WTO system is right now the fairest global economic institution that I know of because it is built on one country, one vote"; he conceded, however, that, as regards the dispute settlement mechanism, there was "an asymmetric power" because the rich countries could afford more lawyers than the poor (Ev II, Q 1732).

192. A number of witnesses, however, were critical of the governance arrangements of the WTO. They alleged that the WTO was biased We detected two main elements in the complaint:

- that the WTO is dominated by the major economies (especially the United States)[103] and also, through the governments of those economies, by transnational corporations; and
- that, as a consequence, developing countries (in particular, those who are unable to fund representation in Geneva) are marginalised.

193. Dr Caroline Lucas MEP challenged the notion that consensus voting was "necessarily the most democratic way of doing things": "if the consensus situation was working well, if it really was truly democratic, then one would expect the interests of the developing countries to be far stronger than they are." (Ev II, Q 1393). And the Department for International Development told us:

> "There are grave concerns among developing countries about the way in which the WTO works … It is a system which in the past has tended to be dominated by a small number of large rich countries and still, I think, developing countries feel that they do not have a weight in its decision making process that is anything like proportionate to their numbers of people. Many developing countries are marginalised from involvement with the WTO, for example, because the smaller and poorer ones do not have any representatives at all in Geneva." (Ev I, Q. 10).

194. Donald McKinnon expressed particular concern about how some developing countries could not be represented in Geneva since, he said, "it is a fact that if you want to have some influence in Geneva you have to go there occasionally" (Ev I, Q 820).

195. The World Bank, in *Globalization, Growth, and Poverty*, also commented on this issue – both in terms of the ability of some developing countries to maintain a presence in Geneva and to measure up against the greater strength of the richer countries. It suggested however (like Professor Greenaway in paragraph 189 above) that the imbalance "… would be even worse if there was no WTO, because then small countries like Bangladesh would have to negotiate one-to-one with the United States

[102] A majority vote is possible but has never been used in the WTO and was used only rarely under GATT.

[103] Martin Wolf put this starkly: "The WTO as an organisation is nothing, it is no more than the vehicle of the concerted will of a very limited number of great powers, and so the idea of the WTO or indeed any of these institutions as autonomous agencies is a fig leaf over the decisions made by ourselves and the Americans." (Ev II, Q 1603). By "ourselves", Mr Wolf was referring to Europe. In the written evidence submitted by the UK Section of the Women's International League for Peace and Freedom concern was expressed that "whilst the WTO claims to be a democratic institution, in fact the rich countries exert much control over its proceedings" (section C) (Ev II, p 391).

without a multilateral set of rules."[104] Clare Short made a similar point: "If we lost the WTO the biggest losers would be the developing countries because bilateral and regional agreements would be made and they would be marginalised and not consulted about the change." (Ev II, Q 2027).

196. The most striking allegation concerning the influence of TNCs in WTO decision-making is in relation to their role in the formulation of the Trade-related Intellectual Property agreement (TRIPS) (in particular that of the pharmaceutical industry) and of the General Agreement on Trade in Service (GATS). (We consider these in more detail below.) Matthew Taylor MP, Liberal Democrat Treasury spokesperson, commented more generally on the power of TNCs to influence the global trading system. They were, he suggested, "better informed and have a better chance to influence than the democratic representatives" of both developing and developed countries (Ev II, Q 1370). This was not a criticism of TNCs, he said – "they are doing exactly what you expect them to do" (Ev II, Q 1371) – but of the absence of transparency at the level of international decision-making.

197. We put the criticisms about WTO governance to Mike Moore. He agreed that until the Uruguay Round the WTO had been "a rich man's club" which reflected its OECD membership (Ev II, Q 1120). He also agreed that despite improvements since the Uruguay Round, the fact that member countries vary in size so their ability to exercise influence would vary. He acknowledged the practical implication of the cost of maintaining a permanent representation at the WTO: "we have 28 or 29 members not represented in Geneva. You have little Caribbean, little Pacific nations who, if they opened a post here, would be spending more money in Geneva than they would be on education or health." (Ev II, Q 1120). The WTO had, however, attempted to respond to this uneven representation by funding poorer countries to attend meetings in Geneva twice a year.

198. Donald McKinnon told us that the Commonwealth was also working within the WTO to assist developing countries (Ev I, Q 820) and Clare Short referred to a number of measures that were being taken to help poorer countries exercise greater influence in the WTO:

> " … not all countries are represented in Geneva because it is expensive to be there. We are working with others to make sure that there is a sort of back-up system of briefing for all countries. Countries need to get briefings back at home in their trade and industry as well as having a representative in Geneva because otherwise you get people in Geneva who know a lot but they never talk to home. You have to build up the competence of both ends." (Ev II, Q 2026).

199. **We recognise that member countries of the WTO vary in size and economic power. They vary, therefore, in their capacity to influence decisions in the WTO and, more fundamentally, to maintain a presence at the WTO. It would be naïve to believe that an organisation like the WTO would not be dominated by a small number of rich countries. The important question, which applies to the International Monetary Fund and the World Bank as well, is whether this domination is excessive. We believe that it is in all three institutions, but the evidence we received placed most emphasis on the WTO. We urge the Government, with its European Union partners, to consider, first, how to improve the balance of power in the WTO and, secondly, how to ensure that decisions are more transparent. We acknowledge the commitment of the Government, contained in the White Paper on globalisation by the Department for International Development, in respect of both matters.**[105]

Developed country protectionism: agriculture and textiles

200. A notable example of how the trading system seems to be operating against the developing countries is developed country protectionism (through tariffs, subsidies and non-tariff barriers)[106] with respect to agricultural products and textiles. George Soros, for example, referred to the "imbalance" in WTO agreements which was due, to some extent, to the incapacity of developing countries "to fight for their cause" (Ev II, Q 1940). He cited, in particular, trade in agricultural products and textiles.

---

[104] World Bank, *Globalization, Growth, and Poverty* (2002), p 57.

[105] :"It is true that the WTO still bears the heavy imprint of the much smaller group of mainly northern countries that have dominated the founding of the General Agreement on Tariffs and Trade (GATT). And it is true that the WTO should be more transparent and open and its rules easier to understand." (para 227). "To create a fairer multilateral trading system, an urgent priority must be to strengthen the capacity of developing countries to participate effectively in the WTO and the international trading system." (para 239). "We will work with developing countries and other development agencies to help build trade policy capacity in both national capitals and in Geneva." (para 240): *Eliminating World Poverty: Making Globalisation Work for the Poor*, Cm 5006, December 2000.

[106] Nicholas Stern gave an interesting example of a non-tariff barrier: he described how a French cheesemaker and Mauritanian camel herders tried to sell camels' cheese in Europe. Not only was the cheese categorised so that it would have the highest possible tariff but a requirement was place on the milk producers that the camels should be milked mechanically. The enterprise failed as a result. (Ev II, Q 1823). It would not be difficult to cite many other examples.

Professor Stiglitz, when asked to explain why the WTO was the target for the anti-globalisation movement, said:

> "After the last round of trade negotiations, the Uruguay Round, there was a calculation done by the World Bank that says sub-Saharan Africa … was actually worse off. … It is because of terms of trade effects that they were forced to open up their markets, but the market for goods on which they had a comparative advantage, low grade textiles, agricultural goods, were not being opened up." (Ev I, Q 735).

201. Dr Supachai Panitchpakdi similarly commented on the belief of developing countries that the Uruguay round had penalised them:

> "… developing countries have these grievances that, while they were looking for more benefits – market access for agriculture, reductions in interventions and subsidies, a faster phasing out of textiles – as a result of the Uruguay Round they did not get that in the end, but they had to bear the burden of TRIPS …" (Ev I, Q 563).

202. UNCTAD refer to the way in which "market-driven globalisation" was deepening the "biases and asymmetries in the world economy". Evidence of "the lop-sided pattern of trade liberalisation" included developed country tariffs in those sectors where developing countries had an advantage: namely, agriculture, low-technology and resource-based industries and high-technology products which involve unskilled labour in the production of components (Ev I, p 363). In a paper prepared by the Australian Department of Foreign Affairs and Trade, based on the position of the Cairns Group of Agricultural Fair Traders, it is suggested that: "No sector is as heavily distorted and protected as agriculture, and no sector is as important to the livelihood of most developing countries … This protectionist behaviour [by rich countries] has marginalised the ability of many developing countries to participate fully in the global economy and to access many of the benefits of globalisation." (Ev II, p 287).

203. The World Bank, in *Globalization, Growth, and Poverty*, shed some light on the background to the problem of protectionism in the textiles market:

> "Unfortunately, the rules on textiles and clothing were written in a way that allowed industrial countries to greatly delay the abolition of their quotas. Instead of specifying the progressive abolition of quotas, the rules specified the progressive integration of textiles and clothing under GATT disciplines. Industrial countries were allowed to choose the products to be integrated; almost without exception, they chose to begin by integrating the products in which developing countries do not have a comparative advantage. Developing countries that thought roughly half of their exports of textiles and clothing would be integrated by 2002 found that almost all would remain restricted until December 31, 2005 – creating concerns about potential backsliding in the industrial countries."[107]

204. Strikingly, Clare Short referred to there being "a lot of hypocrisy in the rhetoric of countries like our own" and other OECD countries, which encouraged developing countries to engage in openness but practiced protectionism themselves (Ev II, Q 2026).

205. Again, we put the complaint about protectionism to Mike Moore. He acknowledged the implications of the textiles agreement ("which was back loaded so that the greatest openings will come by 2005") but was frank about political realities: "it was the best deal you could get at the time", it was "as much as the negotiators could get." (Ev II, Q 1135). Given the level of agricultural support in the European Union,[108] we also raised this issue with Commissioner Pascal Lamy. He was optimistic about the future. It was recognised, he said, within the EU that support for EU agriculture should be "more trade-friendly … and more development-friendly than it used to be"; the reforms of the Common Agricultural Policy had exceeded commitments undertaken at the Uruguay Round and he expected that the Doha Round would see further progress in giving developing countries more market access (Ev II, QQ 1914-16).[109] Mike Moore took a similar line: "There is a billion dollars a day being spent by rich countries to make food dearer. Subsidies are a crazy mechanism but when they make food dearer they are even more stupid. However, in the Doha Ministerial Declaration for the first time the phrase 'phase out' is there." (Ev II, Q 1135).[110]

---

107 World Bank, *Globalization, Growth, and Poverty* (2002), p 61.

108 In 2002, the CAP cost EUR44 billion, nearly half of the total EU budget. *Eurostat*. In his evidence, Professor Krugman described European agricultural policy as "one of the wonders of the world" (Ev II, Q 1891).

109 The Department for International Development asserted that "a key element to gaining liberalisation in the WTO agricultural negotiations is CAP reform" (Ev II, p 232).

110 Paragraph 13 of the Doha Ministerial Declaration refers to the commitment to "to correct and prevent restrictions and distortions in world agricultural markets."

206. Earlier this year, the Farm Security and Rural Investment Act 2002 was passed in the United States,[111] significantly increasing the farm subsidy package to US farmers. Commissioner Lamy acknowledged that the US Farm Act struck a discordant note (because, he said, it ran contrary to the general strategy of de-coupling farm support from production) but suggested that it was "one more incentive to increase disciplines in the WTO"(Ev II, Q 1914). Professor Krugman was clear in his view that the US Farm Act was inconsistent with "the rhetoric" of the United States which remained "strongly pro-free trade" (Ev II, Q 1889). Like Professor Krugman, Paul Volcker, former Chairman of the Federal Reserve, suggested that the incentive behind the US protectionism was political: "Farmers have a lot of direct political support … the typical voter is not upset apparently about providing more support for farmers." (Ev II, Q 1759).

207. The deleterious effect of the US and EU agricultural policies on developing countries and the confusion – as far as the economics is concerned – underlying them were clearly illustrated by Niall FitzGerald of Unilever plc. He gave sub-Saharan Africa as an example: "If there was free access to the OECD economies for agricultural products in sub-Saharan Africa, it would have a value somewhere between $22 billion and $25 billion. All of the aid that goes to sub-Saharan Africa is $14 billion so already the economic equation is ridiculous." (Ev II, Q 1562). Nicholas Stern offered a further illustration: "The total subsidies for agriculture in rich countries are around $350 billion a year, a number which is about seven times total aid and is about equal to the GDP of sub-Saharan Africa. They are colossal and a very serious problem." (Ev II, Q 1822).

208. **We consider that developed countries' protectionism (mainly in the United States and the European Union) with regard to agricultural and textile products in particular is wholly objectionable and unjustifiable. In coming to this view we are particularly struck by the evidence of Clare Short (in paragraph 204) and Mike Moore (in paragraph 205) which we believe should inform future debate on the subject. Developed country protectionism places an unfair burden on developing countries and is in stark contrast to the protestations of the leaders of rich nations that they are committed to helping the world's poor. We urge the Government, within the EU and the WTO, to take stronger steps to ensure that it is brought to an end.**

WTO Agreements

209. A number of witnesses were critical of some WTO agreements. We received a significant amount of evidence in particular about the TRIPS agreement and GATS.

THE AGREEMENT ON TRADE-RELATED INTELLECTUAL PROPERTY RIGHTS

210. TRIPS was introduced during the Uruguay Round in 1994.

211. The agreement has been subject to a great deal of criticism. Two fundamental charges are laid against it:

- that it is the product of corporate lobbying and is likely to act in the corporate interest and to the detriment of developing countries (the principal complaint being in relation to developing countries' access to medicines); and,
- that it is burdensome to developing countries which need to establish an enforcement infrastructure necessary to enable compliance.

Corporate interests …

212. A number of witnesses complained that TRIPS had been inspired by corporate interests against the interests of developing countries. Christian Aid, in *Trade for Life: Making Trade Work for the Poor*, describes TRIPS as "a case of massive corporate protectionism that enables TNCs to secure monopoly rights over knowledge and natural resources, and that transfers wealth from South to North."[112] Christian Aid alleged that TRIPS poses two major threats to developing countries: first, that by allowing companies of one country to patent the natural resources of another, TRIPS enables transnational corporations to expropriate indigenous resources of developing countries;[113] secondly, TRIPS is likely to make it more costly and complex for developing countries to access new or existing science and technology.

[111] H R 2646. This was signed into law by President Bush on 13 May 2002.

[112] Christian Aid, *op cit*, p 71.

[113] A number of examples are given: *ibid*, pp 72-3.

Box 1

TRIPS

According to the WTO's *Trading into the Future*,[114] TRIPS is "an attempt to narrow the gap in the way that [intellectual property rights] are protected around the world, and to bring them under common international rules". The agreement deals with the following broad issues:

- how basic principles of the trading system and other international intellectual property agreements should be applied;
- how to give adequate protection to intellectual property rights
- how countries should enforce those rights adequately in their own territories
- how to settle disputes on intellectual property between members of the WTO
- special transitional arrangements during the period when the new system is being introduced.

The agreement covers copyright and related rights, trademarks, geographical indications, industrial designs, patents, layout-designs of integrated circuits and undisclosed information including trade secrets.

213. We asked Professor Joseph Stiglitz, a former Chairman of the United States Council of Economic Advisers, about the influence of transnational corporations in the globalised economy. He gave TRIPS as an example of the extent of their influence:

> "Both the Council of Economic Advisers and the Office of Science and Technology and Policy in the White House felt that the intellectual property agreement, TRIPS, that was part of the 1994 agreement was not balanced. We worried, for instance, at the Council of Economic Advisers about what it would do to access to life-savings drugs, such as for AIDS, if it were implemented and our worries turned out to be fully realised, but we could not overcome the influence of the pharmaceutical companies and the movie companies that were dictating US economic policy in that area, and that had to do a lot with the structure of governance of the international arena." (Ev I, Q 721).

... acting against developing country interests: access to medicines

214. TRIPS has caused most concern in relation to developing country access to medicines. The recent Report of the Commission on Intellectual Property Rights[115] describes the context of this debate:

> "The impact of intellectual property rules and practices on the health of poor people in developing countries has generated substantial controversy in recent years. Although this predated TRIPS, and featured prominently in the TRIPS negotiations, impetus has been added by the coming into force of TRIPS, and the dramatic rise in the incidence of HIV/AIDS, particularly in developing countries."[116]

The report, after noting the role of the pharmaceutical industry in bringing about the global extension of intellectual property rights under TRIPS, suggests that, as regards developing countries, "a major concern was how the adoption of intellectual property regimes would affect their efforts to improve public health, and economic and technological development more generally, particularly if the effect of introducing patent protection was to increase the price and decrease the choice of sources of pharmaceuticals."117 The report quotes an Oxfam Briefing Paper to demonstrate the core complaint of NGOs: the "essential flaw" of TRIPS, according to Oxfam, was "… to oblige all countries, rich and poor, to grant at least 20 years' patent protection for new medicines, thereby delaying production of

114 WTO, *Trading into the Future* (March 2001), p 25.

115 Report of the Commission on Intellectual Property Rights, *Integrating Intellectual Property Rights and Development Policy* (September 2002). See paras 220-21 below for further information about the Commission..

