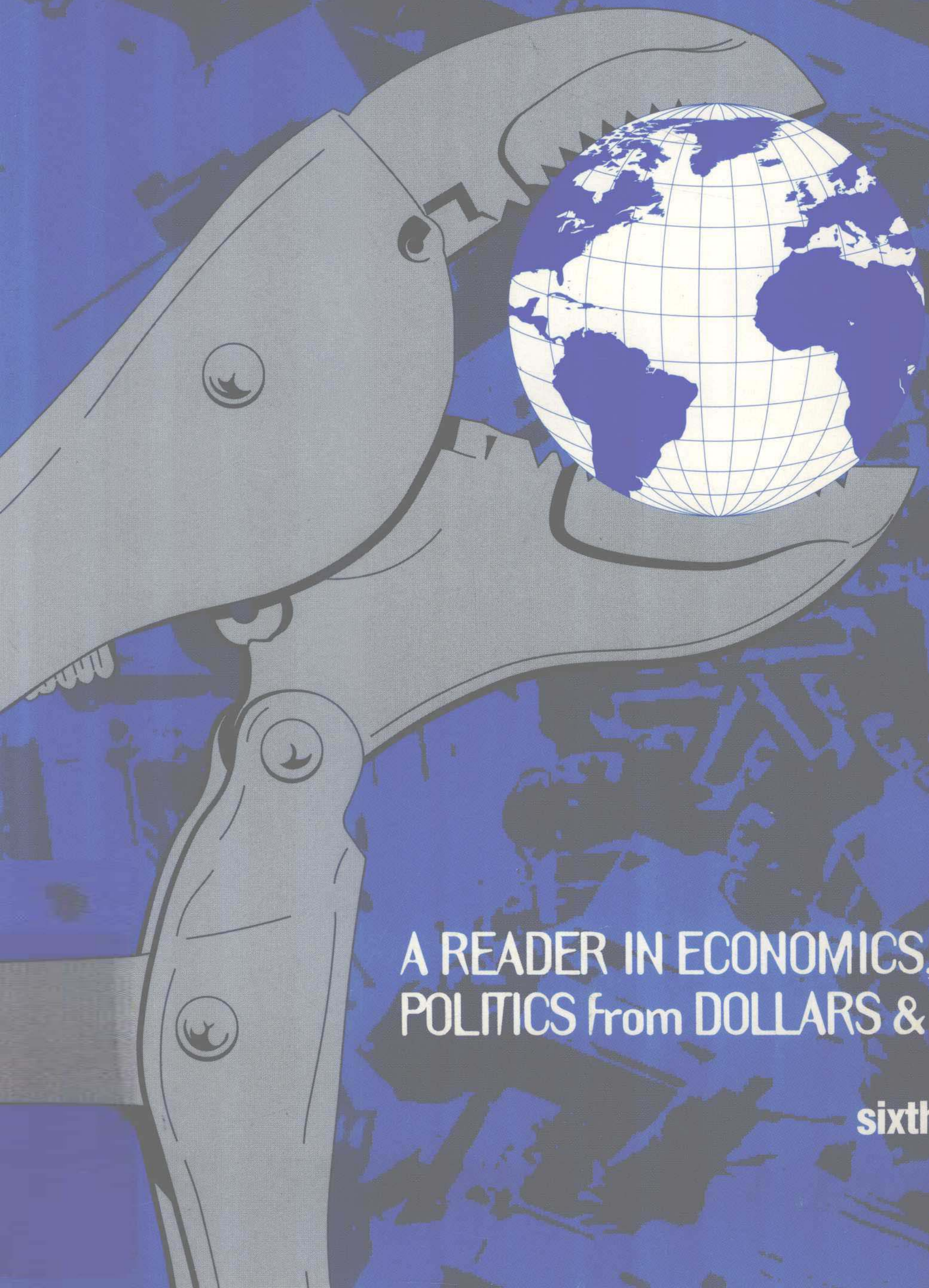
real world GLOBALIZATION



A READER IN ECONOMICS, BUSINESS, AND POLITICS from DOLLARS & SENSE

sixth edition

real world GLOBALIZATION

SIXTH EDITION

Edited by
Ellen Frank, David Levy, Alejandro Reuss,
and the Dollars & Sense Collective

REAL WORLD GLOBALIZATION

(FORMERLY *REAL WORLD INTERNATIONAL*)

SIXTH EDITION

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Ellen Frank, David Levy, Alejandro Reuss
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ISBN: 1-878585-17-7

Published by:
Dollars and Sense
Economic Affairs Bureau, Inc.
740 Cambridge Street
Cambridge, MA 02141
617-876-2434
dollars@dollarsandsense.org

Real World Globalization is edited by the *Dollars and Sense* Collective, which also publishes *Dollars and Sense* magazine, along with *Real World Micro, Real World Macro, Real World Banking, Current Economic Issues, Introduction to Political Economy,* and *The Environment in Crisis.*

Cover Art and Design: Nick Thorkelson
Production: Sheila Walsh

Manufactured by Transcontinental Printing
Printed in Canada

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November 2000

FREE MARKETS, INTERNATIONAL COMMERCE AND ECONOMIC DEVELOPMENT

BY ARTHUR MACEWAN

NEO-LIBERAL THEORY

The essence of the neo-liberal position on international commerce is the proposition that economic growth will be most rapid when the movement of goods, services, and capital is unimpeded by government regulations... A simple logic lies at the basis of [this] free trade position. If, for whatever reasons, countries differ in their abilities to produce various goods, then they can all benefit if each specializes in the production of those items it produces most effectively (i.e., at least cost). They can then trade with one another to obtain the entire range of goods they need. In this manner, each country is using its resources to do what it can do best...

Excerpted from Chapter 2 of the author's recently published *Neo-Liberalism or Democracy? Economic Strategy, Markets, and Alternatives for the 21st Century* (Zed Books, London, and St. Martin's Press, New York).

As an illustration of this logic, consider two countries, one with an abundance of good farm land and the other with a good supply of energy resources (hydro power, for example). It seems likely that each of these countries will gain from trade if the first specializes in the production of agricultural goods and the latter specializes in the production of manufactures. Moreover, if the governments impose no constraints on international trade, then this specialization is precisely what will occur. Without constraints on trade, people attempting to produce manufactured goods in the country with abundant good farm land will not be able to do so as cheaply as people in the country with a good supply of energy resources — and vice versa for people attempting to produce agricultural goods in the latter country...

