Financial Globalization
The impact on trade, policy, labor, and capital flows
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Preface

The growing integration of the world economy—one of the main features of globalization—is increasingly affecting the policy choices of IMF member countries. For that reason, *Finance & Development* magazine has been tracking the trends and consequences of globalization, which refers to the increasing speed and ease with which goods, services, factors of production, the ownership of assets, information, ideas, and consumers themselves move across national borders.

This compilation of articles published over the past eight years in the pages of *F&D* examines the economic implications of, and responses to, globalization in an era when porous borders limit the domestic effectiveness of many national decisions while causing their effects to be transmitted internationally. As the title suggests, the focus is on financial globalization, including the policy implications of the huge growth in cross-border capital flows. Since 1995, these flows have tripled to $6.4 trillion, reaching about 14.5 percent of world GDP, after 15 years of staying within a relatively narrow range of 2–6 percent. Should the surge in capital swirling around the globe be cause for joy or alarm? Alarm seemed to dominate in the aftermath of the East Asian financial crisis in the late 1990s. But a major reappraisal is now under way of the costs and benefits of these global flows, especially since many developing countries are grappling with the question of whether they should open up more to these flows or use capital controls to resist them.

The compilation is the second to be published by *F&D*, following the collection of articles on health and development. By publishing the articles together, we hope that they will form a useful starting point for those examining the globalization of finance.

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Beyond the Blame Game

A new way of looking at financial globalization reexamines its costs and benefits

M. Ayhan Kose, Eswar Prasad, Kenneth Rogoff, and Shang-Jin Wei

FINANCIAL globalization, the phenomenon of rising cross-border financial flows, is often blamed for the string of damaging economic crises that rocked a number of emerging markets in the late 1980s in Latin America and in the 1990s in Mexico and a handful of Asian countries. The market turmoil and resulting bankruptcies prompted a rash of finger-pointing by those who suggested that developing countries had dismantled capital controls too hastily—leaving themselves vulnerable to the harsh dictates of rapid capital movements and market herd effects. Some were openly critical of international institutions they saw as promoting capital account liberalization without stressing the necessity of building up the strong institutions needed to steer markets through bad times.

In contrast to the growing consensus among academic economists that trade liberalization is, by and large, beneficial for both industrial and developing economies, debate rages among academics and practitioners about the costs and benefits of financial globalization. Some economists (for example, Dani Rodrik, Jagdish Bhagwati, and Joseph Stiglitz) view unfettered capital flows as disruptive to global financial stability, leading to calls for capital controls and other curbs on international asset trade. Others (including Stanley Fischer and Lawrence Summers) argue that increased openness to capital flows has, in general, proved essential for countries seeking to rise from lower- to middle-income status and that it has strengthened stability among industrial countries. This debate clearly has considerable relevance for economic policy, especially given that major economies like China and India have recently taken steps to open up their capital accounts.

To get beyond the polemics, we put together a framework for analyzing the vast and growing body of studies about the costs and benefits of financial globalization. Our framework offers a fresh perspective on the macroeconomic effects of global financial flows, in terms of both growth and volatility. We systematically sift through various pieces of evidence on whether developing countries can benefit from financial globalization and whether financial globalization, in itself, leads to economic crises. Our findings suggest that financial globalization appears to be neither a magic bullet to spur growth, as some proponents would claim, nor an unmanageable risk, as others have sought to portray it.

Unanswered questions

The recent wave of financial globalization began in earnest in the mid-1980s, spurred by the liberalization of capital controls in many countries in anticipation of the better growth outcomes and increased stability of consumption that cross-border flows would bring. It was presumed that these benefits would be large, especially for developing countries, which tend to be more capital-poor and have more volatile income growth than other countries.
Emerging market economies, the group of developing countries that have actively participated in financial globalization, have clearly registered better growth outcomes, on average, than those countries that have not participated (see Chart 1). Yet the majority of studies using cross-country growth regressions to analyze the relationship between growth and financial openness have been unable to show that capital account liberalization produces measurable growth benefits. One reason may be traced to the difficulty of measuring financial openness. For example, widely used measures of capital controls (restrictions on capital account transactions) fail to capture how effectively countries enforce those controls and do not always reflect the actual degree of an economy’s integration with international capital markets. In recent years, considerable progress has been made on developing better measures of capital controls and better data on flows and stocks of international assets and liabilities. Studies that are based on these improved measures of financial integration are beginning to find evidence of positive growth effects of financial integration. The evidence, however, is still far from conclusive.

Nor is there systematic evidence that financial integration is the proximate determinant of financial crises. Authors who have looked at different manifestations of such crises—including sudden stops of capital inflows, current account reversals, and banking crises—have found no evidence that countries that are more open to financial flows tend to have a higher incidence of crises than those that are less open.

Although crisis episodes receive most of the attention, they are just particularly sharp manifestations of the more general phenomenon of macroeconomic volatility. On that score, the results are less favorable: financial globalization has not delivered on the promised benefit of improved international risk sharing and reduced volatility of consumption for developing countries.

In sum, the effects of financial globalization have not been conclusively determined. Although there is little formal empirical evidence to support the oft-cited claims that financial globalization has caused the financial crises that the world has seen over the past three decades, the existence of robust macroeconomic evidence of the benefits of financial globalization is elusive, too. Given the shortcomings of cross-country growth regressions, is there another approach that can shed light on the effects of financial globalization?

**Not created equal**

An alternative perspective on the growth and volatility effects of financial globalization is based on differentiating among various types of capital flows. This is particularly relevant because the composition of international financial flows has changed markedly over time.

*Foreign direct investment* (FDI) has now become the dominant source of private capital flows to emerging market economies (see Chart 2); *equity flows* have also risen in importance, whereas *debt flows* have declined. FDI and portfolio equity flows are presumed to be more stable and less prone to reversals and are believed to bring with them many of the indirect benefits of financial globalization, such as transfers of managerial and technological expertise. Debt flows, by contrast, are widely accepted as being riskier; in particular, the fact that they are procyclical and highly volatile can magnify the adverse impact of negative shocks on economic growth.

The increasing importance of portfolio equity flows to emerging markets has motivated a number of studies examining the growth effects of equity market liberalizations. These papers uniformly suggest that these liberalizations have a significant, positive impact on output growth. Whether the estimated growth effects could be picking up the effects of other factors—especially other reforms that tend to accompany these liberalizations—remains, in our view, an open question. On the other hand, the body of microeconomic evidence (using industry- and firm-level data) supporting the macro evidence of the benefits of equity liberalizations is growing. Some of these papers also document the empirical relevance of various theoretical channels that link equity market liberalization to economic growth, including through increases in investment and total factor productivity growth.
Interestingly, despite the general consensus that FDI is most likely to spin off positive growth benefits, these benefits are harder to detect in aggregate data than those associated with equity flows. Fortunately, recent research using micro data is starting to confirm that FDI flows do have significant spillover effects on output and productivity growth.

From the evidence we have reviewed thus far, a key theme emerges: many of the benefits of financial openness seem to be masked in cross-country analysis using macroeconomic data but are more apparent in disaggregated analyses using micro data. An approach based on micro data also has a better chance of disentangling causal effects and capturing the relative importance of different channels through which financial integration affects growth.

Some economists have used micro data to estimate the costs of capital controls. Such controls seem to cause distortions in the behavior of firms (and individuals), which adjust their behavior to evade capital controls. By insulating an economy from competitive forces, capital controls may also reduce market discipline. Thus, their existence appears to result in significant efficiency costs at the level of individual firms or sectors.

Making sense of the evidence

We now introduce a conceptual framework that assembles these disparate strands of evidence in order to shed some light on why empirical evidence at different levels of disaggregation reaches different conclusions.

A basic building block of our framework is the notion that successful financial globalization does not simply enhance access to financing for domestic investment but that its benefits are catalytic and indirect. Far more important than the direct growth effects of access to more capital is how capital flows generate what we label financial integration’s potential collateral benefits (so-called because they may not be countries’ primary motivations for undertaking financial integration). A growing number of studies are showing that financial openness can promote development of the domestic financial sector, impose discipline on macroeconomic policies, generate efficiency gains among domestic firms by exposing them to competition from foreign entrants, and unleash forces that result in better government and corporate governance. These collateral benefits could enhance efficiency and, by extension, total factor productivity growth.

The notion that financial globalization influences growth mainly through indirect channels has powerful implications for an empirical analysis of its benefits. Building institutions, enhancing market discipline, and deepening the financial sector take time, as does the realization of growth benefits from such channels. This may explain why, over relatively short periods, it seems much easier to detect the costs but not the benefits of financial globalization. More fundamentally, even over long horizons, it may be difficult to detect the productivity-enhancing benefits of financial globalization in empirical work if one includes structural, institutional, and macroeconomic policy variables in cross-country regressions that attempt to explain growth. After all, it is through these very channels that financial integration generates growth (see Chart 3).

One should not, of course, overstate the case that financial integration generates collateral benefits. It is equally plausible that, all else being equal, more foreign capital tends to flow to countries with better-developed financial markets and institutions. We also do not dismiss the importance of traditional channels—that financial integration can increase investment by relaxing the constraints imposed by low levels of domestic saving and reducing the cost of capital. But our view is that these traditional channels may have been overemphasized in previous research.

Is there empirical merit to our conceptual framework? We now turn our attention to marshalling the evidence for a key piece of our argument—that financial globalization has significant collateral benefits.

Financial integration’s indirect benefits

The potential indirect benefits of financial globalization are likely to be important in three key areas: financial sector development, institutional quality, and macroeconomic policies.

A good deal of research suggests that international financial flows serve as an important catalyst for domestic financial market development, as reflected in straightforward measures of the size of the banking sector and equity markets and in broader concepts of financial market development, including supervision and regulation.

Research based on a variety of techniques, including country case studies, supports the notion that the larger the presence of foreign banks in a country, the better the quality of its financial services and the greater the efficiency of financial intermediation. As for equity markets, the overwhelming theoretical presumption is that foreign entry increases efficiency, and the evidence seems to support this. Stock markets do, in fact, tend to become larger and more liquid after equity market liberalizations.

The empirical evidence suggests that financial globalization has induced a number of countries to adjust their corporate governance structures in response to foreign competition and demands from international investors. Moreover, financial...
sector FDI from well-regulated and well-supervised source countries tends to support institutional development and governance in emerging market economies.

Capital account liberalization, by increasing the potential costs associated with weak policies and enhancing the benefits associated with good ones, should also impose discipline on macroeconomic policies. Precisely because capital account liberalization makes a country more vulnerable to sudden shifts in global investor sentiment, it can signal the country's commitment to better macroeconomic policies as a way of mitigating the likelihood of such shifts and their adverse effects. Although the empirical evidence on this point is suggestive, it is sparse. Countries with higher levels of financial openness appear more likely to generate better monetary policy outcomes in terms of lower inflation, but there is no evidence of a systematic relationship between financial openness and better fiscal policies.

The evidence that we have surveyed in this section is hardly decisive, but it does consistently point to international financial integration as a catalyst for a variety of productivity-enhancing benefits. Given the difficulties that we have identified in interpreting the cross-country growth evidence, it is encouraging to see that financial market integration seems to be operating through some of the indirect channels.

A complication: thresholds

Some related studies have tackled the question of what initial conditions are necessary if financial openness is to generate good growth benefits for a country while lowering the risks of a crisis. What are these conditions?

**Financial sector development**, in particular, is a key determinant of the extent of the growth and stability benefits financial globalization can bring. The more developed a country's financial sector, the greater the growth benefits of capital inflows and the lower the country's vulnerability to crises, through both direct and indirect channels.

Another benefit of greater financial sector development is that it has a positive effect on macroeconomic stability, which, in turn, has implications for the volume and composition of capital flows. In developing countries that lack deep financial sectors, sudden changes in the direction of capital flows tend to induce or exacerbate boom-bust cycles. Furthermore, inadequate or mismanaged domestic financial sector liberalizations have contributed to many crises that may be associated with financial integration.

**Institutional quality** appears to play an important role in determining not just the outcomes of financial integration but the actual level of integration. It also appears to strongly influence the composition of inflows into developing economies, which is another way it affects macroeconomic outcomes. Better institutional quality helps tilt a country's capital structure toward FDI and portfolio equity flows, which tend to bring more of the collateral benefits of financial integration.

The **quality of domestic macroeconomic policies** also appears to influence the level and composition of inflows, as well as a country's vulnerability to crises. Sound fiscal and monetary policies increase the growth benefits of capital account liber-
Financial globalization and help avert crises in countries with open capital accounts. Moreover, for economies with weak financial systems, an open capital account and a fixed exchange rate regime are not an auspicious combination. A compelling case can be made that rigid exchange rate regimes can make a country more vulnerable to crises when it opens its capital markets.

Trade integration improves the cost-benefit trade-off associated with financial integration. It also reduces the probability of crises associated with financial openness and mitigates the costs of such crises if they do occur. Thus, recent studies strengthen the case made by the old sequencing literature that argued in favor of putting trade liberalization ahead of capital account liberalization.

This discussion suggests that there are some basic supporting conditions, or thresholds, that determine where on the continuum of potential costs and benefits a country ends up. It is the interaction between financial globalization and this set of initial conditions that determines growth and volatility outcomes (see Chart 4).

A comparison of Charts 3 and 4 highlights a fundamental tension between the costs and benefits of financial globalization. Many of the threshold conditions are similar to the collateral benefits. In other words, financial globalization is a catalyst for a number of important collateral benefits but can greatly elevate the risk-to-benefit ratio if the initial conditions in these dimensions are inadequate.

A different threshold is related to the level of integration itself. Industrial economies, which are far more integrated with global financial markets, clearly do a better job than emerging markets of using international capital flows to allocate capital efficiently, thereby accruing productivity gains and sharing income risk. Does this mean that, to realize the collateral benefits, developing countries’ only hope is to attain a level of financial integration similar to that of industrial economies and that the risks they encounter along the way are unavoidable? After all, if the short-term costs take the form of crises, they could have persistent negative effects that detract from the long-term growth benefits. Furthermore, the distributional effects associated with these short-term consequences can be particularly painful for low-income countries.

Risk-benefit calculus

Our synthesis of the literature on financial globalization, while guardedly positive about its overall benefit, suggests that as countries make the transition from being less integrated to being more integrated with global financial markets, they are likely to encounter major complications. For developing countries, financial globalization appears to have the potential to generate an array of collateral benefits that may help boost long-run growth and welfare. At the same time, if a country opens its capital account without having some basic supporting conditions in place, the benefits can be delayed and the country can be more vulnerable to sudden stops of capital flows. This is a fundamental tension between the costs and benefits of financial globalization that may be difficult to avoid.

Does this imply that a country that wants the collateral benefits of financial globalization has no alternative but to expose itself to substantial risks of crises? Or, alternatively, would developing countries do best to shield themselves from external influences while trying to improve the quality of their domestic policies and institutions to some acceptable level? Our view is that, although the risks can never be totally avoided, there are ways to improve the benefit-risk calculus of financial globalization. There is, however, unlikely to be a uniform approach to opening the capital account that will work well for all countries.

The collateral benefits perspective may provide a way for moving forward on capital account liberalization that takes into account individual country circumstances (initial conditions), as well as the relative priorities of different collateral benefits for that country. Depending on a country’s internal distortions—particularly those related to the domestic financial sector—one can, in principle, design an approach to capital account liberalization that could generate specific benefits while minimizing the associated risks. Although we have laid out a framework for thinking about these issues, further research is clearly needed in a number of areas before one can derive strong policy conclusions about the specifics of such an approach.

Meanwhile, we should recognize that some of the more extreme polemic claims made about the effects of financial globalization on developing countries, both pro and con, are far less easy to substantiate than either side generally cares to admit.

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Liberalizing Capital Account Restrictions

M. Ayhan Kose and Eswar Prasad

WHAT accounts for the surge of cross-border capital flows over the past two decades? Capital account liberalization provides a big part of the answer. But while the increase in these flows since the mid-1980s—both between industrial countries and from industrial to developing countries—has been associated with a number of benefits, it has also played a role in a number of financial crises. This raises some fundamental questions. Why have many developing countries followed the advanced economies and signed on to capital account liberalization despite the risks, and is it really the culprit that some anti-globalizers have made it out to be?

What is the capital account?
The capital account in a country’s balance of payments covers a variety of financial flows—mainly foreign direct investment (FDI), portfolio flows (including investment in equities), and bank borrowing—which have in common the acquisition of assets in one country by residents of another. It is possible, in principle, to control these flows by placing restrictions on those flows going through official channels.

Capital account liberalization, in broad terms, refers to easing restrictions on capital flows across a country’s borders. This presumably results in a higher degree of financial integration with the global economy through higher volumes of capital inflows and outflows.

There is, however, a significant difference between financial integration in theory and in practice. Some countries—for example, in Latin America during the 1970s and 1980s—have found it difficult to contain capital outflows in times of economic distress despite apparently pervasive controls. In contrast, many developing countries, including a few in Africa, have no significant controls but have experienced only minimal inflows.

This also points to the difficulty of measuring capital controls and, by extension, the degree of capital account liberalization undertaken. The IMF (which has jurisdiction over current account, but not capital account, restrictions) maintains a detailed compilation of member countries’ capital account restrictions. But even these provide, at best, rough indications because they do not measure the intensity or effectiveness of capital controls.

Why control capital flows?
Controls on capital account transactions represent a country’s attempt to shield itself from risks associated with fluctuations in international capital flows. Capital controls take on special significance in the context of a fixed exchange rate regime. Maintaining such a regime can be made more difficult by unfettered capital flows. This is one reason why even industrial countries had relatively closed capital accounts under the Bretton Woods system of fixed exchange rates, which operated from the end of World War II until 1973.

There could, of course, be various other reasons for maintaining controls, on either inflows or outflows. In a country with a fragile banking system, for instance, allowing households to invest abroad freely could precipitate an exodus of domestic savings and jeopardize the banking system’s viability. And short-term capital inflows can be quickly reversed when a country is hit with an adverse macroeconomic shock, thereby amplifying its macroeconomic effect.
Some developing countries also use capital controls to steer the composition of inflows toward more stable forms, such as FDI. Countries favor FDI, among other reasons, because it usually involves flows that are relatively long term and not subject to rapid reversals associated with changes in investor sentiment. Some countries have also used selective capital controls to try to induce a shift from shorter- to longer-term inflows—in Chile’s case, by imposing an implicit tax on capital inflows reversed within less than a year.

Motives for liberalizing

In theory, capital account liberalization should allow for more efficient global allocation of capital, from capital-rich industrial countries to capital-poor developing economies. This should have widespread benefits—by providing a higher rate of return on people’s savings in industrial countries and by increasing growth, employment opportunities, and living standards in developing countries.

Access to capital markets should allow countries to “insure” themselves to some extent against fluctuations in their national incomes such that national consumption levels are relatively less volatile. Since good and bad times are not synchronized across countries, capital flows can, to some extent, offset volatility in countries’ own national incomes.

Capital account liberalization may also be interpreted as signaling a country’s commitment to good economic policies. For a country with an open capital account, a perceived deterioration in its policy environment could be punished by domestic and foreign investors, who could suddenly take capital out of the country. This provides a strong incentive for policymakers to adopt and maintain sound policies, with obvious benefits in terms of long-term growth. Inflows stemming from liberalization should also facilitate the transfer of foreign technological and managerial know-how and encourage competition and financial development, thereby promoting growth.

What does the evidence say?

The evidence is not quite as compelling as the theory, however. While emerging market countries that have liberalized their capital accounts typically have had higher growth rates, on average, than those that have not, this association does not imply a causal relationship. Statistical analysis suggests that, after controlling for the effects of other factors, the causal effect of capital account liberalization on growth has been weak, at best.

There is also some evidence that emerging market countries have not been able to use international financial markets effectively to reduce consumption volatility. In fact, the financial crises that have occurred in these economies have been associated with sharp falls in both income and consumption. And there appears to be a significant procyclical element to international capital market access for such countries. International investors are willing to lend to them in good times but tend to pull back in bad times, thereby amplifying swings in the domestic macroeconomy.

Is liberalization worth the risk? The answer, as with most such things, is that it depends. Capital account liberalization clearly is not an unqualified blessing and poses major risks if implemented in unfavorable circumstances—particularly without supporting policies.

Opening the capital account while maintaining a fixed exchange rate regime, especially when domestic macroeconomic policies are not consistent with the requirements of the regime, has been followed by crisis in many countries. Countries that have maintained or only gradually eased capital controls while moving toward a more flexible exchange rate regime generally seem to have had better outcomes.

Weak macroeconomic fundamentals can also pose a problem. For instance, capital account liberalization can aggravate risks associated with imprudent fiscal policies by providing access to excessive external borrowing. Premature opening of the capital account also poses serious risks when financial regulation and supervision are inadequate. In the presence of weakly regulated banking systems and other distortions in domestic capital markets, foreign capital inflows could be misallocated and create a host of problems.

What’s a country to do?

While the evidence suggests that transitional risks are associated with opening the capital account, resisting liberalization over an extended period may prove futile and counterproductive. As the forces of globalization advance, it becomes harder for countries to maintain closed capital accounts. Increasing openness to international trade expands opportunities for the avoidance of capital account restrictions through under- and over invoicing of trade transactions. And the increasing sophistication of investors and global financial markets makes it much easier to move capital around under different guises.

One possible strategy is to accept the risks and move forward while controlling the risks as much as possible. History and international experience provide a guide. Sound domestic policies and institutions, a regulatory framework promoting a strong and efficient financial sector, and effective systems and procedures for monitoring capital flows greatly improve the chances of ensuring that capital flows foster sustainable growth.

Notably, the benefits of capital account openness in terms of higher growth and lower volatility seem to be most evident for industrial economies, which also typically have the most open capital accounts. Counterintuitive as it may seem, the relatively more positive experiences of industrial countries therefore suggest that, for developing economies, more—not less—financial integration is the answer. But only if it is done the right way. Perhaps most notably, in all the advanced economies and many other countries, open capital accounts are now taken for granted (see chart): no country that has liberalized its capital account in recent decades has reversed the process other than temporarily.

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TECHNOLOGICAL innovations and faster information flows, aided by a sharp increase in total savings being channeled into financial instruments across borders, have fostered the dramatic globalization of capital flows—defined as the flow of capital across borders. These flows—including debt, portfolio equity, and direct investment–based financing—topped $6 trillion in 2005.

Developed European countries have provided large amounts of finance to emerging European countries that are newcomers to the European Union.

Countries have been shifting toward issuance of local currency debt, reflecting better fundamentals, greater foreign investor appetite, and a growing domestic institutional investor base. A favorable global environment has allowed them to lock in longer-term funding and improve debt structures.

Europe, the leader of the pack, has enjoyed rapid growth in intra-European flows, fueled by the adoption of the euro as the common currency.
Emerging market countries, though still a small share of overall capital flows, have seen their share grow significantly, thanks to the large current account surpluses of Asia and, more recently, of oil exporters.

Capital flows from emerging market countries to mature markets have been dominated by central bank reserves and sovereign wealth funds, mainly from emerging Asia and oil exporters.

Paradoxically, emerging market countries are a key provider of capital to mature markets.

These flows are mainly in the form of official reserve flows into U.S. long-term securities.

Global imbalances have risen in recent years, with a growing current account deficit in the United States and surpluses elsewhere. The attractiveness of U.S. financial markets has supported inflows (including from emerging markets) that financed the current account deficit.

Despite high current account deficits and strong capital inflows, U.S. net foreign liabilities have remained stable in recent years as U.S. foreign assets have appreciated with a weaker dollar and strong stock markets abroad. But, with continued high current account deficits, they are likely to rise sharply.

Prepared by Mangal Goswami and Jack Ree of the IMF’s Monetary and Capital Markets Department and Ina Kota of the IMF’s External Relations Department.
STANDARD economic theory tells us that financial capital should, on net, flow from richer to poorer countries. That is, it should flow from countries that have more physical capital per worker—and hence where the returns to capital are lower—to those that have relatively less capital—and hence greater unexploited investment opportunities. In principle, this movement of capital should make poorer countries better off by giving them access to more financial resources that they can then invest in physical capital, such as equipment, machinery, and infrastructure. Such investment should improve their levels of employment and income.