116 *Ibid*, p 34 (footnote not included).

117 *Ibid*, p 34.

the inexpensive generic substitute upon which developing-country health services and poor people depend."118

215. The track record of the pharmaceutical industry in addressing specifically developing country health problems provides little or any reassurance that their interests and those of developing countries coincide. The following statistics taken from the Commission's report are revealing: "it is estimated that less than 5% of the money spent worldwide on pharmaceutical R&D is for diseases that predominantly affect developing countries";[119] "in 2002, the world drug market is valued at $406 billion, of which the developing world accounts for 20%, and low income developing countries very much less";[120] "large pharmaceutical companies are unwilling to pursue a line of research unless the potential outcome is a product with annual sales of the order of $1 billion";[121] and "of the 1393 drugs approved between 1975 and 1999, only 13 were specifically indicated for tropical diseases".[122]

216. We raised this matter when we visited the WHO in Geneva. Dr Gro Harlem Brundtland, Director-General of the WHO, when asked about intellectual property rights and research by pharmaceutical companies said that "there has been a history in this organisation to try to inspire and to argue and to work with others to have investment in research as a global good" (Ev II, Q 1205). Dr Brundtland described how pharmaceutical companies were encouraged, by the provision of public money, to undertake research into less profitable medicines. But she also thought that rules on intellectual property were necessary to ensure that research was undertaken: without some intellectual property regulation "there will not be investment in new things" (Ev II, Q 1205).

217. Sir Richard Sykes, Chairman of GSK, a major pharmaceutical company, confirmed the view that without intellectual property protection, research by private companies would be inhibited:[123]

> "GlaxoSmithKline believes that TRIPS strikes an appropriate balance in encouraging the innovation that is essential if we are to see advances in treatments and vaccines for developing country diseases, while providing flexibility for governments to safeguard public health interests. … The re-opening of TRIPS … would do nothing to improve access [to medicines in developing countries], but would help to undermine the incentive to invest in the discovery and development of new medicines" (Ev II, p 99).

TRIPS was not, he said, the reason why many developing countries lacked reliable access to essential medicines. The cause was "poverty and the resulting lack of infrastructure and resources that are required to run effective healthcare systems" (Ev II, p 99).

Burden of compliance

218. Dr Supachai Panitchpakdi confirmed the complaints about TRIPS, both in relation to its corporate provenance and the burden of compliance. In describing why developing countries were dissatisfied with the WTO, he suggested that it was because, in general, the burdens of the trading arrangements outweighed the benefits, and he described TRIPS as "the main new burden" arising from the Uruguay Round, an agreement which had emerged late in the day "because of [a] proposal made by the US pharmaceutical companies". Dr Supachai did not refute the need for rules governing intellectual property rights but said that it could not be denied that "the burden that has been put on developing countries in adopting [the] regime is tremendous" (Ev I, Q. 563) because of the need to set up an adequate infrastructure to enable compliance with the TRIPS agreement.

219. Mr Otten, Director of the Intellectual Property at the WTO, agreed that TRIPS had put a burden of compliance on developing countries: "It is certainly true that the TRIPS agreement is one of the more demanding agreements on developing countries and has caused them to have to re-formulate or create new laws in some areas, to reinforce enforcement institutions, to set up new offices in some

118 Oxfam (2001), *Priced Out of Reach*, Oxfam Briefing Paper No 4, Oxfam International, Oxford.

119 Report to the World Health Organisation by the Commission on Macroeconomics and Health, *Macroeconomics and Health: Investing in Health for Economic Development* (December 2001), p 79, quoted in the Report of the Commission on Intellectual Property Rights, *op cit*, p 37.

120 See the Report of the Commission on Intellectual Property Rights, *op cit*, p 37 and p 61, note 17.

121 *Ibid*, p 37.

122 Trouiller P et al (2002), "Drug Development for Neglected Diseases: a Deficient Market and a Public Health Policy Failure", *The Lancet*, vol 359, pp 2188-94, quoted in the Report of the Commission on Intellectual Property Rights, *op cit*, p 37 and p 62, note 19.

123 See also the Report of the Commission on Intellectual Property Rights, *op cit*, p 34: " … without the incentive of patents it is doubtful the private sector would have invested so much in the discovery or development of medicines, many of which are currently in use both in developed and developing countries. The pharmaceutical industry in developed countries is more strongly dependent on the patent system than most other industrial sectors to recoup its past R&D costs, to generate profits, and to fund R&D for future products".

cases, to reinforce existing intellectual property offices …" (Ev II, Q 1125). He said, however, that the World Intellectual Property Organisation (WIPO), which he described as being "in the fortunate situation of being relatively wealthy", was assisting developing countries with technical co-operation, capacity building and legal assistance.

220. Clare Short shared the view that the rules on intellectual property rights were needed to ensure that the pharmaceutical companies undertook research into areas where it was most needed: "We can only get there if we have basic, fair rules so that the private sector knows it can get a rate of return on its research." (Ev II, Q 2019). She agreed, however, that implementation by some developing countries was an issue and that therefore they should be given extra time to phase in the agreement. She also referred to the Commission on Intellectual Property Rights which she had established in May 2001 and which she anticipated would recommend changes to the TRIPS agreement.

221. The Commission reported in September 2002. The principles underlying its approach to intellectual property rights and healthcare provision were that "healthcare considerations must be the main objective in determining what IP[124] regime should apply to healthcare products" and that "IP rights are not conferred to deliver profits to industry except that these can be used to deliver better healthcare in the long term".[125] The Commission made a range of recommendations about how the global intellectual property regime could be applied by developing countries more advantageously and what steps developed countries could take to assist developing countries in ensuring access to healthcare. These included, for example: additional public funding for research on health problems in developing countries (because "[the Commission does] not think that the globalisation of IP protection will make a significant contribution to increasing R&D expenditure by the private sector relevant to the treatment of diseases that particularly affect developing countries");[126] a satisfactory system of differential pricing mechanisms through improved legislative regimes in developed countries to prevent parallel importing of low-priced pharmaceutical products from developing countries; and, a corresponding improved legislative regime in developing countries enabling them to import patented medicines if they can obtain them more cheaply abroad.

222. Work on TRIPS is also taking place in the context of the Doha Development Round. The Doha Ministerial Declaration on TRIPS and Public Health has required the WTO Council for TRIPS to consider certain aspects of the TRIPS agreement.[127]

223. **We are convinced of the central role that R&D play in the process of economic development, and the importance of intellectual property protection as helpful to that end. There is, however, widespread concern that the TRIPS agreement, in some respects, is acting against the interests of developing countries and placing a burden of compliance on developing countries. We share that view.**

224. We also note the following: first, economic analysis tells us that intellectual property law is not the only way that new discoveries can or are protected;[128] secondly, support for legal protection is not the same as saying that the law as present constituted cannot be improved;[129] and, lastly, it is not obvious that the pricing policies of some companies, anxious though they are to maximise their own profits, give a fair deal to the poorest nations. To the extent that they are charged for past sunken costs connected with research from which they will not benefit, they are paying but not receiving.

225. **We therefore support the initiatives both in the UK and the WTO that seek to review the operation of TRIPS and urge the UK Government to take the steps necessary to ensure that the interests of developing countries are properly considered in the amendment of the TRIPS agreement.**

THE GENERAL AGREEMENT ON TRADE IN SERVICES

226. Like TRIPS, GATS was introduced in the Uruguay Round of trade negotiations. Under GATS, countries are encouraged to open up service sectors to foreign competition. At present, they are able to

---

124 Intellectual property.

125 Report of the Commission on Intellectual Property Rights, *op cit*, p 35.

126 *Ibid*, p 39.

127 In particular, the problem of those countries which, because of an insufficient or no manufacturing capacity in the pharmaceutical sector, have difficulty in making effective use of compulsory licensing under the TRIPS agreement. See paragraph 6 of the Doha WTO Ministerial Declaration on TRIPS and Public Health.

128 This ground is well covered in William J Baumol, *The Free Market Innovation Machine* (2002) and Nancy T Gallini, *The Economics of Patents: Lessons from Recent US Patent Policy*, Economic Perspectives, Spring 2002.

129 The length of patent terms and copyright may need to be reconsidered in the light of the needs of the poor nations as well as the interests of the rich. Further thought needs to be given to the nature of infringements and what can be allowed as fair dealing.

choose which sectors are opened up and when it should happen. For this reason, the Department for International Development described GATS as "a bottom-up agreement" (Ev II, p 232).

227. The WTO, in its information about GATS, argues that: "Since the services sector is the largest and fastest-growing sector of the world economy, providing more than 60% of global output and in many countries an even larger share of employment, the lack of a legal framework for international services trade was anomalous and dangerous – anomalous because the potential benefits of services liberalisation are at least as great as in the goods sector, and dangerous because there was no legal basis on which to resolve conflicting national interest."[130]

Box 2

GATS

According to the WTO's *Trading into the Future*,[131] "the General Agreement on Trade in Services is the first ever set of multilateral, legally-enforceable rules covering international trade in services"..

The agreement covers all internationally-traded services – services which are provided on a commercial or competitive basis. These include:

- services supplied from one country to another ("cross-border supply")(for example, international telephone calls);
- consumers or firms making use of a service in another country ("consumption abroad")(for example, tourism);
- individuals travelling from their own country to supply services in another ("presence of natural persons")(for example, fashion models or consultants).

The agreement excludes all services provided in the exercise of governmental authority.

Unlike goods, the agreement on services allows countries temporarily not to apply the "most-favoured nation" (MFN) principle of non-discrimination. "MFN means treating trading partners equally: therefore, if a country allows foreign competition in a sector, equal opportunities in that sector should be given to service providers from all other WTO members."

228. The Department for International Development see GATS as an instrument to assist poverty reduction in developing countries:

> "Research undertaken by a number of organisations including the World Bank, the UN and the Institute of Development Studies into the effects of services liberalisation on developing countries has shown that liberalisation in sectors such as telecoms and financial services often leads to significant increases in economic growth – without which sustainable poverty reduction will not be achieved." (Ev II, p 232).

Patricia Hewitt noted that "increasingly, for instance, in financial services and in telecommunications, [developing countries] are seeing the benefits of liberalisation" – India being an example (Ev II, Q 1878).

229. Although issues relating GATS did not emerge as prominently in the evidence we received as the criticism of the TRIPS agreement, none the less we have a clear impression that there is a concern that GATS, like TRIPS, in some respects, acts against the interests of developing countries.

230. Barry Coates of the WDM suggested that GATS embodied "an inappropriate extension of trade rules that have been developed to apply to trade in goods" (Ev I, Q 931). Save the Children complained that GATS worked against efforts by developing countries to link foreign direct investment with local and national economic development: the GATS agreement, they told us, "bans

[130] See www.wto.org

[131] WTO, *Trading into the Future* (March 2001), p 21.

access conditions on FDI in services, prohibiting countries from setting equity caps on TNC investment or from requiring TNCs to establish joint ventures with local partners" (Ev I, p 335).[132]

231. Christian Aid's fear was less of GATS in its present – voluntary – form than of the implications for GATS of "the WTO's built-in agenda of accelerating liberalisation": "… the GATS framework might in future expand into social sectors like health care, education and water. The danger is that an expanded and revised GATS might threaten developing countries' ability to provide services to meet the needs of poor people."[133] They argued that GATS has (and will continue to) evolve in this way because of the business interests pursuing services liberalisation: "GATS owes its existence to pressure from services companies and governments with major services export sectors – especially the US, but also Japan, the EU and Canada."[134] They gave the following examples: "The US Coalition of Service Industries (CSI) has led international business efforts to shape GATS and directly influence the positions of the former US Trade Representative, Charlene Barshevsky, for example at the Singapore ministerial conference in 1996 where a deal on telecommunications was pushed through. The European Services Forum (ESF) has played a similar role in Europe under a mission to 'support and encourage the movement to liberalise service sector markets throughout the world and to remove trade and investment barriers for the European services sector'."[135] Save the Children similarly referred to the influence of TNCs. They quoted the Director of the WTO's Services Division as saying: "Without the enormous pressure generated by the American financial services industry, particularly companies like American Express and Citicorp, there would have been no services agreement." (Ev I, p 336).

232. Since January 2000, the WTO has been engaged in negotiations on GATS. In the Doha Ministerial Declaration it is asserted that these negotiations will be conducted "with a view to promoting the economic growth of all trading partners and the development of developing and least-developed countries".[136] There is a concern, however, that the WTO's commitment to progressive liberalisation will operate against the interests of developing countries. In particular, there is concern that unreasonable pressure will be applied to force developing countries to open up their service sectors; and that after a particular sector has been opened up, it will be impossible under GATS for this action to be reversed, even if circumstances change. It is, perhaps, too early to predict what the effect of GATS will be. We are convinced, however, that GATS will have a major impact and is something that needs close scrutiny.[137]

233. **The UK Government should help to ensure that the implementation of GATS does not place unreasonable pressures on the governments of developing countries prematurely to introduce competition into their service sectors.**

---

[132] Save the Children is also critical of the WTO's agreement on Trade-related Investment Measures (TRIMS) which, it complains, banned local content and trade balancing requirements.

[133] Christian Aid, *op cit*, p 46, citing Bhagirath Lal Das, *The World Trade Organisation*, pp 325-30.

[134] Christian Aid, *op cit*, p 47, citing Graham Dunkley, *The free trade adventure: The WTO, the Uruguay Round and globalism* (2000), pp 175-6. A report in *The Observer*, 13 October 2002, raised the same concern: "The World Trade Organisation and big business are demanding the sweeping liberalisation of Britain's public services, new government documents reveal. … There are growing concerns that GATS will lead to the full-scale privatisation of public monopolies across the world."

[135] Christian Aid, *op cit*, p 47.

[136] Paragraph 15 of the Doha Ministerial Declaration.

[137] We received submissions from Glenn Rikowski, Visiting Lecturer at University College, Northampton, who expressed concern that GATS would lead to the "business takeover" of education (Ev II, p 352) and from Ruth Rikowski, Visiting Lecturer at Greenwich University and South Bank University, who also expressed concern about GATS in relation to library and information services (Ev II, pp 354 ff).

CHAPTER 7: THE INTERNATIONAL FINANCIAL SYSTEM

234. Globalisation has a macroeconomic and a financial dimension. A number of witnesses have linked national economic crises in many less developed countries to faults in the current international financial system and to the way it is administered by international economic institutions. The system is said to benefit developed countries at the expense of less developed countries. International economic institutions are accused of not doing enough to create a fairer financial system and of creating excessive capital mobility and exchange rate volatility thereby de-stabilising developing economies.

Development of the global capital market

235. The globalisation of capital markets is not a new phenomenon: "The figures tell a clear story about capital markets: they were highly integrated in the late nineteenth century, disintegrated during the inter-war period, and are only now recovering the levels of integration experienced in 1913."[138]

236. Following the Second World War, the Bretton Woods settlement saw the establishment of international institutions which sought to "re-create the international economy that had brought prosperity before the First World War while safeguarding against the dislocation of the 1930s that had led to the Second".[139] The post-Second World War international financial architecture was designed largely to promote the benefits of trade. Andrew Crockett, in his written evidence, observed that the post-war economic order was an attempt to avoid the "… negative experience with isolationism and the monetary disorder of the inter-war years …" (Ev I, p 155). The Bretton Woods system aimed to promote free trade through a set of mutually agreed "rules of the game". It embraced capital controls because it was thought this would " … make it easier to pursue the twin objective of full employment[140] and balance payments of equilibrium". In Andrew Crockett's view, trade liberalisation made it harder to maintain capital account restrictions with the result that " … countries liberalised capital flows as a means of 'leveraging' the benefits accruing from the trade side." (Ev I, p 156).

237. The Bretton Woods system was based on the US dollar. All exchange rates were pegged to it. As Professor Ronald McKinnon, Senior Fellow of the Stanford Institute of Economic Policy, explained in his evidence, much of the world's trade was invoiced in US dollars. The US provided the risk-free assets in the system and had an almost unlimited credit line with the rest of the world (Ev I, Q 528). Even today, the US dollar acts as the world's vehicle currency for trade, and the US must have a trade surplus in order to supply the world with currency and credit. The dominance of the US dollar – what Professor McKinnon describes as the "currency asymmetry" – was therefore built into the system from its inception, and it continues today.

