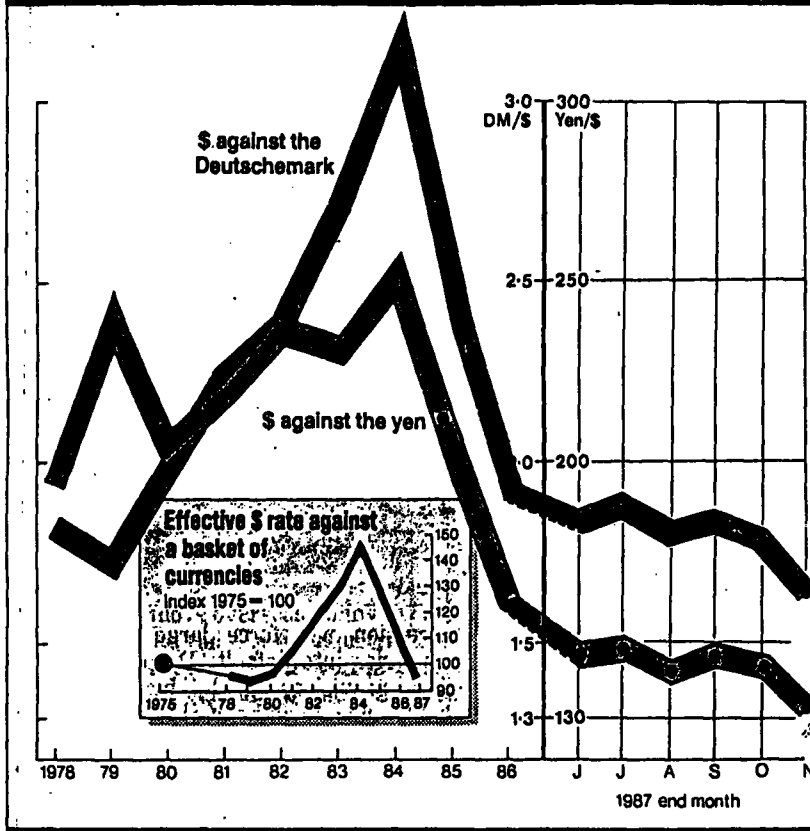
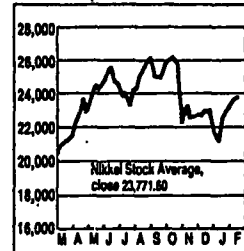


The rise and fall of the \$

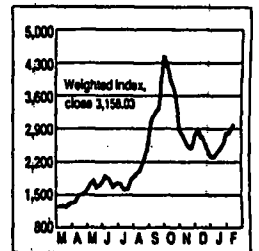


Asian Stock Market - Rises and Falls

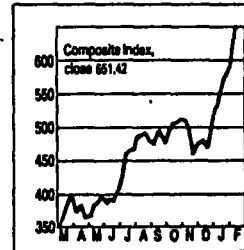
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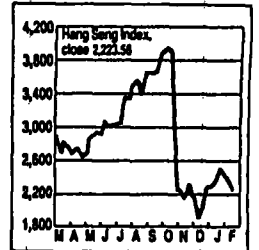
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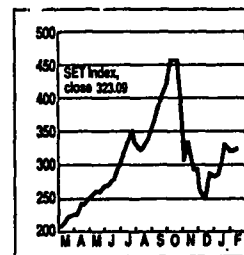
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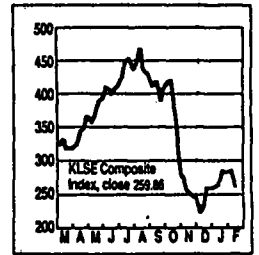
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THE GLOBAL ECONOMIC SYSTEM

The global economic system experienced significant changes over the first seven years of the 1980's. The Stock Market Crash begun in New York on October 19, 1987 brought into sharp focus the problems that had assailed this system in recent years. It appeared that the world was heading towards deep economic crisis.

On October 19, 1987 when the New York Dow Jones index declined a record 508 points or 22.6 percent, in a single day; (some \$ 500 billion in paper value, a sum equal to the entire GNP of France, disappeared into thin air) followed by equally severe drops on the London Stock Exchange, as well as in all other main financial centres of the world, it was believed that the collapse was imminent.