It is natural to expect that as financial globalization—cross-border flows of various forms of financial capital—picks up steam, these flows from industrial to developing countries will increase, making all countries better off. A rosy scenario, indeed, but what is the reality? In a famous article written in 1990, Robert Lucas pointed out that capital flows from rich to poor countries were very modest, and nowhere near the levels predicted by theory. Financial globalization has, of course, surged in the past decade and a half. What then has become of the empirical paradox that Lucas identified? Has increasing financial integration resolved it?

Remarkably, this paradox has, if anything, intensified over time. As Chart 1 shows, the average income, relative to the United States, of capital-exporting countries has fallen well below that of capital-importing countries. In other words, capital has been flowing from poor to rich countries!

Recent U.S. current account deficits and Chinese current account surpluses are, of course, a big part of the reason why capital is flowing “uphill.” But they are hardly the full story. Many industrial economies are now running current account deficits, whereas a large number of emerging market economies are running surpluses. Chart 1 also indicates that uphill flows are not entirely a new phenomenon; a similar pattern can be seen in the mid-1980s.

Capital flows to and from developing economies include official flows, such as inflows of foreign aid and outflows in the form of accumulated international reserves. These flows may be driven by factors other than the basic rate-of-return considerations discussed earlier. Do private capital flows behave more in accord with economic theory? Foreign direct investment (FDI) does flow from richer to poorer countries, which is comforting. But FDI, while rising in importance over time, still accounts for only about 40 percent of private flows to developing countries and a smaller fraction of total flows. Moreover, the pattern of overall flows is ultimately what is relevant in terms of resources available for financing investment in a country. This article examines how capital is allocated around the world and whether foreign capital really promotes growth in developing countries.

Examining the paradox
Perhaps the Lucas paradox isn’t such a paradox if one digs deeper. After all, many developing countries are beset by a variety of problems—inequitable infrastructure, a poorly educated labor force, corruption, and a tendency to default on debt from abroad, among other factors—that reduce the risk-adjusted returns to investment. These problems could explain why capital does not flow to developing countries in the quantities one would expect. The risk-adjusted return that foreign investors get from investing in these countries may be much lower than the rate of return that might be anticipated just on the basis of the relative scarcity of capital and relative abundance of labor.
At any rate, of the capital that does flow to nonindustrial countries, more should go to the countries that are growing the fastest and are therefore likely to have the best investment opportunities. But does it?

To examine this issue, we sorted 59 developing countries into a range from low to high average growth rates over the period 1970–2004. We then divided them into three groups with roughly equal aggregate populations. China and India were handled separately because their populations are so large. We added up current account deficits for each group, deflating the computed flows in dollars by the U.S. consumer price index to make them comparable over time. In principle, more capital should go to the fastest-growing countries and the least to the slowest-growing group.

Chart 2 shows that, over the period 1970–2004, as well as over shorter periods, the net amount of foreign capital flowing to relatively high growth developing countries has been smaller than that flowing to the medium- and low-growth groups. During 2000–04, the pattern is truly perverse, with China, India, high-growth, and medium-growth countries all exporting significant amounts of capital, while low-growth countries receive significant amounts. That capital flows to developing countries do not follow growth. By and large, however, they do, with the fastest-growing group of nonindustrial countries attracting more net foreign capital, while low-growth countries receive significant amounts. That capital flows to developing countries do not follow growth has been dubbed the allocation puzzle by Gourinchas and Jeanne (2007).

The puzzle deepens when we examine net FDI flows (see Chart 3). During the most recent period (2000–04), even net FDI flows do not follow growth. By and large, however, they do, with the fastest-growing group of nonindustrial countries attracting the most FDI over the period 1970–2004, and China receiving substantial amounts. This suggests that fast-growing countries do have better investment opportunities, which is why they attract more FDI. Yet they do not use more foreign capital overall and, in the case of China, they export capital on net.

In short, the apparent perversity of overall foreign financing is even more dramatic when one examines the allocation of capital across developing countries. The paradox of international capital flows is worse than Lucas had imagined!

Driving growth
Why does more foreign capital not flow to nonindustrial countries that are growing more rapidly and where, by extension, the revealed marginal productivity of capital (and probably credit-worthiness) is indeed high? More important, do these perverse flows of capital hamper growth in nonindustrial countries?

A large body of research has essentially reached the same conclusion: it is difficult, using macroeconomic data, to

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**Chart 2**

**Perverse trends**

High-growth developing countries attracted less net foreign capital than medium- and low-growth groups.

<table>
<thead>
<tr>
<th>(aggregate flows to nonindustrial countries, billion dollars)</th>
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<tbody>
<tr>
<td>1970-2004</td>
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<td>1985-97</td>
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<td>2000-04</td>
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</table>

Source: Authors’ calculations.
Notes: Median real GDP growth rates for the countries in each group (after averaging over the relevant period for each country) are shown in parentheses. The nonindustrial countries in our sample are split into three groups with roughly equal total populations in each group. China and India are treated separately. Each panel shows the cumulative current account deficits (in billions of dollars, deflated by the U.S. consumer price index starting at 1 in 2004) summed up within each group over the relevant period. Bars below the zero line indicate a current account surplus.

**Chart 3**

**Better opportunities**

Except for the most recent period, more FDI went to the fastest-growing countries.

<table>
<thead>
<tr>
<th>(net FDI to nonindustrial countries, billion dollars)</th>
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<tr>
<td>1970-2004</td>
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Source: Authors’ calculations.
Notes: Median real GDP growth rates for the countries in each group (after averaging over the relevant period for each country) are shown in parentheses. The nonindustrial countries in our sample are split into three groups with roughly equal total populations in each group. China and India are treated separately. Each panel shows the cumulative net FDI inflows (in billions of dollars, deflated by the U.S. consumer price index starting at 1 in 2004) summed up within each group over the relevant period.
establish a robust causal relationship between private capital inflows and economic growth. But does this mean that foreign capital does not matter?

To address this question in a different way, we examined the long-run relationship between current account balances and growth. Current account balances are a measure of total external capital financing available for investment in a country. This measure is particularly relevant for our purposes because it is the difference between national savings and national investment. Countries that borrow more from abroad should be able to invest more (because they are less constrained by domestic saving) and, therefore, should grow faster.

We examined the correlation between growth and current accounts using data averaged over a long period for each country. Surprisingly, for our sample of 51 nonindustrial countries, the correlation is positive (see Chart 4). In other words, developing countries that have relied less on foreign finance have grown faster in the long run. That is not to say there are no episodes where nonindustrial countries have grown fast and run large current account deficits—East Asia before the crisis is a clear example. We attempted to look beyond short-run foreign-funded booms (and possibly busts) to whether, on average and in the long run, nonindustrial countries that have grown the fastest have depended most on foreign finance. They have not.

We also conducted a more thorough statistical analysis of this relationship, accounting for various other factors that could be driving growth, and examined the robustness of the results in a number of ways. For instance, we looked at the correlation just for the period 1985–97. This was in some sense the heyday of recent global integration, with rising capital flows and a relatively tranquil period in international financial markets (barring the Mexican Tequila Crisis). This should have been the period when the benefits of capital inflows shone forth. In most of these cases, however, the association between current account balances and growth remains positive for nonindustrial countries (the correlation is zero in the remaining cases). In no case do we find the negative relationship predicted by economic theory.

**Tapping savings**

How do we interpret the finding that there is a positive correlation between the current account surplus and a country’s growth rate? One possible explanation is that the relationship reflects and is driven by domestic savings, which are either determined by deeper forces or generated through growth itself. After all, if foreign inflows responded largely to investment opportunities, there should be an unambiguously negative relationship between growth and the current account.

Indeed, it turns out that the positive correlation we have found is driven largely by national savings. That is, nonindustrial countries that have higher savings for a given level of investment experience higher growth. Of course, investment in high-saving countries could also be higher, so high domestic savings do not imply low reliance on foreign savings.

In Chart 5, we split the sample of nonindustrial countries into four groups depending on whether they were above or below the average levels of the ratios of investment to GDP and current account to GDP. The figure shows, as expected, that countries with higher levels of investment fare better than those with lower levels. What is interesting is that countries that had high investment ratios and lower reliance on foreign capital (lower current account deficits) grew faster—on average, by about 1 percent a year—than countries that had high investment but also a greater degree of reliance on foreign capital.

**What’s going on?**

One explanation for the positive correlation between the current account surplus and a country’s growth rate is that higher growth is associated with—and itself generates—higher domestic savings. In other words, fast-growing countries may need less foreign capital. The problem with this explanation is that, typically, as countries grow (that is, when they experience a positive productivity shock), they should want to consume more (because they are richer) and invest more (because of the investment opportunities). Thus, the correlation should, if anything, be negative.

This is where the financial system—especially an underdeveloped one—can play a role. If the financial sector were deep and efficient, a sustained increase in productivity would result not only in more investment (as firms borrow to take advantage of investment opportunities) but also in more consumption as consumers borrow to consume in anticipation of their higher income. Conversely, a weak financial sector could translate a sustained increase in the productivity of certain sectors into weaker investment growth and

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**Chart 4**

Stand alone

Developing countries that have relied less on foreign capital have, in general, grown faster.

(average per capita GDP growth, percent)

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<th>Country</th>
<th>Average current account as percent of GDP</th>
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Source: Authors’ calculations.

Note: Sample excludes Nicaragua.

greater savings growth. Corporate investment could be limited to the funds firms generate internally from past investment, while consumers save much of the increased income stemming from the increase in productivity because they cannot borrow in anticipation of higher future income.

Another possibility is that weak financial systems may not help in efficiently intermediating foreign capital. This too could result in the lack of a positive relationship between flows of foreign capital and higher growth. But if financial systems in developing countries are weak, where are the productivity gains coming from? Our conjecture is that the forces of globalization—especially improved supply chains and greater competition resulting in more efficient production—may be generating productivity gains in nonindustrial countries despite financial system weaknesses.

Consistent with the views that foreign capital may be neither needed nor helpful because of weak financial systems, we find that the positive correlation between current account balances and growth holds up when we examine just the group of countries with less well developed financial systems. For those that experience growth episodes, the range of profitable investment opportunities, as well as the level of private consumption, may be constrained by financial sector impediments, meaning that investment will have to be financed largely through domestically generated savings.

Excessive reliance on foreign capital may also have harmful consequences. It can lead to currency appreciation and, in some circumstances, overvaluation (where the level of the exchange rate is higher than the level warranted by economic fundamentals). In turn, this could hurt competitiveness and exports in key sectors like manufacturing. Recent analyses of growth episodes suggest that a dynamic manufacturing sector is a key to long-run growth. Thus, reduced reliance on foreign capital—and the avoidance of overvaluation—may help the development of an export-oriented manufacturing sector.

**Caution warranted**

An implication of our analysis is that the seemingly perverse flows of capital from poor to rich countries today are not necessarily a sign of inefficiencies in global financial markets. Rather, they may indicate financial and other structural impediments that limit a poor country’s ability to absorb foreign capital.

Taken at face value, our results suggest that there is a growth premium associated with reduced reliance on foreign finance—though we do not have strong evidence to suggest that this is a causal relationship. The reliance of nonindustrial countries solely on domestic savings to finance investment comes at a cost, however. There is less investment and consumption than there would be if these countries could draw in foreign capital on the same terms as industrial countries.

What does all this mean for policies related to capital account openness? Any discussion of the merits of capital account openness is likely to be very specific to a country. Our results suggest that—insofar as the domestic financial sector is underdeveloped and there is a need to avoid exchange rate appreciation caused by inflows—greater caution toward certain forms of foreign capital inflows might be warranted. At the same time, financial openness may itself be needed to spur domestic financial development and to reap the benefits that financial flows and better growth opportunities provide.

How can this tension be resolved? One approach might be a firm—and hopefully credible—commitment to integrate financial markets at a definite future date, thus giving time for the domestic financial system to develop without possible adverse effects from capital inflows, even while giving participants the incentive to prepare for integration by suspending the sword of future foreign competition over their heads.

A recent example of this is China’s approach of trying to spur banking reform by committing to open its banking sector to foreign competition as part of its obligations for accession to the World Trade Organization.

A lot more research is needed to better understand how to increase a country’s absorptive capacity, which in turn would allow developing countries to benefit from foreign finance even during the process of development.

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**References:**


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This paper is based on a forthcoming IMF working paper by the authors that contains detailed results and references to the literature.
What is globalization?
Globalization is characterized by increases in flows of trade, capital, and information, as well as mobility of individuals, across borders. It is not a new phenomenon—globalization has progressed throughout the course of recorded history, although not in a steady or linear fashion.

Has globalization raised living standards?
Increased international trade and capital flows have been a major source of the unprecedented economic growth and rise in living standards globally in the postwar period. Evidence shows that countries that have opened up to the rest of the world have done better than those that have not (see chart). In fact, there are no successful cases of fast-growing countries that followed inward-looking policies. Even so, not all open economies have prospered, nor have all citizens of countries that have globalized. Of course, other factors—including the full range of domestic economic and social policies—also shape countries’ economic growth and how the benefits of that growth are shared.

Has globalization helped the poor?
Not only does international economic integration promote economic growth, but also, on average, economic growth tends to increase incomes of the poor. In fact, without economic growth, there can be no sustained poverty reduction. Globalization has also facilitated the spread of technologies that have contributed to dramatic improvements in health, life expectancy, and literacy in poorer countries and communities.

- Infant mortality rates declined, on average, by 50 per thousand (to 59 per thousand) from 1970 to 1999 in developing countries, versus 10 per thousand (to 6 per thousand) in developed countries.
- Life expectancy in China doubled (to 70 years) over 1960–99; in India it rose by 20 years (to 64 years); and in the United States it rose from 70 to 77 years.
- Over the past three to four decades, adult illiteracy rates have declined by 30 percentage points in China, Ghana, India, Korea, and Mexico.

Has globalization reduced inequality?
Global inequality has two dimensions: inequality among and within countries.

- Globalization has helped promote convergence of per capita incomes among countries. Per capita incomes have grown faster in globalizing developing countries (those lowering their barriers to trade) than in rich countries—5 percent versus 2.2 percent in the 1990s—and there has also been convergence of per capita incomes among the advanced economies. Nonglobalizing developing countries have lagged behind.
- Within industrial countries, increased openness does not appear to be a significant cause of widening inequality. While it is true that inequality has increased within some industrial countries, this increase is linked to a widening gap between wages of skilled and unskilled labor. Evidence suggests that it is technological change, not trade with lower-wage countries, that has driven the widening gap.
- Within developing countries, inequality has increased even as income has grown for both rich and poor. However, it is wrong to link this increase in inequality solely to globalization, as many factors can affect inequality. Some of them are specific to the countries concerned (such as wars and natural disasters), while others are more general (such as technological change).

Quick facts
70% Reduction in cost of ocean freight transport between 1920 and 1990
84% Reduction in cost of air transport between 1930 and 1990
$60.42 Cost of a 3-minute telephone call from New York to London in 1960 (in 2000 U.S. dollars)
$0.40 Cost of same call in 2000
$1,869,004 Price of computer and peripheral equipment in 1960 (relative to GDP deflator; 2000=1000)
$1,000 Price of equivalent computer in 2000

Financial Globalization
Dramatic increases in per capita income have accompanied the expansion of trade

<table>
<thead>
<tr>
<th>Country</th>
<th>Real per capita GDP (constant 1995 dollars)</th>
<th>Trade openness (right scale)</th>
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<tbody>
<tr>
<td><strong>Korea</strong></td>
<td>14,000 (1960) 12,000 (1970) 10,000 (1980)</td>
<td>80% 60% 40% 20% 0%</td>
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<tr>
<td><strong>China</strong></td>
<td>8,000 (1960) 6,000 (1970) 4,000 (1980)</td>
<td>60% 40% 20% 0%</td>
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<tr>
<td><strong>Ghana</strong></td>
<td>3,000 (1960) 1,000 (1970) 0 (1980)</td>
<td>20% 0%</td>
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<tr>
<td><strong>Mexico</strong></td>
<td>1,000 (1960) 3,000 (1970) 5,000 (1980)</td>
<td>10% 20% 30% 40%</td>
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Source: IMF, World Economic Outlook database.
Notes: Trade openness is defined as the sum of exports and imports divided by GDP. Data for Korea, China, and Ghana are for 1960–99 and for Mexico for 1970–2000.

How should governments respond to problems caused by globalization?

**Problem**
Countries that are not involved in globalization may become increasingly marginalized and mired in poverty.

Globalization, like technological change, can cause short-run disruptions, such as job losses and income declines, which disproportionately hit the poor.

Openness to global capital markets can bring greater volatility in financial markets.

**Policy response**
This calls for poverty reduction strategies and policies to promote the integration of low-income countries into world markets. Rich countries need to open their markets to exports from developing countries. Governments need to provide adequate social safety nets to mitigate the effects on the vulnerable and the poor. Governments can also reduce inequalities and help all citizens to achieve their potential through policies that provide equal opportunities, including greater access to public education and health care. Countries that open their financial markets need to develop strong financial systems and sound economic policies.

Globalization time line

*The post-1950 period and late nineteenth–early twentieth centuries witnessed the strongest sustained growth of output in recorded world history.*

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Late nineteenth–early twentieth centuries
Rapid growth in world trade was triggered by sharply falling transportation costs, reduced tariffs, and major inventions, such as the internal combustion engine, the steamship, the telephone, and the telegraph. This expansion in exports resulted in a massive flow of capital from Western Europe to the rapidly developing countries of the Americas, Australia, and elsewhere. Migration was also very large during this period.

1914–50
The outbreak of the two world wars, the unsuccessful attempt to revive the gold standard, and the Great Depression gave rise to protectionist sentiment and halted global integration.

Post-1950 period
Globalization resumed as the barriers to trade and capital flows erected in the 1930s were rolled back. Technology continued to advance, especially in the area of communications and computers. This period of globalization saw a remarkable rise in living standards and dramatic improvements in health and education.

GLOBALIZATION—the process through which an increasingly free flow of ideas, people, goods, services, and capital leads to the integration of economies and societies—has brought rising prosperity to the countries that have participated. It has boosted incomes and helped raise living standards in many parts of the world, partly by making sophisticated technologies available to less advanced countries. Since 1960, for example, life expectancy in India has risen by more than 20 years, and illiteracy in Korea has gone from nearly 30 percent to almost zero. These improvements are due to a number of factors, but it is unlikely that they could have occurred without globalization. In addition, greater integration has promoted human freedom by spreading information and increasing choices.

But in recent years, concerns have grown about the negative aspects of globalization and especially about whether the world’s poorest—the 1.2 billion people who still live on less than $1 a day—will share in its benefits. The beliefs that free trade favors only rich countries and that volatile capital markets hurt developing countries the most have led activists of many stripes to come together in an “antiglobalization” movement. The activists highlight the costs of rapid economic change, the loss of local control over economic policies and developments, the disappearance of old industries, and the related erosion of communities. They also criticize international organizations for moving too slowly in tackling these concerns.

The year 2001, however, saw the debate undergo a subtle but perhaps profound shift, with both sides seeming to step back from approaching it in terms of whether globalization was “good” or “bad”—an approach that seemed overly simplistic. This recognition gained momentum in the wake of the September 11 terrorist attacks in the United States, which exposed the vulnerability of globalization that stems in part—but only in part—from the sense of hopelessness present in some countries unwilling or unable to embrace it.

Both sides increasingly realized that the debate should center on how best to manage the process of globalization—at the national and international levels—so that the benefits are widely shared and the costs kept to a minimum. There is no question that greater integration into the world economy and more openness to other cultures offers all citizens of the global village a more hopeful future.

Globalization, by offering a brighter future for all, provides perhaps the surest path to greater global security and world peace.

This understanding should attract support for the work needed to address the remaining challenges of globalization head-on. Initiatives such as the United Nations Conference on Financing for Development held in Monterrey, Mexico, in 2002 will need to be continued at many other venues. The IMF, along with the World Bank, contributed significantly to Monterrey by helping focus the conference on global priorities, such as the Millennium Development Goals. The IMF, adhering to its mandate and areas of expertise, is also continuing to readapt itself to better help countries meet the challenges of globalization.

Globalization today

The world has experienced successive waves of what we now call globalization, going back as far as Marco Polo in the thirteenth century. These periods have all shared certain characteristics with our own: the expansion of trade, the diffusion of technology, extensive migration, and the cross-fertilization...
of diverse cultures—a mix that should give pause to those who perceive globalization narrowly, as a process nurtured strictly by economic forces.

By the end of the nineteenth century, the world was already highly globalized. Falling shipping costs had led to a rapid rise in trade, and in 1913 the ratio of world trade to world output reached a peak that would not be matched again until 1970. The growth of trade was accompanied by unprecedented flows of capital (as high as 10 percent of GDP, in net terms, in a number of both investor and recipient countries) and migration (for many countries, \( \frac{1}{2} \) of 1 percent of population a year), especially to the Americas.

Following the two world wars and the Great Depression, a new wave of globalization began, characterized by further declines in transport costs, which fell by half in real terms from 1940 to 1960; the expansion of modern multinational corporations, which are well suited to working around barriers to trade imposed by language, national commercial policies, and other factors; and unprecedented growth in output and living standards.

More recently, globalization has been reinvigorated by the unprecedented ease with which information can be exchanged and processed thanks to breakthroughs in computer and telecommunications technologies, which since 1970 have reduced real computing and communications costs by 99 percent. This technological progress has steadily expanded the range and quality of services that can be traded, including those that support trade in goods, moving us toward a globally integrated economy.

Is this a development to be welcomed? Economic theory, as represented by the Heckscher-Ohlin-Samuelson model of trade, suggests that a fully integrated world economy provides the greatest scope for maximizing human welfare. This proposition is based on assumptions about the free international movement of goods and factors of production (capital and labor), the availability of information, and a high degree of competition. But benefits accrue even if capital and labor cannot move freely, so long as goods are freely traded.

In the real world, we know that there are still many barriers to the free movement of capital and labor. And, indeed, important barriers to trade remain. There has, however, been substantial progress in trade liberalization since the Second World War. The Doha Development Round, for example, is the tenth comprehensive trade round. Rising merchandise trade has been one of the hallmarks of the globalization process, and the gains from trade liberalization in recent decades have exceeded the costs by a very considerable margin. The Uruguay Round trade agreement reached in 1995 is estimated to have produced over $100 billion a year in net benefits, accruing mainly to those countries that have reduced trade barriers the most.

These trade gains have translated into faster economic growth and higher standards of living, as most clearly seen in East Asia: real incomes in Korea have doubled every 12 years since 1960. In the Spanish-speaking world, countries such as Spain, Mexico, and Chile have sharply boosted their shares of world trade and per capita incomes since 1980 by embracing globalization. A recent World Bank study also suggests that the countries that have opened themselves to trade in the last two decades have, on average, grown the fastest. These “new globalizers” among developing countries have reduced import tariffs, on average, by 34 percentage points since 1980,
Financial Globalization

compared with only 11 percentage points for those developing countries that, on average, saw no growth in per capita incomes over the period.

Moreover, we know that faster growth goes hand in hand with bigger declines in poverty and larger increases in life expectancy. In a recent World Bank study, David Dollar and Aart Kraay (2001) take this full circle by deducing that since, in broad terms, trade is good for growth, and growth is generally good for the poor—they find that, on average, increased growth raises the incomes of the poor in proportion to those of the population as a whole—then trade is good for the poor.

Capital market integration has also advanced substantially in recent decades. But while the benefits of trade globalization are relatively clear, developing countries need to have a set of preconditions in place to benefit from financial globalization and not to succumb to an increased probability of a currency or banking crisis occurring. That is why capital account liberalization is being approached with much greater caution than during the bullish years of the mid-1990s. Capital inflows contribute to growth by stimulating investment and technical progress and promoting efficient financial development. Openness to capital flows, when combined with sound domestic policies, gives countries access to a much larger pool of capital with which to finance development. Foreign direct investment in particular—as opposed to potentially volatile portfolio flows—speeds up both capital accumulation and the absorption of foreign technologies and, like trade, has been shown to promote economic growth.