238. In the early 1970s, the Bretton Woods system of fixed exchange rates broke down, flexible exchange rates re-emerged and capital market integration resumed. The reasons for the breakdown are still controversial. It is widely thought that a major factor was high domestic US inflation in the late 1960s, rather than the removal of capital controls. The rise in the real price of oil, accompanied by many governments' faulty response to it, also had an effect. High US inflation caused a loss of US competitiveness and so undermined the US trade balance and the value of dollar-denominated financial assets. Countries therefore sought a realignment of exchange rates. The easiest way for this to happen was for the US dollar to devalue against gold. This precipitated the general floating of exchange rates as countries searched for the most appropriate exchange rate level. Under Bretton Woods, monetary policy for all countries was, in effect, determined by the US due to the need to maintain the exchange rate parity with the dollar. Having a flexible exchange rate meant that a country could now determine its own monetary policy and compete for financial capital in world markets. It became increasingly apparent in the years immediately following that capital controls were no longer needed or desirable for most developed countries.

239. Although the broad level of capital market integration is not new, the composition of the capital flows differs markedly from that in pre-First World War globalisation. Andrew Crockett described the difference as follows: "In the more recent [phase of globalisation], short-term, notably bank flows are larger; foreign direct investment has become more important relative to portfolio flows; and within portfolio flows, the share of equity is higher." (Ev I, p 155). The character of current capital flows has been determined in part by advances in technology which has allowed the more efficient trading of traditional financial instruments and the development of more complex financial

---

[138] Centre for Economic Policy Research, *Making Sense of Globalization: A Guide to the Economic Issues*, Policy Paper No 8, July 2002, p 27.

[139] Philippe Legrain, *Open World: the Truth About Globalisation* (2002), p 104.

[140] The pursuit of full employment was central to Bretton Woods and post-war policy making up to the mid-1970s. The collapse of Bretton Woods was accompanied, coincidentally or otherwise, by rising unemployment for two decades, and the emergence of low inflation as a – or the – main macroeconomic objective.

products.[141] It has also been affected by changes in the organisation of production of transnational corporations, with increased fragmentation of the production process leading to increased FDI. Whilst the increase in FDI has given rise to some concerns (see Chapter 5), the evidence we received suggests that the greater concern is short-term speculative capital flows and the consequent financial and exchange rate instability.

The effects of capital market liberalisation

BENEFITS OF THE REMOVAL OF CAPITAL CONTROLS

240. The removal of capital controls resulted in more integrated world capital markets. This has tended to create cheaper and more plentiful international credit, thereby promoting economic development and trade. For example, Stephen King, Managing Director, Economics, HSBC, told us: “From a resource allocation perspective, if capital can flow to immobile – but potentially productive – labour, there should be benefits in terms of rising output … and greater social cohesion.” (Ev I, p 70). George Soros argued that capital mobility was at the heart of globalisation. He suggested that globalisation of the financial markets had brought “great benefits”: “… partly in helping to generate aggregate wealth and also in offering a degree of freedom that cannot be offered by any individual state.” (Ev II, Q 1925). Not only did the evidence we receive suggest that capital market liberalisation has benefited developed countries but we also heard evidence that it had benefited some emerging developing economies as well. Tito Mboweni of the South Africa Reserve Bank told the Committee that the removal of capital controls had led to a massive participation by non-residents in their financial markets, which had quite clearly been a positive feature of the opening up of the economy after apartheid. Martin Wolf suggested that without reforms to exchange control liberalisation a number of developing countries would have grown more slowly than they did, particularly India and China (Ev II, Q 1588).

241. Capital market liberalisation may also help spread the financial risks that arise from increased trade specialisation. As Willem Buiter put it: “Access to global financial markets and international portfolio diversification makes it possible, in principle, to insure the residents of a nation against the risks (eg terms of trade shocks) associated with specialising in the production of a relatively narrow bundle of goods and services in an uncertain global environment.” (Ev I, p 85).

242. There are also distinct disadvantages to having capital controls. By restricting outflows, they tend to reduce the domestic rate of return (because domestic residents having restricted, or no, access to higher returns in international markets are confined to lending at lower rates domestically). This may discourage savings and lead to thin domestic capital markets, although governments and other borrowers will be able to borrow more cheaply. Capital controls also discourage inflows, because investors fear that they will not be able to withdraw earnings. This discouragement of inwards investment constrains economic growth.

243. Furthermore, fears about the transitional effects of the removal of capital controls appear, to some extent, to be misplaced. Often when capital controls are removed, instead of capital fleeing, it flows in to take advantage of unexploited investment opportunities and this promotes economic growth and development. Indeed, even those witnesses who argued in favour of capital controls in some cases did not argue against their eventual removal. For example, Professor McKinnon noted that western Europe kept capital controls for a long time after the war, but “once a country fully industrialises and gets good internal financial markets, then it can ease the capital controls”. He also pointed out that not everybody could have capital controls: “The post-war system could not have worked if the US also had capital controls, but given it is the central money, it is better to have capital controls in the peripheral countries. This is true for the emerging market economies (Asia, Latin America and much of Africa) at the present time.” (Ev I, Q 547). Gerald Holtham, Chief Investment Officer, Morley Fund Management, thought that capital controls were a legitimate short-term instrument but argued that there should be “… a sharp distinction between capital controls as an occasional instrument of policy and capital controls as a continuing fact of life.” Giving the examples of Malaysia (where capital controls were introduced in 1997) and Chile, he added that “[the] danger if you leave them on as a fact of life [is that] they will not only cause distortions in resource allocation, but just general rent-seeking behaviour. And there is an inducement to corruption.”(Ev II, Q 1070).

[141] European Commission, *Responses to the Challenges of Globalisation: A Study on the International Monetary and Financial System and on Financing for Development*, SEC (2002), 14 Feb 2002, p 25, and see Michael Kitson, Ev I, p 111.

THE DOWNSIDES OF GLOBALISATION OF THE FINANCIAL MARKETS.

Financial instability

244. Whilst acknowledging the benefits of capital market liberalisation, a number of witnesses emphasised the problems it has created. It has been suggested to us that the advantages for trade and economic growth have been offset (even, perhaps, more than offset) by the disadvantages to macroeconomic stability and the management of national debt, and because of greatly increased financial instability caused by highly volatile short-term capital flows.[142]

245. Stephen King, for example, referred to capital flows being "a source of instability, particularly when they go into reverse". He gave the examples of Mexico and Thailand in the 1990s (Ev I, p 70). George Soros made the same point, giving Argentina's current predicament as an example (Ev II, Q 1925).

246. Professor Krugman emphasised financial instability as one of the downsides of globalisation: "The first thing is capital markets and financial crises. Those have been very severe. The nineties, I think, was the worst decade since the thirties for international financial crises." (Ev II, Q 1880). Andrew Crockett thought that there had been an increase in the number and severity of episodes of financial distress in recent years, and the costs of this financial turbulence "… in terms of output foregone ran into double digits as a percentage of GDP in a significant number of countries …" (Ev I, p 156).

247. Paul Volcker, former Chairman of the US Federal Reserve, whilst noting the "enormous benefits of open markets", commented: "The ironic thing is that financial markets really only opened up dramatically in the 1990s, following the break-up of the Soviet Union and the triumph of the doctrine of open markets and … with surprising enthusiasm, as I see it, the emerging markets joined in this opening and then they pretty promptly fell on their face." The effect was, and is, that: "The second half of the 1990s or the latter part of the 1990s and even extending to now has not matched the growth rate that they had before the markets were opened." (Ev II, Q 1757). Mr Volcker stressed that although large developed countries were able to be reasonably resilient in the face of financial and exchange rate volatility, this was not true of smaller economies:

> "… my argument is that people do not realise how much … volatility affects a small open economy … you get a sharp fluctuation in exchange rates in those countries and you are talking about half the economy being knocked off course and the exchange rate and the interest rate going up and down in a wild swing in a way that is not very manageable." (Ev II, Q 1757).

248. Michael Kitson gave evidence about how technological developments had encouraged the use of new financial instruments for speculative purposes because of the speed at which they could be bought and sold. He noted the problems this had created. This "hot money", he said, "has led to volatility in exchange rates and asset prices and has deepened recent currency crises." (Ev I, p 111). The Royal Society of Edinburgh made a similar point: "As to the volatility of capital flows, if everything in the system is speeding up, in large part because technology is accelerating the process, then there will be increasing volatility as financial resources seek to flow to where the advantages are perceived to lie." (Ev II, p 378).

249. War on Want shared this concern. In their memorandum to the Committee, War on Want stated that "… systemic instability in global financial markets is a serious threat to any advance in human development." (Ev I, p 376). They continued: "Governments are finding it increasingly difficult to pursue independent policies which may be inconsistent with the interests of global capital, as the case of Brazil shows." (Ev I, p 378). The implication here seems to be that foreign capital flows are highly sensitive to certain domestic polices, and that there may therefore be a conflict of interest between lender and borrower.

250. The OECD argued that:

> "The case for trade liberalisation is quite clear. In contrast, the benefits drawn from financial market deregulation are less obvious. Obviously, an open door to international financial flows is an important channel to utilise foreign savings and meet domestic investment needs. This can also spur competition in the financial sector and lead to efficiency gains. However, financial market volatility is large (although it is not clear whether it has increased in the recent past),

[142] In the cross-Departmental memorandum (Ev I, p 9), Departments were asked whether volatility had increased in the last 10 or 20 years. They suggested that there was "room for debate" and cited a number of studies which offered a complex comparative picture of the Bretton Woods and post-Bretton Woods level of volatility. For example, they referred to Bordo et al, "Is the Crisis Problem Growing More Severe?" Mimeo, December 2000, which demonstrates that crisis frequency since 1973 was double that during the Bretton Woods era and Gold Standard periods but that there was little evidence to suggest that crises were now more severe.

> and many countries have been subject to financial crises following the sudden withdrawal of foreign capital or the flight of domestic savings." (Ev I, p 173).[143]

251. Tito Mboweni identified the greater volatility in international capital movements as "… one of the most important challenges of globalisation to the South African economy …" (Ev I, p 236). The opening up of South African financial markets to international competition plus significant restructuring of the institutional arrangements in the South African capital markets had "… contributed to a large inflow of capital but also resulted in greater volatility in the capital movements between South Africa and the rest of world." (Ev I, p 235).

252. UNCTAD argued that capital market liberalisation had been damaging to both the poor developing countries and emerging economies:

> "Financial liberalisation did bring greater capital flows to developing countries in the 1990s, albeit directed mainly to a handful of emerging markets. But even in these successful countries, the liberalisation of capital flows, particularly where it has been prompted by the need to finance growing external deficits, has actually made matters worse, further impeding investment in productive physical assets by favouring the short-term on financial assets. Higher interest payments have added to the difficulties caused by widening trade deficits, and even the strong growth of FDI flows to developing countries in the 1990s has been accompanied by an increased share of mergers and acquisitions as opposed to greenfield investment, and by investment in sectors characterised by boom-bust cycles.
>
> On recent trends, the level and composition of net capital flows received by most developing countries are inadequate to meet their existing external financing requirements or to contribute to a higher target rate of growth. … The external financing needs of developing countries can be expected to exceed recent net capital inflows by a substantial amount. …
>
> Thus globalisation is not working for many developing countries." (Ev I, p 363).

253. In recent years there has been a removal of capital controls on a scale which has led to a much greater reliance on borrowing from abroad. It appears that the problem described by UNCTAD is not financial liberalisation per se, but external deficits. These may have been caused by over-ambitious or faulty domestic policies accompanied by excessive external borrowing. If that is the case, then this is an argument, in certain cases, for greater, not lower, capital flows (albeit under favourable conditions). The problems for the domestic economy are magnified when the flows are denominated in foreign currency if there is an adverse movement in the exchange rate. This will require a large switch of resources to meet external debt obligations. In the short run, this can be extremely damaging and politically de-stabilising. Therefore, borrowing large amounts short term in a foreign currency is almost certainly inadvisable for a country. It is often done in countries where domestic financial markets are not sufficiently deep to meet a domestic fiscal crisis, and hence the long-run solution is a reform of domestic policy. This does not, of course, address the short-run problem.

Financial contagion

254. Another cause for concern, related to financial instability, is the spread of financial crises from one country to other countries. Donald McKinnon commented that:

> "Globalisation in international capital markets had resulted in far greater linkages between financial markets in economies which had liberalised their financial sectors but this had brought greater risks of financial contagion in a crisis.
>
> A key lesson from the East Asian crisis is that capital flows, particularly short-term flows, can be extremely volatile. Furthermore, the herding instinct of investors actually accentuates crises and fuels contagion." (Ev I, p 303).

He concluded from this that it was important for developing countries to manage financial market liberalisation carefully with an appropriate sequence of policies in building deeper domestic capital markets (Ev I, p 302). Willem Buiter referred to contagion in financial markets, "manias and panics, irrational euphoria and despondency" as one of the elements of "pathological globalisation" (Ev I, p 84), and Sir Howard Davies, Chairman of the FSA, described how the ease of capital flows and technological advances meant that "… the financial shock waves of a major event now transmit to markets on a global basis virtually instantaneously." (Ev I, p 320). Gerald Holtham said, however, that he was interested in "how very little contagion there had been very recently, for example, from the

[143] Footnote not included. George Soros was similarly ambivalent about the benefits of capital market liberalisation: liberalisation has benefits – wealth aggregation and empowering individual states – but it also has "great disadvantages": and one of these disadvantages is instability in the global financial markets (Ev II, Q 1925).

Argentinian crisis" which has not "even affected Chile or Brazil to any significant extent" (Ev II, Q 1068). This appears to be a minority view.

255. Stanley Fischer, when he was First Deputy Managing Director of the IMF, wrote in 1998 in his analysis of the Asian crisis that: "Contagion to other economies in the region appeared relentless. Some of the contagion reflected rational market behaviour … but the amount of exchange rate adjustment that has taken place far exceeds any reasonable estimate of what might have been required to correct the initial overvaluation of the Thai bath, the Indonesian rupiah, and the Korean won, among other currencies."[144] Professor Krugman spoke in terms of the current South and Latin American problems as having a strong element of contagion. This is particularly so in the case of Brazil, which, although it has inherited a large debt burden following fiscal deficits in the early 1990s, currently has a budget surplus, a floating exchange rate and a strong banking system. Contagion is seen as an important reason why international financial institutions like the IMF need to take an active role in crisis management in a country.

256. **The evidence supports our view that there are advantages to capital market liberalisation. Economic theory and the evidence we have received show, in particular, that capital market liberalisation is broadly beneficial to the economic progress of developing countries. It is not without costs, however, and for developing countries to pursue it without adequate preparation of the right policies and institutions would be foolhardy. Our overall conclusion is that the international free flow of capital should be the aim, and become the norm. However, matching the timing of capital market liberalisation with the precise circumstances of the individual country is of the essence.**

The international economic institutions

257. Although some blame for global financial instability and contagion is attributed to national economic policies, much of the evidence to the Committee tended to stress failures in the policies of the IMF, the main global economic institution involved actively in financial and macroeconomic management of countries. The World Bank was criticised to a lesser extent. We turn first to the World Bank briefly and then consider the IMF in more detail.

THE WORLD BANK

258. The World Bank was established as part of the Bretton Woods settlement to assist in financing the re-construction of war-damaged economies. It is now involved in financing development more generally. The evidence we received about the performance of the World Bank was largely positive (especially in comparison with the IMF), with indications that policy changes within the Bank in recent years were to be applauded.

259. Lord Desai, for example, said: "all through the 1990s the World Bank improved immensely in the way it understands growth, poverty and things like that. I would say that the World Bank has done much less harm than the IMF has done." (Ev II, Q 1741). Mathew Taylor MP suggested that although the World Bank had been "truly awful in the past", it was "undoubtedly improving" (unlike, Mr Taylor said, the IMF) (Ev II, Q 1385).

260. Professor Stiglitz, a former Chief Economist at the World bank, told us;

> "As I have watched very carefully both the IMF and the World Bank, I think that there have been much more significant changes in the World Bank than in the IMF and it goes much deeper into the organisation, the change in mindset, the change in how they interact with developing countries. One thing about the World Bank is that it is very decentralised and the country directors and the regional vice-presidents have a lot of autonomy." (Ev II, Q 725).

Nicholas Stern, the current World Bank Chief Economist, confirmed this change in approach. We asked him about the allegation made against the World Bank, as well as the IMF, that it applies a "one-size-fits-all" approach:

> "We have made a big effort, particularly in the last five or six years, to decentralise our activity and put our country directors in the field. The point of doing that is that they get closely involved with the real challenges in the country and they understand the particular environment. As part of that story of trying to support countries to make their own choices, we have been backing the approach called the poverty reduction strategy. There is a poverty reduction strategy paper which is a process which is built within the country." (Ev II, Q 1825).

[144] "The Asian Crisis", Address to the Midwinter Conference of the Bankers' Association for Foreign Trade, January 1998.

261. Clare Short recognised this change within the World Bank: "The Bank has, in the last five years … , focused much, much more on the measurable reduction of poverty being the sign of success in development, empowering local people and governments to take control of the reform agenda against that kind of objective with more openness." (Ev II, Q 2022). We welcome this development.