The immediate impact of the 'crash' was examined by many commentators. One typical American viewpoint stated emphatically "Although Wall Street may eventually stabilize, the tenor of the times will never be the same. What crashed was more than just the market. It was the Reagan Illusion: the idea that there could be a defense buildup and tax cuts without a price, that the country could live beyond its means indefinitely.... Now its the morning after, and the dream of painless prosperity has been punctured.... An economy that was once based on manufacturing might and inventive genius began pursuing wealth through mergers and takeovers and the creation of new "financial instruments". Fortunes were conjured out of thin air.... Just as

the crash of the space shuttle *Challenger* was a blow to America's sense of technological grace, so the crash of the market shattered its sense of financial security....."

Both the reasons for the October crash and the upheavals in the global economy in recent decades need to be examined in their historical perspective for a proper understanding of the situation. Few would doubt that there has been a growing crisis in the international economy from the 1970's, which intensified in the 1980's. The question is what the essential nature and characteristics of this crisis are. The 1950's and 1960's were what some economists have termed the "Golden Age" for the advanced capitalist countries. It appeared that they had found the recipe for constant growth and full employment. They appeared to be reaping the fruits of centuries of capital accumulation and they even advocated that poor coun-

tries by adopting a similar system would also be able to share in the benefits of the system.

But the 'system' had within it the seeds of its own deterioration. By the end of the 19th century Britain had relinquished its leadership of the international economic system to the United States. The two World Wars further secured this position for the US whose dominance was assured by the end of World War II. The 'system' provided the conditions for the international and transnational mobility of capital. This was clearly seen in the progressive global spread of US corporations, followed later by West European and Japanese firms. But, this growing economic and political strength of Western Europe and Japan was also a factor in the gradual erosion of the dominance of the United States, which was further weakened by the political changes since the 1950's in the developing world.

Leadership of this global system had shifted functionally from one nation to another at different times—from Venice and the Hanseatic League and the Iberian Peninsula upto the 16th century, to Holland in the 17th century, to Britain in the 18th and 19th centuries and there after to the US in the 20th century. There were thus a series of hegemonies, by a particular nation, during these centuries. The hegemonic leader naturally found itself obliged to maintain the system which made its leadership possible, and it has traditionally accepted the responsibility.

The United States emerged from two world wars as the global economic leader richer and technologically more advanced than any other single nation. Its leadership had to be sustained and extended and it is argued that the Cold War was used to achieve this.

World War II had helped to establish the political and military dominance of the US. By raising and maintaining fears of another war in Europe and by sometimes identifying the local Left with the Soviet block, it became possible to use a threat of totalitaria-

nism to ensure western cohesion around American leadership. The imaginary global war in which the developed market economy countries were dependent on American support was a way of upholding America's credibility and leadership of the system. This situation created the climate in the US for the extensive development of what has been termed 'Fordist' mass production techniques originating in the 1930's, with a product mix of automobiles, aircraft, military supplies and consumer durables, including the intensive use of oil.

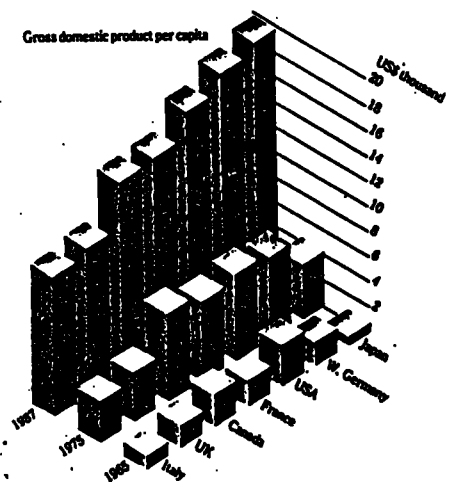
It became possible to promote this philosophy and system through the Cold War and ensure the cohesion of the advanced industrial world. The post war reconstruction assistance to Europe in the form of the Marshall Plan was a significant factor. It also enabled the United States to shape the international economic institutions such as IMF, IBRD, GATT, OECD etc, that were established after the war and were based on the support and consent of the other advanced industrial countries; with the socialist countries withdrawing or refusing to participate in them. Through these institutions was established what has been described as a "free" trade regime guaranteeing the "free" movement of goods and of capital. The freedom, however, was sharply constrained by the wishes of those who held economic and political power. Often economic and global political power was intertwined, and the 'free' flow became a rigged exercise. This "free" trade framework promoted the acceleration of what is termed 'economic interdependence' among developed market economies, and helped to contribute to rapid economic growth. Trade grew much faster than output as a whole. Between 1963 and 1973, trade among advanced capitalist countries quadrupled and these countries share of world trade rose from 48 percent to 62 percent of the total. Foreign investment also rose rapidly, with the global spread of multinational corporations and institutions being the most important form of capital and