A new approach post–September 11

Clearly, globalization has the potential to make all people better off. The problem is that there is no assurance that all people will be better off or that all changes will be positive. The studies that show that, on average, poverty declines with economic growth are encouraging. But averages hide the negative impact on individual countries and on certain groups within them. In addition, there are important questions about the relationships between economic policies and outcomes, especially the impact of macroeconomic and structural reform policies on poverty. For example, when is growth especially beneficial to the poor? And when does growth not benefit the poor? How does trade generate growth? Does all foreign capital raise growth? How can we best ensure that capital flows do no harm?

These are all questions on which the IMF is seeking a better understanding, and as we gain further insights, we will, if necessary, adjust our policy recommendations accordingly. We are also committed to meeting four key challenges that fall in our areas of responsibility. The first is helping the poorest countries sustain the adjustment policies and structural reforms they need to reap the benefits of globalization. The second is increasing the stability of international financial markets—especially critical, given the importance of global financial stability as an international public good. The third is helping all of our members safely access these markets, including those countries that currently have no access. And the fourth is fostering a stable global macroeconomic environment. Only by addressing these challenges—in part through shared principles and rules—can we help our member countries accommodate the changes brought by globalization and cope with the dislocations such changes unavoidably bring.

But the atmosphere in which we are working has changed in some fundamental ways in the wake of the September 11 terrorist attacks—ways that provide an opportunity for a renewed dialogue. Even the antiglobalization movement that organized mass demonstrations in Seattle, Quebec, Genoa, and elsewhere has undergone profound change, as many of those who had been leading the protests against globalization—and against the IMF, the World Bank, and the World Trade Organization, in particular—are questioning whether such protests are an effective means to their ends. How have perceptions changed?

• It has become clear that the issues over which the debate has been conducted—issues central to the course of economic development—are governed by complex forces that defy glib generalization. It does not make sense to oppose globalization as such: the discussion must shift gears, aiming instead to identify effective ways to increase and spread the benefits of globalization while minimizing its costs.

• The importance of international cooperation has come into sharp focus across the broad spectrum of global issues. A by-product seems to be a renewed appreciation of the role of the Bretton Woods institutions as forums for global economic cooperation and of the role of the IMF in particular.

• It has become even clearer that, in the words of IMF Managing Director Horst Köhler [2000–04], “there will not be a good future for the rich if there is no prospect of a better future for the poor.” Besides being a moral question, poverty reduction is now recognized as a necessity for peace and security. The decision to launch the Doha talks is the first evidence that this recognition will translate into greater attention to the requirements of economic development.

• The weakening of world economic growth, manifest in early 2001 but exacerbated by the September 11 attacks, has revealed the fragility of global economic prosperity. The need for the kind of high-quality analysis that the IMF provides, helping to keep the global economy on an even keel, has become more evident.

• Some of the protesters seem to have decided to channel their energies less against the international organizations...
themselves and more toward their member governments. They see that pressing national governments to increase foreign aid and market access for exports from poor countries can result in far greater benefits for the poor than changes in the policies of international lending institutions.

So how should all parties proceed? First, besides finding solutions to problems, we need to find ways to implement them effectively. This means keeping in mind that issues formerly seen as national—including financial markets, the environment, labor standards, and economic accountability—are now seen to have international aspects. The ripple effects of actions taken in one country tend to be far greater and to travel faster than ever before. A purely national approach to solving some problems risks merely pushing the problem across the frontier without providing a lasting solution even at the national level.

Second, we need to ensure that measures are taken to meet internationally agreed targets, such as the Millennium Development Goals, which include halving world poverty by 2015. Such measures would involve debt relief (especially for the heavily indebted poorest countries), social safety nets to cushion the short-term impact of economic reforms on the vulnerable, and higher social outlays, especially on health care and education. In recent years, social outlays have been rising in countries with IMF-supported programs—significantly in countries benefiting from debt relief. Of course, this is only a modest beginning. For example, enormous additional resources are needed to improve health conditions in low-income and (for the poor) in middle-income countries, as pointed out in the World Health Organization’s recent report of the Commission on Macroeconomics and Health.

Similarly, concerted action is needed to achieve the United Nations target that calls on rich countries to spend 0.7 percent of their GNP on development assistance. Action by the international community is also needed to open markets more broadly and effectively to exports from poor countries and to provide several of the poorest countries with life-saving drugs at lower cost; the commitments made in Doha should serve as a minimum threshold for these goals.

Third, we need to revisit the institutions of global governance, to establish mechanisms to implement global solutions to global problems and to ensure that governments become more accountable. On economic issues, the importance countries attach to the open and cooperative multilateral system is reflected in the now virtually universal membership of the IMF and the World Bank and the prospective accession of all major trading countries to the World Trade Organization. These three organizations address a very wide range of international economic issues, but they were not designed to be all-encompassing. Issues not central to any of their mandates are pressing and worthy of national and international attention. These include the environment, labor rights, international and local migration, and human rights, which must be addressed if globalization is to be sustained. As pointed out in the report by Michel Camdessus and others to the Bishops of the European Community, there are still many important institutional gaps in the present system.

Overall, this adds up to a weighty agenda for the international community, but perhaps never has so much been at stake, with so much potential within our reach. Globalization holds the promise of enormous benefits for the peoples of the world. To make this promise a reality, however, we must find a way to carefully manage the process. Better attention must be paid to reducing the negative effects and ensuring that the benefits are widely and fairly distributed. In this global village, we all need to work energetically toward that goal.

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Is Liberalization Reversible?

Harold James

Despite its many benefits, globalization is unsettling, and those who feel most threatened by it may try to turn back the clock.

The most dramatic features of globalization—the liberalization of trade in goods and services and the increasingly unrestricted flow of capital across borders—were by no means inevitable. Indeed, they have surprised many students of political economy, which offers numerous examples of powerful interest groups successfully pushing for policies that restrict trade and depress national incomes.

Free trade has rarely been a popular cause. The history of trade has been full of disappointments, even during the past five decades, a period of remarkable growth for world trade (see chart). The General Agreement on Tariffs and Trade (GATT), which was signed in 1947, was a compromise. It achieved its biggest successes in the early 1960s, largely by reducing its scope to exclude two of the most contentious trade items—textiles and agricultural...
countries began to liberalize their capital accounts in an effort to attract inflows of foreign capital. Because capital account liberalization raises the serious issue of financial governance, there has been some discussion as to whether the IMF should amend its Articles of Agreement to cover it.

The wisdom of liberalizing trade and capital movements was again called into question when the East Asian financial crisis erupted in 1997, threatening to unleash what financier George Soros termed a full-fledged global crisis of capitalism.

The swinging pendulum

Analysts of globalization often present the process as irreversible—a one-way road to the future. But a more sober and pessimistic assessment would be more realistic. History is studded with examples of highly developed and integrated international communities that dissolved under the pressure of unexpected events. Momentum was lost, the pendulum swung in the opposite direction, and the clock was turned back. The universal Erasmian world of Renaissance Europe, for example, was destroyed by the Reformation and the Counter-Reformation, and Europe was once again blighted by separatism, provincialism, and parochialism.

In economic history, the late nineteenth century was a similar universal age, in which integration and progress went hand in hand. But this dynamic and self-confident world also broke apart. The breakup shattered the optimistic belief in the possibility of cooperation across national boundaries—indeed, in the possibility of human progress. The world’s first attempt at globalization and the tragedy of its collapse hold important lessons for us.

At the end of the nineteenth century, the world was highly integrated economically, through the mobility of capital, goods, and people. Capital moved freely between states and continents. Trade was largely unhindered, even in such apparently protectionist countries as the United States and the German Empire. Nontariff barriers hardly existed and quotas were unheard of. Above all, people moved. They did not need passports. There were hardly any debates about citizenship. In a search for freedom, security, and prosperity—three closely interrelated values—the peoples of Asia and Europe left their homes, braving the discomforts of long journeys across continents and oceans. To the countries that welcomed them, the immigrants brought substantial economic growth. And those they left experienced large productivity gains as their populations shrank; migration eased the desperate poverty of countries like Ireland and Norway. The great streams of capital, trade, and migration were linked. Without capital flows, it would have been impossible to construct the infrastructure—such as railways and cities—needed to welcome the new migrants; migration, in turn, created large overseas markets for European engineering products as well as for textiles, clothing, musical instruments, and other consumer goods.

The integrated world of the late nineteenth century bears a close resemblance to today’s world, in which globalization is so hotly debated. Economists who have tried to find a statistical basis for a comparison of the first era of globalization with our own are usually struck by the similarities:

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**Volume of world trade in manufactured products**

(logarithmic scale, with calculated trends)

- **Trade volumes**
- **Calculated trend**

Indeed, the volume of capital flows was relatively greater a hundred years ago than in our own decade.

From the beginning, however, growing integration aroused anxiety and triggered demands for control. Central banks—whose existence is not required for the operation of a gold standard—were charged with using the instruments at their disposal (discount rates, reserves) to modify or prevent volatile short-term capital movements. As countries opened up, they introduced welfare policies designed to compensate citizens who would be hurt by change. Starting in the late 1870s, more and more countries imposed protective tariffs. During the last decade of the century, attitudes to migration became increasingly hostile and policies, more restrictive.

In the interwar period, when policymakers tried to restore the gold standard, they found that short-term capital movements were much more volatile than they had been before World War I, for several reasons: severe structural problems caused by the conflict, the political imbroglio over war debts and reparations, and major policy inconsistencies between the largest countries. Policymakers thought the old mechanisms used to safeguard the system before the war could be pressed into service once again. So tariffs went up; the United States led the way with the Fordney-McCumber Tariff Act of 1922 and the catastrophic Smoot-Hawley Tariff Act of 1930. Immigration was dramatically curtailed. Central banks became more actively interventionist in trying to manage capital flows. When these measures failed to produce prosperity—they made the world more crisis prone instead—calls for more radical intervention became louder.

Now everything was to be national—not only labor and goods but also capital. John Maynard Keynes brilliantly described this development in his 1933 essay, “National Self-Sufficiency”: “Let goods be homespun whenever it is reasonably and conveniently possible; and, above all, let finance be primarily national.” Even leading financiers and businessmen believed that economic integration had failed. The collapse of the world economy brought about a turning away from the market. Even moderate and pragmatic analysts, such as the director of the League of Nations’ Economic and Financial Section, Sir Arthur Salter, believed that the future lay in regulation and control. With the papal encyclical Quadragesimo Anno in the crisis year 1931, the Catholic Church looked for a “third way” between capitalism and socialism.

Increasing regulation and planning encouraged those who believed the state’s function was to externalize the costs of economic adjustment—to impose them on those outside the national community. The state’s duty lay in protecting its citizens and ensuring that the inhabitants of other national communities suffered as much as possible. This position was, of course, the opposite of classical economic liberalism, with its faith in the possibility of a mutuality of gains.

The supposed cure for the crisis of capitalism turned out to be much worse than the crisis. The path away from the market and toward control was also a path to political dictatorship. Keynes was painfully concerned that the move to national self-sufficiency would be accompanied by the “silliness of the doctrine,” “insane and unnecessary haste,” and “intolerance and the stifling of instructed criticism.” The most obvious examples of these evils were in Germany and Russia. But the sentiment that democracy had failed to meet basic social needs was widely shared. In February 1940, even as politically liberal a figure as the French writer André Gide noted in his diary that, “We should be prepared that after the War, even if we are the victors, we will be in such a morass that only a decisive dictatorship can pull us out.”

Reactions against globalization

The current reaction against globalization stems from four major sources, all of which have historic parallels:

• The market economy and rapid economic change are anti-elitist. The position of an entrenched elite defending privileges arising from state control of economic activity—characteristic not only of Soviet-style economies but also of many societies in Asia and Latin America—has become increasingly untenable. Such elites do not deserve our sympathy, nor are they likely to succeed in hanging onto the doctrines that made them powerful. Indeed, their main hope now is lawlessness—the phenomenon of nomenklatura privatization, which, amid the anarchy of transition, allows the old elite to build up a property position for the future. The threat in states that once had centrally planned economies, from the former Soviet Union to several African countries, is not a revival of Marxism but chaos fomented by the elite.

There is a precise analogy between this elite and the aristocracy of preindustrial Europe. Where the aristocracy did nothing but cling to its political power, as in France, it was rapidly overwhelmed. But where it used the remnants of its political power to move into the new industries of the age, such as coal mines and steel mills, as in Britain and parts of Germany, the social order endured. The only way the elite could save itself during a period of political and economic upheaval was by relinquishing its monopoly over political power and acquiring economic power—a lesson well learned by the nomenklatura.

• More important, during a period of rapid technical and economic transformation, it is often easier to see who the losers are than who the eventual winners will be, given the unpre-

"An economically integrated world is likely to see more and more generalized financial and banking panics, which are always frightening and therefore evoke demands for a halt to liberalization."
dictability of the future and the impossibility of knowing what types of occupations and activities will emerge and who will be good at them. Thus, there is always the possibility that the losers will revolt. Like the displaced hand-loom weavers of nineteenth-century Europe, who found it very hard to envisage what the future might hold in store for them, those displaced by today's technology are unlikely to be able to reshape politics.

- Some critics of globalization may be motivated by schadenfreude—that is, they would like to see the cooperative process of mutually beneficial development collapse, not because a collapse will benefit them but because it will harm some hated external figure. This might be termed the Zhirinovsky reaction, after the extremist Russian politician. Vladimir Zhirinovsky is not much of a politician, but he is a fine inventor of malicious aperçus. One of the most revealing is the question he asks of Russians, cited in an article in the Financial Times on December 9, 1993: "Why should that we create suffering for ourselves? We should create suffering for others." Such a reaction was, in the past, a source of conflict and war. It is surprising and perhaps gratifying how rare this reaction is today; it is widely appreciated that the world economy is not a simple zero-sum game. Even in the peculiarly dramatic and colorful world of Russian politics, Zhirinovsky is treated as a clown, not a prophet.

- When unexpected and unpleasant events take place, many blame the "system" as a whole and begin searching for alternative systems. This is the "banana skin" effect: we slip and curse the whole world. Slipping on the banana skin is sometimes unavoidable. It is quite conceivable—indeed, inevitable—that the new economic consensus will be challenged by dramatic fiscal and financial crises. Market economies are dynamic but also disruptive.

There is, moreover, an underlying political problem. In particular, states today are subject to opposing pressures: on the one hand, pressures to reduce taxes because tax cuts enhance the mobility of the factors of production (labor and capital); on the other, pressures to raise additional revenues to finance traditional expenditures. Since the 1970s, the international capital markets have made it easier to finance deficits. Although the markets react sharply to unsustainable fiscal policies, they do not react immediately, at the first sign of trouble, but usually fairly late in the game. As a result, an economically integrated world is likely to see more and more generalized financial and banking panics, which are always frightening and therefore evoke demands for a halt to liberalization. The extent to which the response to crises will actually turn back the clock depends on how we are prepared to think about the problem. It is possible to view crises as opportunities for adaptation. Indeed, many societies find it impossible to overcome inefficiencies and redirect resources to more productive uses without a major shock to entrenched interests and established wisdom.

Angst of the millennium

Today, the case for free trade and unrestricted capital movements is, perhaps, generally understood. But some commentators have begun to chip away at it, presenting the outcomes of certain special situations as yielding lessons with a broad application. One example, taken from strategic trade theory, is a situation in which, because of the existence of an oligopoly, some measure of trade protection may be beneficial. Another example is the abundant literature published since the Asian crisis on the dangers of herd behavior and volatility associated with short-term capital movements.

The turbulence of the mid-1990s has led to increased skepticism about liberalization. As in the 1930s, the smart money is on control, not deregulation. Some major market participants, such as George Soros, have begun to advocate capital controls. Even moderate and pragmatic analysts, such as the World Bank's Chief Economist, Joseph Stiglitz, believe that the future lies in control and regulation of capital markets. Politicians in Europe and America are engaged in an intensive search for a "third way." In his reflections on the dangers of free capital transactions, MIT economics professor Paul Krugman is following directly in the steps of John Maynard Keynes.

The Great Depression, which put an end to the world's first experiment with globalization, was the consequence of financial vulnerability stemming—ironically—from the very institutions created to provide protection against the impact of globalization. Globalization was rapid in the nineteenth century, but almost immediately met with resistance. The interventionist state derived a great deal of its legitimation from globalization and increasingly became an impediment to integration. It was during the Great Depression that those who opposed unrestricted migration and the free movement of goods and capital across borders saw the opportunity to turn back the clock. At that time, and again today, the nation-state and its control mechanisms are supposed to give guarantees against threats from the world economy. But was not, and is not, the protection more dangerous and destructive than the threat?

Are we now living in an age in which the attempt is being made to use not a real Great Depression, but simply its shadow—the fear of one—as justification for backing away from the integration of the world economy? If so, we might really produce a depression and, with it, the complete reversal of liberalization.

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EXTERNAL imbalances and financial globalization have been at the top of the international policy agenda for the past few years. Indeed, such influential observers as former U.S. Federal Reserve Chairman Alan Greenspan and his successor Ben Bernanke have argued that the rapid integration of the international financial system during the past decade has played an important role in enabling these imbalances to persist and be easily financed. In addition, emerging market economies, traditionally recipients of foreign capital, have become a major source of net foreign capital outflows and, most notably, have been collectively important in financing the large and growing U.S. current account deficit.

So what is there to worry about if financial globalization means that the current configuration of imbalances represents a new but sustainable regime for the world economy? Is the system unstable, or are analysts unduly concerned about global imbalances? To answer these questions requires some spade work. We need to decide how to measure international financial integration, track down which countries are net creditors and which are net debtors, and assess the magnitudes of the accumulated external holdings.

As it turns out, unearthing this information is not that straightforward. For example, despite notable progress in recent years, there are very significant gaps in the availability of data on holdings of external assets and liabilities (the so-called International Investment Position in a country's balance of payments), all the more so if one looks beyond the past few years. This means that, for a large set of countries, we know neither their net external wealth nor the size and composition of their external portfolios—hindering a truly global analysis.

We have sought to remedy this problem by constructing a data set comprising estimates of external assets and liabilities for more than 140 countries for 1970–2004. Although measurement error is likely to be substantial for a number of countries for which there is limited data availability on cross-country capital flows and holdings, this extensive coverage provides a useful global perspective on the cross-country distribution of external holdings and its evolution, and enables analysis of the sustainability of global imbalances from a policy perspective.

Insights into vulnerabilities

Why is information on net external positions and the magnitude and composition of external portfolios important? Clearly, the assessment of...
external sustainability requires knowledge of a country’s financial exposure to the rest of the world, while information on the size and composition of international portfolios is key to understanding the interdependencies among countries, as well as their respective financial vulnerabilities.

For example, an emerging market country facing a sudden slowdown in capital inflows will be more vulnerable to a crisis if it has large debt liabilities denominated in foreign currency—because domestic currency servicing costs rise with a depreciation—than if it has relied more heavily on foreign direct investment (FDI), when returns are linked to the performance of the domestic economy.

Similarly, the internationalization of portfolios means that shocks in one country are immediately transmitted to foreign holders of financial instruments issued by that country. While such financial interdependencies are a manifestation of a desirable increase in international risk sharing, they also imply that international events will have stronger domestic repercussions and that large shocks are more likely to have systemic implications, requiring enhanced monitoring by regulators and other policymakers.

**Three big trends**

For our research, described in more detail in Lane and Milesi-Ferretti (2006), we divided data on assets and liabilities into broad categories: portfolio equity investment, FDI, foreign exchange reserves, and debt (which includes portfolio debt securities as well as other instruments, such as loans, deposits, and trade credits). The net external position, given by the difference between total external assets and total external liabilities, measures the net creditor or debtor position of a country vis-à-vis the rest of the world. From this database we can deduce a number of broad trends or stylized facts.

First, international financial integration has increased markedly, particularly among advanced economies. While the trend toward increased international asset trade has been visible since the early 1970s, it has accelerated since the mid-1990s (see Chart 1). In advanced economies, the increase in cross-border asset holdings has been strong for both debt and equity instruments (the latter including FDI and portfolio equity). In emerging markets and developing economies, there has also been a sharp increase in cross-border equity holdings, but the overall stock of debt instruments (assets—including official reserves—and liabilities) has been relatively stable since the mid-1980s. Clearly, factors such as the increase in trade linkages, the reduction in capital controls, domestic financial deepening, advances in telecommunications, and the increased availability of information are important in driving the acceleration of international financial integration.

Second, global imbalances have widened sharply during the past few years, with emerging Asia and the oil exporters increasingly becoming creditors and the United States seeing a worsening in its net external position (see Chart 2). However, despite the massive U.S. current account deficit, the U.S. external position during the past three years has been surprisingly stable, a puzzle we will address below. Which are the largest creditors and debtors, relative to their GDP levels? Although richer countries tend to be creditors, the correlation is less than watertight (see Chart 3). Indeed, in addition to a country’s level of development, several other...
factors—including demographics, the size of public debt, and natural resources—can influence its external position.

Third, with external assets and liabilities now often exceeding 100 percent of GDP, differences in rates of return between external assets and liabilities lead to significant shifts in resources across countries, much larger than those that occurred when the degree of international financial integration was lower. For example, if external assets and liabilities are 100 percent of GDP, a return differential of 2 percentage points between assets and liabilities has the same effect on the country’s external position as a trade surplus or deficit of 2 percent of GDP. These differences in returns can arise for a number of reasons, including the currency of denomination and portfolio structure (with equity holdings, for example, generally yielding higher returns over the medium term than debt instruments). More generally, “riskier” portfolios will have higher returns on average than more conservative ones.

**Good for U.S., but can it last?**

Consider the United States. On average, U.S. investors have earned higher returns on their assets than on their liabilities, especially during 2002–04 (see Chart 4). These rates of return include investment income earnings—such as dividends or interest payments on debt securities—which are recorded in the current account, and capital gains and losses arising from fluctuations in the value of assets and liabilities. These valuation effects, triggered by changes in stock prices, interest rates, or exchange rates, are not included in the current account. They can, therefore, generate changes in the net external position even if a country’s net borrowing from abroad is zero.

To understand these differences, we need to look more closely at the structure of the portfolio of U.S. assets and liabilities. At the end of 2004, portfolio equity and FDI constituted the lion’s share of U.S. external assets, while most U.S. liabilities were in debt instruments (see Chart 5). Not surprisingly, given the dollar’s key role as a global reserve currency and the importance of the U.S. bond market, portfolio debt instruments represent a large (and increasing) share of U.S. liabilities. The larger weight of equity instruments in the U.S. asset portfolio and of debt instruments in the U.S. liabilities portfolio helps explain the positive return differential between U.S. assets and liabilities.

During 2002–04, however, movements in exchange rates and asset prices also played a key role in explaining the return differential. While U.S. liabilities were almost entirely denominated in U.S. dollars, a sizable proportion of U.S. assets (FDI, portfolio equity, a fraction of portfolio debt, and foreign exchange reserves) was denominated in foreign currency, primarily held in Europe and other advanced economies. The substantial weakening of the dollar vis-à-vis the currencies of those countries during 2002–04 raised the returns on U.S. foreign assets through the valuation channel, a development that has been compounded by the movements in relative stock prices, which have increased more sharply overseas than in the United States. (However, there is also evidence that, on average, U.S. investors make superior returns within asset categories—particularly for FDI.)

We can now understand why the U.S. external position did not deteriorate substantially during 2002–04, despite massive net external borrowing. From a “dollar area” perspective, movements in exchange rates and asset prices raised the value of U.S. holdings of assets overseas, while, from a “European” viewpoint, the weakening of the dollar imposed heavy capital losses on holders of dollar-denominated debt instruments.