262. While most of the evidence we received about the World Bank was positive, some criticisms were made. Dr Yilmaz Akyuz of UNCTAD, for example, suggested that unlike the IMF which, because of the Asian financial crisis in 1990s, had gone through a period of re-thinking, the Bank had failed to progress since the 1970s or 1980s. The Bank had, he said, "over-stretched itself" (Ev I, Q 975). It should consider focusing "on a few areas … maybe go back to project financing … maybe programme lending" (Ev I, Q 976). Paul Volcker shared the view that the World Bank was attempting to pursue too many objectives: "I do not criticise them … they are being asked to do too many things and very few of them are what is clearly within their grasp. It was quite different … 30 years ago: the World Bank lent on infrastructure." (Ev II, Q 1774).

263. Martin Wolf also alluded to the "extraordinarily multifarious" and "unbelievably wide-ranging" activities of the Bank. He suggested that the Bank should concentrate on two main functions: first, the provision of advice and knowledge not available from other sources (because the Bank "contains a vast repository of information and a great many very able people"); and secondly, the provision of funds to countries that have no access to capital markets to support programmes which those countries have decided to pursue (Ev II, QQ 1617-18).

264. We note that George Soros, in *George Soros on Globalization*, refers to the criticism of the World Bank by the International Finance Advisory Commission (the Meltzer Commission) Report: "… the Meltzer Commission criticises the World Bank for being a bureaucratic organisation with too large a staff and for engaging in lending activities that could be taken care of by the capital markets."[145] Although not wholly supportive of the Commission's recommendations in relation to the World Bank, Mr Soros endorses the view that the Bank lending operations should be reformed and should include, for example, an even greater emphasis on transparency and the fight against corruption.

265. **We started our inquiry from a position highly critical of the World Bank in its role as an international financial institution. While acknowledging the criticisms of the Bank, the evidence has led us to a more balanced and supportive view. In addition to welcoming the Bank's more client-focused approach in its operations, we are especially impressed by the World Bank as a source of data and research which provides the basis for a sensible and valuable approach to the growth process.**

THE IMF

266. The IMF was also created as part of the Bretton Woods settlement. The Articles of Agreement state that the IMF seeks to promote international monetary co-operation, facilitate the expansion of international trade, promote exchange-rate stability and avoid competitive depreciation.

Criticisms of the IMF

267. A number of witnesses commented on the harmful effects that IMF policies had had on developing countries. It was seen by some as a major cause of the problems arising from globalisation, and by others as making economic crises in some developing countries worse. The crises in East Asia, Argentina and Brazil were frequently cited as examples.

268. Professor McKinnon told the Committee that he thought that the IMF had "lost its sense of mission". In the early days of Bretton Woods "… the strong dollar was at the centre while there was a lack of confidence in European currencies. … So the IMF very explicitly committed all the peripheral countries in Europe and Japan to maintain capital controls. … Today … countries on the periphery and emerging markets should be able to use capital controls (to stabilise their financial systems). The IMF's big sin of commission up to a year or two ago was to be a cheerleader for getting rid of capital controls. … Without capital controls, the stage is set for hot money flows, which are unnecessary."(Ev I, Q 541). He went on: "The leaders of the IMF have for the most part been in favour of free-floating and pushing countries despite these very strong neighbourhood effects, so that when country A devalues, it really hurts country B." (Ev I, Q 544).

269. John Grieve Smith, Fellow of Robinson College, Cambridge, argued in his memorandum to the Committee that "… the IMF should stop prescribing deflationary measures which increase the risk

[145] *George Soros on Globalization* (2002), p 101 (original footnote not included), referring to the report of the International Financial Institution Advisory Commission (The Melzer Commission), March 2000.

of massive increase in unemployment in countries in difficulties and instead help them to stabilise their economies in such a way as to maintain employment." (Ev I, p 63).

270. Professor Joseph Stiglitz thought that the main problems with the IMF arose from its governance: "the voices of all countries are not all equally heard…there is lot of unhappiness about the UN with five countries having veto power and in the IMF one country has effective veto power, and that particular country, I am embarrassed to say, tends to pursue a position which is increasingly best described as unilateralist and which itself is dictated by special corporate and financial interests within the United States" (Ev I, Q 711). Professor Stiglitz suggested that "basically countries are told [by the IMF] to adopt a neo-liberal agenda … and this is causing very severe problems in confidence in democracy and reforms in many developing countries"; he gave capital liberalisation as an example of "an agenda that was being pushed by the IMF and the US Treasury when there was no evidence that it promoted economic growth." (Ev I, Q 718). In his view "the IMF needs to focus on the one area of its supposed competence, that is crises". He went on: "They are beginning to talk about more use of bankruptcy and standstills and away from big bailouts. … Stan Fischer on this issue said if you default it is an abrogation of your debt contract, whereas my view was that bankruptcy has been a fundamental part of capitalism and we would not have the market economy we had if we did not have bankruptcy." (Ev I, Q 733).

271. George Monbiot of *The Guardian* similarly focused on governance issues. He said that he "would like to see the dissolution of the World Bank and the IMF", which he believed were "profoundly undemocratic organisations, that people who control them are exclusively the rich nations and the places in which they work are exclusively the poor nations, so the recipients of their policies have no effective influence over their policies" (Ev II, Q 1317). By way of example he said: "We saw this very clearly with Argentina where the government and certainly the people had a clear view of the sort of economic policies they thought would be appropriate. It was plain the IMF had a different view, the IMF's view prevailed and we all know what happened." (Ev II, Q 1334).

272. Professor Krugman, speaking about the Argentina, crisis said: "The sin of the IMF in 1997-98 was that of, essentially, adopting a crime and punishment point of view of financial crisis, that if you are having a crisis it must be because there is something terribly wrong with you and there can be no recovery without wrenching reform." (Ev II, Q 1883).

The changing role of the IMF

273. The current role of the IMF is very different from its original purpose. This is partly because the financial markets have much more influence. Andrew Crockett put it this way:

> "Today, each of these features of the system – exchange rates, adjustments, and liquidity – are determined by decentralised decision taking in private financial markets. Concerns have shifted from traditional macroeconomic imbalances to the interaction between freer financial markets and the real economy. Addressing financial instability has risen to the top of the international policy agenda, both with regards crisis prevention and management. The effectiveness of the system relies not so much on whether governments take the right decisions, but on whether they provide the right framework to enable the private sector to make the right decisions. The IMF stills plays a key role, but the number of relevant players has increased including national standard setters in the financial sphere and their corresponding international bodies." (Ev I, pp 157-8).

He described the IMF's present role as follows:

> "The [IMF and World Bank], while possibly playing a standard setting role in certain specific areas (eg, transparency of fiscal and monetary policies), are primarily involved in the monitoring of countries' policies, and in particular of their compliance with financial standards. They help countries upgrade their systems, set priorities among competing demands, and can be a vehicle for providing information to markets on the state of financial systems." (Ev I, p 158).

He referred to the constraints the Fund works under in one of the areas where it receives much criticism:

> "The management of sovereign liquidity crises is one of the Fund's central tasks, but is greatly complicated by the fact that there is no international counterpart for insolvency and a lender of last resort in national financial systems. The IMF therefore has a delicate task in ensuring that private creditors are involved in crisis resolution in a way that does not exacerbate moral hazard, or choke off private sector flows for the future." (Ev I, p 158).

274. Willem Buiter was asked whether he thought the IMF should be the lender of last resort. He replied: "The lender of last of resort cannot be done internationally because it requires supranational

institutions of the kind that we just do not have at a global level." (Ev I, Q 219). He went on to suggest that the IMF could not do it "because they do not have the resources or the power" (Ev I, Q 222). Martin Wolf took a similar view. He said that: "The really interesting questions [for the IMF] concern its role as a lender, and the difficulty here is I do not think we have worked out, and it is not even obvious in theory how we could work out, what precisely the lending function of such an institution is. It is clearly not there to save all the lenders. It is not there to ensure that all lenders get their money out. That would be highly undesirable. It cannot be a lender of last resort in runs because it does not have the resources and it is pretty clear it does not have the capacity to minimise the moral hazard that would be created by that. So it has a very limited function in that respect." (Ev II, Q 1628).

275. Referring to what he thought the IMF could do, Martin Wolf suggested that "… if this institution is to have any value, [it] is to make as clear as possible and ideally as publicly as possible when it believes countries are running into very serious difficulties, so that instead of financing growing crises, it forestalls them. This is an incredibly difficult thing for the IMF to do because it will be triggering the crisis it is supposed to avoid." He added that you have to be able to deal with a crisis without bailing everybody out. The Fund's job was to manage default while reducing the extent of the pain imposed upon the country concerned: "… the right package consists … of a default plus a willingness to lend to a country in arrears or in default provided that country is showing real signs of getting to grips with its problems." (Ev II, Q 1628).

276. Given that by definition all funds moved from one place must go somewhere else, it is at least worth considering whether the lender of last resort function could be undertaken by the leading central banks co-operating under the auspices of the IMF. The problem, of course, is how to cope with the moral hazard problem mentioned by Andrew Crockett and Martin Wolf (in paragraphs 273 and 274 above).

277. We were unable to arrange an evidence session with Horst Köhler, Managing Director of the IMF. We were interested to note, however, an article in the *Financial Times*[146] in which Kenneth Rogoff, Chief Economist at the IMF, explained the Fund's role as follows:

> "Distressed emerging-market debtors typically come to the IMF precisely because its financial assistance, combined with the policies it supports, generally alleviates austerity rather than intensifying it. Emerging-market debtors typically come to the IMF only when their finances are under extreme duress – usually through imprudence and bad luck – and other creditors have turned their backs. These countries would otherwise have no choice but to tighten their belts. An IMF loan typically loosens the belt, both directly via added funds and indirectly by helping to stabilise markets."

Critics of the IMF, he said, thought that the Fund's main task was to fight recessions: "They claim that what the creditors really want is to see growth. Ergo, the best way to defend a currency is by cutting interest rates to expand the economy. Similarly, if a country wants to calm creditors, it should be borrowing more money, not less. They think the resulting growth would allow the country to carry proportionately more debt. Sadly, the clear weight of logic and evidence suggests the opposite." He admitted that "there is a real risk in any IMF programme that interest rates might be raised too sharply and the path of fiscal policy set too tight." When it became clear that the economic downturn in the Asian crisis of 1997-98 was worse than initially thought "not just by the IMF but also by just about everyone, the IMF changed its advice to allow fiscal policies to be less restrictive." He warned that "if the programme does not embody sufficiently ambitious targets, it will collapse for lack of credibility." He also drew attention to an important constraint that the IMF works under: its budget. If it lends to some countries for longer terms, it is unable to recycle the funds to other countries. There are, therefore, losers as well as gainers.

Tackling financial instability and crises

278. Central to our consideration of the role of the IMF in addressing problems of global financial instability, two distinctions must be made. The first is the distinction between the long and short term in setting policy; and, the second is between problems arising from faulty macroeconomic policy and those arising from forces outside the control of the government of the country concerned. On the one hand, the IMF can be helpful to countries in formulating a long-term policy strategy which is also connected with their short-term response to policy problems. On the other, the IMF itself can intervene in providing support when a short-term financial crisis emerges. This intervention might involve co-operation with the major central banks.

[146] 27 September 2002.

279. Our thoughts on the role of the IMF are based on the philosophy which underlies the whole of this report: namely, that it is for countries themselves to determine their objectives and means of achieving them. The role of outside bodies is not to take over the macroeconomic governance of a country. It is to be critical, advisory and supportive. Certainly, it is not to place obstacles in the path of a country trying to do the right thing in its own way at its own pace. We emphasise the word "critical". We see nothing wrong in the IMF saying from time to time, and, of course, on the basis of evidence, that such and such a policy on the part of country X has done harm rather than good in the other cases in which it has been tried. This is especially so when a good mark, so to speak, awarded by the IMF is likely to make it easier for a country (or firms in a country) to borrow both short and long term. To give a country a clean bill of health when it is not justified is damaging to international financial markets. Equally to the point, in encouraging poor policies it may lead to a postponement and magnification of disaster. Having said that, we reiterate the point that it is not true that only one policy model is right for all countries at all times. While our evidence has indicated that the IMF appeared to adopt this view at some time in the past, it no longer does so.

IMF AS A "BODY FOR SURVEILLANCE"

280. Gordon Brown, the Chancellor of the Exchequer, clearly sees an important role in the future both for prudent domestic economic management and for the IMF. He told us:

> "I do believe that the new modus operandi around the world is for greater transparency, and in that context the IMF should see itself more as a body for surveillance which is reporting on whether codes and standards are being upheld and whether there is genuine monetary and fiscal transparency and there are good corporate standards being observed. … that is the way forward for the international institutions as well as the way in which the poorer countries can guarantee that they can get support, both in terms of international investment and support from the international institutions." (Ev II, Q 2092).

In his evidence, the Chancellor emphasised the importance of transparency several times. This is particularly important in establishing confidence in financial markets so that they are willing to make long-term, and not just short-term, loans.

281. Mervyn King of the Bank of England emphasised the need to accompany long-term borrowing with appropriate long-term macroeconomic policies:

> "… if a government claims to be pursuing the right policies … the impact of that on capital markets will depend not just on what the government in control on the day is doing, but on what financial markets expect future governments to do as well … if the financial markets, taking a longer term view, feel that it is not sustainable … that is bound to affect the way [they] reach their judgement." (Ev II, Q 2051); and

> "… lenders take a long-term view of what a country will do. ... It is difficult to borrow long term unless you have a framework for policy and an infrastructure in society which enables a country that is borrowing to make an equally long-term commitment to the lenders, and if it is not able to do that, perhaps it should not be looking to borrow quite so much long term from abroad." (Ev II, Q 2052).

BAIL-OUTS AND BANKRUPTCY

282. Bail-outs and bankruptcy provide mechanisms for re-structuring sovereign debt in the presence of an immediate crisis. Increased borrowing or lengthening the maturity structure of debt would resolve an immediate problem in most cases. It is, however, because a country is unable to do this that a problem becomes a crisis. Most of the debt obligations are to private sector banks and other financial institutions. They take the form of syndicated loans, or bonds in emerging market debt. Understandably, given the high-risk nature of additional loans, private investors are reluctant to commit additional resources, or re-schedule debts, without guarantees, or some way of spreading the risks.[147]

283. We have noted (in paragraphs 273-76 above) how the IMF might provide emergency finance by providing a lender of last resort facility, subject to the problem of moral hazard.[148] To some extent

[147] On 25 September 2002, in an after-dinner speech at Lancaster House, Dr Alan Greenspan spoke about the potential importance of using credit default swaps to insure against default risk. This is a new but rapidly emerging financial instrument.

[148] The question arises: what is the IMF to do when the source of the problem is the pursuit of erroneous policies on the part of a sovereign government? It is obvious that if a crisis occurs, the job of the IMF is not to make things worse. It is equally obvious that bail-outs should not be used to enable the country in question to continue with unsound policies or to encourage other countries to follow suit. In other words, the moral hazard problem needs to be resolved.

it does already but, as explained by Kenneth Rogoff , the main problem the IMF faces is that it has limited resources and these have to be re-cycled. The Treasury, in its supplementary evidence, endorsed Willem Buiter's view that the supranational institution of the kind needed to deal with the problem of lack of loanable funds did not exist. They wrote: "In a world of globalised financial markets, the official sector does not have sufficient resources to provide large-scale bail-out packages as a standard response to emerging market crises." (Ev II, p 270). The Committee acknowledges the constraints that the IMF works under in providing short-term finance.

284. There seems to be no good reason to rule out a free-market solution involving obtaining the additional funds from the world's capital markets. It is, however, the increasing reliance on international capital flows and the failure of the world's capital markets to come to the rescue of countries in crisis that lies at the heart of criticisms of global financial capitalism.

285. The key to a free-market solution is to deal with the legal problems arising from re-scheduling debt, to find a way to price default-risk and to develop insurance vehicles for creditors. A country's debt is not necessarily held by a single creditor, but is shared among several. A problem that can occur in re-scheduling debt arises from the fact that it may require a change in a legal contract which is difficult to obtain in some countries. As a result, even minor creditors can disrupt re-scheduling agreements.

286. Default is an extreme form of re-structuring debt. Its attraction for a country is that it immediately removes its debt service requirements as well as its long-term obligations. Debt-forgiveness is another way of removing long-term obligations. The UK government has been taking a leading role in advocating debt forgiveness as amongst other possible measures in debt re-scheduling. The Chancellor told the Committee that "a new international bankruptcy procedure to deal with unsustainable debt" was needed as part of a better framework for crisis prevention and resolution (Ev II, Q 2088).

