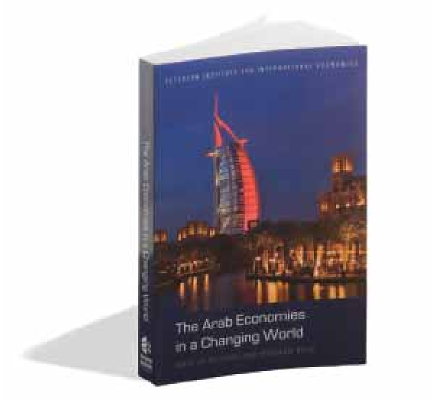
# BOOK REVIEWS

## Defying the Average in the Arab World




*Marcus Noland and Howard Pack*

**The Arab Economies in a Changing World**

Peterson Institute for International Economics, Washington, D.C., 2007, 350 pp., $24.95 (paper).

In *The Arab Economies in a Changing World,* Marcus Noland and Howard Pack examine the economic performance and prospects of 10 Arab countries: Algeria, Egypt, Jordan, Kuwait, Lebanon, Morocco, Saudi Arabia, the Syrian Arab Republic, Tunisia, and the Republic of Yemen. The presumption is that "Arabism" affords a significant degree of homogeneity to compare economic performance and prospects. As someone who wrote a book in 1976 on the region that stretches from Morocco to the Islamic Republic of Iran, I can say that the "Arab" region affords little homogeneity. I found the same to be true in 1997 in the six Gulf Cooperation Council (GCC) countries. These countries did not afford the hoped-for homogeneity (Saudi Arabia and Bahrain can hardly be compared). Later, in 2006, I felt that maybe the oil exporters of the Persian Gulf represented the best indicator of homogeneity, but even this has its limitations. Noland and Pack have silently arrived at a similar conclusion that their countries are too varied to afford neat generalizations.

### Key insights

The main conclusions of this book are that (1) although most of these countries have achieved significant success according to social indicators, their economic performance has been average; (2) the reasons for their economic performance vary; (3) the contributing factors are bad institutions (high degree of corruption, lack of cross-border integration, limited application of technology and innovation, below-average education and skill enhancement, and so on), authoritarian rule, political uncertainty, and large government sectors; and (4) in the case of the oil-exporting countries, oil has created special opportunities and pitfalls. In summary, the authors conclude that "at issue is not the extent of past achievements, . . . but rather whether the existing economic and political models . . . are adequate to successfully address the current demographically driven pressure to deliver jobs. . . . The answer is almost surely no."

While their analysis is thoughtful and highly significant, I have some differences with the authors. For instance, the authors shortchange the importance of women's labor force participation in future unemployment. Also, because of the diversity of their countries, Noland and Pack miss the fact that the performance of the Persian Gulf oil exporters was not average, but below average during 1975–2004.

### Errors of omission

In assessing the reasons underlying average economic performance, Noland and Pack fail to stress the role of conflicts and wars. Iraq, Lebanon, Kuwait, Algeria, Egypt, the Syrian Arab Republic, and Jordan have all paid a heavy price, and certain GCC countries have footed some of the bills.

The authors also ignore the negative role of outside powers, whether in support of dictators, isolation of countries, sanctions, "pushing" of sophisticated military hardware, or simply a divide-and-conquer policy. The authors say, "Because of the unusually long-standing stable nature of Arab political regimes, this legacy (i.e., authoritarianism) appears to have persisted considerably longer in the region than equivalent tendencies did in other regions." But they don't say why. "The issues being contested are fundamentally 'internal' in nature. In this case, the international community can do little." The answer is that foreign powers must shoulder some of the blame for authoritarian rule and for the so-called internal issues in a number of these countries.

> **"Although most of these countries have achieved significant success according to social indicators, their economic performance has been average."**

And, finally, although the authors state in various places that Islam is not a factor in the economic performance of these countries, they appear to also hedge their bet: "It could be that the negative interpretations of Islam's historical legacy reviewed earlier are correct but that enough convergence in institutions, policies, and behavior has occurred that the effects have been attenuated in the contemporary world." They quote only one group of commentators, without offering the balancing perspectives of another—who believe that Islam clearly stresses the importance of economic prosperity and economic justice for the Muslim community.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# Friends or Foes?

*Bill Emmott*

## Rivals

**How the Power Struggle Between China, India and Japan Will Shape Our Next Decade**

Harcourt, 2008, 352 pp. $26 (cloth).