Naturally, the reader may think that the recovery in the dollar’s value during 2005 means that the United States will suffer a currency-related capital loss. Well, not so fast! On the basis of the admittedly incomplete data available so far, that loss was more than compensated for by stronger equity market performance in the rest of the world (including Europe, Japan, and emerging Asia) than in the United States—and so, 2005 goes down as the fourth year in a row of significant net external capital gains for the U.S. economy.

In 2005, the Morgan Stanley Capital International Index of world stock markets (excluding the United States) rose by 12 percent in dollar terms, compared with a 4 percent rise in the S&P 500.

But how long can a large differential between returns on U.S. assets and U.S. liabilities be sustained, thereby allowing the United States to run large trade deficits without experiencing a major deterioration in its external position? Although some positive differential in returns may well persist and would play an increasingly important role as long as financial integration increases, logic would suggest that return differentials of the order of magnitude of those witnessed in the past three to four years cannot be sustained for a prolonged period of time—they would likely require persistent dollar depreciation, which would eventually be incorporated in inflation expectations and interest rate differentials. And higher interest rates together with a global decline in stock market values could reverse the return differential and lead to a substantial deterioration in the U.S. external position. Thus, a substantial correction in the U.S. trade deficit will eventually be necessary to correct external imbalances.
opportunities and risks for emerging markets

It is well known that those same “valuation effects” that help the United States stabilize its external position have in the past wreaked havoc with the external balances of emerging market countries. Indeed, a surprise exchange rate depreciation has conflicting effects for a typical emerging market economy—although its trade balance will eventually improve, its net foreign asset position may deteriorate if it is a net debtor in terms of foreign currency instruments. This conflict between the trade and valuation channels helps explain why emerging market economies are concerned about exchange rate volatility and why it is so difficult to determine appropriate exchange rate policies, especially during times of crisis. It also highlights the importance of promoting local currency debt markets, increasing the role of FDI and portfolio equity inflows as a means of sharing risk more effectively, and using alternative financial instruments such as GDP-indexed bonds, whose returns are tied to domestic economic performance.

The large increase in cross-border equity and direct investment holdings and the shifting patterns in international borrowing and lending can be viewed as factors reducing the vulnerability of emerging markets to external shocks. Equity liabilities (including FDI) now account for about half of total external liabilities in emerging markets and developing countries as a whole. In addition, a number of emerging markets have dramatically reduced their external liabilities or even become net creditors by running large current account surpluses and accumulating reserves (see Chart 6), thus clearly reducing the risks of financial crises. Others, like most countries in Central and Eastern Europe, have instead rapidly accumulated substantial net external liabilities but have relied heavily on equity financing, which improves risk sharing by linking more closely the return on external liabilities to domestic economic performance.

At the same time, the increase in international financial integration naturally increases exposure to external financial shocks, meaning that balance sheet vulnerabilities will need to be closely monitored, particularly in developing countries with less sophisticated financial systems.

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Converting a Tiger

Yaga Venugopal Reddy
Governor of the Reserve Bank of India

Lessons from India’s gradualist approach to capital account convertibility

“The honey is sweet but the bee stings.”
Chinese proverb

I
NDIA began liberalizing its capital account as part of wide-ranging economic reforms initiated in the early 1990s that reversed its 40-year experiment with centrally planned development. The hallmark of the reform process has been a gradual, cautious approach that has been carefully phased and sequenced across the economy. As a result, India has come a long way from its pre-1991 highly restrictive exchange control regime. With gradual liberalization of both foreign direct investment (FDI) and portfolio investment, the rupee has been made convertible for foreign investors. However, some controls remain in place to varying degrees for both foreign and domestic corporates and individuals, with resident corporates facing a more liberal regime than resident individuals.

Over the past decade and a half, India’s economy has become increasingly open (see Table 1), and annual growth has accelerated to about 9 percent (see Table 2), while inflation has been low and stable since the mid-1990s. Foreign exchange reserves have risen sharply to more than $180 billion—well in excess of the country’s total external debt—largely as a result of capital inflows rather than current account surpluses, while the financial sector, including the regulatory environment, has been strengthened. The phased approach to liberalization has enabled the country to withstand several external shocks, including the Asian crisis of 1997–98.

This article examines how India has managed capital account convertibility and looks at the lessons from its gradualist approach.

Matching theory and practice

Given the apparent benefits, why has India been cautious about capital account liberalization? In theory, capital account convertibility is a good idea for several reasons. First, it is reasonable to presume that free capital mobilization would permit efficient allocation of savings and divert resources toward their most productive uses. Second, it could promote trade, enabling countries to smooth consumption. Third, it could facilitate portfolio diversification and risk sharing, reducing transaction costs and improving returns. Fourth, there could be gains through specialization in financial services, incentives for innovation, and improvement in productivity.

Matching the benefits depend on the pace of liberalization in trade and services and on market efficiency. Asymmetric information could lead to inefficient markets, adverse selection, moral hazard, and herd behavior. In such an environment, unfettered capital account liberalization may increase risks leading to currency and banking crises. Further, financial globalization could be welfare reducing if there are domestic market distortions, such as perverse incentives in the form of trade barriers and discriminatory guarantees and subsidies.

But despite the theoretical advantages, economists have found it difficult to show that capital account liberalization by itself produces real benefits. A few years ago, a comprehensive and seminal IMF study that drew a distinction between de jure and de facto liberalization concluded that “it is difficult to establish a robust causal relationship between the degree of financial integration and output growth performance;...there is little evidence that financial integration has helped develop-
ing countries to better stabilize fluctuations in consumption growth; . . . and low to moderate levels of financial integration may have made some countries subject to greater volatility of consumption” (Prasad and others, 2003). The paper did provide evidence, however, that after a threshold level, financial integration could help provide financial sector development that would moderate domestic macroeconomic volatility.

The threshold level, though difficult to define, became a catchword for emphasizing the need for institution building in developing countries. In a recent reappraisal of financial globalization, the same authors have provided some qualified support to the view that developing countries can benefit from financial globalization, but with many nuances (Kose and others, 2006). In addition to traditional channels, benefits are also realized through a broad set of “collateral benefits”—financial market development, better institutions and governance, and macroeconomic discipline (see article on page 1).

Practical experience has also underlined the need for caution. Most advanced countries liberalized their capital account relatively recently and gradually over about two decades from 1974 to 1994, maintaining intermittent controls during the liberalization phase. Some countries now categorized as emerging market economies (EMEs) embarked upon capital account liberalization from the early 1980s. While some EMEs faced the challenge of managing increased inflows, others experienced sudden stops and reversals of flows leading to a series of crises. In response, some countries reversed their policies and reimposed some capital controls.

During the 1990s, the financial crises in Brazil, East Asia, Mexico, and Russia highlighted one of the most important concerns for EMEs—that capital account convertibility carries the potential for currency crises. In the context of the East Asian financial crisis, although country circumstances varied, they largely reflected extant fundamental structural problems, financial sector weaknesses, and poor corporate governance. It became clear that sound macroeconomic policies, an adequate institutional framework, internationally comparable prudential regulation and supervision standards, and improved quality and disclosure of information were all prerequisites for mitigating such recurrences. It was realized that partial and flawed reforms could render financial systems more fragile and more vulnerable to a rapid reversal of capital flows. As a result, emerging market countries, particularly in East Asia, became more attentive to harmonizing capital account liberalization with appropriate macroeconomic, exchange rate, and financial sector policies.

The bottom line is that in both advanced economies and EMEs, studies have shown that an open capital account does not have to mean unfettered capital account liberalization, and in practice some capital controls and significant prudential regulations are consistent with capital account convertibility.

**Laying the groundwork**

India’s approach was carefully considered and planned step by step. Each phase was assessed in advance by a series of committees. The broad framework was laid out in the 1991 Report of the High Level Committee on Balance of Payments, chaired by Dr. C. Rangarajan, former Governor of the Reserve Bank of India and currently Chairman of the Economic Advisory Council to the Prime Minister. The committee recommended liberalization of current account transactions leading to current account convertibility; a compositional shift in capital flows away from debt- to non-debt-creating flows; strict regulation of external commercial borrowings, especially short-term debt; discouraging volatile elements of flows from nonresident Indians; gradual liberalization of outflows; and disintermediation of the government in the flow of external assistance. The committee also recommended introducing a market-determined exchange rate regime while emphasizing the need to contain the current account deficit.

**Table 1**

<table>
<thead>
<tr>
<th>More open</th>
<th>Key indicators for the Indian economy show the impact of increasing liberalization. (percent of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade</td>
<td>14.6  21.5 22.4 24.3 29.3 32.9</td>
</tr>
<tr>
<td>Exports</td>
<td>5.8  9.1 9.9 11.0 12.2 13.2</td>
</tr>
<tr>
<td>Imports</td>
<td>8.8 12.4 12.5 13.3 17.1 19.7</td>
</tr>
<tr>
<td>Trade plus services</td>
<td>17.2 25.7 29.1 31.6 39.5 45.3</td>
</tr>
<tr>
<td>Capital flows (inflows plus outflows)</td>
<td>12.1 12.5 21.6 22.4 24.3 32.7</td>
</tr>
<tr>
<td>Foreign direct investment inflows</td>
<td>0.03 0.6 0.9 0.7 0.9 1.0</td>
</tr>
<tr>
<td>Bombay Stock Exchange</td>
<td>market capitalization, end-March</td>
</tr>
<tr>
<td>Source: Reserve Bank of India.</td>
<td></td>
</tr>
</tbody>
</table>

**Table 2**

<table>
<thead>
<tr>
<th>Stronger position</th>
<th>As India introduced its reform program, its economy picked up, inflation was brought under control, and its foreign exchange reserves were built up.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(percent)</td>
</tr>
<tr>
<td>Real GDP growth rate</td>
<td>5.6 7.3 4.4 8.5 7.5 9.0</td>
</tr>
<tr>
<td>Headline inflation (end-March)</td>
<td>12.1 4.4 4.9 4.6 5.1 4.1</td>
</tr>
<tr>
<td>Current account deficit to GDP</td>
<td>-3.1 -1.7 -0.6 2.3 -0.4 -1.2</td>
</tr>
<tr>
<td>External debt to GDP</td>
<td>28.7 27.0 22.4 17.8 17.3 15.8</td>
</tr>
<tr>
<td>Short-term debt and portfolio stock to reserves</td>
<td>146.6 70.0 58.2 35.2 36.9 43.4</td>
</tr>
<tr>
<td>(percent of GDP)</td>
<td></td>
</tr>
<tr>
<td>Saving rate</td>
<td>23.1 25.1 23.4 29.7 31.1 32.4</td>
</tr>
<tr>
<td>Investment rate</td>
<td>26.3 26.9 24.0 28.0 31.5 33.8</td>
</tr>
<tr>
<td>Combined gross fiscal deficit of center and states</td>
<td>9.42 6.54 9.48 8.50 7.52 7.45</td>
</tr>
<tr>
<td>(billion dollars)</td>
<td></td>
</tr>
<tr>
<td>Foreign exchange reserves</td>
<td>5.8 21.7 42.3 113.0 141.5 151.6</td>
</tr>
<tr>
<td>(months)</td>
<td></td>
</tr>
<tr>
<td>Import cover of reserves</td>
<td>2.5 6.0 8.8 16.9 14.3 11.6</td>
</tr>
<tr>
<td>Source: Reserve Bank of India.</td>
<td></td>
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</tbody>
</table>
Since 1997, the process of liberalization has been guided by the recommendations of the Report of the Tarapore Committee on Capital Account Convertibility. This committee identified several macroeconomic, institutional, and market preconditions for progress in capital account liberalization in terms of fiscal, financial, and inflation indicators. It also gave a road map for specific measures over a period of three years. The analytical framework provided by the committee anticipated, in a way, the dangers of capital account liberalization when the financial sector remained weak. This underlying framework, coupled with sensitivity to domestic sociopolitical as well as global developments, including the lessons from several crises in EMEs, governed the liberalization process.

While the IMF has been blamed for encouraging EMEs to liberalize their capital accounts too quickly (see box), in India's case, the IMF supported the government's strategy of a gradualistic approach from the beginning. In the early 1990s, the Fund was tolerant of transitional current account restrictions, but in February 1994, it indicated that the adoption, at an early stage, of Article VIII status—meaning agreement not to impose restrictions on payments and transfers for current international transactions—would be an important signal of India's transition to a more open economy. India had already decided to proceed in that direction and became convertible for current account transactions later in 1994.

Subsequently, the Fund concurred with the gradual opening up of FDI, the appropriateness of a cautious attitude toward potentially volatile short-term capital flows, and, overall, the generally cautious approach to capital inflows. On exchange rate management, the Fund continued, however, to emphasize greater flexibility and two-way movement of the exchange rate, which would encourage hedging of currency exposures and development of a deep derivatives market. In recent years, the Fund has recognized that India's exchange rate is more flexible. In my view, the perception about the volatility and flexibility in the exchange rate is contextual. What may be perceived as flexible for some economies may turn out to be volatile for other economies. The level of development and preparedness of financial markets and their risk-taking ability are crucial in this context.

With the relaxation of capital account restrictions, particularly for funds coming into the country, sustained foreign capital inflows began from 1993/94 and picked up sharply after 2003/04 (April–March), jumping from $16.7 billion to $23.4 billion in 2005/06. These inflows were largely non-debt-creating and, as a result, the proportion of nondebt flows in total capital flows increased significantly.

Apart from increased exchange rate flexibility, a number of steps have been taken to manage the excess capital flows. What counts as excess flows needs to be viewed dynamically, taking due account of the distinction between enduring and temporary flows and the level of flows that could normally be absorbed in the domestic economy. These measures include a phased liberalization of the policy framework in relation to...
current as well as capital accounts, flexibility to corporates on prepayment of external commercial borrowings, extension of foreign currency account facility, allowing banks to liberally invest abroad in high-quality instruments, and liberalizing requirements for exporters to surrender foreign exchange earnings. In the context of domestic liquidity management, a market stabilization scheme has been made operational for sterilizing excess inflows without significant fiscal impact.

Distinct features of India’s approach

For India, the important lesson from the crises of the 1990s was to realize that domestic policy and especially the strength of the financial system are critical when financial integration with the rest of the world is under way. It was partly the set of prudential regulations that prevented Indian banks from putting their balance sheets at risk, as they operated with limits on assets in real estate, currencies, and stocks. From the policy perspective, the message is that regulatory and supervisory systems need strengthening so that financial institutions could manage risks prudently. The crises of the 1990s also made policymakers realize that they needed to be more aware of the likely sources of contagion and to exercise vigilance, hunting for signs of potential distress and being ready with appropriate policy actions.

Drawing on the experience of the past decade and a half, India’s approach to capital account liberalization can be summarized as follows:

First, capital account liberalization is treated as a process and not an event.

Second, it is recognized that there may be links between the current and capital accounts and, hence, procedures are in place to avoid capital flows in the guise of current account transactions.

Third, capital account liberalization is kept in tune with other reforms. The extent and timing of capital account liberalization is sequenced with other reforms, such as strengthening of banking systems, fiscal consolidation, market development and integration, trade liberalization, and the changing domestic and external economic environments.

Fourth, a hierarchy is established in the sources and types of capital flows. The priority has been to liberalize inflows relative to outflows, but all outflows associated with inflows have been totally freed. Among the types of inflows, FDI is preferred for stability, while excessive short-term external debt is eschewed. A differentiation is made between corporates, individuals, and banks.

For outflows, the hierarchy for liberalization has been corporates first, followed by financial intermediaries, and then individuals. Restrictions have been eased for corporates seeking investments and acquisitions abroad that strengthen their global presence. But banks and financial intermediaries are a source of greater volatility. It is widely understood that banks and financial intermediaries are fragile because their assets are relatively illiquid but their liabilities are demandable, and they are susceptible to contagion and self-fulfilling crises of confidence. Therefore, liberalization in this sector has been tied to financial sector reforms. For individuals, residents are treated differently from nonresidents, and nonresident Indians have a well-defined intermediate status between residents and nonresidents.

Fifth, the pace and sequencing of liberalization is responsive to domestic developments, especially in the monetary and financial sectors, and to the evolving international financial architecture. As liberalization advances, administrative measures are reduced and price-based measures are increased, but the freedom to change the mix and reimpose controls is demonstrably available. In the process, an integrated view of the state of development of all financial markets is taken.

Sixth, significant liberalization on outflows on behalf of individuals, corporates, and mutual funds depends on a comfortable level of foreign exchange reserves and greater two-way movement in the exchange rate. This is reflected in increasing global operations of Indian corporates in search of global synergies and in knowledge related to their operations.

The political economy also has significant influence and is critical for the success of reforms. Since 1990, there have been six elections for the national parliament in India and seven prime ministers, while a number of national and regional political parties have been part of coalition governments. India has also faced border conflicts and sanctions.

Despite the coalition cabinets and periodic elections both at the center and in several states, India’s political system, overall, is characterized by system stability. It is remarkable that, despite diversity in political ideologies and frequent elections, the progress of well-calibrated economic reforms continues to be impressive.

Going forward, India plans to continue the gradualist approach because it enables harmonization with other reforms. Yet another committee has recently laid out a road map for moving toward fuller capital account convertibility within a transparent framework over the next five years. The plan for further liberalization will depend, however, on several domestic factors, as well as on international developments. Among issues to be addressed are progress in reforming the real sector, further fiscal consolidation, strengthening the domestic financial system, and the achievement of certain concomitant macroeconomic parameters relating to the soundness and stability of the economy.

Yaga Venugopal Reddy has been RBI Governor since September 2003.

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IN RECENT years, there has been considerable debate on the globalization of economic activities and its impact on national economies. Yet this process has been under way for over half a century. In its early stages, globalization stemmed from governments’ policy decisions and aroused little debate because its effects were viewed as benign. It was seen in the context of economic integration, achieved through linking markets for goods and services. From 1945 until 1971, the era of the Bretton Woods fixed-exchange-rate system, national governments focused on liberalizing the current accounts of their balances of payments and have made much progress since then.

This commitment did not extend to liberalizing asset markets, however. For this reason, the Bretton Woods agreement of 1944 included an acceptance of capital controls, a provision that is still valid today. At that time, the focus on the current account was based on the need to restore freedom to the flow of trade in goods and services, combined with the fact that international capital movements had not yet acquired the importance they did later on. It was also felt that capital controls would preserve the independence of domestic economic policies.

It is possible, of course, for governments to decide that some areas of economic activity will be liberalized while others will remain subject to control. It is far more difficult for policymakers to maintain the boundary between free and controlled activities. Growing freedom in trade in goods and services can be expected to lead to closer financial relationships among countries. These, in turn, will bring about a liberalization of cross-border financial and capital flows. This liberalization has long been a feature of the international economy and has led to a period of progressive economic integration. As a result, this integration moved to a higher level, namely, globalization.

Causes and consequences

Besides the influence of growing trade relationships among countries in fostering financial ties, the evolution toward liberalizing international capital movements was stimulated by a major change in the perception of the role and scope of government in the economy during the last two decades. Government evolved from being a predominant agent in economic activity toward a situation in which government activity was designed mainly to provide an appropriate setting for private economic activity, which became the dominant force in resource allocation.

This open, liberal economic regime gave a prominent role to market forces and had profound implications for macroeconomic policy management, in general, and for monetary and exchange policies, in particular. Although much of the discussion of these issues has centered on the domestic economy, the discussion cannot be divorced from its external aspects. This interaction is two-way: experience with external liberalization underpins domestic deregulation, while domestic deregulation leads to greater external openness.

Thus, forces developed in the international economy as a result of deliberate government decisions to liberalize capital movements. These, in turn, tightened the links between national economies. Consequently, the world economy entered the era of globalization, with all its risks and opportunities.

The opportunities were evident from the outset. But there was also a danger that coun-
tries would either misuse them or fail to take advantage of them. A first demonstration of the potential benefit of open capital flows was their sudden and dramatic increase in the 1970s following the two major oil price rises, when capital flows helped smooth adjustment to higher prices. These developments were followed by the debt crisis of the 1980s, which reflected a misuse of the new opportunities that capital flows offered.

The recent experiences of the Asian economies provide additional examples of the benefits and costs of an open, integrated, international capital market. Some of these economies recorded a long period of rapid growth and development to which growing foreign capital flows contributed, at the same time as these flows were encouraged by such economic performance. But then policy inconsistencies and institutional shortcomings surfaced and stimulated an abrupt reversal in capital flows.

From a national standpoint, globalization will also have marked consequences. Key among these is the progressive divergence between political and economic boundaries. The nation-states to which governments address their economic policies often deviate from the economic areas in which global market forces operate. The resulting cross-border externalities and spillovers will reduce both the scope and the effectiveness of government economic policy and the autonomy and power of governments in the economic sphere.

The road ahead
The challenges confronting governments as we enter a new millennium already appear intimidating. But, in the midst of a spreading crisis such as the present one, they become even more daunting, if only because the time available to address any challenge grows progressively shorter. Although globalization results from the decisions of national governments, they have yet to absorb and draw implications for their own autonomy and scope for action from the presence of a seamless global market.

Two distinct, though interrelated, issues are raised in current debates about globalization that reflect the impact of the crisis on the international economy. The first debate casts doubt on the view, known as the Washington consensus, of the efficient functioning of markets. The second questions the wisdom of an open system of capital movements from a national perspective. Fundamentally, these doubts bring to the fore issues of the role of government and economic policy in the operation of domestic economies.

The challenges I am discussing confront only those countries that have opened their economies to the external world and have become components of the global system. What options are available to economies that are part of the integrated world setting? In principle, a reversal of the process of integration, or “disintegration,” is one of them. This has been tried in the past and the experience is not particularly attractive (for example, the beggar-my-neighbor policies and competitive devaluations of the 1930s). The option of disintegration is equivalent to turning the clock back toward nationalism and thus toward a regime in which the government, as the administrator and enforcer of controls, once again becomes dominant in the economy.

A second option would be to accept the constraints that a global setting imposes on national decision making and to design international norms and rules that countries would agree to respect. As already noted, the first option is favored in the arguments for capital and exchange controls, while recent calls for internationally comparable standards and frameworks to be monitored through appropriate international surveillance lean toward the second option.

A third option—which is appealing in theory but can be dismissed in practice because few, if any, governments have resorted to it—would be to entrust market forces with the tasks of ensuring both efficiency and stability.

Obsolescence or progress
The choices countries will face in the future will depend on whether they decide to isolate themselves from the consequences of globalization or to accept them. Isolation seems to me to be a futile objective. It will mean introducing progressively broader and tighter controls that, to be effective, will require establishing a bureaucratic structure able to anticipate and thwart market efforts at circumvention. Such steps would be unlikely to succeed.

Acceptance of the constraints of globalization is a more constructive, but also a more challenging, approach. It implies recognizing that national economic policies can insulate a country only to a limited degree from the undesirable effects of being a part of a whole it does not control. It also requires a consensus on the acceptable response to those undesirable effects, particularly the loss of economic policy independence.

Governments are formulating norms and standards that could be a basis for an international consensus. Also, they are reaching understandings or agreements to guide their actions and, in particular, to limit their discretionary activities in areas likely to generate adverse spillovers. Such measures
deal in an orderly way with the loss of national autonomy that countries have experienced in the global system. The real challenge for governments is to convert a de facto reduction of national autonomy (that caused by global markets) into a formal acknowledgment of its existence (through adopting agreed rules of the game).

**International regime for capital flows**

Economics, long known as the “dismal science,” every so often encounters episodes that encourage observers to argue that it is about to shed its dismal nature. There are perennial hopes that sophisticated risk-management techniques will be developed to tame risk once and for all, despite evidence to the contrary. The recent collapse of Long-Term Capital Management, a U.S.-based hedge fund, is a sobering example of the inability of supposedly sophisticated risk-management strategies to tame risks. The only certainties are that markets will continue to be volatile, economic cycles will persist, risk will not be completely tamed, and crises will continue to occur. The best we can do is contain market volatility, limit cyclical gyrations, and improve risk-management techniques.