287. Less extreme measures are standstills to suspend debt service payments and to write down debt obligations. Like debt-forgiveness, writing down debt, which reduces the size of the debt obligation but does not eliminate it, may be very beneficial in obtaining a sustainable long-run solution. As noted in paragraph 270 above, Professor Stiglitz has said that the IMF needs to give these types of solution closer consideration. In fact they are. The IMF and World Bank are currently examining the legal problems of re-structuring debt and the issue of default.

288. The Chancellor told the Committee that the IMF and the Group of 7 (G7) countries are actively engaged in finding new solutions to these pressing problems. In November 2001, the IMF proposed that a new Sovereign Debt Restructuring Mechanism (SDRM) be established. The Treasury's supplementary evidence to the Committee reports that there are four main components of this: (i) temporary protection from creditor litigation; (ii) establishing a mechanism to facilitate debtor-creditor negotiations; (iii) granting seniority to creditors during the restructuring period; and, (iv) a mechanism to bind minority creditors to the agreement. The Treasury states that: "The UK, along with the rest of the G7, has pledged its support for further work to develop this proposal." (Ev II, p 226).

289. Aside from that, part of the aim must be for financial markets to develop new ways to spread the risk to the lender arising from sovereign debt problems more widely across the world financial markets. Financial instruments are required that price default risk as they do other forms of risk. Instruments are also needed to provide the creditor with insurance in the case of default or non-performing assets. Credit derivatives, such as credit default swaps are an example of the latter. It would take a systemic failure of world capital markets on a large scale to prevent this type of risk-sharing from working. Even if these facilities were developed, the ultimate source of risk would still stem largely from individual country macroeconomic policies. This would be costly to a country as it would tend to create a country-specific risk premium.

290. This type of solution, whether it take the form of debt-forgiveness or debt-restructuring, again carries with it the problem of moral hazard: it increases the incentive to the borrower to incur more debt and to undertake more risky investments in the knowledge that it will be bailed out, or the lender has insurance. The problem of moral hazard makes it essential to write appropriate contracts and for them to be enforceable. This is an active area of research in international finance.

291. There is no doubt that the IMF has made mistakes in the past. It has admitted as much. We have noted that it is re-examining many of its policies, including whether it is always appropriate to recommend the removal, or non-imposition, of capital controls. And it is working on better mechanisms for sovereign debt re-structuring. The Committee was told by some witnesses that the IMF should be abolished, but we do not want to see the abolition of the IMF. We agree with the general view that were it not to exist, it would have to be re-invented. We believe that the IMF has a crucial role to play. We note the Chancellor's view that "[t]he role of the IMF is increasingly about

surveillance and monitoring the transparency of individual national policies and publicising that surveillance. Where previously it used to be in secret rather than published, it is far better that it is out there and open and above board what the views of these experts are." (Ev II, Q 2108).

292. **We believe that the IMF is the appropriate body to assist a country faced with an immediate financial crisis. We say this whilst recognising and sharing the criticism of some of the IMF's past interventions. We are aware that in the past the IMF has been seen as being part of the problem rather than the solution. We are glad to note that they have for some time been subjecting their procedures to internal scrutiny, especially as they pertain to dealing with short-term financial crises. In the short term, what is obviously required is immediate assistance to deal with impending sovereign debt default. We recognise that the resources of the IMF are limited and that, therefore, financial support from the United States and other developed countries will have to increase and the role of the main central banks be enhanced. We also recognise the advantages of involving the world's capital markets in providing the necessary short-term finance, and the important role that the IMF can play in sovereign debt re-scheduling. Finally, it is our general view the IMF should pursue an open-minded approach to these problems and one that is carefully tuned to the circumstances of individual countries.**

CAPITAL TRANSACTIONS TAX

293. There is a view held by many economists that financial markets, national and international, show excess volatility even in the presence of sound macroeconomic policies.[149] One solution to this has been a capital transactions tax (CTT) or Tobin tax.

294. A CTT permits access to world capital markets but aims to limit their volatility by taxing movements in capital. War on Want stated that a Tobin tax "… is a pivotal issue for our times. The tax is both necessary, in order to deal with the risks of currency crises, and entirely possible, on a practical political level. It would make considerable sums available for global aid for sustainable development, which continues to suffer from chronic under-funding." (Ev I, p 381). They also said: "A CTT set at the right level should neatly discriminate between short-term investors – who typically undertake numerous currency speculations daily – and longer-term investors carrying out single foreign exchange transactions." (Ev I, p 379). War on Want do not, however, argue that "a CTT alone, even applied internationally, is an adequate measure to address global financial instability" (Ev I, p 379). Rob Cartridge, Campaigns Director for War on Want, told the Committee that "a Tobin tax is not a panacea", and added that War on Want was "not opposed to free and floating exchange rates" (Ev I, Q 995).

295. Rodney Schmidt, North South Institute, Canada, said that "the Tobin tax is relevant to a crisis which occurs by reason of an external shock, by reason of ad hoc movements in international foreign exchange markets." (Ev I, Q1008). Asked about how the tax would be collected, Mr Schmidt said by taxing all inter-bank and retail market foreign exchange transactions through the settlement system (Ev I, Q1027).

296. Demonstrating the size of capital flows, War on Want noted in their memorandum that currency market trading dwarfs trade, central bank reserves and FDI flows to developing countries (Ev I, p 376).[150] They also noted that "80 per cent of global forex transactions take place in seven cities around the world: London, New York, Hong-Kong, Singapore, Frankfurt and Berne. The City of London alone accounts for 32 per cent of the total." (Ev I, p 379).

297. There was no virtually no support from other witnesses for a CTT.[151] The Committee have various concerns about a Tobin tax: the consequences of it not being imposed simultaneously in all countries thereby allowing non-participating countries a huge advantage; the difficulty of collecting the tax; and, the potentially harmful effects on hedging foreign exchange risk through discouraging short-term positions. We also note that although capital flows are large relative to trade and reserves, the currency movements and the financial centres involved are almost entirely in countries with stable currencies for whom short-term capital volatility is not a problem.

---

[149] On excess volatility, the locus classicus is Robert J Shiller, "Do stock prices move too much to be justified by subsequent changes in dividends?" *American Economic Review*, 1981, vol 71, pp 421-35..

[150] War on Want, quoting the *IMF World Outlook*, October 2001, and the World Bank*, Global Development Finance,* 2000, state that while world exports were around US$7.7 trillion annually in 2001, daily turnover in currency markets is around US$1.2 trillion and FDI to developing countries in 2000 was US$178 billion.

[151] We note, however, that Martin Hattersley, former President of the Economics Society of Northern Alberta and former Leader of the Social Credit Party of Canada, suggested that "the idea of a 'Tobin tax' to place a cost on [speculative] international financial transactions … is … very attractive" (Ev II, p 267). Also, Mr Jeremy Wright argued that a Tobin tax should be introduced in respect of all speculative currency transactions (Ev II, p 355).

298. Thus, if the main aim of the CTT is to stabilise world capital mobility and currencies, then it misses its target. If the aim is to apply it in countries that are particularly vulnerable to capital flight, then the danger is that it will make short-term borrowing, usually an emergency measure, much more difficult to acquire. If the aim is to generate aid for development purposes, then it is not at all clear that throwing sand into the financial system is the right way to do it. It is significant that Professor James Tobin, who originally proposed the tax, withdrew his support for the idea. The Chancellor put it this way: "Before he died Professor Tobin distanced himself from the apostles of the Tobin tax. The reason was that the Tobin tax was conceived in a different world of capital markets that were basically national and regulated. He thought, at the time, it was quite easy to impose a transactions tax. In actual fact, in a highly liberalised market, that is not regulated in the same way as it was by national governments in 1970s and 1980s, it is far more difficult to impose this anyway." (Ev I, Q 2105). Sir Edward George, Governor of the Bank of England, said that he was not an enthusiast of a Tobin tax in general. He said he thought some capital flows are good and some are bad and a Tobin tax could not distinguish between the two. He thought "the killer … on the Tobin tax is practicality, because foreign exchange markets can go anywhere in the world … [so] you would divert a lot of foreign exchange market activity to places that did not apply the tax. I think that is not a productive thing to do" (Ev II, Q 2054).

299. **The Committee is not persuaded of the case for a Capital Transactions Tax as a mechanism for reducing capital market volatility. It would be difficult, if not impossible, to impose world-wide and could be very harmful to a country to do so on its own. We recognise that capital outflows can be damaging to an economy, but this is often a symptom of domestic macroeconomic problems, not the cause. Where, however, capital outflows are the result of excess volatility and the irrationality of international financial markets, the IMF, together with the major central banks, should assist in reducing that volatility.** First, it could announce that it views market behaviour in the case in point not to be based on underlying reality; and, secondly, since by definition all outflows have corresponding inflows, the IMF – while lacking sufficient funds itself – could still help to organise a lender of last resort response on the part of the central banks acting jointly. Of course, all this depends on being able in practice to determine the cause of the outflows in the first place. But if we cannot distinguish sensible domestic economic management from what is unsound, there seems little value in having the IMF in the first place. In sum, the aim should be to address the cause, not the symptoms.

APPENDIX 1

Select Committee on Economic Affairs

The members of the Select Committee which conducted this inquiry were:

Lord Barnett
Lord Burns
Lord Cuckney
Lord Elder
Baroness Hogg
Lord Newby
Baroness O'Cathain
Lord Oakeshott of Seagrove Bay
Lord Paul
Lord Peston (Chairman)
Lord Roll of Ipsden
Lord Vinson

Declaration of interests:

Lord Barnett	Chairman, EBS (Education Broadcasting Services) (charitable trust) (unpaid) Chairman and major investor, Mercury Recycling Group plc Chairman, Mercury Recycling Ltd Chairman, Atos Origin (UK) Ltd Trustee, Open University (unpaid) Member of the Advisory Board of EHS and Partners
Lord Burns	Chairman, Dwr Cymru Cyfyngedig Chairman, Glas Cymru Cyfyngedig Chairman, Monteverdi Choir and Orchestra Trustees Governor and Member, Council of Management, National Institute of Economic and Social Research Governor, Royal Academy of Music Joint Deputy Chairman, Abbey National Group plc (Chairman from 1st February 2002) Non-executive Director, The British Land Company plc Non-executive Director, Pearson plc President, Society of Business Economists Vice-President, Royal Economic Society

Lord Cuckney	Formerly Vice-Chairman of Glaxo Wellcome plc
Lord Elder	Consultant, Smith Institute Hon President, Adam Smith Foundation of Fife College
Baroness Hogg	Chairman, 3i Group plc Chairman, Foreign & Colonial Smaller Companies Trust Chairman, Frontier Economics Council Member, Hansard Society Council Member, Institute for Fiscal Studies Council Member, Royal Economic Society Governor, BBC Various education trusts Non-executive Director, 3i Group plc Non-executive Director, GKN Non-executive Director, Martin Currie Portfolio Trust Non-executive Director, P & O Princess Cruises Writing and lecturing for a variety of publications and organisations
Lord Newby	Chairman, Live Consulting Ltd Chairman, Reform Publications Ltd Director, Pall Mall Initiatives Ltd Trustee, Allachy Trust Trustee, Aviation Health Institute Trustee, Centre for Reform Trustee, Coltstaple Trust Chairman, Executive Committee Lloyd George Statue Appeal
Lord Oakeshott of Seagrove Bay	Chairman, Coltstaple Trust (charitable trust) (unpaid) Director, *Aubrey Investments Ltd and its subsidiaries (paid) Director, *OLIM Ltd (paid) Director, *Value and Income Trust plc and its subsidiaries (paid) Treasurer, Make Votes Count (unpaid) Land and Property: family homes in London, the Isle of Wight and Sussex (no rents received) Member, Finance Committee Mansfield College, Oxford (unpaid) Investment Manager with OLIM Limited (a subsidiary of Close Brothers Group plc) *Shareholdings (more than 1% of the issued share capital)

Baroness O'Cathain

Director, Allders plc
Director, BNP Paribas UK plc
Director, British Airways plc
Director, South-East Water plc
Director, Thistle Hotels plc
Director, William Baird plc

Lord Paul

Ambassador for British Business
Chairman of Trustees, Ambika Paul Foundation
Chairman, Business Council, Parliamentarians for Global Action, New York
Chairman, Economic Policy Committee, Engineering Employers' Federation
Chairman, Zoological Society of London Fundraising Advisory Committee
Chairman, College of Senior Fellows, Thames Valley University
Chancellor, University of Wolverhampton
Co-chairman, United Kingdom-India Round Table
Director and Chairman, Caparo Group Ltd *(Lord Paul, Hon Ambar Paul, Hon Akash Paul and Hon Angad Paul are jointly interested in the whole of the issued share capital of the Company through shareholdings registered in the name of Caparo International Corporation, a Company registered in the British Virgin Islands).*
Director, Parliamentary Broadcasting Unit Limited
Member, Advisory Council, John Smith Memorial Trust
Board of the London Development Agency
Member, the Corporation of the Hall of Arts and Sciences (Royal Albert Hall)
Member, Corporation Visiting Committee, Massachusetts Institute of Technology
Member, Foreign Policy Centre Advisory Council
Member, House of Lords Select Committee on Economic Affairs
Member, Industrial Development Advisory Board
Member, The Prince's Trust Business Expansion Initiative Committee
Member, VSO Council
Patron, National Children's Centre
Patron, Plan International
Patron, United Kingdom Youth
President, Family Service Units
Trustee, Police Foundation
Vice-president, Engineering Employers' Federation
Chairman of the Board of PiggyBankKids, a children's charity, and its trading subsidiary PiggyBankKids Projects Limited

Lord Peston	Director, Philip Allen Publishers Ltd Emeritus Professor of Economics, Queen Mary and Westfield College, University of London Patron, Council for Education in the Commonwealth President, Institute of Administrative Management Vice-president, Action for Dysphasic Adults
Lord Roll of Ipsden	
	Director, Pan Holding S.A. Senior Adviser, UBS Warburg Ltd
Lord Vinson	Director, Ancroft Hill Ltd Farmer, (Farm in Northumberland - part of which is in the Northumberland National Park) Trustee and Vice President, Institute of Economic Affairs Past interests have included being a main Board Director of Barclays Bank; Chairman of the Institute of Economic Affairs; Chairman of a property company; Chairman of an Investment Trust; Deputy Chairman of a large venture capital company; Director of the British Airports Authority; and Chairman of the Rural Development Commission; experience of building up a business from the age of 21, and floating a company on the Stock Exchange. Past winner of the Queen’s Award for Industry.

APPENDIX 2

List of Witnesses

The following witnesses gave evidence. Those marked * gave oral evidence.