The theory appears to run into trouble if one country produces everything more efficiently than the other. Yet the trouble is only apparent, not real. Under these circumstances, all will gain if each country specializes in the production of those goods where it has a *comparative advantage*. For example,... [l]et's assume that the country with abundant farm land produces agricultural goods at half what it costs to produce them in the other country. At the same time, this country with abundant farmland has a workforce with great capacity for industrial labor, and it therefore can produce manufactured goods at one-quarter of what it costs to produce them in the other country. Under these circumstances the country's skilled labor force gives it a greater advantage in the production of manufactures than the advantage that its abundant farmland gives it in the production of agricultural goods. Thus it has a *comparative* advantage in the production of manufactures. Similarly, the second country, even though it is less efficient in the production of both categories of goods, has a *comparative* advantage in the production of agricultural goods. To produce manufactures would cost four times as much in this country as in the other, whereas to produce agricultural goods would only cost twice as much. Consequently, both countries can gain if each specializes where it has a comparative advantage, and they then trade to obtain their full set of needs...

The theory of comparative advantage has played an important role in the history of economics, for it has provided an intellectual rationale for free trade policies. An intellectual rationale has been necessary because, whatever the larger efficacy of the policy, free trade is always costly to groups that have prospered under any prior trade restrictions...

Advocates of the neo-liberal position ... base their policy prescriptions as much on certain myths about history as on the internal coherence of their theory. They argue that their theory is validated by the history of successful economic growth, both in the longer experience of the relatively advanced economies and in the recent experience of successful growth in newly industrialized countries. They cite, in particular, the history of economic development in the United Kingdom, other countries of Western Europe, and the United States, and the more recent experiences of countries in East Asia.

An examination of these experiences, however, quickly demonstrates that the neo-liberal claims are but crude myths, having only a vague connection to reality...

HISTORICAL EXPERIENCE: A BRIEF SKETCH

Virtually all of our experience with economic development suggests that extensive regulation of foreign commerce by a country's government has been an essential foundation for successful economic growth. In the United Kingdom, perhaps the case most frequently cited to demonstrate the success of free trade, textile producers secured protection from import competition at the end of the 17th century, and high tariffs served British manufacturing well through the era of the country's rise to world economic preeminence. At the beginning of the 19th century, the average tariff rate on manufactures was 50 percent — high by almost any comparative standard. Later in the century, the United Kingdom did eliminate its tariffs on manufactures, but then it had passed the early stage of development and its industry was well established... Moreover, state support for industry in the United Kingdom came through the creation and maintenance of empire...

Tariff protection also played a large role in the emergence of U.S. industry. The textile industry, which was especially important in the country's economic development, got its start when the hostilities leading up to and through the War of 1812 provided implicit protection by limiting international shipping. After the war, the protection became explicit as a tariff was established. According to the World Bank, the average U.S. tariff on manufactures was 40 percent in 1820... [In] the last third of the 19th century, with tariff protection well established at an average of around 30 percent for most of the 1870 to 1910 period, the United States experienced a great industrial expansion. Only after World War II, when U.S. industry's dominant position in the world economy was secure, did a steady and lasting reduction of tariffs take place...

Countries that achieved their developmental advance at a later historical period were generally characterized by a significantly greater role for the state in the regulation of foreign commerce, both with regard to trade and investment. Japan's experience in joining the ranks of advanced capitalist countries provides the prime example... [and, insofar] as any country has broken out of underdevelopment in more recent decades, South Korea would provide the most important case study. In broad terms, the South Korean experience is very similar to that of Japan. From the early 1960s, the South Korean state followed policies of protecting domestic markets, heavily favoring Korean owned firms, and using state owned industries to develop national production in certain "strategic" sectors...

One of the important aspects of the South Korean experience is that in protecting and supporting the development of national industry the government did not by any means encourage Korean firms to abjure exports and follow an "inward looking" policy. On the contrary, the government used a firm's ability to compete in export markets as a measure of whether or not it was succeeding in becoming more efficient. The South Korean experience shows how economic policy can both regulate foreign commerce but at the same time make sure that national firms reap the many advantages associated with international commerce — including, especially, the transfer of knowledge and technology that come with foreign exposure...

RE-EXAMINING THE THEORY

So the neo-liberal theory of international commerce does not sit very well with historical experience, and this lack of congruence between theory and reality suggests that there are some problems with the theory. Indeed, there are several...

Technology in Economic Growth [T]he theory of free trade is fundamentally flawed because it fails to take account of the ways in which production itself affects technological change. "Learning-by-doing" is a particularly important form of the phenomenon. In a new activity, initial production may be very costly. Yet as time passes and experience accumulates, the people engaged in the activity learn. They change the way they do things, which is to say that they change the technology. Such an activity might never develop were it forced to compete with already established firms in other countries where the learning-by-doing had already taken place. Yet if the activity were protected from foreign competition during an initial phase in which experience could be accumulated, it could develop and become fully competitive...

Yet protection involves costs. Why should society in general bear the costs of protection in order to assure the development of any particular activity?... The answer to these questions lies in the concept of *location specific technological externalities.* Different kinds of production activities tend to bring about different kinds of changes in the overall economic environment. In the 18th and 19th century, for example, manufacturing tended to generate new methods of production and a development of skills that had far reaching technological impacts. In the current era, "high tech" production appears to have similar far reaching impacts. Because the gains from these sorts of changes are not confined to the industry or firm where they originate, they are not reflected in the profits of that industry or firm and will not be taken into account as a basis for investment decisions. These positive technological impacts of particular production activity that do not affect the profits and are outside of — or external to — the purview of the people making decisions about that production are "technological externalities." When positive technological externalities exist for a particular activity, then the value of that activity to society will be greater than the private value... [T]echnological externalities are often "location specific," having their greatest impact within relatively close geographic proximity to the site where they are originally generated — or at least having their principal impact within the same national unit....

> EXTENSIVE REGULATION OF FOREIGN COMMERCE BY A COUNTRY'S GOVERNMENT HAS BEEN AN ESSENTIAL FOUNDATION FOR SUCCESSFUL ECONOMIC GROWTH.

The U.S. experience with the cotton textile industry, which I have cited above, provides a particularly good example of the generation of location specific technological externalities. The textile industry emerged in the early decades of the 19th century, prospering especially in the Northeastern part of the United States. Mill towns throughout southern New England became centers of growth. Not only did they create a demand for Southern cotton, but they also created a demand for new machinery, maintenance of old machinery, parts, dyes, *skills*, construction materials, construction machinery, *more skills*, equipment to move the raw materials and the products, parts and maintenance for that equipment, *and still more skills.* As centers of economic activity, innovation, and change, mill towns made a contribution to the economic growth of the United States that went far beyond the value of the textiles they produced...

Trade and Employment The theory of comparative advantage and arguments for free trade rest on the assumption that full employment exists, or at least that the level of employment is independent of the *pattern* of trade and production. In addition, the theory assumes that when patterns of trade and production change, labor will move from one activity to another instantaneously — or at least sufficiently rapidly so as to cause no great welfare loss or disruption of overall demand. In reality, most low income countries are characterized by very high levels of unemployment and underemployment, the pattern of trade and production does affect employment levels (at least in the short run), and labor markets adjust to change relatively slowly...