A first issue is to determine what individual countries can do to cope with volatile capital flows. Country-specific experiences and policy actions can provide a wealth of information. The essential question is what national monetary and exchange rate policies, as well as domestic fiscal management and exchange controls, can contribute in this area. This issue is critical because it concerns the extent to which such individual country policy instruments may be able to counter the impact of capital flows.

In addition to the lessons that can be learned about particular country reactions and approaches, a second issue, that of the global dimension, must be considered. The complexities of capital account liberalization, and the policy constraints it imposes, should be distinguished from the procedures that must be designed to guide and monitor each country’s experience and progress in this domain.

The first issue is fundamentally empirical and has to be approached from a country-specific perspective. While such subjects as the pace and sequence of liberalization may be analyzed in the abstract, their translation into actual policy action will depend on the situation of each country.

For the orderly liberalization of capital flows, we need to address the second issue: the development of norms and procedures that all countries agree upon and that are flexible enough to cover all potential country situations. In this regard, a few time-tested principles of international relationships are eminently well suited for the purpose at hand:

- a provision to allow countries a measure of flexibility in liberalizing capital transactions—that is, a transitional arrangement giving countries the chance to pace and sequence the process according to their individual circumstances;
- a set of common prudential norms, based on generally recognized practices, to underpin and ensure proper management of cross-border risks;
- a principle of temporary international acceptance of restrictive measures on capital transactions when these are necessary for balance of payments or macroeconomic management reasons; and
- a provision to allow countries to resort temporarily to controls in emergency situations.

These principles, properly implemented, can address issues of capital account liberalization for all types of countries. All the ingredients to establish and operate such a set of principles already exist in the surveillance responsibility that countries have vested in the IMF. There are also grounds to build a consensus on common prudential norms that have been and are being developed by national regulatory and supervisory authorities, such as the Core Principles of the Basle Committee on Effective Banking Supervision.

All the necessary elements for a commonly accepted set of procedures to monitor the evolution of capital flows and capital accounts are in place. All that remains is for governments to show they are willing to accept and abide by them.

**Key pending challenges**

Each period of global turbulence adds fresh instruments to our arsenal of prevention tools. The crisis in Mexico in 1994–95 underscored the importance of information and data, of debt-management strategies, and of sound financial sectors. This message has been even more forcefully conveyed by the continuing crisis that began in Asia over a year ago, which highlighted the importance of proper governance and of arm’s-length relationships between governments and other sectors in the economy. These lessons acquire even greater relevance as economies become more closely integrated.

There is general agreement that transparency, disclosure, proper governance, and sound financial standards are necessary for a well-functioning market environment. As market forces are provided with better information that is both timely and appropriately disclosed, as well as with a measure of policy certainty, their ability to make efficient decisions is
enhanced. A key challenge will be to find ways to let markets bear the costs of their decisions when their arbitrage is incorrect or when they fail to differentiate properly. An inability to ensure that market forces not only reap the benefits but also bear the costs of decisions carries consequences that go beyond the normal concept of moral hazard. It eliminates the relevance and validity of the concept of underlying economic fundamentals.

Besides letting markets bear the costs of their own decisions, governments must ensure systemic stability. At times, this aim conflicts with achieving market-driven outcomes. Solutions to this dilemma have yet to be found, but they would seem to flow logically from the conclusions to which the current crisis is leading. These emphasize the importance of sound policies and frameworks; transparency based on accurate, comprehensive, and timely information; and proper governance standards. Presumably, capital would flow away from economies that deviated from these principles, encouraging them to resume observing them. At the same time, capital would flow toward economies that abided by the principles, thereby underpinning their performance.

The much-touted evidence of contagion, though, implies that not only is such differentiation not taking place but also that attempts to encourage it are failing. The implications of such failures are serious. Fundamentals that are sustainable with efficient arbitrage will no longer be sustainable when markets do not perform this function well. When contagion sets in, a mechanism must be put in place to protect economies with sound fundamentals.

This line of reasoning uncovers a vacuum in the existing institutional structure at the international level: the absence of a lender of last resort. Consensus is still to be reached on the need for this building block in the institutional architecture. One reason is a resistance to accepting the resource implications of setting up such an entity.

Less well known and more relevant is a reluctance to accept the supranational authority that a lender of last resort requires if it is to discharge its systemic responsibilities properly. The cession of national sovereignty implicit in such authority has not yet been accepted, even though global markets have already de facto curtailed it. Recognition of this situation would soon lead to a willingness to construct an international structure sufficiently robust to deal with global market forces and safeguard systemic stability.

Conclusion

The growing threat of global crisis is fueling a debate over the means available to contain and resolve it, as well as over the ways in which countries can protect themselves from its consequences. The world economy has become so closely integrated that not only do countries need to ensure that they manage their own economies well; they must also be ready to anticipate, and adapt to, economic mismanagement elsewhere. We have yet to agree on a set of rules to manage international capital flows. Those I described would go far toward helping countries gauge the risks they face in capital markets by making acceptable behavior transparent and by bringing to the surface some of the problems capital flows have posed for countries with proper economic fundamentals.

Just as the specter of contagion has led me to advocate a lender of last resort endowed with resources commensurate with the scale of potential systemic threats, the prospect of efficient arbitrage channeling capital flows to economies on a scale that far exceeds their size must be confronted.

Ways must be found to bring those inflows to a sustainable level. This calls for the lender of last resort to exercise surveillance over capital flows to ensure that sound policies are in place in the countries in which the capital flows originate, so that their scale and direction do not reflect policy inadequacies. This is a key task for international surveillance and it will require an analysis and understanding of the factors underlying global capital flows. More generally, it will also require those countries with the most influence in the world economy to accept responsibility for ensuring its stability, including in the domain of capital flows.

Maintaining order in the world economy in the absence of a global authority is a hard challenge. If we are to meet it, we need to acknowledge that all countries are part of the global society. Establishing universally applicable orderly norms is not the same as asking individual countries to bend to outside pressure. On the contrary, such a common endeavor will benefit everyone. In the words of José Ortega y Gasset: “Order is not a pressure which is imposed on society from without, but an equilibrium which is set up from within.”

Manuel Guitián was Director of the IMF’s Monetary and Exchange Affairs Department when he retired in late 1998.

Suggestions for further reading:

Customers wait at a bank in Beijing.
ROSS-BORDER asset accumulation has risen dramatically over the past decade. After a period of relatively narrow fluctuations during 1980–95, global cross-border flows tripled during the past decade to $6.4 trillion, reaching about 14.5 percent of world GDP by 2005 (see Chart 1). Much of the movement is due to a number of trends. Investment is increasingly diversified across borders, global capital markets are becoming more integrated as a result of liberalization and advances in technology, and the current economic environment offers many opportunities for growth around the world.

The confluence of these factors, combined with the rapid growth of assets under management outpacing the availability of domestic assets, has contributed to heightened cross-border flows. Low-risk premiums on assets have emboldened investors to venture down the credit curve in search of better yields. These developments have also been accompanied by increased leverage and risk taking.

Analyzing the changes in the international investor base and their investment allocation behavior is fundamental to understanding the buildup of strengths and weaknesses in international financial markets. Decisions that key investors make about where to allocate their assets not only affect the prices of financial assets, but also have wide-ranging implications for economic performance and welfare in various countries. The size of these cross-border flows and the rapid pace of innovation have given rise to concerns for financial stability, as countries remember that past booms in financial investment were followed by crises. Although it is admittedly difficult to disentangle the complex links and networks of investors around the world, this article attempts to illustrate the key underlying changes in the global investor base and assess the implications for financial stability.

Where's the money coming from?
Mature market countries remain the dominant supplier of gross capital flows, driven by intra-European cross-border flows, followed by the United States and Japan. European Union (EU) integration has facilitated financial regionalization within the continent, boosting Europe's share in global cross-border flows to about 70 percent in 2005 from 50 percent in 1996. Indeed, because euro member countries
Financial Globalization
disproportionately invest in one another relative to other
country pairs, there is considerable empirical support for
euro area bias in bond portfolios (Lane, 2006). Developed
Asia’s position as a major supplier of gross capital flows has
decreased somewhat, with Japan, though still sizable, losing
ground over the past decade. However, the contribution to
cross-border flows from Asia—the emerging economies,
newly industrialized economies (Hong Kong SAR, Korea,
Singapore, and Taiwan Province of China), and the oil-
producing countries—has risen significantly since 2000.
An examination of trends in net capital flows reveals
a notable shift in the composition of the global balance
sheet and casts a spotlight on global payments imbalances.
Most notably, emerging market countries, as a group, have
become net exporters of capital and an important investor
class in mature markets over the past five years (see Chart 2),
for their outflows mirroring the U.S. external financing
gap. However, this movement of capital from emerging
markets to mature markets is channeled primarily through
Asian central bank reserves and sovereign wealth funds,
mainly of oil exporters (such as those managed by the Abu
Dhabi Investment Authority, Kuwait Investment Authority,
and others). But private capital is also flowing from mature
markets to emerging markets as institutional investors,
banks, and corporates increasingly allocate their growing
financial assets to cross-border investment to diversify and
enhance risk-adjusted returns.
A surge in flows of institutional money has buoyed global
capital flows over the past decade. The most significant
growth has been in portfolio flows, mainly in debt, and in
cross-border banking. These inflows, combined with the
appreciation of asset prices and facilitated by financial inno-
ventions in the derivatives markets, have led to an unprece-
dented growth and deepening of financial markets. The size
of the world’s equity and bond markets is now double the
level of world GDP, with global stock market capitalization
reaching $38 trillion in 2005, compared with $45 trillion for
bond markets (see Chart 3).
Aside from the institutional money and banking finance,
foreign direct investment (FDI) originating from mature
market countries has also partially recovered since the burst-
ing of the dot-com bubble. FDI inflows to emerging markets
have been increasing but remain largely concentrated, with
China accounting for about 50 percent of emerging market
flows since 2002. Among the emerging markets, Asia-Pacific
and emerging Europe are the leading recipients of FDI, while
inflows to Latin America, dominated by Brazil, have fallen
since 2000.
How the investor base is changing
The rapid growth in cross-border flows has been accompa-
nied by changes in the investor base that have been fueled
by three key trends: the phenomenal growth in assets under
management of institutional investors, the rapid growth of

“In emerging markets, central banks and sovereign wealth funds have become key players in the cross-border allocation of capital, with U.S. financial markets a major focus.”

Chart 2
Mirror image
Private capital is flowing from mature markets to emerging ones while official capital is flowing in the opposite direction.

Chart 3
Expanding markets
Global bond and equity markets have witnessed unprecedented growth in the past 15 years.
hedge funds, and the rise of emerging market central banks and sovereign wealth funds as key players.

There has been a sharp increase in assets under management of traditional mature market institutional investors (pension funds, insurance companies, and mutual funds). Assets of these investors grew from about $21 trillion in 1995 to about $53 trillion in 2005, with the United States accounting for about half and Europe for more than one-fourth (see Chart 4). Pension funds in the United States represent a sizable portion of this asset base, while—except for Ireland, the Netherlands, and the United Kingdom—the share held by Europe is relatively small. Mutual funds and insurance companies, however, constitute a major share of institutional assets both in the United States and in Europe.

Another key trend has been the rapid growth of hedge funds. The number of hedge funds (excluding subsidiary funds) multiplied from 530 in 1990 to more than 6,700 by 2005. Inflows to hedge funds have been very strong since 2002, driven by a widening of the investor base to bring in institutional investors alongside high-net-worth individuals. Assets managed by the hedge fund industry, though smaller than those of other institutional investors, grew from $30 billion in 1990 to more than $1.4 trillion in 2005. Most of these funds are managed from the United States and the United Kingdom, which accounts for the bulk of Europe’s share (see Chart 5). For example, U.K. pension funds significantly increased their allocation to hedge funds in 2004 (UBS, 2005).

In emerging markets, central banks and sovereign wealth funds have become key players in the cross-border allocation of capital, with U.S. financial markets a major focus. The volume of U.S. treasury securities held by foreigners has more than tripled over the past decade, and the acquisition of capital, with U.S. financial markets a major focus. The volume of U.S. treasury securities held by foreigners has more than tripled over the past decade, and the acquisition of capital, with U.S. financial markets a major focus. The volume of U.S. treasury securities held by foreigners has more than tripled over the past decade, and the acquisition of capital, with U.S. financial markets a major focus. The volume of U.S. treasury securities held by foreigners has more than tripled over the past decade, and the acquisition of capital, with U.S. financial markets a major focus. The volume of U.S. treasury securities held by foreigners has more than tripled over the past decade, and the acquisition of capital, with U.S. financial markets a major focus. The volume of U.S. treasury securities held by foreigners has more than tripled over the past decade, and the acquisition of capital, with U.S. financial markets a major focus.

Looking overseas

The increase in assets managed by mature market institutional investors has been accompanied by an increase in cross-border asset allocation and a trend decline in home bias. The home bias emerges from the observation that weights in international portfolios tend to be biased toward the home country (French and Poterba, 1991; Aurélios, 2006).

Cross-border portfolio assets as a share of total assets under management of mature market countries have increased sharply over the past five years or so, dominated by institutional investors. During 2001–05, there was a cumulative increase in cross-border portfolio assets of more than 100 percent, reaching about $19 trillion. Cross-border portfolio assets from the United States grew from $2.3 trillion to $4.6 trillion over the same period, and those originating from Japan increased by $0.6 trillion to $2.1 trillion as of 2005. Europe saw the most significant decline in home bias, with an increase in cross-border portfolio assets of $6.1 trillion during 2001–05. However, a large share of that decline took place within developed Europe, as its investor base preferred to invest within continental Europe and the United Kingdom. Cross-border portfolio flows from Japanese households have been rising since 2000, channeled through Japanese mutual funds. The institutional investors, such as pension funds and mutual funds from mature market countries, have been increasing their investments in emerging markets.

The decline in home bias has been driven by structural as well as cyclical factors. Diversification has been an overarching motivation for most institutional investors. Regulatory and accounting changes for pension funds have also contributed to the shifts in investors’ asset allocation decisions. In particular, because of the increase in expected liabilities of
pension funds, such investors have sought to diversify investment strategies that not only match more closely their liabilities but also achieve the highest risk-adjusted return.

**Implications for global stability**

Although cross-border capital flows and the change in investor base have significant implications for financial stability, there are both pluses and minuses. On the one hand, a more globally diverse investor base, representing different types of institutions and different countries, is less likely to suffer simultaneous, symmetric, and significant shocks and therefore may be better able to manage risks and absorb shocks during a period of stress. On the other hand, a period of low volatility and low credit spreads may well be masking new exposures and new risks, such as increased activity in alternative assets that are relatively more illiquid, raising financial stability concerns. Such concerns are compounded by increased leverage of market participants and how the unwinding of such positions can be executed under duress.

The surge in cross-border capital flows from mature market institutional investors has helped broaden the investor base for emerging market external sovereign debt, leading to the stability and lower volatility of this asset class over the past five years—as reflected in the global spreads of the JPMorgan Chase emerging markets bond index (EMBI). Interest in emerging market assets has undergone a structural upward shift, with institutional investors such as U.S. pension funds adding emerging market external debt to their benchmark portfolio allocation.

Investor perception of the maturity of the emerging market asset class has been underpinned by improved credit fundamentals, more flexible exchange rate regimes, higher reserve coverage, a structural boost from the convergence of emerging European countries to EU levels, and transparency of information originating from emerging market countries (Byun and Oswald, 2006). These changes have resulted in a higher strategic inflow to this asset class. Indeed, assets under management of emerging market funds benchmarked to emerging market bond indices grew from $27 billion in late 2000 to about $230 billion as of mid-2006. These strategic investors tend to buy and hold and usually have a lower, or no leverage because they aim largely to match the duration of their longer-term liabilities.

Net and gross capital flow volatility has increased substantially over the past decade, both in mature markets and in some emerging markets, although the resilience of most emerging market countries to shocks has improved. Indeed, for most emerging market countries the rise in cross-border capital flow volatility, when adjusted for the rise in foreign exchange reserves, shows a significant decline from 1996 to 2005.

Asset price volatilities have seen a long-term decline across asset classes for bonds, equities, and foreign exchange. Both realized volatilities and implied volatilities have moderated considerably in a range of assets in mature markets. Emerging market assets, such as sovereign external debt, have also followed this trend. Although such a phenomenon could, in the words of U.S. Federal Reserve Chairman Ben Bernanke, be attributed to “the great moderation,” its durability remains to be tested in a less benign environment.

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References:


FINANCIAL markets are generally seen as providing the best unbiased insights into future economic developments. But in recent months, many market segments have appeared to be sending competing, if not confusing, signals, such as the following:

- Many national equity markets finished 2006 at or near all-time highs, prompting analysts to see them as signaling confidence that robust global growth and subdued inflation will continue—what has become known as the “global Goldilocks” scenario (“not too hot, not too cold”). Yet bond markets—especially in the United States but also increasingly elsewhere—were suggesting a more cautious outlook.
- There has been an unusual degree of disagreement among major Wall Street analysts (the “Fed watchers”) as to the direction of U.S. policy rates in 2007. With the Fed Fund’s rate at 5¼ percent, some have predicted a move down to 4 percent by December of this year, others, a move up to 6 percent. Moreover, measures of market volatility have been unusually muted across virtually all major markets (including foreign exchange, equities, and fixed income) notwithstanding the lack of market conviction about U.S. policy rates.

It is tempting to dismiss these competing signals as “noise”—that is, market movements devoid of serious information content. But that would be inadvisable. These apparently inconsistent signals carry important information about the changing global circumstances facing national policymakers, multilateral institutions, and market participants—circumstances that call for changes in the way these participants in international finance react.

**Big changes afoot**

At the root of these seemingly competing signals are three major structural changes that have been influencing the global economy simultaneously. The most visible of these changes comes from the positive productivity shock associated with the growing integration of large segments of the labor force residing in developing economies. The immediate result has been to broaden the sources of global economic growth. Indeed, developing countries account for a significant and growing portion of total global expansion. In addition, the increasing integration of their labor forces has reduced overall input costs for a range of products, allowing companies in industrial countries to better contain spending and enhance profits.

The second structural change speaks to the repricing of commodities. This is a direct consequence of the broadening of global growth—a process that is seeing rising demand for commodities from an expanding list of countries, but only a limited supply response so far. The resulting increase in commodity prices has helped a larger group of emerging economies run sizable current account surpluses, with a concurrent rapid increase in their holdings of international reserves. For some economies, this transition is nothing short of a dramatic regime shift: from international debtor status to international creditor status. Indeed, this combination of higher commodity prices...
and productivity advances, together with the manner in which the surpluses have been deployed, has transformed the emerging markets as a group into a major source of low-cost funding for the rest of the world (and the United States in particular).

The third structural change is more technical. It pertains to a significant and far-reaching bout of financial innovation triggered by the proliferation of derivative-based instruments. The overall impact has been to dramatically reduce the barriers to entry to a host of markets. And the lowered entry barriers are turbocharging important asset allocation adjustments among institutional and retail investors.

Together, these three factors have fundamentally altered the marginal determinants of global growth, trade, price formation, and (internal and cross-border) capital flows. In the process, we are seeing some notable changes to the determinants of market valuation, volatility, leverage, velocity, and liquidity.

No wonder traditional models have become less effective in both explaining developments and predicting the future. No wonder policy reaction functions have become more tentative. It is also not surprising that markets have adopted a hesitant and bumpy path to pricing the new global realities, some of which are still developing robust anchors.

Temporary or here to stay?

As recognition of these structural changes grows, participants in international finance are playing serious catch-up. Analytical approaches are being recalibrated, traditional policy wisdom is being revisited, business models are being reassessed, and new market instruments are being created. There is also growing recognition of the changing nature of cross-border linkages, with implications for multilateral institutions (particularly their activities, effectiveness, resource requirements, governance, and funding).

The catch-up process, although increasingly obvious to many, is also inherently complex in terms of design and implementation. Moreover, the dynamics of the process itself are prone to overreactions. At a minimum, the process encourages a temporary but notable dispersion in views—not an entirely surprising outcome in view of the profound structural changes in play, and the delicate balance that needs to be struck between transitory and longer-run considerations.

Perhaps the best way to vividly illustrate the complexities in play is to refer to some of the extreme differences of views that have emerged in the secular-versus-cyclical debate. The best place to start is with the loudest of all current global discussions—that is, the one pertaining to payments imbalances, particularly the persistently large U.S. current account deficit and the large surpluses in Asia and oil-exporting economies.

In discussing the implications of the global payments imbalances, proponents of the secular view see the unprecedented U.S. current account deficit as an efficient accommodation of the regime shift being experienced by several emerging economies. Specifically, by running a large deficit, the United States is absorbing what U.S. Federal Reserve Board Chairman Ben Bernanke has labeled “the savings glut” emanating from emerging economies. Some go further and argue that, responding to limitations in their domestic financial systems, emerging economies have also outsourced the financial intermediation function to the more efficient U.S. capital markets. All of this is seen as consistent with the maintenance of high global growth and financial stability.

Proponents of the cyclical view see things very differently. For them, the large U.S. deficit is nothing more than the result of domestic overconsumption—a reversible phenomenon that has played out in many other countries in the past, and historically has often assumed disorderly characteristics. It is affecting the largest economy in the world, which, for now, has been able to “sustain the unsustainable” because of its special economic attributes (such as the dollar being a reserve currency) and the depth of its financial markets.

This discussion has also tended to spill over to what is already quite a heated discussion about the unusual pricing of virtually any risk premium—a phenomenon that is visible in many markets in both emerging and industrial countries. For some, the virtual disappearance of risk premiums is the result of global economic convergence and the ability of markets to better tailor risk management instruments and techniques—that is, secular factors that are deemed permanent and consequential. Proponents of this view also cite the “great moderation” of inflationary pressures and the enhanced transparency of macro policy around the world (and in the United States in particular).

Others argue that risk premiums are bound to reappear as temporary investor euphoria gives way to a repricing that is more consistent with underlying economic fundamentals. For them, the cyclical compression in risk spreads is both temporary and reversible. They go on to argue that, as this repricing takes hold, the “risk-mitigation” characteristics of many of the new derivative-based instruments will assume destabilizing dynamics, bringing to the fore the “weapons of financial mass destruction” that investor Warren Buffet warned about a few years ago when he commented on the derivative phenomenon.

The secular-versus-cyclical debate is also at the root of some major disagreements about the potential role of multilateral institutions, including the IMF. One view sees the
IMF as having lost relevance, leading some to question its existence and others to advocate major changes in the institution (including expertise, governance, and representation). At a minimum, the institution must develop new sources of revenue generation, given the decline in income now that few emerging economies borrow from the IMF. The cyclical view warns against such “overreaction,” noting that it is simply a matter of time before the IMF is again thrust center stage in its traditional roles of crisis management and crisis prevention.

Market participants are also being forced to express a view about the secular-versus-cyclical balance. If nothing else, the structural changes noted above are eroding the traditional sources of investment returns. Here, the secular camp argues for fundamental changes in the approach to asset allocation, the management of investment return expectations, and the specification of correlations among instruments. On the other hand, the cyclical camp cautions against reacting to an overshoot in markets. Instead, it argues for biding one’s time. It notes that forgone investment returns in the short run are a small price to pay to limit exposure to potential capital loss.

Thoughts on coping strategies
So how should the various participants in international finance design their strategies to cope with this fluid financial landscape? It is best to start with what participants should avoid at all costs: they should not allow the complexity of the issues to paralyze deliberations and appropriate actions. Indeed, it is critical, whether they operate in the public or the private sector, to be explicit about the set of (often implicit) secular-versus-cyclical assumptions that underpin their current approaches, relate these to the current fluidity of the global system, and enunciate both the upside and the downside associated with alternative approaches. In the process, there will be an identification of the costs and benefits associated with possible changes to operating models, business strategies, and risk management approaches.