*Akyuz, Dr Yilmaz, Director of the Division on Globalisation and Development Strategies, UNCTAD

*Aven, Mr Peter, President, Alpha Bank of Russia

*Bank of England, The Rt Hon Sir Edward George, Governor, and Mr Mervyn King, Deputy Governor for Monetary Policy

*Bendookidze, Mr Kakha, Chief Executive Officer, United Heavy Machinery, Russia

*BP plc, Lord Browne of Madingley, Group Chief Executive

*Brittan, Sir Samuel, *Financial Times*

*Buiter, Mr Willem, Chief Economist, European Bank for Reconstruction and Development

*Bulmer-Thomas, Professor Victor, Director, Royal Institute of International Affairs

*CAFOD, Mr Barry Coates, Director

*Christian Aid, Mr Mark Curtis, Head of Global Advocacy Team

*Commonwealth, His Excellency the Rt Hon Donald McKinnon, Secretary General, and Dr Indrajit Coomaraswamy, Director of Economic Affairs

*Confederation of British Industry, Mr Ian McCafferty, Director-Economics, and Mr Andy Scott, Director-International

*Coyle, Ms Diane, Managing Director, Enlightenment Economics

*Crocket, Mr Andrew, General Manager, Bank for International Settlements

*DHL, Mr David Coles, Managing Director, and Dr Axel Gietz, Corporate Affairs Director

*Desai, Lord, Director, Centre of Global Study of Governance, London School of Economics

*Engineering Employers' Federation, Mr Martin Temple, Director-General, Mr Stephen Radley, Chief Economist, and Miss Lee Hopley, Economist

*European Commission, Commissioner Solbes Mira, Commissioner for Economic and Monetary Affairs

Fair World Project

*Financial Services Authority, Sir Howard Davies, Chairman, Mr Michael Foot, Managing Director,and Mr Andrew Sykes, Head of Department

*FitzGerald, Mr Niall, Chairman and Chief Executive Officer, Unilever plc

Forum for Stable Currencies

Foundation for the Economics of Sustainability (Feasta)

*Friends of the Earth, Mr Matt Philips, Senior Campaigner, Ms Ronnie Hall and Mrs Simone Lovera

*Greenaway, Professor David, Professor of Economics and Director of the Leverhulme Centre for Research on Globalisation and Economic Policy, University of Nottingham

*Grieve Smith, Mr John, Fellow of Robinson College, Cambridge

Hattersley, Mr Martin, Former President, Economics Society of Northern Alberta

Henry George Foundation

*Holtham, Mr Gerald, Chief Investment Officer, Morley Fund Management

*HM Treasury, The Rt Hon Gordon Brown, Chancellor of the Exchequer, and Mr John Cunliffe, Managing Director, International Finance, Mr Stephen Pickford, Director, International Finance, and Mr Ed Balls, Chief Economic Adviser

*International Development, Department for, The Rt Hon Clare Short MP, Secretary of State

*International Labour Organisation, Mr Gerry Rogers, Director, Policy Integration Department, and Mr Steve Pursey, Senior Advisor to the Director-General

*King, Mr Stephen, Managing Director, Economics, HSBC

*Kitson, Mr Michael, Judge Institute of Management Studies, University of Cambridge, and the Cambridge-MIT Institute

Knight, Mr Tim

*Krugman, Professor Paul, Professor of Economics, Princeton University

*Large, Sir Andrew, Deputy Chairman, Barclays Group plc

*Lucas MEP, Dr Caroline, Green Member of the European Parliament for SE England

*McKinnon, Professor Ronald, Senior Fellow of Stanford Institute of Economic Policy

*Mboweni, Mr Tito, Governor, South African Reserve Bank

Mittelstadt, Mr Robert

*Monbiot, Mr George, Columnist, *The Guardian*

*Officials of the Department of Trade and Industry HM Treasury, the Foreign and Commonwealth Office and the Department for International Development

*Palliser, Sir Michael, Vice-Chairman, Salzburg Seminar

*Panitchpakdi, His Excellency Dr Supachai, Director-General Designate, World Trade Organisation

Resource Use Institute Ltd, Mr Farel Bradbury

Rikowski, Mr Glenn

Rikowski, Ms Ruth

Robertson, Mr James

Roddick OBE, Ms Anita

*Rowthorn, Professor Robert, Fellow of King's College, Cambridge

Royal Academy of Engineering

Royal Society of Edinburgh

*Save the Children, Mr John Hilary, Trade Policy Adviser

*Schmidt, Mr Rodney, Principal Researcher, North South Institute, Canada

Shared Capitalism Institute, Mr Jeff Gates

*Soros, Mr George, President and Chairman of Soros Fund Management LLC

*Stern, Mr Nicholas, Chief Economist and Senior Vice President, World Bank

*Stiglitz, Professor Joseph E, Columbia University

Sustento, Mr Rafiq Manji

*Sutherland, Mr Peter, Partner and Chairman, Goldman Sachs International

*Sykes, Sir Richard Chairman, GlaxoSmithKline plc

*Taylor MP, Mr Matthew Liberal Democrat Treasury Spokesperson

*Trade and Industry, Department of, The Rt Hon Patricia Hewitt, Secretary of State

*Trades Union Congress, Mr John Monks, General Secretary, Mr Ian Brinkley, Senior Policy Officer, Economic and Social Affairs Department, and Ms Sharon James, Policy Officer, International Department

*UNCTAD, Mr Carlos Fortin, Deputy Secretary-General, Mr Abdelaziz Megzari, Officer-in-Charge, Division on International Trade in Goods and Services, and Commodities, Mr Richard Kozul-Wright, Economic Affairs Officer, Mr Heiner Flassbeck, Division on Globalisation and Development

Strategies, Mr Karl Sauvant, Director, Division on Investment, Technology and Enterprise Development, Ms Anh-Nga Tran-Nguyen, Head, Investment Issues Analysis Branch, Division on Investment, Technology and Enterprise Development, Mr Habib Ouane, Office of the Special Coordinator for LDCs, Mr Taffere Tesfachew, Special Assistant to the Deputy Secretary-General, Executive Direction and Management, and Mr Charles G Gore, Senior Economic Affairs Officer, Office of the Special Coordinator for LDCs

*Visco, Mr Ignazio, Economics Department and Chief Economist, Organisation for Economic Co-operation and Development

*Volcker, Mr Paul, former US Federal Reserve Chairman

*War on Want, Ms Angela Royal, Executive Director, and Mr Rob Cartridge, Campaigns Director

*World Development Movement, Mr Barry Coates, Director

*World Health Organisation, Dr Gro Harlem Brundtland, Director-General, Mr Denis Aitken, Special Policy Advisor, Ms Namita Pradhan, Policy Analyst, and Dr A Asanoa-Baah, Ex-Director, Governing Bodies and External Relations

World Humanity Action Trust

*World Trade Organisation, Mr Mike Moore, Director-General, Mr Adrian Otten, Director, Intellectual Property Division, Mr John Kingery, Counsellor, Mr Chiedyu Osakwe, Director, Technical Co-operation Division, Mr David Porter, Special Adviser to the Director-General's Office, Mr Evan Rogerson, Director, Council and TNC Division, and Mr Patrick Rata, Director-General's Office

*Wolf, Mr Martin, Columnist, *Financial Times*

Women's International League for Peace and Freedom (WILPF), UK Section

Wright, Mr Jeremy

Zacchaeus 2000 Trust, Reverend Paul Nicholson

Contributions were also received from the following. They have not been printed, but are available for inspection at the House of Lords Record Office (020 7219 5314).

Christian Council for Monetary Justice, Canon Peter Challen, Chairman

International Simultaneous Policy Organisation, Mr John Bunzl

Mearns, Mr Damien

Oxfam

WWF-UK

APPENDIX 3

Call for Evidence

The Economic Affairs Committee was set up on 7 March 2001, and reappointed on 28 June 2001. It has wide-ranging terms of reference: "*to consider economic affairs*". The first principal inquiry to be undertaken by the Committee will be an investigation into what is called *the global economy*. Initially, the important part of the inquiry will be to clarify what is meant by "globalisation" and therefore to consider broad questions along the following lines:

- How should economic globalisation be defined? Does it mean anything different from an open and integrated world economy? If so, what?
- Is globalisation a new phenomenon or just a new label?
- Should the main focus be what is called the real economy or the financial economy?
- How does globalisation impact on the UK economy, and how does it impact on UK national and international policy making?
- How does globalisation affect the major world economic institutions?
- Does globalisation require regulation and, if so, is this possible at the national level, or will the need for international regulation be reinforced?

It is anticipated that these broad questions will give rise to a large number of more detailed questions, spanning both issues relating to the real economy and financial issues. These will include:

1. What are the driving forces causing globalisation? Are they chiefly real or financial?
2. How are firms changing their business methods and the international location of their activities? What are the implications of any change?
3. Has globalisation affected goods and services differently?
4. How is globalisation affecting employment (a) in the UK, (b) more generally in the advanced world, and (c) in the developing world? What are the implications for skill structure, job security and income distribution?
5. Who are the gainers and who are the losers?
6. How will globalisation affect product market competition and consumer choice? How dominant are the transnational corporations? Is their dominance growing?
7. What is the connection between globalisation and the communications revolution?
8. What is the connection between globalisation and labour mobility?
9. Does it matter to a nation who owns its companies, including UK banks and financial markets such as the London Stock Exchange?
10. How significant is global banking? What role should the government play in determining the capital adequacy of international banks present in London?
11. Are capital and money markets more interdependent than before? Are international capital flows too volatile? Is international financial instability increasing? Has market uncertainty increased?
12. Is it important that individuals (and companies and pension funds) should be allowed unlimited access to international capital markets?
13. What UK government policy responses are required in areas including education and infrastructure investments, social safety nets, and the regulation of financial and other markets?

14. Bearing in mind the last of the broad questions listed above, what part should international organisations, such as the IMF, the World Bank, the WTO, play in the regulation of globalisation? Should their roles be changed in any respect?

23 July 2001

APPENDIX 4

Letter from Mr Glyn T. Davies, Deputy Chief of Mission of the United States Embassy, London, to the Chairman dated 16 October 2002

This letter is in reference to the invitation by your committee for the United States to submit evidence on the economic impact of globalization. The evidence was to take the form of written answers to questions submitted by the Committee, and was to form part of the report of the Committee's inquiry.

I very much regret to inform you that the United States will be unable to provide written responses to the questions that the Committee has posed. In spite of efforts on the part of the embassy, my authorities in Washington have advised me that they will be unable to approve a written submission on this topic. Our lawyers have made it clear that going on record before the legislative branch of another government is extremely difficult for us. If we were to agree to do so on one occasion, we would find ourselves obliged to agree to do so whenever we were asked. We therefore need to be extremely cautious in taking actions that would seem to create a precedent. I know that in certain circumstance in the past we have provided evidence to the Parliament. In fact, it is largely because of the increase in requests of this sort that my authorities have decided to draw the line, albeit reluctantly. Additionally , given the broad nature of the topic, it would be difficult for us to explain our stance in a way that could not be misrepresented or taken out of context, not by the House of Lords, but by other who might read the report.

My staff has already spoken to Christine Salmon, the Clerk to the Committee, and informed her that we will be unable to provide written evidence. She understands that we are constrained by our authorities in Washington. We would be willing to appear before the committee informally and off the record to discuss this issue, if the Committee would find it useful. I am sorry for any inconvenience this decision may have caused you and the Committee.

Glyn T. Davies
Deputy Chief of Mission

APPENDIX 5

Note on Globalisation prepared for the Select Committee on Economic Affairs by Mr Martin Stewart and Professor Anthony Venables, London School of Economics

This note outlines some of the economic changes associated with globalisation. Section 1 addresses the forces driving globalisation – changes in trade policy and technology. Section 2 looks at the consequent changes in trade flows, and section 3 turns to foreign direct investment. The note does not attempt an assessment of the effects of globalisation, merely offering an introduction to some of the driving forces and direct impacts.

1. Driving forces

Economic transactions of all sorts – trade flows, investment flows, technology transfers – depend on distance, and are much lower between two distant countries than between two close ones. For example, doubling distance cuts trade flows by more than half so, on average, two countries 8000km apart only have 7% of the bilateral trade volume of two countries 1000km apart. However, both policy changes (tariffs and trade barriers) and technical changes (in transport and new technologies) have contributed to a substantial decline in the costs of distance and in the costs of crossing most borders.

1.1 Tariffs and trade barriers

Tariff and other trade barriers have been reduced by a series of successful GATT/WTO trade rounds, by unilateral trade liberalisations, and by the formation of regional integration agreements. Table 1 illustrates how developed countries' average tariffs on industrial products have been dramatically cut in the postwar period from an average of about 40 percent in the 1940s to less than 4 percent today. Average agricultural tariffs in 1999 stood at 17.3 percent in the EU and 11 percent in the US, although in the Uruguay Round developed countries agreed to an average reduction of 36 percent and developing countries agreed to a 24 percent cut over a 10-year period (WTO, 2001). Since the formation of the WTO in 1995, negotiations have been further expanded to incorporate trade in services.

Table 1: Industrial countries' import tariffs on manufactures

Period		Average tariff rates (%)
1940s	Pre-GATT/WTO	40.0
Late 1970s	Pre-Tokyo Round	7.1
Late 1980s	Post-Tokyo Round	4.7
Late 1990s	Post-Uruguay Round	3.8

sources: WTO, Kenen (1994)

Alongside multilateral reductions in tariffs, there has been a move towards increased regionalisation. This trend has been especially pronounced in the past decade or so, with developments in Europe (EU enlargement and bilateral agreements), the Americas (NAFTA, MERCOSUR and numerous bilaterals), Asia (development of the ASEAN free trade area, the South Asian free trade area, and APEC), and Africa (the formation of new regional agreements and the rejuvenation of old ones). As of mid-2000, 114 RIA's had been notified to the WTO and were in effect. More than one-third of world trade now takes place within such agreements, and almost 60 percent of world trade if the Asia Pacific Economic Cooperation (APEC) is included (World Bank, 2000).

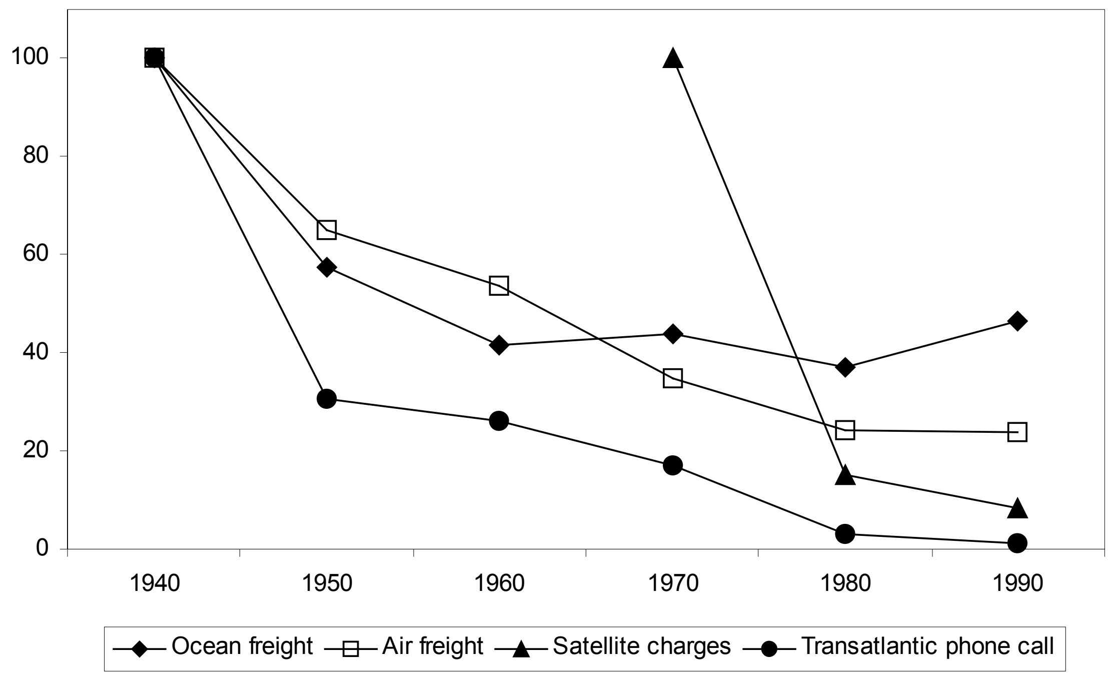
Other measures in the policy environment – liberalisation of foreign ownership restrictions, investment agreements, and simplification of frontier procedures – have had significant effects on trade and investment. For example, after China changed its policy stance toward foreign investors in 1982, foreign direct investment (FDI) as a percent of GDP rose from what was effectively a zero base to 4 percent in 1999. Meanwhile, India's share stagnated at about 0.05 percent until it started economic liberalisations in 1999, then rising to 0.5 percent by 1999.

1.2 Transport costs

Transport costs have fallen in recent decades, but remain important. In the mid-1990s, freight expenditure for the US was only 3.8 percent of the value of imports, but was higher for many other countries; for example, equivalent numbers for Brazil and Paraguay are 7.3 percent and 13.3 percent (Hummels 1999, from customs data). These values incorporate the fact that most trade is with countries that are geographically close, and in goods that have relatively low transport costs. Looking at transport costs unweighted by trade volumes gives much higher numbers. The median freight charge between all country pairs for which data is available is 28 percent of the value of imports.

Technical change has reduced the costs of transport and slashed the cost of communications. Estimates of the changes in these costs are given in Figure 1. This shows the continuing rapid fall in the costs of transmitting digital information, and declines in the costs of ocean shipping and airfreight that appeared to bottom out in the 1960s and 1980s respectively. These figures almost certainly understate the true fall in trade costs, which include not only freight and insurance charges, but also the costs of time in transit. Hummels (2000) estimates that the cost of time in transit is around 0.3 percent of the value of goods shipped *per day,* around 30 times larger than the interest charge alone. In this case the speeding up of ocean shipping (due to containerisation and faster vessels) combined with the rising share of airfreight, has cut transport costs on US imports over the post war period by an amount equal to an 11-12 percent tariff reduction.

Figure 1: Transport versus Communication costs



source: Baldwin and Martin (1999)

1.3 Digital trade

New information and communications technologies (ICT) have made a class of activities 'weightless' – they can be digitised and shipped at essentially zero cost. These include software and media products, and 'IT-enabled services' such as call centres, some accounting services, medical transcription, and so on.

Although these activities have expanded rapidly, they still only account for a relatively small share of world GDP. World Bank data puts the figure at just under 7% in 1999, which includes spending on information technology products and telecommunications. The OECD estimates that all software and computer related services accounted for 2.7 percent of US GDP in 1996, and half that figure in other OECD countries. Software products and computer services combined accounted for just 0.8 percent of US exports in 1996 (OECD 1999). Even in such a fundamentally weightless activity as banking, it is estimated that only some 17-24 percent of the cost base of banks can be outsourced (Economist, May 5th 2001). Another way to get a sense of the magnitude of these activities is to look at the recent experience of the highly successful Indian software and IT-enabled services sectors. The value of all Indian software and related services output in 2000 was around $8bn, with exports of $4bn. Indian IT-enabled services exports to the US are $0.26bn, predicted to grow to $4bn by 2005 (Economist, May 5th 2001). These are substantial size activities compared to total Indian exports of $45bn in 2000, but are less than 1 percent of total US imports of around $950bn.