An illustration of the problems is provided by experience in many low income countries when trade restrictions on grain imports are lifted... In Mexico, where the internationalization of grain supply was proceeding apace in the 1980s, even before the establishment of the North American Free Trade Agreement (NAFTA), the replacement of peasant grain production by imports has not worked out so favorably. In fact, those parts of agriculture that have expanded in recent years — meat production and vegetable exports, for example — and export manufacturing use relatively small amounts of labor. Peasants displaced by the import of inexpensive U.S. and Canadian grain, instead of finding employment in these sectors, swell the ranks of the unemployed or underemployed, often in cities. Consequently, instead of labor resources being used more efficiently under the pressure of import competition, labor resources are wasted...

Free Trade and Large Firms The neo-liberal argument for free trade is based on the assumption that if government did not intervene and regulate international commerce, then the economy would operate in a competitive manner with advantageous results... International commerce, however, is often dominated by a relatively small number of very large firms that operate in a monopolistic manner. Competition among them exists, and in some cases is very intense. It is, however, monopolistic competition, not simply the price competition that is assumed in the argument for free trade. The patterns of trade and production engaged in by very large firms are determined as part of their complex global strategies — with results that do not necessarily coincide with either the price competition model of the free trade argument or the long run development interests of a particular country...

Large firms are sensitive to price considerations, and they are often quick to re-locate production to take advantage of low cost resources. Yet resource costs, the foundation of the theory of comparative advantage, are only one element in the strategies of large, internationally integrated firms. The Japanese automobile companies, for example, established their leading role in the industry through a strategy of developing linkages to suppliers in close physical proximity to the central plant. Resource costs were secondary to the issue of strategic control, which had important impacts on technological change and the management of inventory. In the international textile industry, flexibility is a paramount concern in the strategy of large firms, and issues of market proximity and control over product supply stand along side of resource costs as factors determining the location of production. Similarly, in the semi-conductor production of the electronics industry, many firms (particularly U.S. firms) have followed a strategy of vertical integration. When companies produce semi-conductors for use in their own final products, their location decisions tend to be dominated by concerns about control of the technology and production process; concerns about least-cost siting tend to be secondary. In all of these examples, selected from industries that are both highly international in their operations and in which very large companies play central roles, monopolistic firms employ strategies of control that enhance their own long run profits. There is no reason to expect the outcomes to conform to those envisioned in the theoretical arguments for free trade...

Primary Product Problems When the argument for free trade was developed in the 19th century, it was a rationalization for the particular character of the international division of labor that emerged so clearly at that time. That division of labor placed a few countries of Europe and North America in the position of specializing in the production and export of manufactured goods, while several other countries — many of which are today's low income countries — specialized in the production and export of primary products. Today, although the international division of labor has changed, there are still many low income countries characterized by primary product specialization.

Primary product specialization is problematic, first of all, because the prices of primary products are highly unstable. Primary products are, by definition, the raw materials that enter at an early stage into the production of other goods. Sugar, for example, is used largely in the manufacture of a great variety of sweets, and the cost of sugar plays a small role in affecting the final price of those sweets. Copper finds its demand as an input to houses, automobiles and other machinery. Like sugar, its cost plays a small role in determining the price of the final products of which it is a part. Grains, vanilla, cocoa, cotton, coffee and several other products fit this pattern. Consequently, the demand for such a product is very insensitive to its price (that is, the demand is very price inelastic). When the supply of a primary product increases — for example, because of good weather and a resulting good crop in some region of the world — prices will decline a great deal as producers compete with one another to unload their surpluses on the very limited market. Conversely, with a small decline in the supply — resulting, perhaps, from bad weather and a resulting crop failure — producers will be able to push up the price a great deal. Even when the average price of a primary product is in some sense "reasonable," price fluctuations create severe cyclical problems that, when the product is important, may disrupt the development of an entire national economy.

An additional problem of specialization in primary products... [is] that in general the average prices of primary products are not "reasonable," in the sense that the demand for the products is subject to long term downward pressure. Consider, for example, the case of foods — sugar, coffee, cocoa — exported from low income countries to the advanced economies of Europe and North America. As income rises in the advanced countries, the demand for food rises less rapidly... Under these circumstances, insofar as countries rely on primary product exports to the advanced countries for their national income, their national income must grow more slowly than income in those advanced countries...

INTERNATIONAL COMMERCE, INCOME DISTRIBUTION, AND POWER

The deregulation of international commerce that is envisioned in the neo-liberal model is largely, if not entirely, a deregulation of business. By removing constraints on the operation of business, it necessarily would give more power to the owners of capital. It would allow business to seek out profits with fewer constraints — on the location of production, on its sources of supply, on characteristics of production, and so on. Power is largely a question of options, and by providing more options to the owners of capital, neo-liberal globalization would give them more power. Most clearly, within a deregulated international environment, owners of capital can resist labor's demands by exercising, or threatening to exercise, their option of shifting production to regions of the world where labor costs are lower. This is not only an option of moving from high wage to low wage countries, from Britain to Sri Lanka, for example. Owners of businesses in Sri Lanka may move, or threaten to move, operations to Britain if productivity is sufficiently higher in the latter country. So the power that business gains vis-a-vis labor by the deregulation of international commerce can be important in low wage and high wage countries...

Power in economic life means primarily an ability to shift more and more of the value produced by society into one's own hands. In this way, neo-liberal globalization is a *de facto* formula for shifting income to the owners of capital, that is, for increasing inequality in the distribution of income...

KNOW-NOTHINGS AND KNOW-IT-ALLS

WHAT'S WRONG WITH THE HYPE ABOUT GLOBALIZATION

BY JESSICA COLLINS AND JOHN MILLER

Protesters against globalization have no idea what they are talking about. At least that is the verdict of the mainstream press. According to their coverage, the "protectionist" labor unions and the "privileged, cause-happy" college kids that took to the streets of Seattle and Washington, D.C., were content to accept as gospel "the vaguest snippets of knowledge" about the economics of globalization, the World Trade Organization, the International Monetary Fund, and the World Bank.

"[The protesters'] tales rarely get fact-checked," complains Paul Krugman, the M.I.T. economics professor and *New York Times* columnist. "Nobody asks whether the moral of the story is really as clear-cut as it seems." Quick to dismiss the protesters' views as uninformed and illegitimate, Krugman would have done better to fact-check the mainstream media, which was itself guilty of recycling data uncritically and accepting as gospel the conclusions of the institutional powers themselves.

Take "Parsing the Protests," an article written by Thomas Friedman, the *Times*' star international reporter turned columnist, in anticipation of the April 16 Washington, D.C., protest. Friedman warned his readers that they would be hearing "much blarney" from the protesters. Under "facts you won't hear," Friedman provided his supposed antidote to the protesters' nonsense: the results from a recent study conducted by the A.T. Kearney Co., an economic consulting firm. The report proves, according to Friedman, that "globalization" promotes faster economic growth, higher standards of living, and greater political freedom. While he does note the downside reported by Kearney – greater inequality, corruption, and pollution – Friedman is quick to point out that, increased inequality notwithstanding, the economic growth he associates with "globalization" still results in decreased poverty.