For national authorities in industrial countries, the challenges include how best to react to the reduction in policy-related insights emanating from traditional market measures (such as the shape of the yield curve and the level of various risk premiums). They also need to incorporate explicitly in their modeling the impact of the more rapid internationalization of national labor forces, as well as the notable change in cross-border capital flows (particularly the growing importance of emerging economies as holders of industrial country government and corporate bonds).

For several emerging economies, the challenges include adjusting to the dramatic change in their external payments situation. At a minimum, this involves their adopting more sophisticated approaches to managing their outstanding liabilities (including how best to buy back and/or re-profile debt) and to enhancing the management of their growing financial assets. In some cases, they will need to adapt their institutions to improve operational transparency and accountability, as well as change the guidelines governing investments and liability management. There is also the difficult question of whether certain countries should use the bout of economic and financial strengthening to implement greater flexibility in some key policy areas, such as exchange rate determination and domestic consumption.

For institutional investors, the challenges go well beyond how best to react to unusual valuation and volatility measures. They also face some fundamental questions about how best to adjust their asset allocation and portfolio construction to take into account the ongoing structural changes. Given that such adjustments inevitably involve a migration to a more internationalized investment positioning, they need to enhance their risk management techniques so that they can better navigate embedded risks.

For multilateral institutions, the challenge is to remain credible and effective as trusted providers of policy advice that incorporates the right balance between national and international considerations. In the IMF’s case, many of the issues have already been identified in the Managing Director’s medium-term strategy documents issued in September 2005 and April 2006. And, in the words of the Managing Director, “the imperative is [for the Fund] to stay relevant in a changing world.” Measures are thus needed to address a host of challenges, such as enhancing the Fund’s ability to inform national policies, including improving its ability to be an effective cross-border conveyor of best practices and imparting a multilateral dimension to national policy dialogues; better integrating financial sector analysis in national and international economic assessments; updating its outmoded approach to governance and representation; modernizing the institution’s skill set and expertise; and shifting to a more robust model for generating income internally.

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In sum, this is an unusual time for the global economy and markets. Both are being affected by structural changes that are consequential not only in themselves but also in the way they interact. As a result, participants in international finance face many moving pieces, some of which appear contradictory.

When faced with such fluidity, participants have a natural tendency to wish to remain on the sideline awaiting greater clarity. But this would be inadvisable. The longer they put off reacting, the greater the risks associated with existing—and increasingly outmoded—approaches. Instead, participants would be well advised to test and retest the robustness of their operating models to the world’s changing realities. And, in going back to first principles, they need to be able and willing to consider necessary adaptations should their approaches prove less effective.

THREE decades ago, a manufacturer building a new factory would probably have been restricted to borrowing from a domestic bank. Today it has many more options to choose from. It can shop around the world for a loan with a lower interest rate and borrow in foreign currency if foreign-currency loans offer more attractive terms than domestic-currency loans; it can issue stocks or bonds in either domestic or international capital markets; and it can choose from a variety of financial products designed to help it hedge against possible risks. It can even sell equity to a foreign company.

A look at how financial globalization has occurred, and the form it is taking, offers insights into its benefits as well as the new risks and challenges it has generated.

Forces driving globalization

What has driven the globalization of finance? Four main factors stand out.

Advances in information and computer technologies have made it easier for market participants and country authorities to collect and process the information they need to measure, monitor, and manage financial risk; to price and trade the complex new financial instruments that have been developed in recent years; and to manage large books of transactions spread across international financial centers in Asia, Europe, and the Western Hemisphere.

The globalization of national economies has advanced significantly as real economic activity—production, consumption, and physical investment—has been dispersed over different countries or regions. Today, the components of a television set may be manufactured in one country and assembled in another, and the final product sold to consumers around the world. New multinational companies have been created, each producing and distributing its goods and services through networks that span the globe, while established multinationals have expanded internationally by merging with or acquiring foreign companies. Many countries have lowered barriers to international trade, and cross-border flows in goods and services have increased significantly. World exports of goods and services, which averaged $2.3 billion a year during 1983–92, have more than tripled, to an estimated $7.6 billion in 2001. These changes have stimulated demand for cross-border finance and, in tandem with financial liberalization, fostered the creation of an internationally mobile pool of capital and liquidity.

The liberalization of national financial and capital markets, coupled with the rapid improvements in information technology and the globalization of national economies, has catalyzed financial innovation and spurred the growth of cross-border capital movements. The globalization of financial intermediation is partly a response to the demand for mechanisms to intermediate cross-border flows and partly a response to declining barriers to trade in financial services and liberalized rules governing the entry of foreign financial institutions into domestic capital markets. Global gross capital flows in 2000 amounted to $7.5 trillion, a fourfold increase over 1990. The growth in cross-border capital movements also resulted in larger net capital flows, rising from $500 billion in 1990 to nearly $1.2 trillion in 2000.

Competition among the providers of intermediary services has increased because of technological advances and financial liberalization. The regulatory authorities in many countries have altered rules governing financial intermediation to allow a broader range of institutions to provide financial services,
and new classes of nonbank financial institutions, including institutional investors, have emerged. Investment banks, securities firms, asset managers, mutual funds, insurance companies, specialty and trade finance companies, hedge funds, and even telecommunications, software, and food companies are starting to provide services similar to those traditionally provided by banks.

Changes in capital markets

These forces have, in turn, led to dramatic changes in the structure of national and international capital markets.

First, banking systems in the major countries have gone through a process of disintermediation—that is, a greater share of financial intermediation is now taking place through tradable securities (rather than bank loans and deposits). Both financial and nonfinancial entities, as well as savers and investors, have played key roles in, and benefited from, this transformation. Banks have increasingly moved financial risks (especially credit risks) off their balance sheets and into securities markets—for example, by pooling and converting assets into tradable securities and entering into interest rate swaps and other derivatives transactions—in response to such regulatory incentives as capital requirements, as well as to internal incentives both to improve risk-adjusted returns on capital for shareholders and to be more competitive. Corporations and governments have also come to rely more heavily on national and international capital markets to finance their activities. Finally, a growing and more diverse group of investors are willing to own an array of credit and other financial risks, thanks to improvements in information technology that have made these risks easier to monitor, analyze, and manage.

Second, cross-border financial activity has increased. Investors, including the institutional investors that manage a growing share of global financial wealth, are trying to enhance their risk-adjusted returns by diversifying their portfolios internationally and are seeking out the best investment opportunities from a wider range of industries, countries, and currencies. At the wholesale level, national financial markets have become increasingly integrated into a single global financial system. The major financial centers now serve borrowers and investors around the world, and sovereign borrowers at various stages of economic and financial development can access capital in international markets. Multinational companies can tap a range of national and international capital markets to finance their activities and fund cross-border mergers and acquisitions, while financial intermediaries can raise funds and manage risks more flexibly by accessing markets and pools of capital in the major international financial centers.

Third, the nonbank financial institutions are competing—sometimes aggressively—with banks for household savings and corporate finance mandates in national and international markets, driving down the prices of financial instruments. They are garnering a rising share of savings, as households bypass bank deposits to hold their funds in higher-return instruments—such as mutual funds—issued by institutions that are better able to diversify risks, reduce tax burdens, and take advantage of economies of scale, and have grown dramatically in size as well as in sophistication.

Fourth, banks have expanded beyond their traditional deposit-taking and balance-sheet-lending businesses, as countries have relaxed regulatory barriers to allow commercial banks to enter investment banking, asset management, and even insurance, enabling them to diversify their revenue sources and business risks. The deepening and broadening of capital markets has created another new source of business for banks—the underwriting of corporate bond and equity issues—as well as a new source of financing, as banks increas-
actively traded among institutions, investors, and countries, it becomes harder to identify potential weaknesses and to gauge the magnitude of risk. Enhanced transparency about economic and financial market fundamentals, along with a better understanding of why asset market booms and busts occur, can help markets better manage these risks.

Finally, creditworthy banks and firms in emerging market countries can reduce their borrowing costs now that they are able to tap a broader pool of capital from a more diverse and competitive array of providers. However, as we saw during the Mexican crisis of 1994–95 and the Asian and Russian crises of 1997–98, the risks involved can be considerable—including sharp reversals of capital flows, international spillovers, and contagion. (Even though the extent of contagion seems to have decreased, for reasons that are still unclear, since the 1997–98 crises, the risk of contagion cannot be ruled out.) Emerging market countries with weak or poorly regulated banks are particularly vulnerable, but such crises can threaten the stability of the international financial system as well.

Benefits versus risks

All in all, the radical change in the nature of capital markets has offered unprecedented benefits. But it has also changed market dynamics in ways that are not yet fully understood.

One of the main benefits of the growing diversity of funding sources is that it reduces the risk of a “credit crunch.” When banks in their own country are under strain, borrowers can now raise funds by issuing stocks or bonds in domestic securities markets or by seeking other financing sources in international capital markets. Securitization makes the pricing and allocation of capital more efficient because changes in financial risks are reflected much more quickly in asset prices and flows than on bank balance sheets. The downside is that markets have become more volatile, and this volatility could pose a threat to financial stability. For example, the OTC derivatives markets, which accounted for nearly $100 trillion in notional principal and $3 trillion in off-balance-sheet credit exposures in June 2001, can be unpredictable and, at times, turbulent. Accordingly, those in charge of preserving financial stability need to better understand how the globalization of finance has changed the balance of risks in international capital markets and ensure that private risk-management practices guard against these risks.

Another benefit of financial globalization is that, with more choices open to them, borrowers and investors can obtain better terms on their financing. Corporations can finance physical investments more cheaply, and investors can more easily diversify internationally and tailor portfolio risk to their preferences. This encourages investment and saving, which facilitate real economic activity and growth and improve economic welfare. However, asset prices may overshoot fundamentals during booms and busts, causing excessive volatility and distorting the allocation of capital. For example, real estate prices in Asia soared and then dropped precipitously before the crises of 1997–98, leaving many banks with nonperforming loans backed by collateral that had lost much of its value. Also, as financial risk becomes

Safeguarding financial stability

The crises of the 1990s underscored the need for prudent sovereign debt management, properly sequenced capital account liberalization, and well-regulated and resilient domestic financial systems, to ensure national and international financial stability.

Private financial institutions and market participants can contribute to financial stability by managing their businesses and financial risks well and avoiding imprudent risk taking—in part by responding to market incentives and governance mechanisms, such as maximizing shareholder value and maintaining appropriate counterparty relationships in markets. In effect, the first lines of defense against financial problems and systemic risks are sound financial institutions, efficient financial markets, and effective market discipline.

But, because financial stability is also a global public good, national supervisors and regulators must also play a role. Indeed, this role is becoming increasingly international in scope—for example, through a strengthening of coordination and information sharing across countries and functional areas (banking, insurance, securities) to identify financial problems before they become systemic.

The IMF itself has an important role to play. In accordance with its global surveillance mandate, it has launched a number of initiatives to enhance its ability to contribute to international financial stability: identifying and monitoring weaknesses and vulnerabilities in international financial markets; developing early warning systems for international financial market imbalances; conducting research into the nature and origins of international financial crises and the channels of contagion; and seeking ways to contain and resolve crises quickly and smoothly, for example, by involving the private sector.

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EPISODES of high volatility in international capital flows to emerging market economies in the 1990s put foreign investors in the limelight—these investors are frequently seen as the culprits behind bouts of instability and the ensuing currency crises. Some have argued that market participants disregarded fundamental economic conditions in emerging economies and instead acted as a “herd”—that is, they reflexively did what other investors were already doing. Widespread herding behavior by a group of investors could worsen volatility and touch off panics that do not reflect the true economic conditions in emerging market countries. In our paper published in 2000, we examined the herding proposition empirically for international funds that invest in emerging economies’ equity markets and found that although herding is more prevalent there than in other markets, it is probably not to blame for the observed volatility of international capital flows.
Herding can be fully rational from the point of view of an individual investor. For example, an investor may have only limited access to direct information about asset returns and therefore needs to learn from the actions of others. Sometimes, the best thing an uninformed investor can do is follow the actions of more informed investors. Alternatively, fund managers’ compensation may be linked to the performance of the fund they manage relative to those of other funds of the same type. This may prompt managers to try to avoid falling too much behind their comparator funds, which would lead them to invest in a portfolio of assets that never diverges very much from their comparator funds’ portfolios.

Herding may sometimes be more apparent than real. For example, foreign investors may appear to act as a herd if they react simultaneously to the same news about fundamentals. In this case, their behavior speeds up the adjustment of prices and is not destabilizing. However, in an efficient market, speedy price adjustment should occur without many actual trades having to take place. Moreover, the question remains as to why international investors would react differently to certain news than domestic investors.

What does the evidence show?
Assessing the behavior of international investors in a systematic way is difficult. Most of the available financial information consists of data on prices, and it is difficult to convincingly trace movements in prices to the behavior of particular groups of investors. Moreover, herding by international investors may not have an immediate impact on asset prices but may nevertheless worsen a country’s balance of payments.

We studied the behavior of international investors by exploring a novel data set, compiled by Emerging Market Funds Research, Inc., comprising monthly data on the individual portfolios of about 400 dedicated emerging market equity funds for January 1996–March 1999. The database covers 80 percent of dedicated emerging market funds, and—with an aggregate net asset value of over $100 billion—about 90 percent of the market value of all such funds’ assets. While the period covered is relatively short, it encompasses significant financial crises, enabling us to examine each of these in detail. This database also has the advantage of covering a well-specified class of investors—it makes sense to search for evidence of herding within a subset of investors, because the whole market cannot move in the same direction: for every seller, there must be a buyer.

First, we examined gross and net flows into and out of emerging equity markets in different regions. Chart 1 displays gross and net flows into emerging markets in four major regions for the whole period we examined. Our findings show that funds do not always move in the same direction: large outflows may occur at the same time as large inflows. The chart also suggests, however, that funds have pulled out, on a net basis, just before major crises or periods of turbulence. For Asia, there were sizable net outflows starting in June 1997. For Europe, there was a substantial drop in net inflows in July 1998, just before the Russian crisis occurred. For Latin America, there was a sharp outflow one month before the Brazilian devaluation of January 1999.

Chart 2 takes a more detailed look at some important episodes of turbulence that are encompassed by this data set: the Czech Republic’s devaluation of May 1997, Thailand’s crisis of June 1997, Russia’s ruble collapse of August 1998, and Brazil’s floating of the real in January 1999. In general, the emerging market mutual funds in our sample tended to withdraw funds from the affected countries in the month before the crisis. (The exception, interestingly, is Thailand, whose crisis has been blamed by many observers on the behavior of international investors.)

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Perhaps more important, relatively large inflows have persisted even during periods just before the crises, which suggests that not all foreign investors anticipated the approaching events. Furthermore, funds did not withdraw indiscriminately from emerging markets in turbulent periods. For example, while it is true that, viewed in the aggregate, funds withdrew large amounts of capital from Latin America and Asia during the Russian crisis, many funds in our sample that reduced their exposures in Russia increased their investments in Latin America. This contradicts a simplistic view of mutual funds’ behavior and suggests that their portfolio choices need to be examined more closely.

A more systematic, quantitative measure of the degree of herding among funds confirms the casual impression given by Charts 1 and 2. The index of herding originally introduced by Lakonishok, Shleifer, and Vishny (1992) essentially counts how often funds end up on the same side of the market relative to what one would expect if they traded independently and randomly. Except for a trend correction, the measure assumes that in the absence of herding, there would be an equal number of buyers and sellers among funds. Naturally, computation of this index makes sense for only a subset of the market because, in the aggregate, it is impossible for all investors to join a herd and be on the same side of the market.

The quantitative results indicate that herding behavior is statistically significant but probably does not have a large economic impact. The overall mean of the herding index is 7.2 percent, implying that for a given country, the number of funds buying or selling was slightly more than 7 percent larger than one would have expected if they had acted independently and randomly.

“Contrary to our presumption, there is more herding in the largest stock markets than in the smallest ones.”
This number is approximately twice as large as the values found in other studies for U.S. institutional investors in the U.S. stock market. It is clearly not as large a figure as would have been expected, however, if one believed that herding by international investors was the main cause of international financial volatility. The measure of herding is fairly stable across regions and over time; moreover, considering all countries, herding does not seem to increase significantly during crises. We did find, however, that there is a positive correlation between herding and stock market volatility across countries. It is also important to highlight that, since we are investigating the behavior of dedicated emerging market funds, we can analyze herding in and out of the emerging market asset class as a whole in only a limited sense.

By looking at differences among funds and countries, one can obtain a better understanding of the herding phenomenon. For example, if it were more costly for fund managers to acquire information about small markets than large ones, herding would probably be more common in the former. Similarly, one might expect offshore investment funds to display different investment patterns than domestic funds, given the lesser regulatory constraints that the former face. Because closed-end funds (which have a fixed number of shares issued at their initial public offer) are not subject to redemptions by their investors, one should—if herding involves mainly individual investors—observe lower herding index numbers among closed-end funds.

The empirical results we obtained confirm some, but not all, of these hypotheses. Contrary to our presumption, there is more herding in the largest stock markets than in the smallest ones. This suggests that herding is not a result of fund managers trying to avoid incurring fixed information costs, which, relative to market size, are lower in the largest markets. Instead, illiquid markets may prevent fund managers from imitating the behavior of others in the smallest stock markets. Offshore funds tend to herd less than other funds, while herding by large, global, and international funds is not very different from the average for all funds. In line with our a priori reasoning, herding is less pronounced among closed-end funds, suggesting that the observed tendency to engage in herding might, to some extent, be traceable to the behavior of individual investors.

Leaders and followers
Who are the leaders and who are the followers within the mutual fund industry? The funds in our sample have different expertise and constraints, and operate under different rules and objectives. These differences may affect how they react to each other’s transactions. One might imagine, for example, that regional or single-country funds are more familiar with the specific economic situations in the countries where they invest and thus play a leading role in triggering inflows or outflows. Similarly, if the acquisition of country-specific information involves fixed costs, smaller funds may be at a disadvantage compared with larger funds and may be induced to follow the latter’s strategies. In addition, open-ended funds may be subject to redemptions by nervous individual investors and be forced to reduce their exposures to certain countries before closed-end funds are. In instances where open-ended funds are important enough to affect market trends, however, closed-end funds would be induced to follow them. It is therefore conceivable that a small fraction of funds may regularly be responsible for starting large stampedes into or out of a country.

We divided funds into four interesting pairs: single-country funds and multiple-country funds, global and international funds and regional and single-country funds, large funds and small funds, and closed-end funds and open-ended funds. Then we used an econometric procedure (vector autoregression) to
detect systematic relationships in the timing of transactions by these different groups of investors. The results for regional and single-country funds versus global and international funds yield a result consistent with information transmission in the market: inflows or outflows by regional or single-country funds precede flows of global and international funds into the same country. The results also show that open-ended funds’ flows precede closed-end funds’ investments, which, again, is consistent with the view that herding begins with individual investors.

Trading strategies

Another type of behavior that is not consistent with the underlying economic strength of companies in emerging market economies occurs when investors follow “positive feedback” or “momentum” trading strategies. These basically imply a tendency to buy past strong performers and to sell recent weak performers. To test for the existence of such behavior, we examined whether the degree of herding is related to past returns. If funds follow momentum strategies, we should observe herding to be more pronounced if there were extremely low or high returns for the preceding month. For example, a “sell herd” would form after particularly low returns were experienced for a country during the preceding month. We computed separate herding measures for individual countries for months when the proportion of buyers was distinctly below or above average and investigated the relationship between these developments and the prior performance of individual stock markets. We also computed two measures of excess demand and examined their correlations with prior returns.

The results are, again, mixed. Although there is no clear relation between the herding measures and returns for the preceding month, the results indicate that, on average, funds did tend to buy past winners. There is, however, no evidence that this behavior is accentuated during crises. Such trading based on past returns is at least as pronounced for single-country funds as for funds in the aggregate.

Overall, our results suggest that the behavior of emerging market equity funds is more complex than is often suggested. It is true that this class of investors tends to pull out of emerging market economies just before the outbreak of a crisis, with regional and single-country funds appearing to move first. Although funds show some degree of herding behavior, this reaches only modest proportions and is probably too limited to justify considering funds responsible for starting “stampedes.” Similarly, there is some evidence that funds follow destabilizing feedback strategies—buying past winners and selling past losers—but only to a limited extent. Interestingly, neither herding behavior nor feedback trading is more pronounced during crises. In light of this evidence, at least, the case against dedicated emerging market funds remains to be proven: simple characterizations of this class of investors as “panic prone” do not seem to be appropriate.

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References:


Small Fish, Big Pond

Augusto de la Torre and Sergio Schmukler

The world’s financial system—and particularly capital markets—has undergone substantial changes during the past three decades, with financial depth, diversity, and globalization increasing sharply. While most of this change has taken place in financial centers and developed countries, it has also occurred in developing countries to a significant extent. Many developing countries tried to deepen their securities markets by introducing major reforms, especially during the 1990s. They liberalized their financial systems, improved their investment climates (through macroeconomic stabilization and better business environments), developed new supervisory frameworks and institutions, and improved the basic infrastructure for capital market operations. Many countries also implemented comprehensive pension reforms and privatized state-owned enterprises, hoping to encourage capital market development.

As reforms intensified, so did expectations regarding capital market development in developing countries. These high expectations, however, have not been met in many countries. After nearly two decades of reform, the state of capital markets in developing countries is quite mixed. The pace of growth, though rapid overall, has not been as dramatic as in developed nations. Some developing countries have experienced stagnation or even contraction of their securities markets, particularly for equity and domestic currency–denominated bonds. Latin American countries, in particular, have embraced financial globalization more vigorously than have Asian countries, but have lagged considerably behind Asia in terms of deepening their domestic securities markets. These developments are disheartening: they are too meager a payoff relative to the intense reform efforts. They are also puzzling because of the lack of clarity and consensus on how to modify the capital market reform agenda.

This article attempts to shed some light on the mixed results, arguing that greater attention must be given to the roles that globalization and size play in securities markets development. It concludes that policymakers will need to reshape their expectations and take a new approach to building up domestic capital markets.

Insights into weak capital markets

It is difficult to explain the poor performance of domestic stock and bond markets across developing countries with reference only to macroeconomic and institutional fundamentals—such as monetary stability, overall economic development, economic size, and rule of law—or capital market–related reforms. In fact, the empirical results of a recent World Bank study comparing Latin American capital markets with those of other regions show that better fundamentals foster both domestic stock market development and its internationalization—in terms of the issuance and trading of securities abroad—but not symmetrically. As fundamentals improve, stock issuance and trading abroad actually increase relative to domestic activity. Similarly, the introduction of capital market–related reforms has a larger positive impact on stock market internationalization than on local stock market activity.

Contrary to expectations, this internationalization of equity markets has, in addition, not "crowded in" local market activity. Instead, in many cases, local stock market liquidity has been undercut. As the local liquidity of firms that issue securities on overseas stock markets declines, negative spillovers occur: the liquidity of the firms that do not go abroad is negatively affected. Moreover, there are trade diversion effects. The remaining liquidity in...
the domestic stock market tends to concentrate on the firms that have already accessed international capital markets.

These effects have been particularly strong in Latin America, resulting in the slow development of domestic securities markets. Latin American local markets are not only below what could be expected, given the region's economic and institutional development, they have also been less responsive to the introduction of reforms. Conversely, Latin America exhibits an "excess" degree of stock market internationalization, which is partly explained by the intense privatization process that led to a shift of new issues to international markets and has been reflected in significant delistings (see chart). While certainly an outlier, Latin America is not alone, as some of the smaller developed and developing countries in Europe are facing similar patterns. East Asia, in contrast, displays a different behavior, with several of its domestic markets for equities and corporate bonds developing relatively well.