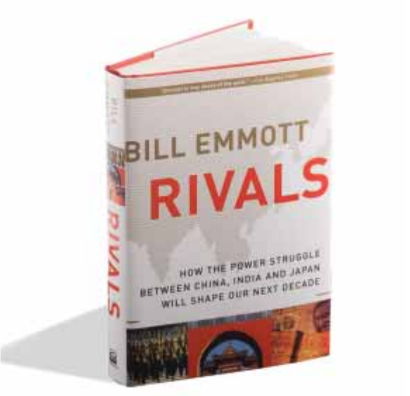
For 13 years, Bill Emmott labored as editor-in-chief of *The Economist,* a lofty position he ascended to after a stint as the magazine's correspondent in Tokyo, where he served during the 1980s. At the time, Japan's economic expansion was arousing fears in the United States and elsewhere that the country was determined to remake the world in its image. But in 1989, Emmott wrote a counterintuitive book, *The Sun Also Sets: The Limits to Japan's Economic Power,* forecasting that the country's growth was unlikely to continue in the 1990s.

With that bulls-eye prediction, Emmott comes to Asia discussions with a healthy dose of credibility. His departure from *The Economist* in 2006 enabled him to return to reporting, and he has unleashed a fresh dose of illuminating observations in *Rivals: How the Power Struggle Between China, India and Japan Will Shape Our Next Decade.* Heavy on nuance and light on cliché-ridden cheerleading, *Rivals* is a valuable and accessible contribution to the (often turgid) discussion of Asia's economic and political future.

### Who is right?

Emmott begins with the insight that Asia has never before been home to three powerful countries, all at the same time, and thus central to the continent's future will be how well they can manage their political and economic relationships with each other. The book quotes a senior Indian official, from the Ministry of External Affairs, expressing the zero-sum view: "The thing you have to understand," said the official, "is that both of us [India and China] think that the future belongs to us. We can't both be right."

China's grievances against Japan's conduct during World War II remain an open wound, with many Chinese charging the Japanese with failure to repent for their war crimes. And China still lays a claim to the Indian state of Arunachal Pradesh—a claim that led to war in 1962—while India says it is the rightful owner of a remote parcel of Himalayan land that today belongs to China.




Against this backdrop, China's decision to increase its military spending by 18 percent a year, and India's to increase its by 8 percent (while also signing a nuclear energy pact with the United States), looks ominous. Even Japan, although limited in what it can do to bolster its military, signed a security declaration with Australia last year—the first time Tokyo has entered into such an agreement since signing a peace treaty with the United States in 1952.

### The tie that binds

The encouraging news is that the three countries are being woven together through economic integration. In July 2008, for example, Japan exported more to China than to the United States—the first time this has ever happened. As high growth continues (at least in China and India), this integration should deepen, uniting Asia to a degree without precedent since the exploits of Genghis Khan.

But will the integration continue? That depends on the ability of each country to pursue reforms that will catalyze economic growth.

China's capital markets are, for example, riddled with weaknesses. Indeed, the vice-chairman of the National People's Congress declared last year that 70 percent of the country's publicly traded companies are worthless and should be de-listed.

India's economy is still handicapped by a phalanx of regulatory measures that stifle business activity (it scores a lowly 134th in the World Bank's *Doing Business* rankings). And the country's infrastructure and inefficient governing system threaten investment and economic growth.

Japan's economy is still plagued by widespread inefficiencies, and the Nikkei index recently fell to its lowest level since 1982. In 1998, while editor of *The Economist*, Emmott published a cover story with the headline "Japan's Amazing Ability to Disappoint." The headline would still work today.

### Making peace

Emmott closes with a number of recommendations for managing the rivalry between the three nations. These include initiatives involving security (persuading India to sign the Nuclear Non-Proliferation Treaty), environment (reducing emissions and increasing investment in clean energy), and diplomacy (encouraging U.S. support for the East Asia Summit launched in 2005, because it is the only regional body encompassing China, India, and Japan). Given Emmott's past success as a predictor, his failure to declare whether he expects the three nations to emerge as self-destructive rivals or as mutually beneficial allies is a curious omission.

But he rightly observes that relations between the three countries will be dictated by the behavior of China. The successful staging of the Beijing Olympics will do wonders for China's image, though more meaningful for the long term are the words of Deng Xiaoping when asked about China's approach to governing: "Stability overrides everything." Japan and India, and other nations in Asia, can only hope this means a commitment to regional partnership—and peace.

***Matthew Rees***
*President, Geonomica*

## Eyes on the Price

*Robert J. Samuelson*

**The Great Inflation and Its Aftermath**

**The Past and Present of American Affluence**

Random House, New York, 2008, 336 pp., $26 (cloth).