Despite the appearance of evenhandedness and objectivity, the report contains, to borrow Thomas Friedman's phrase, "much blarney," including "snippets" that Friedman passes around uncritically. A.T. Kearney Co. itself is a for-profit research company with corporations for customers. It boasts a "distinguished 75-year history of helping business leaders gain and sustain competitive advantage." But the Kearney Co.'s stake in promoting "globalization" is a fact Friedman never shared with his readers.

INSIDE THE KEARNEY REPORT

To make the pro-globalization case, Kearney's Global Business Policy Council ranked 34 developed and developing countries on a scale from "globalizing slowly" to "globalizing rapidly" based on their scores on ten different indices. The report uses this "globalization ledger" to engage in some crucial sleight of hand. It passes off "the greater integration of the economies around the world," measured by their globalization indices, as the equivalent of free trade. By misrepresenting isolation from the world economy as the only alternative to free trade, the study preordains its pro-globalization (really pro-free trade) conclusions. Opponents of free trade have not endorsed isolation from the world economy as a development strategy since the early days of dependency theory some three decades ago.

The "globalization" debate is not about economic isolation vs. integration into the world economy; but about what policies allow a developing economy to most successfully engage with the world economy. The Kearney Co., Friedman, and other "globalizers" presume that engagement requires complete submission to the neoliberal policy agenda promoted by international capital, economic powers like the United States, and international agencies like the IMF. Opponents of "globalization" argue instead that a different form of engagement with the world economy – based on more democratic control of the economy, more protections for workers and the environment, and greater limits on the movement of capital – is likely to produce a more widespread and equitable form of economic development.

The Kearney globalization ledger fails to distinguish between these two different strategies for economic development in today's international economy. In one way or another, seven of the ten variables in its globalization index measure a country's *degree* of engagement with the world economy, but say little about the policies determining the *manner* of engagement.

TRADE, GROWTH, AND OPENNESS

One of Kearney's indices is a country's level of trade, the combined value of its exports and imports as a percentage of gross domestic product (GDP). This is an index used in many mainstream studies of globalization. Finding a positive correlation between the levels of trade and economic growth (measured as GDP growth per capita), the report cites this data as support for free-trade policies. All the data really mean, however, is that international trade and economic growth tend to move in the same direction. It says nothing about whether trade *causes* faster economic growth. You might just as well conclude that economies enjoy high levels of trade because other economic policies promote rapid economic growth.

Even if international trade does promote economic growth, this does not mean that "free-trade" *policies* (lower tariffs and non-tariff barriers to trade) cause growth. Japan's export boom during the 1980s would have registered high marks on Kearney's trade index. But Japanese authorities oversaw their boom not with the free-trade policies endorsed by the Kearney study, but managed-trade policies, such as selective tariffs and export subsidies.

When economists address the current policy debate about globalization properly, the evidence fails to endorse the pro-globalization position touted in the Kearney study. In their exhaustive survey of the major studies on trade policy and economic growth, mainstream economists Francisco Rodríguez and Dani Rodrik find, "little evidence that open trade policies – in the sense of lower tariff and non-tariff barriers to trade – are significantly associated with economic growth." By weighing down their globalization index with trade *performance* variables that say little about trade *policies*, the Kearney study manages to obscure this anti-free trade finding.

The same criticisms apply to the Kearney report's claim that "globalization" alleviates absolute poverty (measured as the number of people living on less than US$1 per day). Apart from the problems presented by their use of the World Bank's measure of poverty, the correlation between the report's "globalization" index and reduced poverty tells us little more than that economic growth is associated with lower poverty rates. Over the last 50 years, the most dramatic reductions in poverty have actually occurred in East Asia, among countries such as South Korea, Taiwan, and China, all of which have implemented extensive trade restrictions and relied on government intervention into their economies.

Beyond all the problems with its method, the findings of the Kearney study are downright strange. Their globalization ledger is highly misleading. Look, for instance, at two Latin American countries. Chile, identified as an "aggressive globalizer," has surely embraced liberalization. But at the same time, Chilean authorities restrict the free movement of short-term international capital, requiring financial investors to make a one-year interest-free deposit, in their central banks, equaling 30% of their investments. Mexico, a "stalled globalizer," has during the last two decades adopted neoliberal policies. But when the Mexican economy sank into crisis, its trade performance deteriorated, causing several of its globalization indices to plummet. That hardly constitutes grounds for attributing Mexico's growth problems to a lack of openness.

The Kearney analysis of East Asia yields equally strange results. Part of the problem is that its globalization ledger ranks countries not by their absolute level of globalization but the change in their globalization index. For instance, China is classified as an "aggressive globalizer" because it has recently liberalized its trade policies. But Singapore, the most global economy on the Kearney list, is only a "strong globalizer." Despite its recent liberalization, China is no poster child for the neoliberal agenda. It does not have a convertible currency, it maintains state control of its banking system, and it allows little foreign ownership in equity markets.

Even Kearney's comparison of different countries' growth rates is problematic. The report looks at two different periods, 1978 to 1982 and 1993 to 1997, and finds that its "rapid globalizers" grew more quickly than the other countries, especially during the later period. Looking over the longer period from 1970 to 1998 eliminates much of the association between a high "globalization" score and rapid economic growth. For instance, five countries from the Kearney report made the IMF's list of fastest-growing developing economies over the last three decades (with per capita income growth over 3.75% a year). Just one, China, is classified a "rapid globalizer" (though inappropriately). The rest came from much further down on the Kearney globalization ledger. Thailand was but a "moderate globalizer"; South Korea, a "passive globalizer"; Indonesia and Malaysia, "stalled globalizers."

ACCEPTING THE CHALLENGE

In its period of most rapid economic development, the half century following the Civil War, the United States imposed import tariffs averaging around 40%, a level higher than those in almost all of today's developing economies. During the 19th and 20th centuries, German and Japanese economic development depended on managed trade, not free trade. Even the World Bank, in its 1993 report *The East Asian Miracle*, acknowledged as much for the Japanese postwar boom. South Korea and Taiwan, whose key growth periods came during the 1960s and 1970s, faced a world economy with far less capital mobility and engaged that world with managed-trade policies – export subsidies, domestic-content requirements, import-export linkages, and restrictions of capital flows, including direct foreign investment.

In his *New York Times* article, Thomas Friedman challenges the critics of "globalization" to name "a single country that has upgraded its living or worker standards, without free trade and integration." As the above list suggests, every single one of today's developed countries did exactly that. You can file that under "facts you won't hear" from the mainstream media.

LEARNING FROM THE SOUTHEAST ASIAN CRISIS

BY JOHN MILLER

In summer 1997 bullishness on Asia's miracle economies disappeared. The Thai economy, the epicenter of the crisis, suffered a financial meltdown. The Thai currency, the baht, lost 40% of its value *vis-a-vis* the dollar. The Thai stock market crashed, off 70% from its peak in 1994.

