

Korea, East Asia and the European Union: what can we learn from each other?

I. Introduction

In the talk on which this paper is based, I was asked to speak on comparative models of economic development looking in particular at South Korea¹ and The Netherlands. There are some similarities between these two countries: both have a long and proud historical tradition; both are resource-scarce, late industrialisers; both have experienced repeated foreign occupation; both were severely damaged by 20th century war, and for both the post-war period produced a changed constellation of domestic political forces enabling the state to play a key role in fomenting economic development.

Nevertheless, it is questionable whether these apparent similarities are of more than passing interest. The Netherlands is after all a small European state tightly integrated with its immediate EU neighbours; South Korea's economy and population size is more comparable to that of the EU's core economies, its post-war growth rate is unparalleled and, most particularly, the political division of the peninsula recalls that of Germany. If a comparison is to be made, it is between Korea and the core EU states.

This paper is divided into three sections. Initially I examine the question of division and re-unification. In section II, I look at Korea's 'model' of development in comparison to the EU. Finally, the paper considers the role of the major East Asian economic powers, within a multipolar world. The general argument made in this paper is that leading countries in East Asia and the European Union may share far more than is often realised. They certainly share an interest in building and maintaining the multilateral political and economic institutions needed to ensure an

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¹ Throughout this paper we use South Korea and North Korea in place of their official designations, the Republic of Korea and the Democratic People's Republic of Korea respectively.

equitable growth in world trade and sustainable development. Any return to a Hobbesian world of unfettered nationalism would be deeply damaging to the future of both regions.

II. Division and Reunification

An obvious parallel between Korea and the EU is its political division at the end of the Second World War. Orthodox history treats this division as one between ‘totalitarian communism’ and the ‘free world’; in reality the story is of course more complex. Just as the defeat of Germany left Europe divided between parties of left and right, so too did the defeat of Japan. The Yalta Conference created a framework in which parts of Europe---for many years called ‘Eastern Europe’---came under the political hegemony of the Soviet Union. In some Western European countries there were strong communist opposition parties; eg, France, Italy and Greece. But with the exception of the civil war of 1948 in Greece, the revolutionary left was contained and post-war consensus established between Christian-Democrat and Social-Democrat parties. At the heart of the post-war Western European consensus was the notion that in return for the ‘protection’ of the NATO umbrella, the United States would tolerate the establishment of a European welfare state, in effect a social pact mediated by government between Europe’s strong trade union movement and its industrialists. In essence, this state of affairs persisted until the end of the Cold War in 1990.

Like Europe, Korea was effectively partitioned by American and Russian forces in 1945. But the political landscape of South Korea was far more sharply divided than in Europe, in part because Koreans had resisted nearly four decades of Japanese colonial rule. Conventional historians describe the Korean War as a Russian-inspired aggression against the government of Syngman Rhee, a war started by the North under Kim Il-Sung.² In reality, during the period 1945-50, left-wing People’s Committees and the Seoul government lived uneasily. This period is marked by a series of uprisings---in 1946 and 1948---put down ruthlessly by the authorities in the South. Indeed, until 1948, Korea remained a single nation, its rule contested by

² See for example Hastings, M (1987).

different governments back by rival foreign powers.³ In this sense, the Korean War (1950-54) was the final stage of a civil war.

Prior to the initiation of peace talks, the initial hostilities (1950-1), left more than 3 million dead and reduced much of the country to rubble, particularly in the north. In short, while historians may disagree whether a political ‘consensus’ in Korea after 1945 was possible, what is clear is that the emergence of a genuine national political dialogue in South Korea involved a far longer and more violent struggle than anything experienced in Western Europe. Relatively speaking, the dialogue with between the two Koreas has only just begun.

There are further parallels worth mentioning between the two Koreas and the two Germanys. In Germany, throughout the second half of the Cold War, a dialogue was maintained between the BRD and DDR.⁴ German re-unification did not begin with the fall of the Berlin Wall in 1989; rather, it began with Chancellor Willy Brandt’s *Ostpolitik* in the 1970s, a policy initially opposed by the USA.⁵

While it is true that the 1953 political uprising in the DDR resulted in Soviet intervention and that German partition was re-enforced by the Berlin Wall of 1959-60, in the end reunification was the culmination of a long political dialogue both within East Germany and between the two Germanys. Moreover, military threat played no part in the dialogue between the two Germanys. During much of this period, foreigners and West Germans (other than Berliners) were allowed access to the DDR. Within the most of the DDR, West German television transmissions were tolerated. This is hardly comparable to the current situation in Korea where the two countries are still technically at war, where large numbers of troops are massed along a heavily fortified border and where political dialogue has been intermittent, tentative and politically contentious between the external mediating powers.