A puzzling gap

How do these results help explain the gap between the high expectations and intense reforms of the 1990s, on the one hand, and the low level of development of domestic capital markets, on the other? They give reason to question whether traditional views on the gap hold up. One such view ascribes the gap to impatience, and imperfect and incomplete reform efforts, recommending that market forces be given time to work while forging ahead with further reforms. In this view, the basic elements of necessary reforms are well known—since "best practices" are already described in various international standards and codes. But this view largely ignores the finding that improvements in institutional and macroeconomic fundamentals and the introduction of reforms spur not only domestic securities markets development but also—and to a greater extent—the increased tendency to issue and trade securities abroad. While not invalidating the importance of reforms, this finding clearly calls for a major change in expectations and suggests that the issues associated with financial globalization must be revisited to reshape expectations appropriately.

Another view claims that the gap is due to faulty reform sequencing. It stresses the importance of establishing a good institutional and regulatory framework and developing a local market for domestic currency–denominated debt before financial market liberalization. There is nothing wrong, in principle, with the prescription to postpone full capital account opening and unrestrained competition until certain conditions are in place. But the political economy reality is that institutional reform does not happen simply because of good logic, which in most cases is insufficient to dislodge the resistance coming from those who feel the losses from reform up-front and can organize vigorously to resist change. By contrast, gains from reform accrue in the future and are spread among numerous winners who, as a result, face a collective action problem. With little incentive to act as a group, they tend to remain relatively voiceless and unorganized. Historical experience amply illustrates that external competition induces insiders to become more efficient and, as a result, changes incentives vis-à-vis reform—pushing efficient incumbents to become supporters of the very reforms they had previously resisted.

The bottom line is that both of these views either leave out or fail to adequately address critical elements. The World Bank study offers a complementary view that emphasizes the need to step back and reconsider the implications of certain basic issues—such as financial globalization, liquidity, diversification, and size—as a prior step to a more solid reformulation of the reform agenda.

Role of financial globalization. Financial globalization complicates policy actions in debt and equity markets in different ways. In debt markets, globalization magnifies problems associated with weak currencies. The current globalization wave—which is unfolding in a context of floating exchange rates—bestows benefits that increase depending on how well the local currency performs two functions simultaneously: that of shock absorber and that of a reliable store of value for savings. Performing these two functions well is already difficult for all but the few currencies used internationally as reserve assets. It is drastically more complicated if, in addition, the local currency is not fully accepted, even at home, as a reliable receptacle for savings. This situation encourages the arrangement of financial contracts that are either heavily dollarized (in a strong foreign currency) or predominantly of short duration, creating large unhedged exposures in debtors’ balance sheets that make the financial system vulnerable to sudden, large depreciations of the real exchange rate or increases in the real interest rate, respectively. In these circumstances, policy is not only constrained but it is also liable to be torn between the goals of the currency as a shock absorber and store of value.
In contrast, the internationalization of equity markets does not create balance sheet mismatches for equity issuers and therefore does not create systemic vulnerability, even if the integrating country has a weak currency. Equity contracts are not subject to default risk because they do not commit the issuer to paying flows that are independent of its performance. Although the performance might be affected by real exchange rate fluctuations, such effects are passed on to equity investors via changes in dividend payments. But because internationalization hurts the local stock market’s liquidity, the internationalization of equity issuance and trading may create a policy dilemma—possibly accentuated by the fact that, as a developing economy becomes more integrated into global financial markets, incentives for issuers of equity securities rise unambiguously in favor of issuing abroad rather than at home. In effect, once corporations can break the cost and size thresholds required to issue equity at reasonable prices in the deeper, significantly more liquid global financial centers, there would be no apparent advantage in issuing in domestic stock markets.

**Role of liquidity, diversification, and size.** For many developing countries, particularly smaller ones, illiquidity begets illiquidity by limiting the capacity of investors to unwind their positions without affecting prices, thereby discouraging the entry of new players, which, in turn, further limits liquidity. The implications are far-reaching, given that illiquidity fundamentally hinders “price revelation”—one of the most distinctive functions of securities markets vis-à-vis banking markets. Similarly, evidence strongly suggests that, in many developing countries, domestic securities markets do not seem to add much directly to risk diversification, beyond the function already performed by local banks, while risk diversification by international portfolio investors tends to marginalize small countries and small corporate issuers.

Illiquidity and insufficiently diversified portfolios are intrinsically related to a prevalent structural feature of many developing countries’ capital markets: small size. The small size of both markets and corporations matters for many developing countries’ capital markets: small size. The intrinsically related to a prevalent structural feature of corporate issuers. Investors tends to marginalize small countries and small banks, while risk diversification by international portfolio diversification, beyond the function already performed by local markets do not seem to add much directly to risk diversification. Similarly, evidence strongly suggests of the most distinctive functions of securities markets vis-

Avoiding financial globalization is neither realistic nor desirable in the long run.”

**Reshaping the reform agenda**

As policymakers weigh new approaches to developing a domestic capital market, they might want to begin by determining whether it could realistically meet the size thresholds for sustaining a liquid domestic secondary market for private sector securities. For countries that meet these size thresholds, formulating suitable reforms would be relatively easy, not least because they could learn from the experiences of developed capital markets. Reforms would still need to be significantly reshaped, however, particularly to better accommodate financial globalization. Sketching a suitable reform package for a smaller country’s domestic securities markets is a more daunting challenge because much more thought and analysis are needed to take into account the constraints implied by its small size. This sketch would have to be accompanied by a realistic definition of what can be expected from such unavoidably illiquid securities markets. Related issues also arise regarding the participation of small firms in capital markets, irrespective of country size.

Capital market reforms for developing countries should envisage improved integration into international financial markets with complementary financial development at home. Avoiding financial globalization is neither realistic nor desirable in the long run, not least because integration induces reform. A broader vision would emphasize linkages between financial markets and, in particular, the ways in which capital markets in developing economies can enhance the workings of the financial system as a whole. Such linkages are crucial, for instance, in the markets for housing, infrastructure, and structured finance, where local and international securities markets can help engineer suitable products, such as asset-backed securities, spreading risks among a greater number of players, and bringing new institutional investors to the scene. Greater financial market competition, coupled with constant improvements in the contractual environment, will ultimately deepen and broaden the provision of financial services, producing new “bridging” vehicles and instruments to fill any potential access gaps.

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This article is largely based on the Latin American and Caribbean Regional Study Whither Latin American Capital Markets? (Washington: World Bank, 2004), led by de la Torre and Schmukler, and several background papers. The full report and background papers are available at http://www.worldbank.org/laccapitalmarkets.
ESPTIE the internationalization of financial markets and the growing links between national financial systems, for the most part, economic policy is still conducted at the national level. The creation of global capital markets can therefore make it more difficult for countries to assess, diagnose, and prescribe macroeconomic policies. The platitude that markets will swiftly and brutally punish deviations from prudent policies is well worn but not the full truth. In fact, markets often seem quite capricious from the domestic point of view: sometimes they seem to tolerate imprudent behavior for a remarkable stretch of time, and sometimes they react preemptively; usually, their reactions are governed by a wide array of domestic and international considerations.

The financial aspects of national economic analysis—and IMF health checks of member countries, known as surveillance—therefore need to be more sophisticated in three distinct but related areas.

• Monitoring of the interactions between financial markets and macroeconomic conditions. A sophisticated analysis of high-frequency data from financial markets—that is, parsing the data for signals about market expectations, volatility, risk, default probabilities, arbitrage potential, and the like—can be an important diagnostic tool for macroeconomic advice and policy prescription.

• Analysis of the financial sector itself—that is, its robustness or fragility, whether it will cushion or amplify shocks, and how it is regulated and supervised.

• Assessment of both underlying vulnerabilities in the economy and potential events that could interact with these vulnerabilities to trigger a financial crisis.

The analytics we would want to bring to bear on these issues span a broad range, with no simple “cookbook” guide. But at the conceptual level, there are useful general characterizations: what we refer to as the balance sheet approach and the prevention of financial and capital account crises. These terms recognize that open economies must be viewed as sets of globally interlinked balance sheets that are vulnerable to exposure and counterparty risk.

Policymakers and country authorities should therefore be concerned about the potential for problems to spill over to other sectors, the economy as a whole, and the regional or global economy. This is what former IMF Managing Director Michel Camdessus (1987–2000) was alluding to when, with extraordinary insight, he referred to the Mexican crisis of the mid-1990s as the “first crisis of the 21st century.” That crisis and those that followed in Asia, Latin America, and central and eastern Europe over the ensuing decade have forced us to rethink the relationship between finance and macroeconomics. This article explores the centrality of finance to macroeconomic analysis by focusing on three rather practical cases: the first centered on balance sheet vulnerabilities, the second on the interaction of domestic monetary policy with global financial markets, and the third on a national stabilization program in a highly integrated capital market.

Vulnerabilities and triggers

Much of the work on balance sheet exposures now makes a conceptual distinction between underlying vulnerabilities, or exposures, on the one hand, and trigger events—that is,
events that, combined with underlying vulnerabilities, could trigger a crisis—on the other.

Take the hypothetical country Xanadu, which can borrow abroad only in foreign currency (see table). The official position shows liquid foreign assets (40) that cover 80 percent of total short-term liabilities (50), which is less than ideal but not dire. (It would, of course, be useful to know something about current account flows and the maturity structure of medium- and long-term positions.) The banking system has a seemingly balanced foreign exchange position. And the nonbank corporate sector has sizable foreign exchange exposure.

How would we figure out Xanadu’s underlying vulnerability? It is clear from the numbers that the banks are hedging their currency exposure with the nonbank corporate sector, which, in addition, has sizable currency exposure to foreigners. Much depends, therefore, on the characteristics of the nonbank corporations with foreign exchange liabilities. If they are exporters with foreign currency revenues, they may well be naturally hedged. Alternatively, they may have solid derivative hedges (assuming that there are foreign counterparties prepared to have some exposure to the domestic currency), and the return on their investments may be such that the foreign borrowing is profitable even after hedging costs. The data are consistent with these benign scenarios. If we consider the trigger of a sudden contagion-induced repricing of risk with an immediate, large exchange rate effect, the worst that will happen is a banking sector liquidity problem that the country could address through its reserves or an IMF program.

But the data are also consistent with a more problematic situation: commercial banks borrowing money short term abroad to lend longer term in foreign exchange to domestic companies, such as domestic real estate developers, without any natural or derivative hedge. In this case, any shock to the exchange rate could cripple the nonbank corporate sector and, by effectively eliminating the banking system’s currency hedge, the banking system too. In effect, the exchange rate shock transforms the banks’ foreign exchange risk into credit risk.

In situations like these, some knowledge of the characteristics of the corporations with foreign exchange exposure is critical to assessing the vulnerability. The necessary nonbank corporate data may be hard to come by, and the importance of obtaining them will depend, to some extent, on the domestic institutional structure. Certainly, if the country has an exchange rate with little flexibility (and a government, therefore, perceived to be essentially underwriting foreign exchange risk), there will be moral hazard problems and a substantial likelihood of unhedged foreign currency borrowing. There may thus be a presumption of an underlying vulnerability that needs to be uncovered and discussed. But if the country has a history of wide exchange rate movements, corporations that are forced to bear the brunt of these fluctuations, appropriate regulatory incentives for banks, and efficient bankruptcy mechanisms, the likelihood of risky currency exposures is much lower.

As noted above, there are two separate aspects to assessing the potential for a crisis: the underlying vulnerability and the trigger event. In this example, the trigger is a sudden repricing of risk. This may be highly unlikely (a “tail event”), perhaps because the country has excellent policies with a strong current account position and the region in general is sound. Although it is always worthwhile being aware of the underlying vulnerability, whether it is worth focusing on the potential crisis is a judgment call and depends on the probability of the trigger event and the likely severity of a crisis. Of course, an analysis of vulnerabilities and triggers is often made more difficult by imponderables (for example, the duration of a shock) and insufficient data (for example, on corporate balance sheets). As a matter of policy, moreover, analysis of severely detrimental hypothetical events—“thinking the unthinkable”—always needs to be handled with great discretion.

Nothing here implies that all vulnerabilities should be avoided: if a country needs external financing to realize its growth potential and can borrow very little in its own currency, it will almost certainly have some foreign exchange exposure. Banks that do their normal job of maturity transformation will almost certainly have some interest rate exposure. These vulnerabilities are a normal aspect of business and cannot be eliminated without an excessive increase in intermediation costs. At best, they will be borne by the institutions most robust to the risks entailed.

**Tough monetary policy choices**

In our second case, an open capital account and integrated financial markets make it even more complicated to conduct monetary policy, especially if the country (like many of the emerging market economies) is experiencing significant underlying real (structural) changes.

Conventional wisdom favors an inflation-targeting regime with a floating exchange rate, which does, indeed, have advantages: the monetary authorities are relieved of the
formal responsibility for growth and unemployment, and there is no implicit exchange rate guarantee that encourages unwise foreign currency exposure. As a result, a “fear-of-floating” trap (when so much foreign exchange exposure has been built up under a fixed or quasi-fixed exchange rate that the authorities resist a depreciation) is less likely. An alternative is a hard peg with a fully credible exit strategy—for example, a peg to the euro at a rate that is credible as the eventual entry rate to the euro area. Some countries, however, have continued to opt for ad hoc intervention strategies guided by a combination of factors, including the competing demands of mercantilist trading objectives and a desire to control the money supply.

• Changes in interest rates for domestic stabilization purposes are unlikely to be accompanied instantaneously by changes in risk premiums or exchange rate expectations; thus, they may induce huge actual or incipient portfolio adjustments that could swamp domestic stabilization policy.

• The behavior of risk premiums and exchange rate expectations often appears entirely capricious and unpredictable to the domestic monetary authorities.

These points have implications for policy in many countries—see, for example, “The Tosovsky Dilemma” (F&D, September 2002), which analyzed the problems of monetary policy in the more advanced transition countries of central and eastern Europe. But the case of Iceland in 2003–06 provides a poignant illustration of how the interaction between domestic cyclical developments, monetary policy, and global financial markets can exert a destabilizing effect (see box).

As it turned out, a perfectly sensible increase in domestic interest rates—in the context of liquid global capital markets and a voracious hunt for higher yields—elicited massive capital inflows, a dramatic expansion of bank credit, and an eventual capital account reversal. Even when these relationships are well understood in theory, it is difficult to conduct policies when substantial capital flows raise the possibility of large exchange rate change and/or interest rate fluctuations. Fortunately, in Iceland, hedging behavior and generally sound balance sheets made the financial system relatively robust to the shocks.

But the problem for monetary policy is acute in cases like this. Suppose the domestic monetary authority wants to cool an overheated economy—that is, raise interest rates consistent with its inflation-targeting regime. It decides, on the basis of a slew of empirical evidence, that interest rates should be raised by 1 percentage point. But for a flexible exchange rate regime, the contractionary effect of this interest rate shift will depend critically on the exchange rate change it elicits—a 1 percentage point increase coupled with no exchange rate change is massively different from one coupled with a 10 percent appreciation. Moreover, to the extent that the portfolio

Iceland weathers market jitters

In Iceland beginning in 2003, large investment projects, based on an abundance of cheap energy, were tightening local labor markets, contributing to robust overall demand, and widening the current account deficit—although they were expected to generate growth and some currency appreciation. As monetary policy was tightened in response to the strong demand, interest rates rose and there was a significant trade-weighted appreciation of the Icelandic króna.

Icelandic banks exploited the interest rate differential by borrowing in euros, hedging their exposure, and lending in krónur. The combination of a rising currency, high interest rates, and good credit quality—the sovereign was rated AAA—also attracted foreign portfolio investors, who financed their long positions in króna debt by borrowing in lower-yielding currencies—the “carry trades.” (This was exacerbated by financial innovation—that is, the offshore issuance of króna-denominated eurobonds (“glacier bonds”) by foreign institutions that swapped their króna liabilities for the euro liabilities of Icelandic banks.) Yield differentials including exchange rate adjustments were about 9½ percent in 2003, 7½ percent in 2004, and 18 percent in 2005.

With commercial banks flush with funds and looking for new ways to lend, policy changes encouraged banks in mid-2004 to start competing directly with the government-run Housing Finance Fund for first mortgages. Banks were able to offer more favorable terms than this housing fund, and their lending to households grew by 98 percent in 2004, fueling the rapid rise in housing prices and the associated withdrawal of housing equity through refinancings. This, in turn, underpinned the surge in domestic consumption, further widening the current account deficit.

Iceland’s financial changes were enormous. External debt surged. Private sector borrowing tripled between 2003 and 2006, with huge increases in both household and corporate debt. Real estate and equity prices appreciated rapidly, with stock market valuations rising almost fourfold between mid-2003 and end-2005. Eventually, all this led to significant market jitters and pressures on the currency and equity prices in the spring and summer of 2006.
effects will depend on decisions made in New York, London, or Frankfurt and will be based on spreads on, and exposure to, other currencies, there is no way for the domestic monetary authorities to predict the outcome. A country’s best course of action in these difficult circumstances—although this may not seem like much of a policy prescription—is to go slowly, watch the markets continuously, and be fully aware of underlying vulnerabilities.

**Tracking stabilization**

Finally, let’s look at stabilization programs for countries with globally integrated financial markets. In monitoring these programs—which detail the policies countries are implementing or will implement to achieve macroeconomic stabilization—both the IMF and many national authorities often use some variant of a financial programming framework based on the balance sheet of the central bank or the consolidated banking system. The central bank balance sheet looks like this:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net foreign assets (NFA)</td>
<td>Base money (BM)</td>
</tr>
<tr>
<td>Net domestic assets (NDA)</td>
<td></td>
</tr>
<tr>
<td>Private credit (PC)</td>
<td></td>
</tr>
<tr>
<td>Net government credit (NGC)</td>
<td></td>
</tr>
<tr>
<td>Other items net (OIN)</td>
<td></td>
</tr>
</tbody>
</table>

The accounting identity from the central bank balance sheet is a useful organizing device and consistency test. Net domestic assets are defined as the sum of private credit, government credit, and other items net; base money is defined as the sum of net domestic assets and net foreign assets. The financial programming framework would normally set some floor for net foreign assets and some ceiling for net domestic assets.

In the old days of fixed exchange rates and more or less closed capital accounts, this organizational device was wonderfully simple. We had some idea of the stock of NFA that was consistent with prudent policy and a plausible projection of current account flows. Therefore, given an estimate of the demand for money from our econometric exercises, we could also get a reasonable fix on the appropriate rate of credit expansion and its allocation between the government and the private sector, consistent with achieving reasonable rates of growth and inflation. Of course, we might get the money demand equation wrong—that is, over- or underestimate the rate of money supply expansion consistent with our income and inflation targets—but we would probably be able to pick this up when reviewing the program. If, for example, inflation and income were more or less on track, but credit expansion was significantly more rapid than targeted and the NFA position was stronger than envisaged, this would be prima facie evidence of stronger-than-estimated money demand, and we could adjust the NDA ceiling.

In a situation of floating exchange rates with inflation targeting, interpretation of the balance sheet identity is slightly more complex—even with limited capital market integration. If, for example, the authorities use foreign exchange intervention to limit a (supposedly temporary) incipient depreciation (for fear of its inflationary effects), the NFA floor will limit the scope of intervention, and the NDA ceiling will limit the scope for sterilizing its monetary effects. It might certainly make sense to intervene to resist short-lived downward pressure on the currency and to sterilize this intervention. But if the depreciation forces prove durable, there is a point at which the intervention-sterilization strategy needs to be questioned—the simple financial programming identity constraints can help to define that point and bring the appropriate questions to the fore.

But consider how much more complicated the financial programming framework is with full integration with global capital markets. NFA and/or exchange rates become highly unpredictable, with fluctuations dominated by capital market conditions. If NFA are more or less fixed by the prudent objective of covering short-term external foreign exchange liabilities, then a jump in the risk premium on the currency would result in some combination of a depreciated currency and higher interest rates. This could influence the liquidity position of the financial system if it is engaged in foreign currency maturity transformation, the solvency of the financial system if it has foreign currency loans to unhedged domestic borrowers, the sustainability of the government’s debt position, and the sustainability of the debt positions of the nonbank corporate sector and the household sector. All or some of these effects could elicit a call on the central bank—for foreign exchange or additional credit expansion—and undermine the integrity of monetary policy.

By the time any of these effects shows up in a central bank’s accounts, the damage will be done and the situation may be irretrievable. Thus, we move from the simple world of a closed capital account to the complex world of vulnerabilities and trigger events—that is, into the world of the first case given above. In this world, data needs are more exacting, and only imaginative, forward-looking modes of analysis will suffice. This is a world in which we need to determine vulnerabilities and assess the likelihood of crises by analyzing scenarios with potential trigger events of uncertain probability.

**In sum . . .**

The three cases described in this article are complex and suggest that there are no easy answers. But they do point the way to better macroeconomic analysis in the highly unpredictable world of integrated global financial systems and capital markets. This is a world in which macroeconomists need to think preemptively about possible future events. They must therefore be aware of vulnerabilities and events capable of triggering crises; of the global context within which domestic monetary policy has to operate; and of how shifts in risk assessments, interest rates, exchange rates, and growth will influence the financial position of the government, the banks, and other parts of the private sector.

Leslie Lipschitz is Director of the IMF Institute.
Financial institutions around the world are consolidating at a rapid pace. The number of institutions is declining, their average size is increasing, and it is a rare week when no new bank merger or acquisition is announced. The period 1998–2000 witnessed the creation of the world’s largest banking groups through several mergers (see chart on page 60). In the United States, the lifting of interstate banking restrictions in 1994 triggered a wave of mergers, and European integration has intensified consolidation in Europe—which the introduction of the euro in January 1999 further encouraged. In many emerging markets, such as Argentina, Brazil, and Korea, consolidation is also well under way as banks seek to become more efficient and more resilient with respect to shocks.

Nor has consolidation been confined by national borders. In a drive that has created powerful “national champions” in many industrial countries, financial institutions have not waited for opportunities for growth and increased profitability to be exhausted domestically before transcending national frontiers. This process of globalization has been dominated by industrial country banking groups’ exploitation of the growth potential in emerging markets, as witnessed by the expansion of Spanish banks in Latin America, German banks in Eastern Europe, and U.S. banks in East Asia. At a somewhat slower pace, cross-border consolidation is also taking place between industrial countries, initially in the form of strategic alliances that offer some of the benefits of diversification without the costs of merging different business cultures.

Developments in technology, and especially the impressive growth of Internet banking and brokerage services, have allowed globalization to go beyond the ownership structure of financial conglomerates and to reach the retail markets. In fact, many banks are using their online operations to expand into foreign markets, avoiding the costly process of building retail brick-and-mortar networks of branches. Moreover, the emergence of alliances between major banks and telecommunications conglomerates suggests that, in the future, competition in the electronic marketplace will be fierce. In addition, the appearance of virtual banks and the development of electronic money for the global Internet market have created the possibility for the growth of nonbank (and, possibly, largely unregulated) institutions that provide credit to, and collect funds from, the public. Faster communications require faster reactions from both markets and policymakers but also quickly make information obsolete.

The final vehicle for this transformation of the financial sector is the universalization of banking, which is increasingly blurring the boundary between bank and nonbank financial services. This trend is already well developed in certain European countries—as exemplified by the widespread distribution of insurance products through bank branches, a phenomenon known as bancassurance—and presages the formation of conglomerates that provide all types of financial services. To some extent, this irreversible trend was confirmed in the United States by the merger of Citicorp and the Travelers Group and the subsequent repeal in 1999 of the Glass-Steagall Act (which restricted
banks' involvement in equity financing and artificially separated investment banks from commercial banks).

**Benefits and drawbacks**

The advantages and disadvantages of these four trends have been the subject of many articles and much debate. On the plus side, bank mergers and acquisitions, if completed successfully, will lead to cost savings and improved profitability, benefiting both clients and shareholders. Globalization will facilitate risk diversification by banks and improve the overall performance of individual economies by improving resource allocation. On the minus side, if consolidation is taken too far, it could lead to abuse of dominant market positions and moral hazard issues, such as when institutions are considered to be too big to fail. In addition, excessive involvement in foreign markets without sufficient knowledge of local economic conditions could increase the vulnerability of individual banks.