The U.S. Federal Reserve—"the Fed"—has committed two major blunders in its 95-year existence. The Fed worsened the Great Depression of the 1930s by refusing to inject liquidity into a global economy thirsting for it. And in the 1970s, the Fed permitted the Great Inflation to unfold by not soaking up liquidity from a global economy drowning in it. The Great Depression looms large in public consciousness, but the Great Inflation has faded from memory.

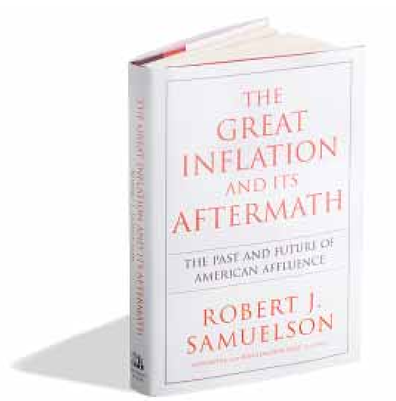
Robert Samuelson's book is a successful attempt to reclaim the "lost history" of the Great Inflation, an episode he regards as the U.S. government's "greatest *domestic* policy blunder [emphasis in original]" in the post–World War II era. But the book is much more than the story of the conquest of inflation; it provides one of the best narratives of U.S. and global economic history since 1960.

### Never-ending rain

From 1960 to 1979, annual U.S. inflation increased from less than 1½ percent to nearly 13½ percent. Price increases, says Samuelson, were "like the rain that never stopped." At the time, U.S. citizens protested vehemently against this rise in inflation. And in public opinion polls of the time, inflation was described as "more upsetting" than either the Vietnam War or the Watergate scandal.

Samuelson argues that allowing inflation to drift into double digits had devastating consequences for the U.S. economy in the 1970s. High inflation "incontestably destabilized the economy, leading to four recessions of growing severity." High inflation—and the accompanying high and volatile interest rates—stunted the increase in living standards by lowering productivity growth, causing stagnation in the stock market, and leading to a series of debt crises that affected "American farmers, the U.S. savings and loan industry, and developing countries."

Was the rain that never stopped simply a run of bad luck? No, says Samuelson, it was the "perverse consequence of well-meaning policies, promoted by some of the nation's most eminent academic economists." In the 1950s and early 1960s, economists came to believe that there was a stable inverse relationship between inflation and unemployment, implying that unemployment




could be reduced by accepting a bit more inflation. The Fed was a "prime accomplice" in triggering the Great Inflation. All major inflations involve too much money chasing too few goods, and the worst U.S. peacetime inflation occurred, writes Samuelson, "because the government, through the Fed, created too much money."

### Morning in America?

How was inflation reduced from double digits in 1980 to a mere 4 percent by 1982? Samuelson argues that this "was principally the accomplishment of two men—Paul Volcker and Ronald Reagan." But what they had to do to lick inflation was not pretty. Essentially, the Fed under Chairman Volcker tightened liquidity enough to bring about the most "punishing economic slump" since the Great Depression. Former U.S. President Reagan's role was to allow the Fed to maintain this policy "long enough to alter inflationary psychology." Even today, Samuelson says, the social costs of what the U.S. economy had to endure between 1980 and 1982 to reduce inflation "seem horrendous."

Samuelson credits the conquest of inflation with ushering in "the past quarter century's prosperity," reversing much of the adverse effects of letting inflation rise to double digits. These years were marked by U.S. income growth, which outstripped that of other advanced nations; entrepreneurial vitality reflected in the emergence of companies such as Microsoft; and revived confidence in the U.S. dollar. This vitality helped transform international finance by encouraging a dramatic surge in cross-border capital flows.

### The skies darken again

No success is unvarnished, nor does it last forever. Samuelson concedes that the 25-year run of good economic performance had its blemishes and may now be coming to an end. The years following the conquest of inflation were ones of economic growth, but it was "a starker society that had reverted to the rough-and-tumble existence of a more market-driven economy." And prolonged prosperity—continuous economic growth with only two mild recessions—helped "spawn a complacency and carelessness" about the consequences of the increased complexity of international finance, culminating in the present turmoil.

Samuelson says that the links between the financial system and the rest of the economy, which over time have become "larger and less predictable," will have to be better understood to restore the prosperity of recent decades. While new lessons have to be learned, Samuelson is keen that the lesson learned from the conquest of inflation not be forgotten: "The lesson from the Great Inflation is that inflation ought to be nipped in the bud: The longer we wait, the harder it becomes."