³ A good example of the new ‘revisionist’ history of post-war Korea is Halliday, Jon and Bruce Cummings (1990).

⁴ BRD and DDR stand respectively for ‘Bundesrepublik Deutschland’ and ‘Deutsche Demokratische Republik’; I use the original acronyms in place of their English equivalents, the FRG and the GDR.

⁵ For an early orthodox assessment see Dean Ascherson ‘Willy Brandt’s Ostpolitik: what’s at stake’ New York Review of Books, Volume 18, Number 7, April 20, 1972.

Another crucial difference between the German and Korean cases is the cost of reunification. Seen in retrospect, Chancellor Kohl's decision in 1990 to set a unitary exchange rate between the Ostmark and the Deutsche Mark was a colossal blunder. In 1990, the choice appeared to be between setting an 'egalitarian' exchange rate or facing an attempted flow of labour from East to West Germany. In reality, the exchange rate should have reflected the labour productivity and product quality differentials between the two Germanys. Had this principle been followed, the Ostmark would have been worth less than half a DM and East German industry would not have collapsed so precipitously.

The failure to adhere to this simple economic logic ultimately costs the West German taxpayer millions both in reconstruction and in unemployment benefit; an amount estimated equivalent to an annual transfer of nearly 4 percent of West German GDP to the east since unification.⁶ But even had a more sensible exchange rate policy been pursued, reunification would have entailed a massive cost in terms of rebuilding productive industry and its supporting social and economic infrastructure. In short, reunification of countries with widely divergent standards of living is an expensive business.

South Korea is today a relatively rich, industrialised country; it belongs to the OECD club. Nevertheless, it is not yet as rich as Germany was in 1990; equally important, North Korea is a good deal poorer today than was the DDR in 1990. Hence, successful unification would need to be financed, in part at least, by the international community. Given the current climate in Washington, it seems unlikely that the bulk of the required resources will come from the United States. The US may help 'buy' military stability, but achieving stability and achieving reunification are separate issues. After South Korea, the main contributors to reunification will be the countries of Asian region followed by the EU.

Nor, given the experiences of 1992 in Russia and 1997 in Asia, does it seem wise to allow such a project to be supervised by the US-dominated IMF or the World Bank.

⁶ See Wikipedia http://en2.wikipedia.org/wiki/German_reunification

The lesson of Eastern Europe is that the transition from of a centrally planned economy to a market-based economy is long and arduous. When the ‘big bang’ approach was applied in Russia in 1992 under Yeltsin and Gaidar, the results were catastrophic. Amongst others, Stiglitz (2002) estimates that per capita GDP in Russia during the past decade has fallen by 50 percent; this is borne out statistics showing dramatic increases in the incidence of infant mortality and the proportion of the population now in poverty.

By contrast, the two countries that have followed a cautious transition strategy to a market-based economy (eg, PR China, Viet Nam) have experienced some of the highest growth rates of the past decade. The lesson appears to be that South Korea, instead of aiming for hasty unification, should concentrate instead in promoting the sort of incremental political change in its northern neighbour leading to the adoption of a Chinese-style strategy. In short, helped by international aid, closer ties between the two Koreas leading to sustained economic growth in the north should precede unification; such a goal may take several decades to achieve.

III. Models of Development

Another important similarity between Korea (and more generally East Asia) and the EU is that both have models of ‘market economy’ distinct from that of the USA. As globalisation has accelerated in the past quarter-century, it has become increasingly clear that US-style capitalism and the accompanying ideology of market deregulation cannot provide a universal model of development. The so-called ‘Washington consensus’⁷ view of the world promoted by successive US administrations since the advent of Ronald Reagan has been challenged repeatedly. While I shall not detain the argument with an account of this debate, suffice it to say that, at Japan’s behest, the World Bank---a pillar of the Washington consensus--- produced an influential publication on the role of the ‘developmental state’ in Southeast Asia’s development.⁸ In the case of Europe, authors such as Dore (2000) and Hutton (2002) have contrasted

⁷ The phrase ‘Washington consensus’ was coined in Williamson (1990) and is most succinctly summarised as comprising of ‘economic deregulation, privatisation and fiscal austerity’.