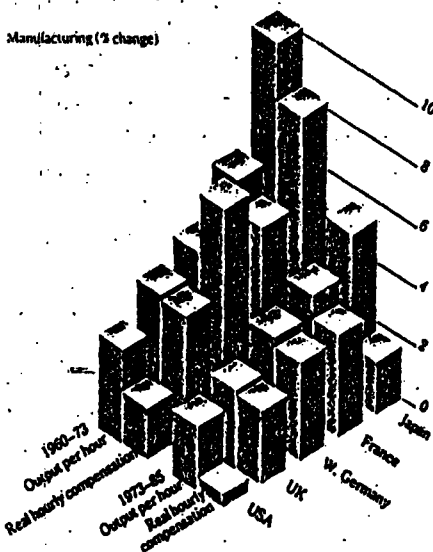
technology transfer.

The Cold War would not have been possible without a parallel process in the East. It sustained the Soviet political and military hegemony in Eastern Europe established during the Second World War. The conflict of the two economic systems turned out to be a struggle between capitalism and socialism; and although the Cold War was the outcome of the political struggles that occurred from the late 1940's between the two systems, organised economic interests no doubt contributed to it.

A more concrete way in which the Cold War helped to uphold the system was in the various military alliances that tied up many parts of the globe. Particularly in the Western world and among allied third world states, was witnessed a build up in the infrastructure required for military purposes which included the establishment of military bases arms supplies and the various military and consumption requirements of troops, which in turn promoted the spread of these modern mass production technologies and also the build up of Western capital whose security was ensured.

Although the US maintained its leadership position and relative prosperity in the 1950's and 60's, its economic growth had lagged behind that of other advanced market economy industrial countries, namely some other OECD countries. During the years 1950-73, US annual productivity





growth averaged 2.6 percent, which was very high by historical standards; but it compared with an average of 4 to 6 percent annual productivity growth for OECD countries as a whole and a startling 8 percent for Japan. This relatively slow rate of productivity growth was reflected in the declining competitiveness of US manufacturers. During the 1950s and 1960s, it was believed that the US could afford an overseas network of military bases and large amounts of military and economic assistance because outflows of dollars returned to the United States in the form of purchases of US goods. As the competitiveness of American manufacturers declined, overseas dollars were increasingly spent on West European and Japanese goods. Thus, in the 1950s US foreign exchange reserves amounted to \$ 24.3 billion, while the combined reserves of Germany, Italy and Japan were \$ 1.4 billion. By 1970, US reserves had fallen to \$ 14.5 billion, while the reserves of Germany, Italy and Japan had risen to \$ 23.8 billion, and the United States experienced its first trade deficit since 1936.

What was more significant is that from the 1960's US productivity began to decline. The production techniques and technologies of the US, adopted in the 1950's and 60's, were being left behind by newer developments and markets for its products were not growing as before. The Japanese exploiting techniques pio-

neered in the US itself had made major inroads into both the components market and consumer electronics, while the Europeans played a leading role in industrial applications of information technologies. In the US the business giants of an earlier era (which generally had privileged access to government) such as the automobile companies, the oil multinationals, the aerospace companies, etc were finding it increasingly difficult to survive. Some of the roots of the present economic ills in the global system could be traced to this bid for their survival in the face of the advancing technologies. Many industrial countries, including the US, have been caught up in this change over from the "automobile era" and smoothe industries to what is known today as the "microchip and biotech era".