The miracle economies of Southeast Asia fell into depression. Conditions varied from country to country but all were hurting. Recession prevailed in Malaysia and Thailand; a double-digit decline in real output cost over two million workers their jobs by the end of 1998. In Indonesia, crippling stagflation doubled the price of staple goods at the same time that it pushed nearly one half the population into poverty.

These once high-flying Southeast Asian economies fell into receivership. In Thailand and Indonesia, the International Monetary Fund (IMF) administered austerity measures in return for emergency loans to help repay foreign lenders. Meanwhile, Malaysia independently administered similar austerity measures. The $63 billion bailout crafted by the IMF and the U.S. Treasury exceeded the U.S.-financed bailout of Mexico in 1995. With South Korea added in, the East Asian bailout package was over $100 billion.

Economic growth returned to much of the region within two years, but the economic miracle seems to be a thing of the past. While Indonesia has yet to show signs of recovery, the Southeast Asian economies as a group registered 3.2% growth in real output in 1999. Still, that growth was less than half the 7.8% to 9.0% rates Thailand, Malaysia, and Indonesia posted in the three years before the crisis. And millions in the region continue to endure terrible hardships brought on by the crisis: aggravated poverty, lost jobs, reduced income, and diminished access to health and educational services.

The more pessimistic observers at the time of the crisis feared that the Southeast Asian financial debacle might trigger a deflationary spiral sucking all of East Asia, and perhaps the whole world, into a depression. The threat of economic collapse was in fact genuine (and might have become a reality if conditions had worsened in Japan, the region's most important economy and already the victim of a decade-long recession). During most of the 1990s, East Asia accounted for nearly one half of the expansion in the world economy. The region's financial crisis has rattled financial markets around the globe in a way the Mexican peso crisis of 1995 never did. Latin American, European, and Russian currencies all came under attack. Even the booming U.S. economy slowed in the summer of 1998 under the weight of a ballooning trade deficit caused by fewer exports to East Asia.

For those not blinded by free market faith, the Southeast Asian crisis is a shocking reminder of the failures of markets. Capitalism remains much as Marx and Engels described it one hundred and fifty years ago in the *Communist Manifesto* – dynamic but unstable and destructive. We need to look more closely at what lessons we can learn from the economic sufferings and financial miseries of Southeast Asia.

A STORY OF MARKET FAILURE

The financial crisis in Southeast Asia differs in important ways from previous crises in the developing world. Unlike the Latin American debt crisis of the 1980s, the roots of the current turmoil are in private sector, not public sector, borrowing. Most of the afflicted countries ran budget surpluses or minimal budget deficits in the years prior to the crisis. At the same time, private sector borrowing increased heavily, especially from abroad and especially on a short-term basis. For instance, loans to Thai corporations from international banks doubled from 1988 to 1994. By 1997, Thai foreign debt stood at $89 billion – four-fifths of which was owed by private corporations. But most disturbingly, one half of the debt was short-term, falling due inside a year.

The Southeast Asian miracle economies got into trouble when their export boom came to a halt as these short-term loans came due. For instance, stymied by a decline in First World demand, especially from recession-ridden Japan, Thai exports did not grow at all in 1996. Also, the opening of domestic markets to outside money (under an early round of pressure from the IMF) brought a deluge of short-term foreign investment and spurred heavy short-term borrowing from abroad, fueling a building boom. By the mid '90s, a speculative binge in everything from high-rise office towers to condos to golf courses accounted for nearly 40% of growth in Thailand. When the bubble burst, the region endured a horrendous drying-out process. Southeast Asian exports from autos to computer chips to steel to textiles glutted international markets, all made worse by intensified competition from Chinese exports. Foreign financial capital fled. Domestic spending collapsed. Banks failed at unprecedented rates. Unemployment mounted, and as more and more people across the region fell into poverty, the Southeast Asian financial crisis became a story of tremendous human suffering.

In the language of economists, the crisis is also a story of market failure. Southeast Asian capital markets failed in three critical ways. First, too much capital rushed in. Lured by the prospect of continued double-digit growth and searching for new places to invest its overflowing coffers, financial capital continued to flow into the real-estate sectors of these economies even when financial instability was widespread and obvious to all. Second, the capital markets and the banking system could not channel these funds into productive uses. Too much money went into real estate and too little went into productive investments likely to sustain the export boom. Third, too much capital rushed out, too quickly. The excessive inflow of capital reversed itself and fled with little regard for the actual strength of any particular economy.

In their more candid moments, leaders of the financial community owned up to these market failures. For instance, late in 1997, just a few months into the crisis, Stanley Fischer, economic director of the IMF, confessed at a regional meeting in Hong Kong, "Markets are not always right. Sometimes inflows are excessive and sometimes they may be sustained too long. Markets tend to react late; by then they tend to overreact."

WHERE THE RIGHT WENT WRONG

Despite the doubts of their high priests, most financial conservatives continue to believe that international markets are stable, if subject to periodic excesses, and that whatever their excesses in the East Asian crisis might be, they can be traced back to a misguided interference into those markets. The culprit varies – industrial policy, crony capitalism, fixed exchange rates, or some other shibboleth. But in each case, these conservatives would have it that the economies of Southeast Asia ran into trouble because nonmarket forces had a hand in allocating credit and economic resources better left entirely up to the financiers.

The conservative solution to the crisis? That is easy, if painful: Put an end to these nonmarket allocations of resources. Alan Greenspan, the chair of the U.S. Federal Reserve, argued that the East Asian crisis would root out "the last vestiges" of this sort of thing and ultimately would be regarded as a milestone in the triumph of market capitalism.

But none of the leading economies of the region relied on government-managed industrial policies to direct economic growth. One World Bank study placed Malaysian and Thai trade policies as among the most open in developing economies. Since the 1970s, another study reports, the Thai government tended to "allow free markets rather than to intervene with them."

Nor was the crony capitalism, which the right derides, the cause of the current crisis. This widespread practice – of political connections guiding private sector investment decisions – was a constant, not a new element in the Southeast Asian economic mix, just as present in the boom as in the crisis.

"Transparency" refers to the disclosure publicly traded companies are required to make about their operations to their investors. But signs galore of financial instability and overcapacity were there for anyone, even first-time visitors to the region, to see. Bangkok alone had over $20 billion of vacant residential and commercial units by 1997. Despite plunging returns, foreign investors pumped more loans into Thailand betting that double-digit growth would continue and make these risks pay off.

In addition, we should remember that this crisis hit first and hardest in Thailand and then Indonesia, the two Asian economies with private domestic banking systems that had been recently deregulated and opened to foreigners. The shortfall of Japanese investment in the early 1990s left Thailand desperate for foreign funds. Under pressure from the IMF and the WTO, Thai authorities moved to further open their economy to foreign investors, allowing foreigners to own stock, real estate and banking operations as well. On top of this, government policies lifted Thai interest rates above those in the West, making Thailand a place where Westerners could turn a quick buck.