⁸ See World Bank (1993).

‘stakeholder capitalism’ in the core EU countries with Anglo-Saxon ‘shareholder capitalism.’⁹

South Korea’s economic growth has been one of the world’s major success stories. Starting at the end of the Korean War with a per capita GDP lower than that of India and a higher population density than Bangladesh, it has achieved a high level of industrial development in less than 50 years and currently has a per capita income comparable to EU member states such as Spain and Portugal. Moreover, South Korea has very high levels of literacy and life expectancy and a low level of inequality.¹⁰

Much has been written about the nature of the Korean development model.¹¹ Simply stated, the dominant academic view is that government intervention in two crucial fields was vital to rapid industrial development. First, land reform prior to industrialisation ensured an ample supply of food (the wage good) and laid the foundations for macro stability; secondly, the government’s industrialisation policy moved from one of simple import substitution industrialisation (ISI) to a carrot-and-stick approach in which ISI-style protection was made contingent of meeting industrial export targets.¹² In Alice Amsden’s phrase, not only did Korean planners avoid Washington’s obsession with getting prices right, in key areas they concentrated on ‘getting prices wrong’.

It is hardly surprising therefore if the spread of the 1997 Asian financial crisis to South Korea and the economy’s subsequent contraction caused some orthodox economists to declare that Korean success was little more than a facade for economic cronyism and a weak financial system; in economists’ terminology, the crisis reflected the twin sins of poor corporate governance and morally hazardous banking rules compounded by an unofficial exchange rate peg. While it would be churlish to suggest that Korean institutions were blameless, it remains true nonetheless that in 1997 Korean fundamentals were sound: neither the government current budget nor the

⁹ While some recent US authors have argued that US-style capitalism has effectively triumphed---eg, Bobbit (2002)---such triumphalism is has been strongly criticised in the EU by authors such as Gray (2002).

¹⁰ The latest UN publication lists South Korea’s Gini coefficient for household income as 0.29; ie, by international standards the country is highly egalitarian.

¹¹ See for example Song (1997), Amsden (1989) and Wade (1992).

¹² This has been dubbed the ‘EPcumEP’ (effective protection cum export promotion) strategy by Chris Edwards; see Edwards, C in Hewitt, Tom, Hazel Johnson and Dave Wield *eds* (1992).

external account were in deficit and inflation was flat. Rather, certain Korean banks and companies---led by some notable *chaebol*---were highly leveraged, rendering them vulnerable any drying up of foreign loans. As first Thailand, the Indonesia and Malaysia were hit by the crisis, intra-regional trade and capital flows began to slow, in turn triggering loss of confidence throughout Asia by international capital markets. With South Korea unable to renew its loans, it turned to the IMF, which imposed a draconian deflationary package on the country.

In short, the conservative interpretation of Korea's crisis---namely, that it was the result of Korean financial weakness and corporate cronyism---is deeply misleading.¹³ The 1997-98 crisis was triggered by financial contagion and compounded by the imposition of deflationary policies causing further damage. Thankfully, the economy has since bounced back and is currently growing at just over 6 percent. But the crisis cost the economy at least 10-15 percentage points of growth foregone, bankrupted businesses and threw people out of work. Such a cost is not negligible; moreover, it was avoidable since it resulted from prescribing a dangerous remedy for a misdiagnosed illness. Possibly the most positive thing to come out of the Asian financial crisis was the notion that the region should establish its own 'bailout' facility in the form of an Asian Monetary Fund. Not surprisingly, the notion has been unpopular in Washington, and so is currently being discussed with caution under the innocuous title of the Chang Mai Agreement.

Considering the above story, what parallels if any can be found with the EU? Clearly there are strong dissimilarities, so one must proceed with caution. However, I would like to make a few tentative suggestions.