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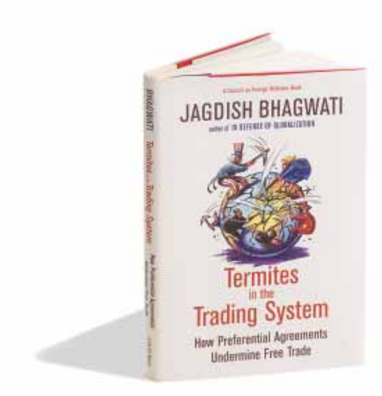
# A Passionate Voice




*Jagdish Bhagwati*

## Termites in the Trading System

**How Preferential Trade Agreements Undermine Free Trade**

A Council on Foreign Relations book, Oxford University Press, 2008, 160 pp., $24.95 (cloth).

Challenged by the mathematician Stanislaw Ulam to name a single proposition in all of social science that was both true and nontrivial, Paul Samuelson—the undisputed titan of 20th century economics—offered the principle of comparative advantage: "that it is logically true need not be argued before a mathematician; that it is not trivial is attested by the thousands of important and intelligent men who have never been able to grasp the doctrine for themselves or to believe it after it was explained to them." As Jagdish Bhagwati, a titan of 20th century international economics and author of *Termites in the Trading System*, might point out, these thousands of important and intelligent men have not done much better in grasping the distinction between free trade and free trade areas (trade agreements between a group of countries, described more precisely below), although that distinction also follows from a short set of axioms, and the failure to grasp it imperils the global trade system.

Bhagwati has been alerting the important and the intelligent to this distinction, and its relevance, for a long time, through both scholarly contributions and accessible writings in the popular press. In the early 1990s, when the recent drift in the direction of preferential trade agreements (PTAs) had only just begun, he stood as a lone cautionary voice against this fragmentation of the trade system (see his 1993 article "Regionalism and Multilateralism: An Overview," in *New Dimensions in Regionalism*, edited by Jaime DeMelo and Arvind Panagariya, New York: Cambridge University Press). Now, with the number of preferential agreements in the hundreds, and with the complexity of regulations governing the flow of goods and services into these countries growing proportionately, Bhagwati's caution seems particularly prescient.

Although the General Agreement on Tariffs and Trade (GATT), established in 1948, held nondiscrimination between member countries as a key principle, it sanctioned—through Article XXIV—exceptions to this principle, by permitting PTAs in the form of free trade areas (FTAs) and customs unions (CUs). According to the prevailing definitions, members of FTAs, such as the North American Free Trade Agreement (NAFTA) group, and CUs, such as the European Union, must eliminate internal trade barriers, but members of CUs also agree on a common external tariff against imports from nonmembers. Although FTAs and CUs are expected to eliminate barriers to trade between their member countries, doing so is not tantamount to multilateral free trade. The discriminatory tariffs that member countries impose on nonmembers imply that there may be inefficient sourcing of imports, with important (and possibly adverse) normative consequences for both members and nonmembers. Specifically, as Jacob Viner demonstrated in his classic 1950 analysis (in *The Customs Union Issue*, New York: Carnegie Endowment for International Peace), some trade may be "created" between member countries in goods that they produce efficiently relative to the rest of the world, but trade may just as easily be "diverted" from efficient nonmember countries because of preferences member countries grant each other. Thus, member countries may well worsen themselves.

In 100 brisk pages imbued with his characteristic wit and wisdom, Bhagwati dissects the PTA question with scholarly precision, historical depth, and attention to policy detail. In Chapter 2, he analyzes the historical origins of GATT Article XXIV and the political imperatives that led the United States to abandon its once-principled stand on nondiscrimination and admit Article XXIV's exceptions. His arguments in Chapter 3 about the negative consequences of trade diversion in practice, drawing on recent findings, add empirical heft to the theoretical case against trade preferences. He also discusses in depth the consequences of preferential trade to the multilateral trade system, and he is surely right that the current evolution of the trade system into a chaotic network of overlapping and intersecting PTAs (what he has famously called the "spaghetti-bowl" phenomenon) could not possibly be efficient. In Chapter 4, he lays out an appeal for countries to eschew bilateral initiatives, for broad-based multilateral liberalization to dilute the distorting effects of trade preferences, and for moving us closer to global free trade.

But will they listen, these thousands of important and intelligent men and women? Over the past few decades, Bhagwati—like an Indian classical virtuoso—has generated every variation of the argument for free trade and for multilateral approaches to achieve it. *Termites* contains some of Bhagwati's most striking arguments for the distinction between free trade and free trade areas, strongest refutations of those who confuse the two, and passionate descriptions of the consequences to the trade system that have arisen from this confusion. His arguments deserve serious attention.

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