Nor did tying the value of their currencies to the dollar cause these economies to fall into crisis. Having stable exchange rates was an important building block for the region's trade relations. It allowed manufacturers to import components from Japan and Korea for assembly in Thailand and elsewhere in Southeast Asia, before being sold in the United States and Europe. And pegging the value of their currency to that of the dollar allowed the Thais, for example, to lure capital into their country, fueling investments. But the Thai authorities did not take the next step of regulating the foreign capital that they attracted into the economy this way.

What seems clear now is that the cause of the economic crisis of Southeast Asia was not misaligned exchange rates, or mistaken domestic policy, or even a lack of transparency in the banking sector, although that surely didn't help. Rather, the root cause of the crisis that threatened the world with depression was the abrupt reversal of the excessively rapid rise of capital inflows and the falling global demand for the exports from the region. These arose from a global economy increasingly turned over to the rule of markets.

By the end of 1997, the Southeast Asian economies suffered "the equivalent of a massive bank run on the region without any lender of last resort," says economist Jan Kregel. In 1996, a net $78 billion flowed into the region from foreign bank loans and short-term portfolio investments like stocks. In 1997, that turned into a $38 billion outflow from the countries most hit by the crisis – Indonesia, Malaysia, South Korea, Thailand, and the Philippines. The biggest drop came in short-term portfolio investment, such as stocks, and bank lending.

The IMF, the prime candidate to act as lender of last resort, turned down the role – instead putting in place policies that imposed more austerity and yet tighter credit conditions. Steadfastly insisting that the cause of crisis was "home grown" as Stanley Fischer of the IMF put it, the IMF tightened credit for these countries already suffering from the disappearance of capital.

Even by the IMF's standards, these austerity measures were applied in an arbitrary and disproportionate manner. First World economies facing financial crises came in for far different treatment. The leading industrialized economies (and the IMF) urged Japan to increase government spending, cut taxes, and keep interest rates low to counteract its continued economic stagnation – just the opposite of the IMF prescription for the rest of East Asia.

In the Southeast Asian crisis, some reckless behavior was punished, while other reckless behavior was forgiven. Surely international investors are just as much or more responsible for the instability of the region as its local capitalists, bankers, governments, and workers. Yet foreign investors were being bailed out by the IMF, not punished. That is, foreign lenders had their loans repaid. The IMF did not deem the foreign shareholders ravaged by plummeting stock prices and collapsing currencies worthy of a bailout. Go figure.

LESSONS FOR THE LEFT

Left analyses of the crisis need to guard against two excesses: concluding with too much confidence that rapid growth is never to return to the Southeast Asian economies and that the severity of the crisis is proof that the growth that preceded it was artificial.

Depressions happen. Or depressions happen again, as Hyman Minsky, the left-leaning economic theorist of financial fragility, would have put it. Financial crises and economic downturns are the flipside of periods of unbridled capitalist growth. For these rapidly expanding, high debt, and now even less regulated Southeast Asian economies fell into crisis is hardly surprising.

But did the crisis bring the Asian miracle to an end or unleash the forces that would bring down the world economy? It seems not. Also, whether or not the current crisis was the death knell for rapid growth in the region, or the world economy for that matter, the growth preceding the crisis was dynamic and unstable – much like the capitalist growth that Marx and Engels observed transforming Europe in the middle of the last century. That the growth was based on brutal super-exploitation and relied more often on capital from the outside does not make it artificial or "ersatz," ready to disappear for that reason, as some claimed. After all, the region sustained growth over a long time, not just for the last decade, when Japanese investment was heaviest.

The enhanced mobility of capital – domestic and foreign – during the 1990s adds to the instability of these economies and reduces the bargaining power of labor. This is a very real concern, especially in economies such as Indonesia and Thailand where a numbing absence of social accountability has left the investors and corporations to operate unchecked. A profoundly flawed economic development has taken hold, both in the earlier period of rapid growth and since the crisis.

LIMITED CAPITAL MOBILITY, SOUND ECONOMIC DEVELOPMENT

A public policy that regulates capital, whatever its national origins, is called for in Southeast Asia. Only regulation demanding genuine accountability from both the cronies and the capitalists offers the prospect of genuine reform. The crunch of economic losses and slack labor markets makes reform more difficult. But to the extent that the crisis punctured the belief in infallible markets, strengthened the opposition to free markets, and spurred movements to organize, the potential for regulating capital has been enhanced, not diminished.

The proposal most favored in the region to limit capital mobility is a transaction tax on all cross-border flows of capital, designed by Nobel prize winning economist James Tobin. Although on its own it could not cool out a speculative fever or capital panic, the Tobin tax would discourage speculation. As a bonus, the tax revenues collected would more than adequately fund an IMF-style agency, freed from the dictates of the United States, that would bail out bankers and capital investors only when they invest long term, pay living wages, and respect international labor standards.

Malaysia took the more immediate action of imposing capital controls – banning the trading of the Malaysian currency, the ringgit, outside of the country. Malaysia's prime minister Mahathir called the plan "the only way to isolate the economy from the currency speculators and traders" whom he blamed for the country's economic crisis. Banning the trading of the ringgit in overseas markets in effect decoupled the Malaysian economy from the international currency markets. While Malaysian stock prices initially plummeted in response, the value of the ringgit remained steady, and Mahathir's move found support from some surprising sources. One maverick mainstream economist, M.I.T.'s Paul Krugman, endorsed the concept of capital controls, for they allowed Malaysian authorities to lower interest rates to counteract Malaysia's recession without causing the ringgit to collapse.

In addition to controlling international capital, whether internationally or domestically, public policy must also compel domestic capital and local elites to accept greater social accountability. Elites seldom pay taxes in these countries. Taxing elites would add to sources of domestic savings and at the same time make the distribution of income more equal. Also, giving these governments more money could add to domestic demand – providing a buffer against the shortfall in global demand that had a hand in this crisis. This social accountability must extend to conditions of work as well – notoriously dangerous in Southeast Asia – recognizing the rights of workers to organize, to work in safe conditions, and to earn a living wage.

These forms of social accountability would foster a more sustainable and equitable economic development, and perhaps lay the groundwork for a Southeast Asian economy that does more to relieve human suffering and less to add to it.

ARTICLE 4

November 2000

THE RUSSIAN FINANCIAL CRISIS OF 1998

A RETROSPECTIVE LOOK

BY DAVID M. KOTZ

Russian scientists were once famous for launching the world's first space satellite. Their counterparts today survive by growing vegetables in their small yards. These are not retirees enjoying some well-deserved leisure-time gardening, but prime age workers – miners and teachers as well as scientists – trying to meet basic needs in the face of economic collapse. People go to work every day and do whatever their employer asks, yet weeks and months pass without a single paycheck. They stay on the job because at least it provides some fringe benefits, and no alternative paying job exists.