A distinct feature of the period 1950-1970 was that the market economies of Europe grew rapidly, relative to that of the United States, and a major significance of this growth was that the relative proportion of trade among Europe's market economies expanded much faster than their overall ratio of world trade. For these countries the share of imports from within Europe rose from less than one half to nearly two-thirds of total imports between 1955-1970; while their percentage share of imports from the United States was nearly halved, and there was a similar decline in the percentage share from other developed market economies. While rapid growth of output in the market economies of Europe was associated with closer integration through trade, such integration was at least partly at the expense of trade with both developed and developing countries outside Europe.

While there was an expansion in international trade among developed industrialised economies there was a sharp decline in the relative share of developing countries in world exports (with the exception of oil). This was due to a deterioration in the relative unit prices of developing country exports, particularly agricultural raw ma-

terials and the growing constraints placed on their exports by the developed countries. It was only after the middle of the 1960's that manufactures began to assume importance in the exports of developing countries, though it was mainly the newly industrialising developing countries that shared this market.

Another aspect of the structural changes that took place in the world economy over the last 25 years was in that of capital movements and economic integration among the advanced industrial countries. It may be observed that the changes in the pattern of trade balances and capital movements during the last three decades have had a more direct bearing on the present global crisis. In the 1950's and early 1960's trade deficits were maintained within modest limits through export and import controls and drawings on available foreign exchange reserves, inter governmental loans, and official loans from multilateral institutions. There were in the 1950's and 1960's transfers of capital between the industrialised countries through, for instance direct investment in Europe by American Corporations and in turn portfolio investment by West Europeans in the shares and bonds of American corporations. The rapid expansion of international banking, encouraged by the emergence of the Euro currency market, together with the high rate of growth of output in Europe and Japan during this period speeded up the process of capital movements and economic integration. The new financial institutional structure and practices helped to provide the necessary funding when international liquidity was proving to be inadequate. As one commentator stated "the Euro-currency system provided the necessary mobility of money and credit, unrestricted by national barriers or controls".

These channels of capital flow and credit expansion, opened up during the 1960's had major repercussions on the functioning of the world economy, particularly in the 1970's when trade imbalances between countries

began to widen and reserve currencies were being used on a much larger scale to settle current and capital account transactions. The increase in oil prices during the 1970's gave the banking system a surfeit of funds which contributed to the phenomenal growth of the international banking network and its scale of operations and resulted in a massive movement of capital across countries. This international mobility meant that foreign exchange markets came to be dominated more by capital transactions than by trade transactions. Trade which had been perceived as a "vehicle for growth" in the 1950's and 1960's in particular in the second half of the 1960's when "nearly every country discovered the virtues of exporting" came increasingly to be viewed after 1973 by the western industrialised countries as a major source of instability and imbalance, with detrimental effects on their domestic economies. This change in outlook was particularly pronounced in developed market-economy countries and thus affected the overall "trade environment" since these countries continued to be the leading actors in international economic relations.

Other measures that challenged the post-war global economic interstate system and slowed down international trade included the cuts in economic assistance that consequently increased the growing dependence of Third World countries on commercial bank loans; the shift from military assistance to commercial purchases of military equipment; the end of food aid and the dismantling of US grain reserves which led to a rapid rise in food prices; and the oil price hikes of 1973 and 1979.

The fluctuations in productivity trends in the advanced industrialised countries had also contributed to structural changes in the system. The changes that took place could also be related to the developments in technology, changes in the pattern of consumer spending associated with rising income levels, and other factors which, as already noted, contributed to a

slowing down in the rate of increase in productivity in some developed countries, particularly the US. Its lower productivity also resulted in a drop in the rate of investment. A report on the US economy showed that a rise in the share of depreciation in the 1970's (on account of a variety of factors such as "a general shift in net investment from long-lived assets, such as structures towards assets with shorter lives", higher rates of obsolescence of a variety of past investments following the rise in energy costs and, more generally, "a higher ratio of capital to GNP") lowered further the rate of net investment, and as the labour force was growing twice as fast in the 1970's as against that of the 1950's there was a dramatic decline in the rate of growth of net capital stock per worker.