The EU, like East Asia, is a dynamic trade region; eg, it derives much of its regional dynamic from the growth of trading ties and capital flows within the region. This process is of course more advanced in the EU, particularly since the Treaty of Rome dates back nearly half a century and the region has recently adopted a common currency. The salient point, however, is that since the end of the Second World war,

¹³ One might add that Western banks did much of the lending, that the US had faced a similar banking crisis a few years before (the 'thrift' bailout) and that the US and EU are certainly not immune to 'cronyism' as the Enron and other scandals have shown.

the EU has been catching up with the world's great economic power, The United States. East Asia is on the way to doing the same.

Just as in East Asia, the EU's 'model of capitalism' differs from that of the USA. European countries, like many Asian countries, place great emphasis on social cohesion and inclusiveness, although these goals tend to be realised in different ways. The EU possesses a body of social legislation emphasising the importance of full employment, the rights of workers to be represented on industrial councils, the universality of education, health insurance, the right to old-age pensions and so forth. Such a conception of the social modalities of a market economy is probably best summed up by the German expression *soziale Marktwirtschaft* or social market economy, and has been enshrined at EU level in the 'Social Chapter' of the Maastricht Treaty (1992). To a degree, universal literacy, access to higher education and a concern with maintaining social cohesion through entrenched workers' rights are shared aims in much of East Asia. Expressed in somewhat different terms, in neither the EU nor in East Asia is it thought that a free market economy can deliver prosperity with equity unless strong mechanisms of social regulation are in place.

In this respect, the capitalist model prevalent in the United States, particularly in the form it has taken in the past two decades, is not a universal model. Neither Asia nor the EU are converging on a single model.¹⁴ For that matter, the USA's closest geographical neighbour, Canada, is in matters of social policy far closer to the EU.

Equally, just as the EU began as a trading association of market economies, closer integration---including the abolition of internal borders and the adoption of a single currency---has not led to cultural homogeneity. Not only has cultural diversity been preserved in the EU and national and regional identities retained, it is highly improbable that these will ever disappear. Clearly, globalisation does contribute an additional layer to social identity; ie, a new generation has grown up wearing jeans, playing much the same music and eating occasionally at the local MacDonald. But for all the mobility of this generation, the EU is probably more culturally diverse than it was a generation ago. If you stand on a street corner in London, Paris or Madrid you

¹⁴ For a detailed discussion of this issue, see Gray (2002).

will see a greater ethnic diversity and hear more languages spoken (including more European regional dialects) than in 1950 or 1975. The same holds true, although to a lesser degree, in Asia.

It would be mistaken, however, to believe that both the EU and East Asia are immune to the effects of US-led globalisation. Globalisation has had negative impacts on the EU and while one could cite a variety of examples, but for present purposes I dwell on only one: the globalisation of economic ideology.

Starting in the 1970s, the Keynesian post-war consensus regarding the role of the state in the regulation of a market economy came under increasing attack. This attack began in US academic circles, first taking the form of ‘monetarism’ as developed by Milton Friedman and his disciples at the University of Chicago¹⁵, and later by Thomas Sarjant at the University of Minnesota and other members of the rational expectations school, best represented today by MIT’s Robert Barro.¹⁶ The political ascendancy of anti-Keynesian economics was marked by the election of Reagan in the United States and Thatcher in Britain. For well over a decade, a new ideology of ‘market fundamentalism’ gained ground in academic and governmental circles, spreading to developmental circles with the end of McNamara presidency at the World Bank. This new conservatism has had a disproportionate impact on the way governments conduct business, in part because economics has for so long been dominated by the Anglo-Saxon world and in part because the United States produces by far the largest number of economic graduates and PhDs.

My example of the negative impact of the new economic ideology is taken from Europe (though it could just as well be taken from, say, Japan). At the end of the 1980s, economists and politicians in Brussels were struggling with the drafting of the Maastricht Treaty, the defining document which, when signed in 1992, committed its members to completing the integration of the European Community (or Union as it was renamed) and the introduction of a single currency.

¹⁵ Arguably, the ‘monetarism’ of the Chicago school was merely a throwback to the explicitly anti-Keynesian doctrines of Hayek and others. For brevity’s sake, I abstract away from the finer details.

¹⁶ The best short summary of the rise of neo-conservative economics is to be found in Part I of Krugman (1994).