This has been the meaning of Western-inspired "reform" since 1991 to a majority of public and private sector workers in Russia. But the media first began calling it a crisis only in August 1998, when Russia stopped making timely payments to Western bankers and other investors who had taken a chance on Russian bonds.

Russia's 1998 financial crisis came after years of suffering by ordinary Russians, who were victims of the Western-inspired "neoliberal" program for rapidly building capitalism in Russia. This program was devised in 1991-92 by top economic advisors to the post-Soviet Russian government, working closely with specialists from the International Monetary Fund (IMF).

Any visitor to Russia can see the effects of the IMF program. The nation's economic output has fallen by half and its investment by three-fourths since 1991. Following the IMF's tight-money advice, money was made so scarce that half or more of economic transactions have been conducted through barter in recent years (the ratio of money in circulation to the gross domestic product fell from 53% in 1991 to 9% two years later). A small group of influential insiders, popularly known as "oligarchs," were handed ownership of the former Soviet Union's most valuable properties, while the majority has been plunged into poverty and hopelessness. Surveys show that 55% of Russian households now rely on their own small gardens for half or more of their food consumption. The economic and social collapse has caused more than two million premature deaths since 1991, due to sharp increases in alcoholism, murder and suicide, infectious diseases, and stress-related ailments.

Despite the unprecedented economic depression, until the summer of 1998 Russian bankers kept getting richer and, for a time, the stock market soared, buoyed by the lucrative trade in Russia's valuable oil, gas, and metals. In 1997 Western banks helped to finance a speculative binge that drove up Russian stock prices, making it one of the world's best-performing stock markets that year. Then in the late spring of 1998, Russia's stock market began to fall and investors started to pull their money out of the country.

The Clinton administration, fearing that former Rus-

Revised and updated from "Capitalist Collapse: How Russia Can Recover," *Dollars and Sense*, November/December, 1998.

sian President Boris Yeltsin's government would not survive a looming financial crisis, pressed a reluctant IMF to approve a $22.6 billion emergency loan on July 13 of that year. This bailout proved unsuccessful. Four weeks later the financial crisis resumed as investors fled and Russia's government had to pay as much as 300% interest to attract buyers for its bonds.

After Washington rejected Yeltsin's desperate plea for still more money, Russia did the unthinkable: it was forced to suspend payment on its foreign debt for 90 days, restructure its entire debt, and devalue the ruble. Panic followed, as many of Russia's high-flying banks collapsed, depositors were unable to withdraw their money, and store shelves were rapidly emptied of goods. While Russia's oligarchs were able to shield their own fortunes, most of which were already stashed abroad, the deprivation long endured by ordinary Russians now spread to the small new middle class as well. The entire regime built up in post-Soviet Russia – run by a tiny group of corrupt pro-Western politicians, supported by the new financial oligarchy, and doggedly attached to the IMF's neoliberal program – began to totter.

WHAT CAUSED THE FINANCIAL CRISIS?

Two immediate developments turned Russia's euphoria into financial crisis. One was the growing realization that the IMF had so far failed to resolve the previous year's Asian financial crisis, despite huge loans and the imposition of severe economic measures (known as "structural adjustment programs") upon the suffering Asian countries. This created a ripple effect in the late spring of 1998, spreading fear of the world's "emerging markets" among international investors. Equally important was the sharp drop in oil and other raw material prices during 1998. This caused the value of Russia's oil exports, its main source of foreign currency earnings, to fall by almost half in the first six months of 1998 compared to the same period of 1997. Together, these two developments led investors to begin removing their funds from Russia.

Russia suddenly began slipping into a classic debt trap. In the early summer of 1998 the growing flight of capital out of the country forced the government to pay rapidly escalating interest rates on the money it borrowed to finance its relatively modest budget deficit. To make matters worse, Russia mainly sold very short term bonds, some coming due in a matter of weeks after issue, which only deepened its repayment problem. By July, Russia's monthly interest payments exceeded its monthly tax revenues by 40%. Realizing this was unsustainable, investors began a stampede for the door despite the IMF's huge bailout loan.

But the underlying cause of Russia's financial debacle runs deeper than the Asian financial flu or short-term movements in raw material prices. The ultimate cause of Russia's financial collapse was nearly seven years of free fall in its real economy. The financial sector cannot prosper indefinitely while production of real goods and services is collapsing. At the IMF's urging, Russia had dismantled its pre-existing economic system – abolishing central planning, eliminating controls on imports and capital movements, and privatizing most state enterprises. A new and effective capitalist market system was supposed to appear rapidly through individual initiative, if only the government kept out of the way. But in the contemporary world building a capitalist system requires an active state role and a considerable period of time. With its old economic system dismantled and no new one to take its place, the economy and society descended into chaos.

The IMF also insisted that, to combat inflation, Russia must pursue a tight fiscal and monetary policy – that is, make sharp cuts in public spending and keep money and credit scarce. This assured that plunging demand for goods and services would bring on a major depression. Eventually the Russian government found it could meet the mandatory IMF spending reduction targets only by increasing delays in paying workers and suppliers. Unpaid suppliers could not pay their own workers, spreading a chain of unpaid wages and taxes through the economy.

When the financial crisis struck Russia, the IMF actually insisted that the solution was more of the same – more cuts in government spending, higher taxes, and tighter credit. For a country suffering from a 50% decline in production, this was absurd advice. Any economics textbook notes that such measures, by further reducing the demand for goods and services, will only make an already severe recession worse – as U.S. President Herbert Hoover proved during 1929-32.

POLITICAL REPERCUSSIONS

The financial crisis undermined any remaining credibility in Russia for the IMF's neoliberal program. President Yeltsin began negotiating with the Communist opposition in the Parliament for a safe retirement. Sensing that their freedom to steal might be about to end, several of the oligarchs considered immediate flight to the West. The Communists and their allies, who formed a majority in Parliament, probably could have pushed the Yeltsin regime aside at the height of the crisis. Instead, they chose to compromise and forced President Yeltsin to accept a highly-regarded centrist political figure, former Foreign Minister Yevgeny Primakov, as Russia's new Prime Minister in September 1998.

Russia and the West waited to see what Primakov would do. For years Russia's political opposition had proposed an alternative economic strategy to the disastrous neoliberal approach. Many of Russia's best economists participated in drawing up detailed economic plans. These plans have had three main principles in common: The recovery of Russian industry and agriculture must take center stage; the economy should be directed toward producing consumer goods for the domestic market, rather than exporting raw materials and relying on imported consumer goods; and the state must play an active role in economic recovery and long-run economic development instead of leaving it to the "free market." The most important specific policy measures in the opposition strategy were the following:

1. Resume paying wages and pensions on time, and pay off back wages and pensions, which would stimulate domestic demand for the output of Russian industry.
2. Take control of the hard currency earnings from Russian exports, to redirect them from importing luxury automobiles into the purchase of goods and technologies needed to rebuild Russian industry.
3. Expand the money supply to eliminate barter and permit economic growth.
4. Increase public spending for infrastructure investment, public health, science, technology, and education.
5. Impose capital controls to stop the approximately $20 billion per year outflow of capital sent abroad by Russia's new rich.
6. Renationalize key sectors, such as the oil, gas, and raw materials sector, to redirect its output into Russian industry, and also the banks, to turn them from speculation to financing of productive activity.