When sizeable deficits began to emerge in the balance of trade in the US in the early 1970's and outflows of capital further aggravated its balance of payments a significant step taken was to delink the dollar from gold and later to let it float freely.

In August 1971 President Nixon announced the end of dollar convertibility into gold and a 10 percent surcharge on dutiable goods, which marked the beginning of the end of the Bretton Woods system and a new form of protectionism. By March 1973 all the major currencies had abandoned fixed exchange rates. The devaluation of the dollar in terms of other international currencies helped the competitiveness of American manufacturing industry. The value of American merchandise exports which had not exceeded 4 percent of its G.N.P. throughout the 1960's rose to nearly 8 percent of its GNP by the 1970's. It also helped to more than double US companies profits from manufacturing over the 1970's. But, when this expansionary movement led to a cumulative rise in prices and to a sharp loss of confidence in the dollar there was a reversal in this policy. The new US policy was to counter inflationary pressure by using high interest rates; and also revive confidence in the dollar,

both through these high interest rates and by permitting capital inflows on a scale large enough to more than offset its deficits on current accounts in the balance of payments. But, although these inflows of capital helped the US to raise its government spending substantially and stimulate internal recovery during this period with funds from outside; there were negative effects on the world economy from this policy.

The high interest rates, encouraged massive inflows of capital to the US though at the same times the industrial economies of Western Europe, as well as a number of developing countries, were deprived of investible funds. There were signs of a crisis emerging in the global economy in the 1970's and this had been aggravated by the two oil price hikes of 1973 and 1979. From a long period of unprecedented growth and prosperity in the 1950's and 60's the world economy began to move into a state of price instability, uncertainty and stagnation. This situation also resulted in a fundamental change in attitude towards economic growth, particularly in economic and trade policies, of the developed market economy countries. As observed above, in the period when trade was thought to be the "handmaiden" of growth these governments tried to facilitate its development at both the national and international levels. But when the destabilising influence of trade came to be perceived their policies began to change. Many of them moved towards protectionism, abandoning their "free trade" policies.

The impact on the developing countries drawn into the global network of trade and exchange relations, was particularly harsh. Especially for the low income developing economies the situation was critical though it is mainly the middle-income economies who have received the most attention because of their heavy debt servicing obligations.

As one development economist stated "Never before in the history of the capitalist mode of production has the

SLOWDOWN: Real GNP Growth & Nominal Per Capita Income

growth in percent, income in dollars converted at end year rate

	1986 actual		1987 estimate		1988 forecast	
JAPAN	2.4%	\$17,200	3.5%	\$22,100	3.5%*	\$24,600*
HONGKONG**	11.0%	\$6,850	12.0%	\$8,000	5.5%*	\$8,870*
SINGAPORE*	-1.4%	\$6,600	6.5%	\$7,550	5.5%	\$8,000
TAIWAN	11.6%	\$4,000	11.2%	\$5,275	7.5%	\$6,200
SOUTH KOREA	12.5%	\$2,300	12.7%	\$2,800	8.5%	\$3,000
MALAYSIA	1.2%**	\$1,600	2.5%**	\$1,690	4.0%**	\$1,700
THAILAND	5.5%	\$800	7.0%	\$860	6.0%	\$940
PHILIPPINES	1.5%	\$600	5.0%	\$630	6.0%	\$670
INDONESIA*	3.2%**	\$350	4.0%**	\$390	4.5%**	\$430

*averages of private sector figures

**GDP, fiscal year for Indonesia

Sources: Economic Planning Agency & Ministry of Finance, Japan; Economic Services Branch, Hongkong; Bureau of Statistics and Council for Economic Planning and Development, Taiwan; Bank of Korea, Korea Development Institute & Economic Planning Board, Ministry of Finance, Malaysia; Bank of Thailand; National Economic & Development Authority, Philippines.

Aswath Chart

contrast between the enormous unmet hopes of the vast bulk of humanity, living in poverty, and an enormous unused, productive capacity unused because its use is not profitable - been so glaring as in the developing countries in the periphery today".