The men and woman who drafted the Treaty were not particularly conservative; in anything, they shared many of the ideas of the Commission's notably progressive President, Jacques Delors. But the economic doctrine informing the treaty was deeply conservative. The Treaty specified that the Brussels budget, in effect the EU federal budget, should not exceed 1.3 percent of combined European GDP. More important, it created an independent European Central Bank whose single goal is to combat inflation (unlike the US Fed which must balance the risk of inflation against a full-employment target as well), and which sets an EU-wide interest rate in light of this goal. Finally and most dangerously, Maastricht enshrined the fiscal principles that no member state should exceed a 3 percent budget deficit nor allow cumulative public borrowing to exceed 60 percent of GDP. The Treaty was supplemented in 1997 by the Stability and Growth Pact, which specified penalties to be imposed against member states for breaking these rules.¹⁷

Arguably such conservative measures were devised to placate international financial markets in the run-up to the unification of European currencies on 1 January 1999. Whatever the reasons, the results have been disastrous. At the time of writing, three of the four major EU economies are technically in recession as are a number of the smaller EU member states. Germany, France and Italy are all forecast to exceed the Maastricht 3 percent budget-deficit limit in 2003 and seem likely to do so in 2004 as well. Austria, The Netherlands and Portugal---three countries that have implemented drastic spending cuts in order to remain within the Maastricht rules---are currently challenging the Big Three in the Economic and Financial Committee of the European Commission. Germany---the motor of the European economy---is struggling to contain the damage by cutting social expenditure. Germany, moreover, has experienced very low growth for over a decade, largely as a result of the poor economic design and high consumption costs of unification.

As any first year economics students should know, cutting government expenditure during a recession merely makes the recession deeper. If a recession (or even very slow growth) lasts long enough---as has been the case in Germany for nearly a decade---'deflationary expectations' can set in. (This is incidentally precisely what

¹⁷ For a detailed discussion of these issues see Irvin, G (2003).

has happened in Japan where, at present, zero real interest rates and a massive fiscal deficit have not yet produced sustained economic growth.) In short, anti-Keynesian economic doctrine has moved from the halls of academia into the corridors of power where it now threatens to delay not just European recovery, but slows world growth. Only US exceptionalism---in the form of budget giveaway for the rich and a massive consumer debt bubble---keeps the world economy afloat.

In the wake of the 1997 crisis in Asia, the exceptionally painful results of deflationary fiscal and monetary policy should be obvious. The lessons of the current European economic crisis will be evident in Asia, most of all in a country such as South Korea.

III. A Unipolar World?

We owe the phrase ‘multipolar world’ to the Anglo-American historian, Paul Kennedy.¹⁸ Today the phrase has become politically sensitive: the current US administration clearly believes we live in a unipolar world. Not only is the United States the world’s most powerful economy but, since the end of the Cold War, it has become by far the world’s strongest military power. According to the Stockholm Peace Research Institute (SIPRI), the US currently spends some \$400 bn of defence, having increased defence spending dramatically in its 2002 budget. The EU-15, which has a larger population than the US but an economy roughly the same size, spends only about one-third this total of defence (\$140 bn). Put most dramatically, the US military budget is larger than those of the next largest 15 nations combined. Hence, political analysts like Robert Kagan can claim that it is US military strength that enables it to adopt a pro-active, bilateral approach to international relations; by contrast, a weaker Europe remains bound to the multilateral institutional framework that has governed international relations in the past half-century.¹⁹

The same argument extends to East Asia, a region which broadly speaking has moved increasingly towards multilateralism---- as evidenced by China’s recent support of Germany and France in their opposition to the US-led invasion of Iraq in defiance of

¹⁸ See Kennedy, P (1989).

¹⁹ See Kagan, R (2003).

the majority of the Security Council. Japan and South Korea are traditionally closely allied to the US but their support for the Iraq invasion was little more than nominal. South Korea's position is, of course, somewhat special. On the one hand, it has relied on US military strength to ward off the threat of renewed hostilities with the North. On the other hand, South Korea has remained acutely aware of the need for a negotiated settlement on the Korean peninsula, and to that end repeated efforts have been made to engage a dialogue with Pyongyang. What is also clear is that any attempt by the USA to neutralise North Korea by military means would entail high risks for South Korea and might even precipitate conflict with other regional powers. The threat to South Korea's today may be far more complex than that faced by Germany in the 1970s, but some form of *ostpolitik* remains an important ingredient in its resolution.