Apart from the renationalization plank, none of the above policies is very radical. Many of them were used at some point during the New Deal era by the U.S. government, which explains why the Russian opposition often refers to the American New Deal as an inspiration for its program!

Prime Minister Primakov named a Communist, Yuri Maslyukov, as his chief economic strategist, and he voiced support for the general outline of the opposition economic program. However, he followed a cautious centrist approach. In his first few months, he pursued the first three measures listed above but not the last three. The government began paying back wages and pensions, and by June 1999 wage arrears, while still substantial, had fallen by one-third. He increased the government's share of hard-currency earnings from exports from 50% to 75%. And he expanded the money supply, somewhat reducing the prevalence of inefficient barter transactions.

These first timid moves helped spur the first significant economic recovery in Russia since 1991. Industrial output rebounded by 26% from September 1998 to April 1999, although part of the increase stemmed from the 4-fold devaluation of the ruble following the financial crisis, which priced imports out of reach for many Russian consumers. Russia's GDP grew by a modest 3% in 1999. Despite the IMF's dire warnings about the inflationary effects of monetary expansion, once the burst of inflation caused by the ruble devaluation had passed, inflation declined steadily, to 1.9% per month in June 1999.

However, the caution of Russia's political opposition, and of Prime Minister Primakov, proved to be their undoing. As long as the oligarchs kept control of Russia's valuable raw materials, the effort to rebuild the Russian economy was bound to be ineffectual in the long run. The oligarchs' maximum profit dictated continuing export to the world market of the oil, gas, and metals they controlled, along with freedom to send the proceeds abroad. If the oligarchs were allowed to keep the properties they had stolen, eventually they would regroup politically, pump life back into President Yeltsin, who had temporarily receded into the background, and get rid of the threatening forces in the government.

That is just what happened. By May 1999 the crisis had passed and the oligarchs realized they were not going to be expropriated. Worried about polls showing Prime Minister Primakov as the country's most popular political figure, Yeltsin summarily fired him, replacing him with a more pliable successor, Sergei Stepashin. Stepashin in turn was soon replaced by the little-known former intelligence chief Vladimir Putin, whose candidacy had been promoted by some of the leading oligarchs.

In December 1999, President Yeltsin abruptly resigned, making Putin the Acting President. This allowed Putin to use the full power of the presidency, including a monopoly of the mass media, to campaign for a full term as president. Aided by a temporarily popular war against the breakaway Russian republic of Chechnya, and divulging nothing about his future plans for Russia except a pledge to rebuild a "strong Russian state," Putin won the election in a vote marked by widespread irregularities. By fall 2000 President Putin's economic program was still unclear, although his main economic advisors are drawn from the group of neoliberal economists who destroyed Russia's economy.

Fortunately for the regime and the oligarchs, oil prices turned around at the beginning of 1999 and by early 2000 had reached historically high levels. This poured wealth into the oligarchs' pockets, while also increasing tax revenues. But, given the only partial modification of the neoliberal program, Russia's economy has hobbled along with only a weak recovery. At the 3% GDP growth rate of 1999, it would take 24 years for Russian GDP to reach its 1991 level! But even the recent slow growth is likely to collapse when oil prices inevitably decline. Only if Russia completely abandons the neoliberal program will there be hope for its future.

Resources: Revolution from Above: The Demise of the Soviet System, David M. Kotz with Fred Weir, 1997; *Russia in Figures,* 1999, Russian State Committee on Statistics; *Current Statistical Survey Quarterly of the Russian State Committee on Statistics,* various issues; *IMF Economic Review of the Russian Federation,* various issues; *RFE/RL Newsline,* various issues.

CHAPTER 2
Corporate Power and the Global Economy

ARTICLE 5

May/June 1999

CORPORATIONS SPONSOR CRACKDOWNS ON DISSENT

BY ARVIND GANESAN

In the sleepy fishing village of Veldur in India, Sadhana Bhalekar, a young woman in her mid-twenties, was taking a bath on the morning of June 3, 1997 when police broke down her door, beat her retarded nephew, and mercilessly dragged her out of her house naked, beat and then arrested her. She was three months pregnant at the time. The police officer in charge reportedly said, "This is Baba Bhalekar's wife, bash her head on the road." Why? Vithal "Baba" Bhalekar, is a leading opponent of the Houston-based Enron Corporation's Dabhol Power project — the largest power plant in the world — in the state of Maharashtra, India. The brutal police raid on Veldur village was clearly an act of terror to silence critics of the project.

Police assaults against opponents of Enron's project are a regular occurrence in Ratnagiri district, where the power plant is located. Authorities threw in jail a high profile critic of the project, Sadanand Pawar, an economics professor from Bombay, because he had "spread false information to the public which is against Enron."

The police — in what is often viewed as the world's largest democracy — criminalized demonstrations against Enron in December 1996, by banning all "public utterance of cries, singing of songs, playing of music" and the "delivery of harangues, the use of gestures or mimetic representations, and the preparation, exhibition or dissemination of pictures, symbols, placards or any other object or thing which may in the opinion of such authority offend against decency or morality..." The orders squashing free speech expire every fifteen days, but police routinely renew them to maintain the semblance of rule of law. By March of 1998, more than 3,000 people had been jailed, and some beaten, simply for demonstrating against the project.

The Indian state government did everything it could to ensure that Enron's project would move forward. What about the company? Enron paid the police who arrested and beat the protesters and continues to pay them to this day, a relationship legal under state law. Enron also loaned police a helicopter to survey the demonstrators.

But the actions of the company go beyond material and financial support for abusive police. On at least four occasions, contractors for the company directly threatened, harassed, and attacked individuals who opposed the project. When the victims tried to press charges, they found the rule of law did not operate for them. The police looked the other way in some cases. In others, the police arrested the victims.

The corporation denies any culpability. Instead, the multinational criticizes human rights organizations for documenting its abuses.

Since the East India Company first embarked on colonial ventures centuries ago, corporations have been complicit in human rights abuses. Because energy companies like Enron invariably displace residents from their land, or make it unlivable by polluting it, they are involved in some of the worst human rights abuses today. They have received more attention since November 1995, when the Nigerian government executed human rights activist Ken Saro-Wiwa and eight others who opposed the environmental devastation wrought by Royal Dutch/Shell in the Ogoniland region. An international campaign against