Although it is difficult to quantify the share of the economy that is, or is likely to become, weightless, one fundamental point can be made. As activities are codified and digitised, not only can they be moved costlessly through space, but also they are typically subject to very large productivity increases and price reductions. Thus, the effect of ICT on airline ticketing (for example) has been primarily to replace labour with computer equipment, and only secondarily to allow remaining workers to be employed in India rather than the US or Europe. Technology that can capture voice or handwriting may well make the booming Indian medical transcription business obsolete.

1.4 Costs of managing remote operations (production networks)

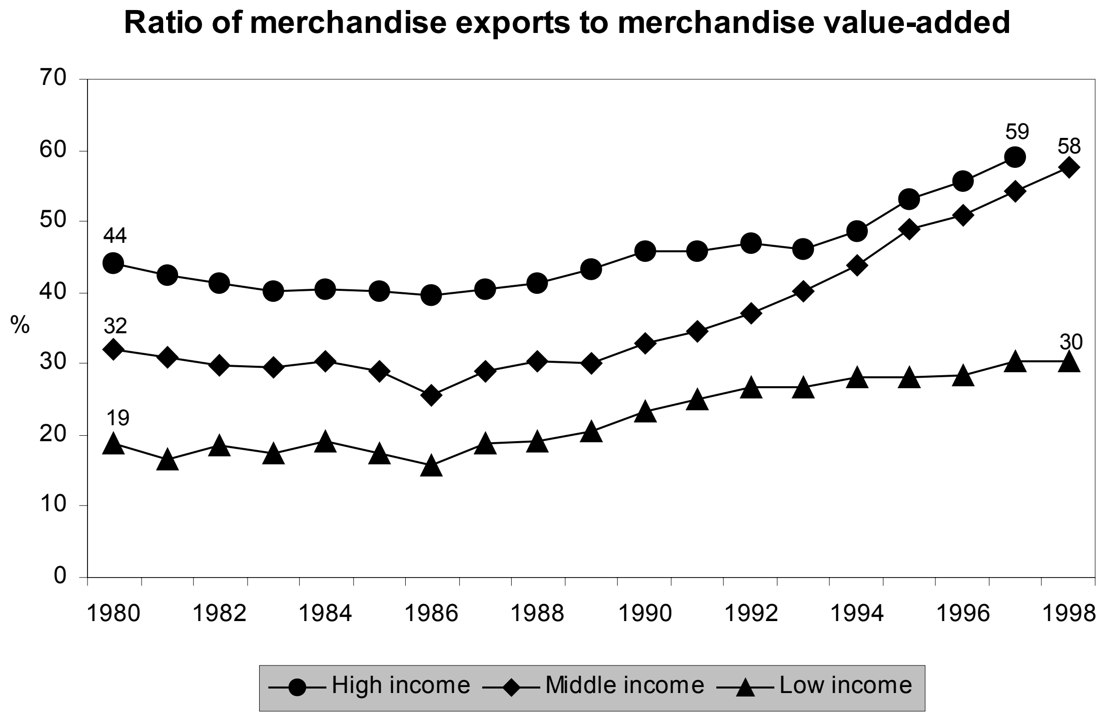
ICT has also reduced the cost of managing and monitoring supply chains, enabling firms to better ‘fragment’ their production processes. This fragmentation has been partly organisational (sub-contracting within a country) and partly geographical (purchasing from or producing in multiple locations). The extent to which this has become possible varies widely across sectors. Information concerning routine operations can be codified and digitised, allowing remote operation. However, for many activities information transmission still requires face-to-face contact and the difficulties of writing and enforcing fully specified contracts puts a premium on keeping many activities within the firm.

2. Trade flows

The cost changes outlined above have led to changes in trade and investment flows, which we outline in this and the next section.

2.1 The growth of trade

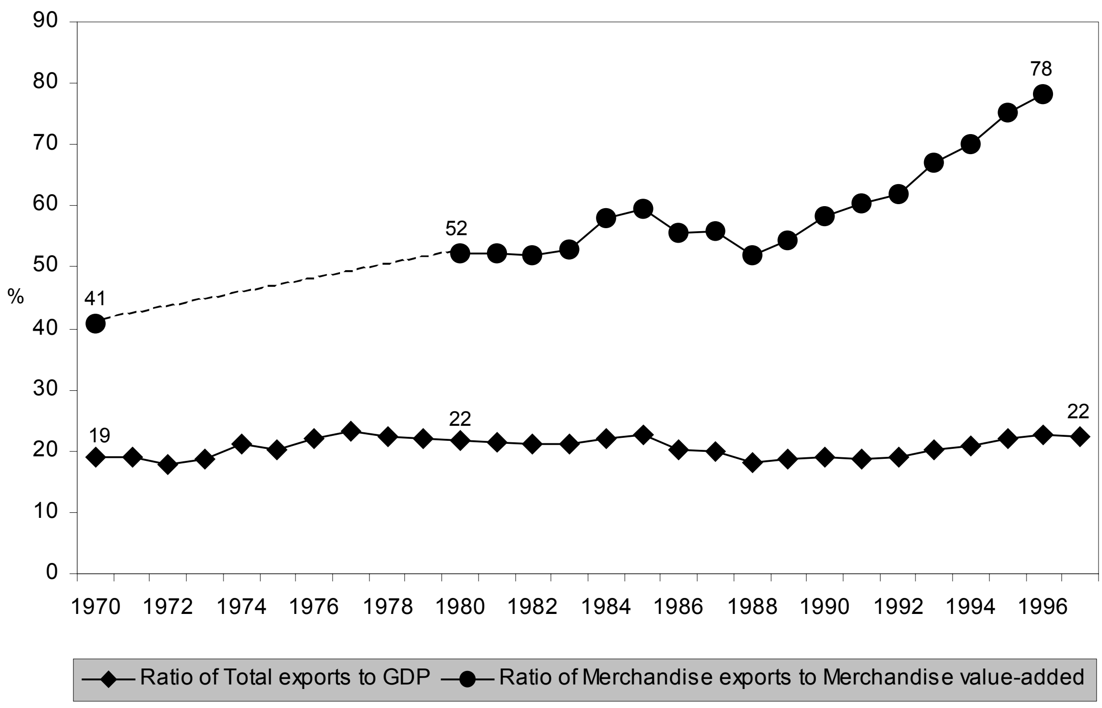
Trade in goods in both industrial and developing countries has grown consistently faster than GDP. In Figure 2 the upper panel gives the ratio of exports to GDP for high-, middle-, and low-income countries from 1980. There has been a substantial increase in this ratio for low-income countries, and a modest increase for high-income countries. Increases in trade to income ratios are modest largely because of the increasing importance in GDP of service sector activities, which are largely non-tradable. An alternative measure of the trends in goods trade is the ratio of merchandise exports to merchandise value-added (merchandise being agriculture, mining and manufacturing). This is reported in the lower panel of Figure 2, and indicates a much more substantial increase. For high-income economies this ratio grew from 44 percent to 59 percent over the period. For middle-income countries the increase was from 32 percent to 58 percent, and low-income from 19 percent to 30 percent.



sources: NBER World Trade Database, World Bank World Development Indicators

The figures for the UK are broadly in line with the trends in high-income countries as a whole – a slow-growing trade to GDP ratio but faster growth in the merchandise trade ratio (see Figure 3). The total trade ratio grew from 22 percent in 1970 to 27 percent in 1980, and it has remained relatively stable at that level since. The merchandise trade ratio, however, grew from 41 percent in 1970 to 53 percent in 1980 and to 71 percent in 1999

Figure 3: UK Trade to income ratios



sources: NBER World Trade Database, World Bank World Development Indicators, Feenstra (1988)

2.2 Directions of trade

As trade volumes have increased so there have been changes in the geographical sourcing of imports and direction of exports. Table 2 indicates the substantial increase in high-income countries' imports of merchandise from developing countries, expressed relative to high-income countries' GDP. The share has more than doubled (from 0.48 percent to 1.22 percent), but remains extremely small. Imports from other high-income countries are over ten times larger, although the rate of increase in this share is much less.

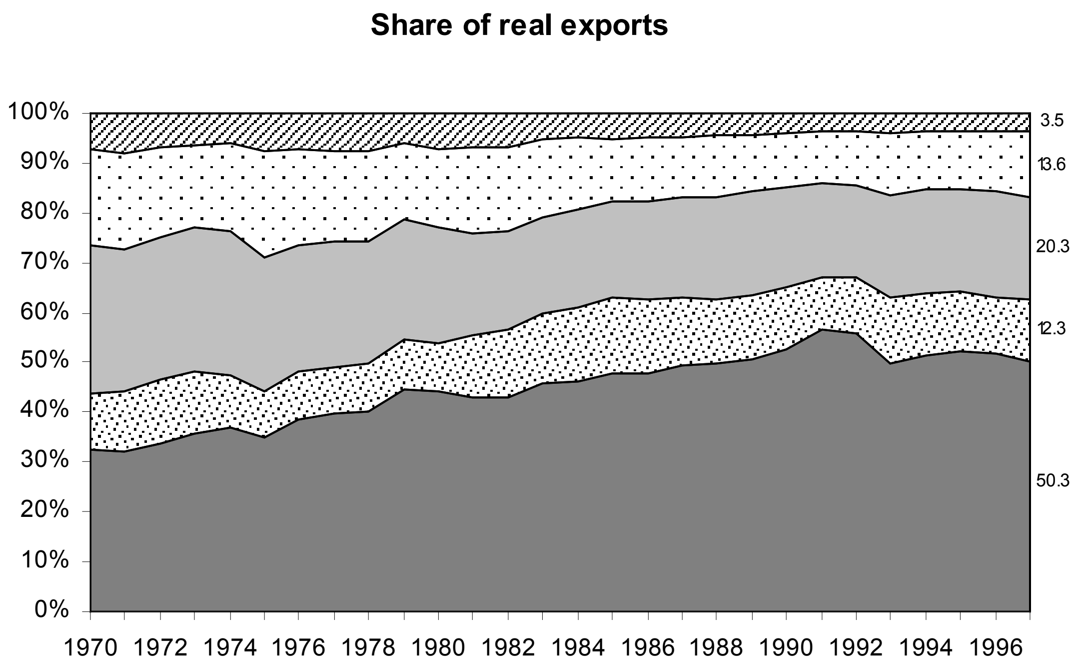
Table 2: Sources of high-income countries' imports of merchandise (percent of high-income countries' GDP)

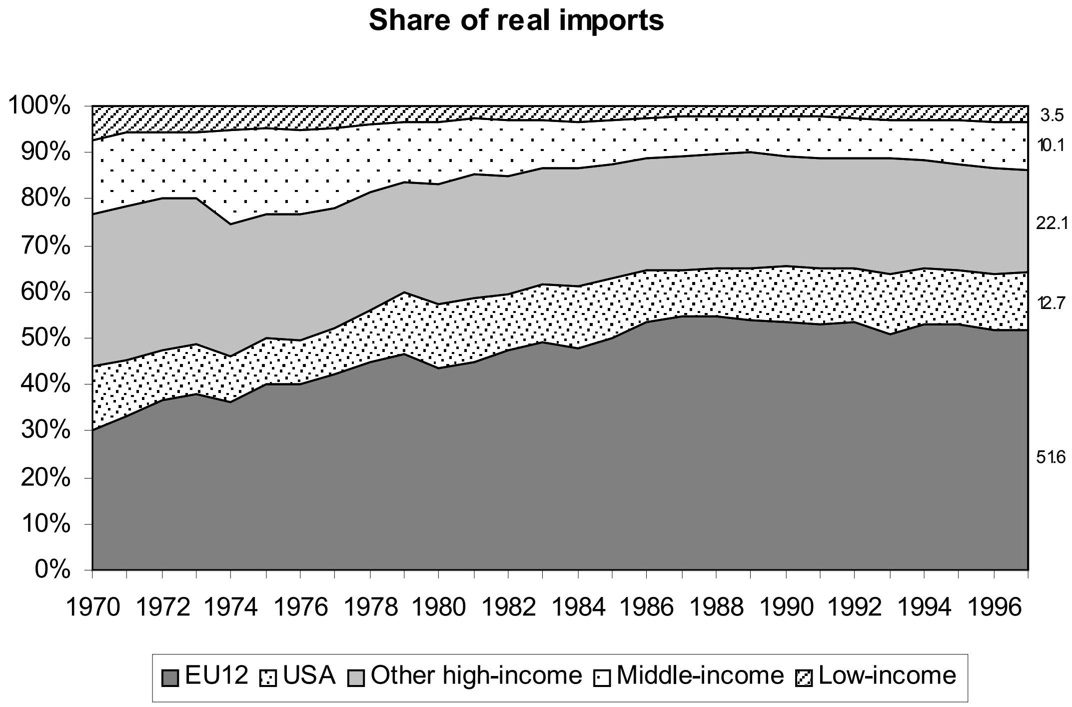
Year	Low-income countries	Middle-income countries	High-income countries
1970	0.48	1.67	8.55
1997	1.22	3.03	14.10

source: NBER World Trade Database, World Bank World Development Indicators

Figure 4 looks at the geographical pattern of UK trade in more detail. The most significant development is the reorientation of UK trade towards EU partners. Less than one-third of UK exports and imports in the early 1970s were to countries that comprised the EU12 countries (the 1990 membership), yet by the late 1990s this share had risen to over one-half. The share of total trade with the US has remained relatively stable over the same period at around 13 percent, while the share of other high-income countries fell from 31 percent in 1970 to 21 percent in 1997. Middle-income countries' share fell from 18 percent to 12 percent, and that of low-income countries fell from 7 percent to 3.5 percent.

Figure 4: Share of UK trade





source: NBER World Trade Database

2.3 Commodity composition of trade

The most rapidly growing elements of trade have been manufactures and services. From 1980-1998 real world trade in manufactures increased at an average 6.3 percent per annum, trade in services increased at 6.6 percent per annum and primary products (agricultural raw materials, food, ores and metals, fuel) at 2.8 percent per annum. The shares of these sectors in trade flows is given in Figure 5, both for the world as a whole and for UK exports and imports. Over 60 percent of world trade is now in manufactures, as it is for the UK's exports and imports. Services account for almost 21 percent of world trade, a similar proportion of UK imports and just over 28 percent of UK exports.

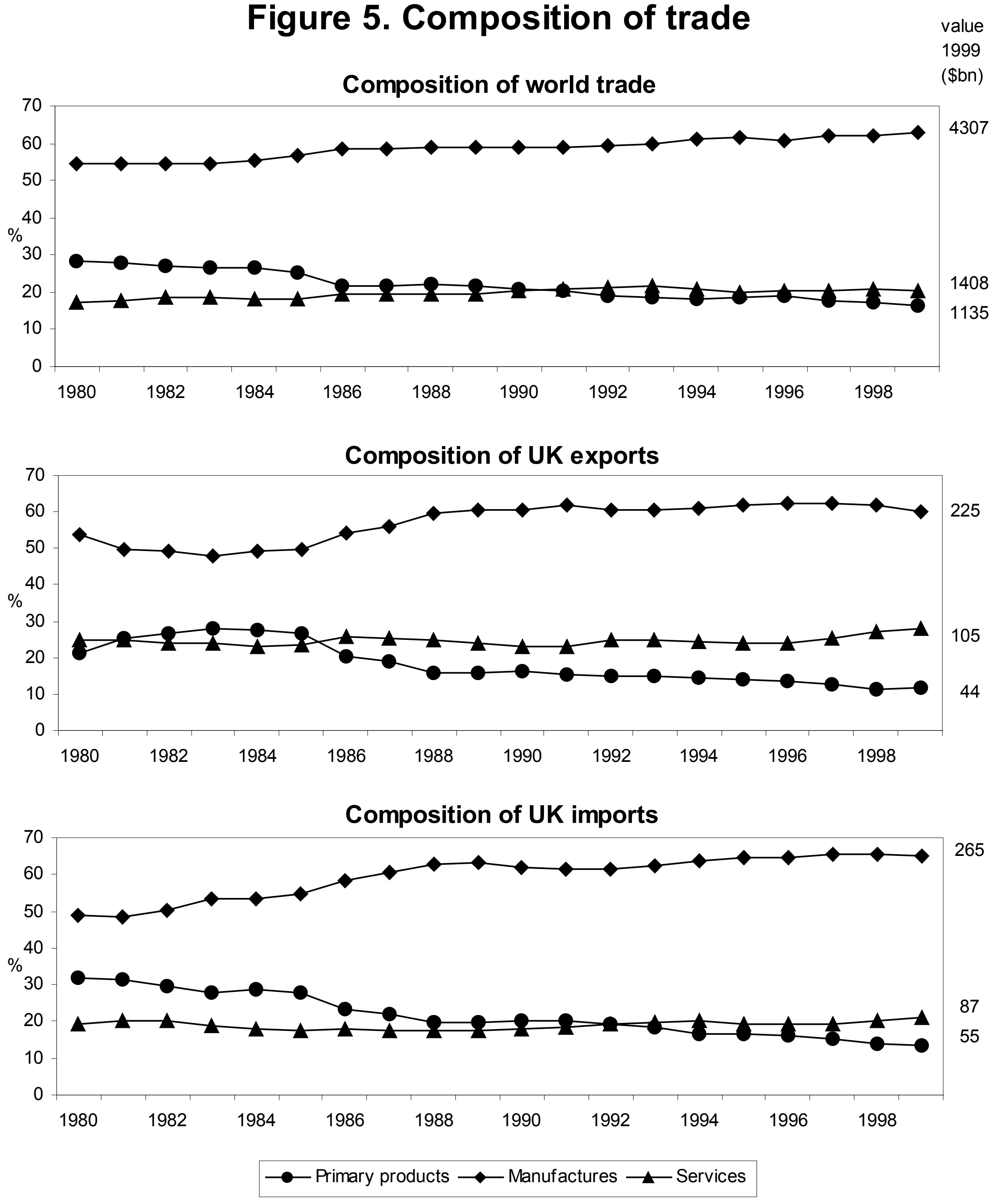
2.4 Qualitative changes

A comparison is often made with trade to income ratios pre-1913, a period of close international integration founded on the technologies of the railroad, steamship and telegraph and on open trade policy. For some countries, these ratios were higher then than they are today – for the UK, the ratio of trade to GDP in 1913 was 29.8 percent compared to 22 percent in 1995, and the ratio of merchandise trade to merchandise value-added was 76.3 percent compared to 78 percent in 1995. However, present day trade is different in several respects.