The situation over the 1980's, in the Western world, also continued to grow more acute. In 1985 the OECD estimated that 31 million people were unemployed in advanced capitalist countries; in Western Europe alone, nearly one person in five was unemployed, many over a period exceeding their unemployment insurance cover. Centrally planned economies also experienced a slow-down in the rate of growth. Imports of Western technology resulted in a growing indebtedness. East Europeans began to experience rising prices, especially rising food prices, for the first time since the end of the Second World War, combined with stagnant standards of living. Over the 1980's the US was transformed into the world's largest debtor nation.

It was also becoming clear that there was no way for the US to maintain both a stable domestic economy and a stable exchange rate. The twin budget and trade deficits of the US were being blamed and there was pressure for a reduction of the deficits. With the high interest on loans and the high exchange rate of the dollar, foreign investment and goods had flowed into the United States. Tax privileges for corporations and income tax reductions had helped to augment the

profits of industrialists and the demand of more affluent Americans. This policy also helped the US economy somewhat to overcome its growing inflation of the 1970's. More significant, however, was the de-regulation of financial markets which included the liberalisation of current operations. This helped to spur the stock market boom and speculation in 'fictitious' capital. By the 1980's there was a growth of demand mainly attributed to the expenditure of those better off sections, including over 40 million stock holders and rentiers whose prosperity was built up on these policies. Their interest incomes from securities were reported to run to over \$ 500 billion in 1987. Furthermore, the living standards of these better off sections had been rising on an average of 6 percent an year, or double the growth rate of the US economy as a whole.

The strains on the US economy were intensifying by the mid 1980's. US industry was finding it difficult to compete. The massive take over of American markets by foreign production and shifting abroad of many of the industries that had in the past been the foundation of the United States economy and a major source of well paid jobs for Americans led to an unanticipated and strong decline. Many of the good jobs were lost by Americans; and their good jobs moved to other countries which had gained by producing advanced goods for the American market. In countries like Japan, Taiwan and the Republic of

Korea, people were moving up to good jobs, firms were expanding rapidly and investment was increasing while in the United States the situation was reversed. As a result of the enormous trade deficit, averaging in recent years around \$ 150 billion annually the United States was fast going into debt; while the Japanese loaded with dollars were taking over assets in the United States by buying up banks, businesses, farm land and real estate. From 1981 through to 1985 US current account balance (including both goods and services) declined from a positive \$ 6 billion to a negative \$ 118 billion. The 1987 deficit on merchandise (visible) trade is reported to be \$ 171 billion. The result is that the United States has in well less than a decade gone from being the largest creditor nation in the world to being its largest net debtor nation. If these trends continued net external indebtedness in the United States was expected to increase to \$ 500 billion before the turn of the decade.

A fundamental problem facing the United States was that it was consuming more than it produced and borrowing more than it saved and such a condition was not sustainable. As the London based 'Economist' commented "All in all, it is sheer profligacy which poses the biggest threat to Americans' hopes of smoothly putting their trading house in order. The threat is intensified by some politicians' bazaar reaction to their own ability to cut the federal budget deficit. In total,

Americans and their governments will spend about \$ 150 billion more in 1988 than they produce. All of that will have to be financed by foreigners, either by borrowing or by the sale of American assets. But, rather than cut the deficit, some are perversely beginning to clamour for restraints on foreigners' ability to finance it".

Furthermore, the US dollar which for nearly 40 years was the world's leading currency and had stood at a high of 260 yen to the dollar in 1985 began to slide in value against the leading currencies. Between 1985 and 1987 the US dollar had dropped nearly 50 percent in value against the Japanese Yen and the West German Mark. The falling value of the dollar also cheapened the value of the hundreds of billions of dollars' worth of U.S. securities held by investors abroad, notably in West Germany and Japan, and made them correspondingly less eager to invest in US stocks, bonds and Treasury bills. With the U.S. also now heavily dependent on foreign trade deficits, a loss of confidence in the currency seemed inevitable.