More generally, in the context of the unipolar-multipolar debate, one may well ask what importance military prowess plays in a world where economic strength is the ultimate prize. East Asia may have faltered briefly in 1997-98, but if its current growth rates are sustained, China's economy will soon become the second largest in the world. In terms of GDP per capita, South Korea can be expected to overtake the leading members of the EU within this generation, and even sooner if the core EU economies continue to stagnate.

Moreover, while the United States economy picked up strongly based on 3rd quarter results for 2003, whether such growth is sustainable is a moot point. The US budget surplus of 2000 has now turned into a large deficit, and its external deficit is equivalent to 5 percent of GDP. A number of leading US economists have expressed serious doubt as to whether such a deficit is sustainable. The US dollar has already fallen relative to the euro; if it falls seriously relative to Asian currencies---as it must do if external balance is to be restored---Central Banks might well reduce their holdings of US Government debt to a degree that would cause the dollar to fall even more sharply, possibly precipitating a world-wide financial crisis. My own view is that such a scenario is unlikely, but the possibility of crisis cannot be ignored.

IV. Conclusions

The general conclusions of this paper have already been stated clearly. The EU member states and the countries of East Asia have more in common than they realise. The specifics of the argument can be summarised as follows.

The experience of Germany, the core EU economy, holds important and obvious lessons for Korea. Re-unification requires time, patient negotiation and, above all, it required financial resources. Federal Germany has paid dearly for absorbing the DDR to quickly and at the wrong exchange rate. That cost is not only expressed in terms of consumption transfers to the east, it is expressed by Germany's poor growth performance over the past decade, which has now spilled over into other EU economies. The optimal strategy for Korea is probably to encourage the North to shift to a high-growth market economy in much the same fashion as has happened in China and Viet Nam. If this process can be hastened by aid from the international community---admittedly a big 'if'---then a solid basis for successful reunification process will have been laid.

The other lesson to be learned is about economic management. Here, the EU has more to learn from East Asia than vice-versa. East Asia's financial crisis, although not precipitated by the IMF, was exacerbated by the highly orthodox fiscal rules countries such as South Korea were forced to adopt. Luckily, the underlying strength of these economies has enabled them for the most part to return to pre-1997 levels of growth. In the EU, by contrast, the self-imposed orthodoxies of the Maastricht Treaty have contributed to continued stagnation and, at present, to a dangerous confrontation between member-states over the question of adhering to the Stability and Growth Pact. The problem will be further exacerbated by the agreed enlargement from the EU-15 to the EU-25, an enlargement which will further slow the already cumbersome decision-making process in Brussels. The lesson for Europe is that problems, which can be resolved under conditions of buoyant growth, become intractable when the economy stagnates. East Asian countries know how to stimulate economic demand and keep the speed up (even Japan appears to have learned the lesson). The EU must still learn.

I have argued that East Asia and the EU also have models of capitalism which, while distinct from each other, are distinct from the ‘pure’ market-dictated capitalism exported by the United States. Understanding economic ideology is an important part of understanding economic policy. The market fundamentalism of the United States is neither suitable nor desirable for either East Asia or the EU. By and large, Asians and Europeans place a greater value on social coherence and inclusiveness than do Americans.²⁰ This means that the state has assumed a more interventionist role in Asia and Europe; this state of affairs will continue in future, current US political fashion for ‘the market state’ notwithstanding.

More generally, I have argued that political leaders in Asia and Europe generally accept that we live in a multipolar world, one in which no nation has the right to pursue its interests without regard to the institutional framework regulating international relations. While one cannot doubt the military strength of the United States, it is legitimate to ask whether it is wise to resort to precipitous military action where long-term diplomacy might achieve the same ends. The salient point, however, is that no country, however strong militarily, can expect to be dominant where it relies on the rest of the world for its continued economic prosperity.

The continuation of economic prosperity, or more specifically the broader notion of socially and environmentally sustainable development, is the underlying theme of this paper. As time passes, the world becomes increasingly dependent on Europe and Asia to take timely initiatives in making sustainable development possible. To do so has become more than a mere challenge; co-operation in pursuing this goal has become an imperative.

²⁰ ‘Americans’ stands here for ‘citizens of the USA’; Canadians, Mexicans (and for that matter all those who inhabit the two continents) have an equal right to call themselves ‘Americans’.

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