First, it involves higher levels of 'intra-industry' trade, rather than 'inter-industry' trade. Prior to 1913 the bulk of trade was inter-industry, as countries exchanged the products of one industry for those of another – and often manufactured goods for primary goods. For the last 50 years there has been a steady increase in intra-industry trade, as countries both import and export products from the same industry – for example, the exchange of one model of car for another model.

Second, over the last 20 years or so there has been rapid growth of trade in parts and components as firms increase their outsourcing and become involved in international production networks. Yeats (1998) estimates that 30 percent of world trade in manufactures is trade in components rather than final products. Hummels, Ishii and Yi (2001) measure trade flows that cross borders multiple times, such as when a country imports a component and then re-exports it embodied in a downstream product. They find that (for 10 OECD countries) the share of imported value-added in exports rose by a third between 1970 and 1990, reaching 21 percent of export value. Much of the growth of this vertically specialised trade is concentrated in a few countries neighbouring existing centres – in Asia, Europe and America.

Figure 5. Composition of trade



source: World Bank World Development Indicators

3. Foreign direct investment

Accompanying trade growth has been even more rapid growth of foreign direct investment (FDI). Arguably, FDI is a more important mechanism of international interaction than is trade; the overseas production of affiliates of US firms is now three times larger than total US exports. Of course, trade and investment are inter-related; in the mid 1990s, 66 percent of total US exports were undertaken by multinational firms, and 45 percent of these exports went directly to affiliate companies

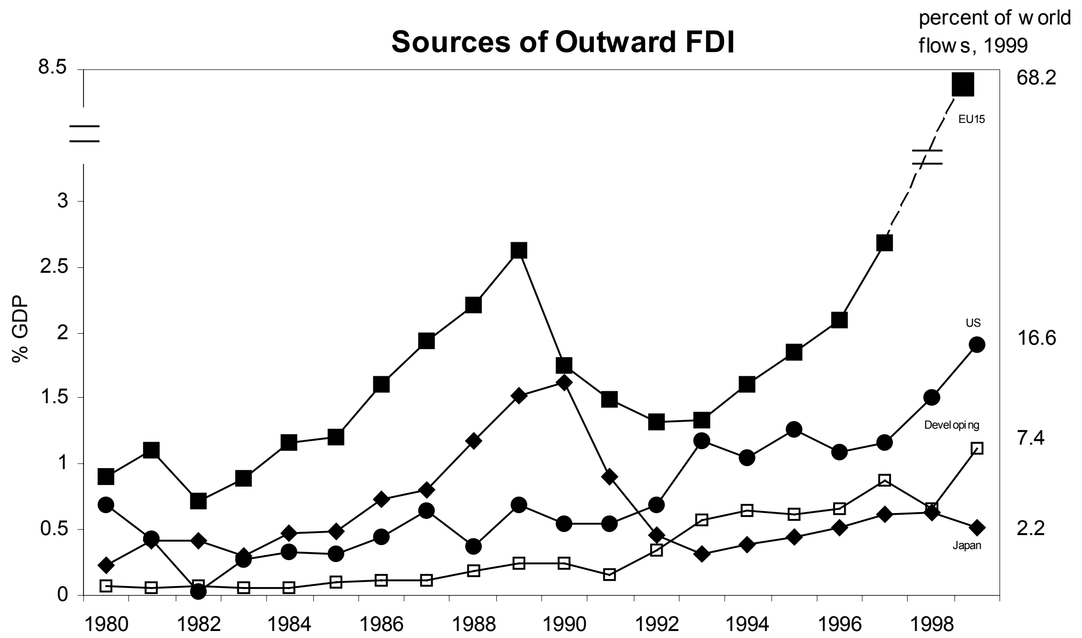
3.1 The growth of foreign direct investment

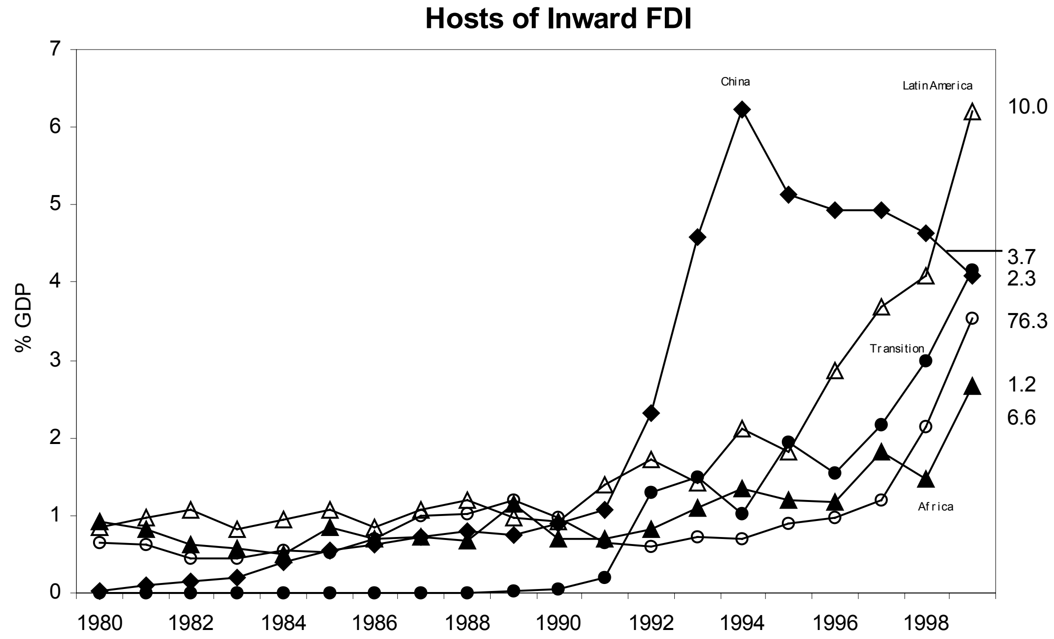
FDI has grown much faster than either trade or income; whereas worldwide nominal GDP increased at a rate of 5.3 percent per year between 1980 and 1999 and worldwide imports at 5.6 percent, worldwide nominal inflows of FDI increased at 16.1 percent. These figures comprise the financing of new investments, retained earnings of affiliates, and cross border mergers and acquisitions. Mergers and acquisitions are a large proportion of the whole (especially among the advanced countries), with their value constituting 49 percent of total FDI flows in 1996 and 58 percent in 1997 (UNCTAD, 1998).

The predominant sources of supply of FDI are high-income countries which, in 1999, controlled 86.5 percent of worldwide FDI stock, compared to 13.5 percent for the developing and transition countries. FDI flows are given in Figure 6, by source (top panel) and destination (lower panel). As can be seen in the top panel, recent FDI flows show some decline in the dominance of the high-income countries; whereas during the 1980s they accounted for almost 94 percent of total FDI outflows, this share had fallen to 88.7 percent in the 1990s. Within advanced countries, the major single investor is the US, which in 1999 controlled 23.9 percent of the world's FDI stock, compared to 47.9 percent for all the European Union 15, and less than 4 percent for Japan. Japanese and European flows boomed during the late 1980s, although they have now fallen back to a position broadly in line with existing stocks.

Most of the difference between the advanced and developing countries is accounted for by sheer economic size, and the difference in outflows relative to GDP is perhaps less than might be expected. Outward flows from the advanced countries averaged 1.8 percent of their GDP in the 1990s, with the EU having much the highest rate (almost 3 percent of GDP), largely on the basis of intra-EU investments. For developing countries, outward FDI flows averaged 0.6 percent of their GDP during the 1990s, compared to 0.1 percent in the preceding decade, a six-fold increase.

Figure 6: Source and Destination of FDI flows





sources: UNCTAD FDI/TNC Database, World Bank

Turning to the destination of FDI in the bottom panel of Figure 6, most FDI goes to the advanced industrial countries. Since 1980, the developed countries received fully 69 percent of FDI flows. Inevitably most of this is advanced-to-advanced country FDI. Of the G-7 countries, France, Germany, Italy and the UK sent more than three-quarters of their 1997 FDI flows to the rest of the OECD; Canada, Japan, and the US sent more than 60 percent. This pattern of reciprocal FDI shows up strongly at the industry level as well, with a large share of flows appearing as intra-industry investment.

While intra-OECD investment and intra-industry investment within the OECD have been long-established facts, an emerging trend is the rise of FDI to developing countries. The share of worldwide FDI received by the developing and transition economies jumped from 22.4 percent in the 1980s, to over 30 percent in the 1990s. The picture is more dramatic if we look at FDI relative to the size of the host country's economy, as shown in the bottom panel of Figure 6. During the 1980s, advanced countries received FDI inflows at an average annual rate of 0.9 percent of their GDP, while developing and transition countries received FDI at an average annual rate of less than 0.1 percent of their GDP. By the next decade, the inflow rate of developing and transition countries had risen six-fold to almost 0.6 percent of GDP, while that for the advanced countries had only doubled to 1.8 percent of GDP.

Among developing countries, the distribution of FDI is quite uneven. Only 12 countries accounted for two-thirds of all inward flows during the 1990s (Argentina, Bermuda, Brazil, Chile, China, Hong Kong, Indonesia, Malaysia, Mexico, Poland, Singapore, Thailand). China alone accounts for much of the increase in flows to developing countries, with its share of world total FDI flows rising from 1.6 percent during the 1980s to over 7 percent in the 1990s. In nominal dollar terms, inward direct investment to China increased from $57 million in 1980 to $40.3 billion in 1999. The source of all these flows, about four percent of China's GDP in 1999, remains hotly debated. The main sources are considered to be Chinese business groups resident in Asia, Chinese businesses resident in China that send their money out and then bring it back to get certain benefits available to foreign investors (the so-called 'round trippers'), and investors from the advanced industrial economies.

In contrast, all of sub-Saharan Africa, including South Africa, received an annual average of 3.6 percent of all flows to developing and transition countries in the 1990s, a decrease of almost 2.5 percentage points from the annual average of 6.1 percent during the previous decade. Relative to world inflows, sub-Saharan Africa's share fell less sharply from around 1.4 percent in the 1980s, to around 1.1 percent in the 1990s. This is also reflected in its inflows of FDI relative to host country income, as in Figure 6, where we see some increase in FDI to Africa, but at levels dwarfed by inflows to East Asia and Latin America.

3.2 What does FDI do?

An important distinction in the analysis of FDI is between 'horizontal' and 'vertical' investments. Horizontal occurs when FDI is essentially for the purposes of getting better market access. It takes the form of investments that duplicate facilities in the home country in order to sell to the host country, for example, plants in different countries assembling essentially the same car. Vertical occurs when firms split their production process, moving unskilled labour-intensive parts of the process to low wage countries, research-intensive parts to locations with large research communities, and so on.

Through most of the postwar period FDI was largely horizontal, almost all between high-income countries, although there was some 'tariff jumping' into low-income countries. Recent years, however, have seen rapid growth of vertical FDI, associated with production networks as discussed in section 2 above.

4 Conclusions.

This note has sketched some of the facts concerning the growth of trade and foreign direct investment during the current era of globalisation. Descriptions of continuing developments are reported annually in the World Bank's publication, Global Economic Prospects, and UNCTAD's World Investment Report.

22 November 2002

References

Baldwin, R.E, and P. Martin (1999), 'Two Waves of Globalisation: Superficial Similarity and Fundamental Differences' NBER Working Paper, 6904.

Dickens, P. (1998) *Global shift; transforming the world economy,* Chapmans, London.

Economist (May 5th 2001), 'Outsourcing to India'.

Feenstra, R.C (1998) 'Integration of trade and disintegration of production in the global economy', *Journal of Economic Perspectives*, 12, 31-50.

Hummels, D. (1999), 'Toward A Geography of Trade Costs', mimeo Purdue University, http://www.mgmt.purdue.edu/faculty/hummelsd/

Hummels, D. (2000), 'Time as a trade barrier', mimeo Purdue University, http://www.mgmt.purdue.edu/faculty/hummelsd/

Hummels, D., J. Ishii and K-M Yi (2001) 'The Nature and Growth of Vertical Specialization in World Trade' *Journal of International Economics*, 75-96.

Kenen, P.B. (1994) *The International Economy*, 3rd edition, Cambridge University Press, Cambridge

Krugman, P. and M. Obstfeld (1997) *International Economics: Theory and Policy*, Addison Wesley.

OECD (1999), 'The software sector; a statistical profile for selected OECD countries' OECD Paris.

Shatz, H. and A.J. Venables (2000) 'The geography of international investment', in Clark, G.L., M.S. Gertler and M.P. Feldman, *The Oxford Handbook of Economic Geography,* Oxford University Press, Oxford.

UNCTAD (1998), *World Investment report 1998; trends and determinants*, UN, New York and Geneva..

Venables, A.J. (2001) 'Geography and international inequalities; the impact of new technologies', paper prepared for Annual World Bank Conference on Development Economics, http://econ.lse.ac.uk/staff/ajv

Yeats, A. (1998) 'Just how big is global production sharing' World Bank Policy Research Working Paper no. 1871.

World Bank (2000) *Trade Blocs*, OUP & World Bank, Washington DC.

World Bank (2001) *Global Economic Prospects*, World Bank, Washington DC.

WTO (2001) *Annual Report*, World Trade Organisation.

APPENDIX 6

Abbreviations

BIS	Bank for International Settlements
BP plc	British Petroleum plc
CAFOD	Catholic Agency for Overseas Development
CBI	Confederation of British Industry
CEO	Chief Executive Officer
CSR	Corporate Social Responsibility
CTT	Capital Transactions Tax
EBRD	European Bank for Reconstruction and Development
EEF	Engineering Employers' Federation
EU	European Union
FDI	Foreign Direct Investment
FSA	Financial Services Authority
GATS	General Agreement on Trade in Services
GATT	General Agreement on Trade and Tariffs
GDP	Gross Domestic Product
GSK	GlaxoSmithKline
HSBC	Hong Kong and Shanghai Banking Corporation
IFI	International Financial Institution
ILO	International Labour Organisation
IMF	International Monetary Fund
IP	Intellectual Property
LSE	London School of Economics
M&A	Mergers and Acquisitions
MP	Member of Parliament
MEP	Member of the European Parliament
MFN	Most-Favoured Nation
MIT	Massachusetts Institute of Technology
MNC	Multinational Corporation
NGO	Non-Governmental Organisation
OECD	Organisation for Economic Co-operation and Development
R&D	Research and Development
SDRM	Sovereign Debt Restructuring Programme
TNC	Transnational Corporation
TRIPS	Trade-related Intellectual Property Rights
TUC	Trades Union Congress
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development

WDM	World Development Movement
WHO	World Health Organisation
WIPO	World Intellectual Property Organisation
WTO	World Trade Organisation