There existed a paradoxical and brittle situation. Americans were consuming far more than what they produced, and borrowing from abroad and selling off assets for even cheaper dollars, although in the first half of 1987 rapid economic expansion was recorded. Most of all the stock market was soaring; but there had to be a limit to the optimism, which was finally manifest in the market crash of October 19. Looking back on the situation a leading US business journal summed up the situation as follows: "A soaring stock market, yes....but it has spawned a class of baby magnates who are sometimes shameless in their business practices and their self-cherishing materialism. With so many misgivings lurking behind the optimism, it hardly needed program trading to bring about a 508-point drop in the Dow. Above all, the laws of financial physics explain the crash: the market had reached altitudes where atmosphere was too thin to support in. No single event, but a

swarm of converging causes among them Treasury bonds breaking the 10 percent yield barrier and Treasury Secretary James Baker threatening to beat down the dollar if the Germans raised interest rates-provoked the panic. Now, however, resilient the underlying economy, that shattered investor confidence, that change from "yes" to "but" had become one of the fundamentals of the new bear market

As its peak in August 1987 US stocks were valued about US\$ 4 trillion. Eight weeks later, after the crash the value plunged roughly 30 per cent. In those roughly two months between Tuesday, August 25 and Monday October 19, almost one-third of it was "lost on paper", measured in terms of the net worth of all American households, either saved in their lifetime or inherited from generations past. (It may be more than a paper loss, if the underlying assets had been pledged or used as collateral to borrow). This is what analysts call the "wealth effect" of the 1987 crash. This loss of the "wealth effect", as the influence of well off Americans has been describ-

bed, could be painful for the US economy; and its real impact could determine and dictate the future course of the American economy.

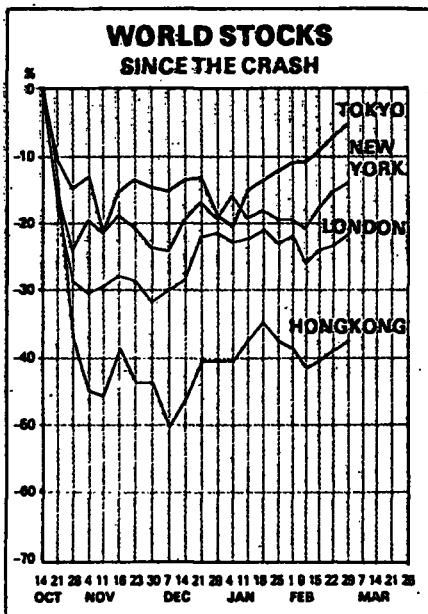
In Western Europe too prospects are getting gloomy with a drop in both industrial production and exports. According to OECD estimates, the slump is partly a reflection of a global downturn and Europe is feeling it severely.

Fears are being expressed that the situation may worsen in 1988, with an increase of protectionism and a new 'mercantilism' in the West, which could result in further turmoil for both the developed and developing worlds. This would no doubt depend on how effectively the global capitalist system could correct its errors and excesses.

In Japan they ask, whether there was really a major long term stock-market crash initiated in October 1987. By the end of January 1988 the Nikkei 225 - share indicator had recovered over the 23,000 level for the first time since last October, and even foreigners were net buyers on the Tokyo Stock Exchange during January. London and New York although partially recovering were still more than 25 percent off their record highs and not moving steadily, Tokyo's rise had left it hardly 10 percent away from its peak and looking ahead strongly; a clear indicator that, unlike in the case of the US, Japan's economy was now booming after two years of relatively slower growth.

In Europe too markets were "sputtering back to life" by February 1988, as one analyst noted. On the Paris Bourse the comeback had restored more than half the ground lost after the October 19 crash. In Brussels too there was recovery and the stock exchange ended February up 30 percent from its post crash low; while markets in Frankfurt, Milan and Amsterdam had also registered strong gains. The question being asked was how long the rally would last.

Our next issue discusses the changes in the Socialist World, focussing on the USSR).



Stock markets appeared to be heating up. Tokyo's exchange was well on its way to re-couping its losses since October 19; Wall Street also appeared poised for a rally of its own and by the beginning of 1988 a new confidence was setting into business in the US with corporations buying up rivals and injecting new money into the market. London and Hongkong displayed similar trends.