An important issue that has only recently been considered is the implications of these developments for prudential and supervisory policy—that is, for systemic risk and the ability of the appropriate authorities to manage it. First, how should risk be assessed and managed in this environment? The growing use of derivatives and off-balance-sheet operations, coupled with the diversification across countries and sectors of banking activities, has quickly made traditional risk-management techniques obsolete. Second, how does one deal with a distressed bank? Experience shows that closing a large bank can create problems because of the systemic repercussions and the potential large disruption in the real economy. In this respect, the international consolidation of the banking sector introduces an important nuance: what is the relevant market to consider when deciding, for instance, whether to provide liquidity support or public funds to assist a distressed globalized bank? In the euro area, would the fate of a bank holding, say, 25 percent of national deposits in its country of origin but only 1 percent of euro-area deposits compromise competition and the stability of the system and therefore merit special treatment? If public sector intervention is appropriate, who should carry it out? International conventions provide for supervision of the worldwide operations of a bank to be the responsibility of the supervisory authorities of the bank's home country. Consider, for example, a bank domiciled in country A whose operations...
in country B, although small relative to the global operations of the bank, make it the dominant bank in country B. If that bank suddenly becomes insolvent, would the bank’s home-country supervisors fully take into account the massive potential disruption of activity in country B that could result from the bank’s liquidation and therefore be willing to provide financial support—which would entail a wealth transfer from country A to country B?

Finally, the development of new financial techniques, the globalization of investments, and the introduction of new technologies have significantly increased the scope for, and speed of, contagion. Thus, an unexpected drying up of liquidity in a particular financial market can rapidly spread throughout the global capital market. Again, the reaction of the supervisory authorities may be affected by globalization. Would the Federal Reserve Bank of New York, for instance, have intervened to facilitate the restructuring of Long-Term Capital Management’s (LTCM) hedge fund in the same way had LTCM’s exposures been spread across many foreign markets rather than concentrated mainly in the U.S. market?

**Addressing risks of globalized banking**

In response to these challenges, financial regulators have focused on increasing transparency and on strengthening prudential regulation and supervision in a manner that takes explicit account of the risks arising from the increasing globalization of banking. A first step to better risk monitoring has been a push for greater transparency that facilitates market discipline and supervision by allowing both the public and bank supervisors to better assess the risk profiles of financial institutions. A more fundamental reform has entailed addressing the deficiencies of the Basel Committee on Banking Supervision’s 1988 capital-adequacy ratio recommendations. The rigidity of these recommendations, compounded by the creation of new markets for credit derivatives and the unprecedented growth in loan sales and securitization, has allowed bank managers to actively manage their risks and engage in “regulatory capital arbitrage” practices. These practices help banks reduce the average riskiness of their portfolios, as measured by the capital-adequacy ratio, and thus also lower the capital required under the Basel recommendations without a commensurate reduction in the effective risks faced by the banks. This reduces the effectiveness of the capital-adequacy ratio as a prudential tool.

The Basel Committee has proposed a number of solutions to these problems. One proposal is for a “bucketing” approach, which would impose capital requirements based on borrowers’ ratings provided by independent rating agencies. Alternatively, banks would be allowed to use their internal credit risk models, which they already use to assess market risks in their trading books. None of these options, however, is fully satisfactory. Credit-risk models are still at an early stage of development, and it may be difficult for supervisors to evaluate the adequacy of a particular bank’s model and how the bank is using it. When rating agencies are used, how should credits from unrated firms be assessed? Another problem is that these ratings have not been designed to determine capital requirements, and events such as the 1997 Asian crisis suggest that rating agencies can swiftly swing from overoptimism to extreme pessimism, which will be reflected in their ratings. Moreover, rating agencies could also face a conflict of interest if their ratings were used to assess their clients’ capital needs.

The second important regulatory issue is the complexity and globalization of financial transactions and the creation of large financial conglomerates spanning several countries, which make purely domestic assessments unsatisfactory. International agencies and groups (such as the IMF, the World Bank, the Bank for International Settlements, and the Basel Committee) have supported and complemented the work of national agencies in addressing the challenges that globalization poses for the stability of financial sectors.

To enhance transparency, these international agencies and groups have begun developing guidelines to consolidate financial statements and achieve greater cross-country harmonization in accounting and auditing standards and in disclosing information. They are also working to identify and close gaps in regulatory and supervisory regulations in order to avoid problems such as regulatory arbitrage—that is, taking advantage of looser regulations in a particular jurisdiction or applying to certain types of institutions. Adopting and monitoring compliance with standards are part of these efforts. The IMF, for its part, has introduced the Special Data Dissemination Standard, the General Data Dissemination System, and the Code of Good Practices on Fiscal Transparency and on Monetary and Financial Policy Transparency. The IMF and the World Bank—in an effort that also involves

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**The largest world banks by total assets**

<table>
<thead>
<tr>
<th>Bank Name</th>
<th>Total Assets (Trillion Dollars, 1999)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fuji/IBJ/DKB</td>
<td></td>
</tr>
<tr>
<td>Sanwa/Ashai/Tokai</td>
<td></td>
</tr>
<tr>
<td>Sumitomo/Sakura</td>
<td></td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td></td>
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<tr>
<td>Bank of Tokyo-Mitsubishi</td>
<td></td>
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<tr>
<td>UBS AG</td>
<td></td>
</tr>
<tr>
<td>Citigroup Inc.</td>
<td></td>
</tr>
<tr>
<td>Bank of America</td>
<td></td>
</tr>
<tr>
<td>Hypo Vereinsbank AG</td>
<td></td>
</tr>
<tr>
<td>HSBC Holdings</td>
<td></td>
</tr>
</tbody>
</table>

Sources: Fitch-IBCA; and IMF staff estimates.
2 UBS: United Banks of Switzerland.
international standard-setting bodies and national supervisors—have begun to assess the stability of financial sectors in member countries that have volunteered to participate in this process (the Financial Stability Assessment Process (FSAP)), which is currently operating on a trial basis. The FSAP framework takes into account the links between the various financial institutions and markets, as well as those between the financial sector and macroeconomic conditions. It also assesses compliance with relevant standards and codes.

In launching their efforts, the IMF and the World Bank have come up against important obstacles. Regulations have a basis in national law and cannot simply be transplanted from one country to another. Also, national practices for financial operations and institutions have developed over time, and changing them can be costly. As noted above, a major effort is under way to revise the Basel Accord of 1988, which was designed for internationally active banks. However, over time, more and more banks and countries have sought to apply the requirements of that accord, because doing so is viewed as a way to enhance the reputation of banks (even those that have a limited international presence). This provides further evidence of the globalization of financial markets but also raises questions as to how to adapt such requirements to a wider range of institutions. Similarly, the Basel Core Principles for Effective Banking Supervision have become a key element of the move toward improved banking supervision worldwide.

Remaining challenges

Despite significant progress, challenges remain. For instance, for capital-adequacy requirements to be meaningful, the definitions used in the calculations must be consistent across countries. Also, further progress is needed to ensure an adequate flow of information between supervisory agencies. Efforts are under way to deal with both these issues. The Basel Committee, for instance, has developed guidelines for sharing information on cross-border operations; further work in this area will be needed. Another challenge—how to provide the right incentives for compliance—may be particularly complicated for offshore centers, where most transactions in the financial system involve only nonresidents.

As noted earlier, the universalization of banking is leading firms to conduct operations that had been the preserve of a different type of institution. Moreover, the growing sophistication of finance has resulted in closer links between financial institutions of different types. These developments have made necessary a comprehensive approach to risk assessment that cuts across the boundaries of institutions. Some countries (for example, Korea and the United Kingdom) have addressed this concern by consolidating prudential supervision and regulation of financial institutions in a single agency. Others have improved coordination among various supervisors. These links have also been recognized at the international level. The Financial Stability Forum, a forum of national and international financial agencies set up in 1999, is mandated to promote international financial stability through information exchange and international cooperation in financial supervision and surveillance. In fulfilling its mandate, it seeks to identify gaps in regulation and take steps to eliminate them. Also, as noted above, the FSAP exercise takes a comprehensive approach to identifying financial sector vulnerabilities shared by various types of institutions.

Globalization and the increasing ties between financial intermediaries also pose problems for such safety nets as deposit insurance and lender-of-last-resort arrangements. What institutions and operations should be protected? Who should bear the cost of safety nets, and when should they be activated? These questions have been difficult to answer even in simpler contexts, such as a domestic banking system that operates only with residents. They are much harder to answer in a globalized financial system and are becoming even more difficult as Internet banking undermines the validity of concepts based on domicile, such as the home-country supervisory principle.

In short, the banking sector is entering a new world in which national and institutional boundaries are becoming less important. Inevitably, supervisory and regulatory systems will have to adapt their work methods in order to remain effective. The growing emphasis on risk management, exchange of information, and coordination at the international level is evidence of efforts to adapt. Nevertheless, some questions, such as the specific measures to be taken for banks in difficulty, are not easily answered. Adapting regulatory and supervisory frameworks to rapidly changing financial markets will remain a daunting challenge and will require further cooperation between supervisors, markets, and individual market participants.

At the time of writing, Tomás Baliño was a Senior Advisor in the IMF’s Monetary and Exchange Affairs Department and Angel Ubide was an Economist in the IMF’s European Department.
An IMF study suggests that opening up to the global economy could help developing countries cope with the adverse effects of volatility on growth

A growing number of developing countries weigh whether to further integrate with the global economy through closer trade and financial linkages, they must cope with the prospect that greater openness often leads to greater volatility—witness the emerging market financial crises of the 1980s and 1990s. And they must grapple with fears that greater volatility will lead to lower growth. But are these fears justified?

The reality is that economists have yet to fully come to grips with the complex relationship between macroeconomic volatility and economic growth. During the 1980s, it was generally accepted that the impact of volatility on economic growth and welfare was at most minor and that, therefore, volatility was hardly anything to be feared. However, research in the 1990s (by, for example, Garey and Valerie Ramey) reached a strikingly different conclusion—that macroeconomic volatility may actually reduce long-term growth. This was an important result since it implied that policies and economic shocks that increased volatility could hurt economic welfare in the long run by reducing growth.

With the recent financial crises, however, economists have noticed that while the affected countries faced episodes of high output volatility, they actually posted much better than average growth rates during the period of globalization than other developing economies. Does this mean that in a period of rising globalization, the negative relationship between growth and volatility has changed?

To shed light on this question, we examined the dynamics of growth and volatility in a large sample of industrial and developing countries over the past four decades. Our findings suggest that the answer depends subtly on the degree and nature of a country’s linkages with the global economy, as well as a few other factors, including the country’s stage of development.

**Analyzing globalization**

The recent wave of globalization started in earnest in the 1980s. Global trade linkages had already begun to increase significantly in the 1970s, but it was in the 1980s that most developing countries undertook substantial trade liberalization and trade expansion became a more universal phenomenon. The mid-1980s also represent a turning point in the process of financial globalization. A

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**Chart 1**

**Expanding globalization**

Many countries have liberalized their trade and financial regimes over the past two decades.

Source: Kose, Prasad, and Terrones (2005).

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**Reprinted from F&D December 2004**

**Taking the Plunge Without Getting Hurt**

*M. Ayhan Kose, Eswar S. Prasad, and Marco E. Terrones*
number of industrial and developing economies reduced restrictions on capital flows across their borders, resulting in a sharp increase in international capital flows from industrial countries to developing economies.

To analyze these trends, we compiled a data set comprising 85 countries—21 industrial and 64 developing. Between 1985 and 2000, the share of countries in our data set that had liberalized their trade regimes increased from 30 percent to almost 85 percent. The share of countries with open financial accounts rose from 20 percent to about 55 percent over this period (see Chart 1). Spurred by these liberalizations, the volume of international trade has registered a dramatic increase, with the ratio of world exports and imports to world GDP rising from 75 percent in the mid-1980s to over 150 percent by the end of the 1990s. Private capital flows from industrialized to developing economies have also increased dramatically since the mid-1980s, with the bulk of these flows going to emerging market economies (23 of which are in our data set).

**Tracking growth and volatility**

How have these trends in globalization affected the growth-volatility relationship? Although economic theory suggests that globalization should have a positive impact on growth, it does not provide strong predictions about its impact on volatility or on the relationship between growth and volatility. Hence, this is essentially an empirical question.

To assess whether globalization has had an effect, we first examine the average relationship between growth and volatility over the last four decades. We use per capita GDP as the measure of output and use annual growth rates in our analysis. To capture macroeconomic volatility, we use a traditional measure—the standard deviation of per capita output growth.

Chart 2 shows that there is a negative relationship between growth and volatility during the period 1960–2000. Interestingly, when we break this relationship down by country groups (see Chart 3), it is far from uniform. The relationship in fact appears positive for industrial economies, indicating that, for economies at an advanced stage of development, volatility is not necessarily associated with lower growth. Even among developing economies, the relationship is hardly uniform. For emerging markets, the relationship looks positive, whereas it is negative for other developing economies that have not participated as much in the process of globalization.

Since the emerging markets are the ones that have undergone the most significant degree of globalization, it is of interest to examine how trade and financial integration have affected the relationship between growth and volatility over time for this group. For each of these countries, we determined a particular date for trade and financial liberalization, respectively, based on country-specific historical descriptions of liberalization episodes. Although most of these dates cluster around the mid-1980s, there is enough diversity across countries to justify using liberalization dates specific to each country.

Chart 4 (top row) shows that, for the emerging markets, the relationship between growth and volatility is negative before trade liberalization and positive after. In other words, there is suggestive evidence from these economies that trade integration changes the sign of this relationship. Chart 4 (bottom row) shows a similar, although less strong, result when one compares the relationship before and after financial liberalization.
Our descriptive analysis so far has suggested two important themes in analyzing the growth-volatility relationship. One is that the level of development appears to matter, as the sign of the relationship varies across different groups of countries. The second is that trade and financial integration affect the nature of this relationship. However, our descriptive analysis has not established whether the differences across countries and over time in the growth-volatility relationship are robust or significant in a statistical sense. In addition, there could be other factors that affect growth and volatility independently as well as the relationship between these two variables. Hence, we now examine the growth-volatility association using a more formal statistical framework.

Effects of trade and financial integration
We employ a regression model to analyze how a country’s long-term growth is influenced by volatility as well as a number of other variables that have been found to influence growth—such as a country’s initial income level, the national investment rate, population growth, and the fraction of the population that has at least a primary-level education. We also include measures of trade and financial integration—in both cases, first whether or not liberalization has taken place, and second, a de facto measure of openness (the ratio of a country’s total external trade to GDP and the ratio of gross capital flows for a given country to its GDP).

When we include all of these other potential determinants of growth in the regressions, we find on average that volatility is still negatively associated with growth. Consistent with the results from recent research by other authors, we also find that trade integration clearly has a positive effect on growth. However, the effect of financial integration is less obvious.

The major question of interest to us is whether trade and financial integration directly affect the growth-volatility relationship. To get at this issue, we consider the roles played by some “interaction” variables that allow us to measure how changes in each measure of integration affect this relationship. We find that these interaction terms generally have a positive relationship with growth. In other words, although the basic relationship between volatility and growth is negative, higher levels of trade and financial integration make this relationship much weaker, that is, much smaller in absolute terms. The implication of these findings is that economies that are more globalized have the ability to withstand higher levels of volatility without adverse effects on growth.

Are the roles played by trade and financial integration significant in terms of economic magnitudes? Interestingly, our data set indicates that, during the 1990s, emerging markets had a similar level of output volatility, on average, as other developing economies but experienced much higher growth. Using the estimated coefficients from our regressions, we find that the higher level of trade openness of emerging markets accounts for about half of the observed difference of about

![Chart 2](image-url)

**Negative correlation?**
When taking all countries in the sample together, there is a negative association between growth and volatility.

![Chart 3](image-url)

**Or positive?**
But when countries are split into different groups, the relationship between growth and volatility appears positive for both industrial and emerging market economies.

Source: Kose, Prasad, and Terrones (2005).
While our study does not address this question, recent research suggests several possible channels. For example, trade integration could help a developing economy to export its way out of a recession since a given exchange rate depreciation could have a larger impact on its export revenues than in an economy that is less open. Stronger export revenues could also help in servicing external debt, which is quite substantial in a number of developing countries. These factors also suggest that openness to trade flows could make developing countries less vulnerable to sudden halts in international capital flows.

2 percentage points in average growth rates between emerging markets and other developing economies. In other words, despite experiencing a similar level of volatility, the greater degree of trade openness of emerging markets still allowed them to post higher growth rates. We find a similar result for financial integration, which also explains close to half of the observed differences in growth rates between these two groups of countries.

This is, of course, a purely mechanical exercise and our regression framework by itself cannot be taken as providing strong and conclusive evidence of a causal relationship between volatility and growth. Nevertheless, it is still interesting to note that most of the difference in the average growth rates in the 1990s between emerging markets and other developing economies, despite their having similar levels of volatility, can be accounted for, in the context of our framework, by the differences in their average levels of trade and financial integration.

We conducted a variety of experiments to check the sensitivity of these results (see Kose, Prasad, and Terrones, 2005). For instance, we use alternative statistical techniques, control for additional factors that could potentially affect either growth or volatility, and also account for the fact that any relationship that we uncover between these variables could simply reflect common factors that affect both of them simultaneously. The basic results discussed above proved to be quite stable across all of these experiments.

What are the channels through which openness to trade could mitigate the adverse impact of volatility on growth? While our study does not address this question, recent

Policy Implications

Our analysis has shown that the negative relationship between growth and volatility has persisted in the most recent era of globalization, but with some important qualifications. In particular, trade integration appears to significantly attenuate this negative relationship. Thus, for a given level of volatility, countries that are more open to trade experience higher growth. Or, to put it differently, countries that are more integrated with the global economy through trade linkages appear to be able to tolerate higher levels of volatility without a negative impact on their growth rates. The results are similar, but weaker, for financial integration.

In summary, there are significant benefits to be derived from undertaking enhanced trade integration, notwithstanding the potential associated risks of increased volatility. Building on work by other researchers showing that trade openness is positively associated with growth, our analysis indicates that these benefits are not adversely affected by the increased volatility that appears to be associated with greater trade openness. The effects of financial integration on the growth-volatility relationship are similar, if somewhat less robust in a statistical sense. Overall, our research suggests that exposure to higher volatility is not by itself a good reason for developing economies to avoid globalization, as the forces of trade and financial integration could help reduce the adverse impact of volatility on economic growth.

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ONE OF THE most common criticisms of trade liberalization and globalization, particularly in developed countries, is that it drives down wages and exports jobs to low-wage economies. Critics see the creation of a global “sweatshop economy” in which corporations pit workers around the world against each other in a race to the bottom to see who will accept the lowest wages and benefits. In contrast, developing countries worry about a brain drain to the North of their most skilled workers and fear that greater openness and economic liberalization will bankrupt domestic industries overwhelmed by foreign competition. What is the basis for believing that reducing trade barriers and opening economies up to competition can increase wealth and help reduce poverty?

We focus on the links between trade and growth, for the simple reason that changes in average per capita income are the main determinant of changes in poverty. Over the past 20 years, the share of extremely poor people in the world (those living on less than two 1985 dollars a day) has fallen sharply, from 38 percent in 1978 to 19 percent in 1998. This decline is almost entirely attributable to growth itself, not to changes in income distribution. The irrelevance of changes in income distribution in explaining changes in overall poverty over the past 20 years is not a coincidence. In general, income distributions move around much less over time than does average per capita income. Thus, most variation in the income of the poor is a result of changes in average income, not changes in income distribution.

But how important is the contribution of trade openness to higher incomes, and how does trade openness affect poverty and inequality? We attempt in this article to cut through the mass of material on this topic by focusing on a number of key issues and by keeping in mind a few important methodological concerns. One such concern is the measurement of openness. The openness of an economy is the degree to which foreigners and nationals can transact without government-imposed costs (including delays and uncertainty) that are not levied on a transaction between two domestic citizens. Tariffs and other charges, nontariff barriers, domestic content requirements, and health and safety requirements (or inspection delays) above and beyond those imposed on domestic products raise the cost of buying from abroad.

As should be clear from this definition, it is extremely difficult to compare degrees of openness over time or, especially, across countries. In our survey of empirical work, we necessarily take an eclectic approach. We consider case studies and microeconomic studies, which often allow for the most detailed and careful measurement of trade barriers. We also consider many analyses that use policy-based measures, particularly the work of Jeffrey Sachs and Andrew Warner. Finally, we look at studies using outcome-based measures of openness, such as the share of exports and imports in GDP. In a foreshadowing of our own conclusion, it turns out that measurement error is not strong enough to bury the positive effect of trade on growth.

A second methodological concern is that we pay close attention to the difference between opening and openness. Considerable trade restrictions remain in many economies that have opened substantially, for example, and trade opening may increase growth for a time...
even in an economy that remains quite closed (and poor). Thus, we might look for a relationship between trade opening and growth, or between trade openness and the level of incomes, but it would, in general, be a mistake to expect one between, say, growth and the level of trade openness.

**Openness and average incomes**

We look in our paper at various pieces of evidence on the relationship between trade and growth—cross-country regressions, case studies, and firm- and industry-level analyses. The story that emerges is overwhelmingly that openness contributes greatly to higher productivity and income per capita and, similarly, that opening to trade contributes to growth. Empirical work from the past 15 years has concentrated on cross-country and panel regression analyses. Many papers have concluded that openness to trade is a significant explanatory variable for the level or the growth rate of real GDP per capita. Rather than review the many papers in this area, we concentrate on two complementary strands.

The first looks at the relationship between levels of income and trade openness across countries. Research by Robert Hall, Charles Jones, Andrew Rose, Jeffrey Frankel, and others has shown that the huge differences across countries in the level of output per capita are systematically and importantly related to openness.

This result holds up across various measures of openness, when the possible feedback from income to openness is controlled for and when a variety of other variables that may explain income are included. It also turns out, though, that institutional quality—defined broadly as the rule of law, the effectiveness of the government, and so on—is also an important determinant of cross-country variation in the level of productivity and income per capita. Moreover, institutional quality is closely correlated with openness. It is thus difficult to separate the effects of openness and institutional quality in a satisfactory way in this context.

In an effort to unravel the overlap between openness and institutional quality, we turn to a second strand of analysis that examines the relationship between changes in openness and changes in per capita GDP over time within countries. This approach avoids the difficulty associated with distinguishing the roles of slowly changing geographic, institutional, and cultural factors from trade openness by looking only at these differences over time.

The basic result is that changes in trade volumes are important determinants of changes in growth, after controlling for possible reverse causality from growth to trade. David Dollar and Aart Kraay estimate that an increase in the trade share of GDP from 20 percent to 40 percent over a decade would raise real GDP per capita by 10 percent. For example, if a country with a trade share of 20 percent of GDP and 1 percent annual growth in real per capita GDP were to raise its trade share to 40 percent, real per capita GDP growth would increase to 2 percent a year. This result turns out to hold even when other control variables are included.

Case studies have also shown the benefits of trade liberalization. Perhaps the central finding of the large multicountry studies of trade liberalization in the 1970s and 1980s was how distortionary the import-substituting regimes were before liberalization. In more recent years, a variety of studies have followed this approach, attempting to define liberalization episodes in a sample of cases and examine the effects. They also find that strong and sustained liberalization episodes result in rapid growth of exports and real GDP.

Recent studies at the firm and industry levels have delineated some of the ways that trade liberalization and the resulting increase in import competition work to increase...
productivity and, hence, growth. Trade helps spread knowledge that contributes to productivity, partly through access to imported inputs. It lowers margins and increases turnover and innovation. Exit of firms is only the most visible part of the story—entry of new firms is also higher in sectors that liberalize imports.

Clearly, import competition helps. So does an emphasis on exports. While many studies have shown that exporting firms are more productive, the reasons are harder to establish. Recent evidence from several African countries and China, however, reveals unusual increases in productivity after firms begin to export. Moreover, recent evidence from East Asia suggests that firms aim at export markets, so that even pre-entry productivity increases are, at least in part, due to the promise of the export market. Finally, exporting firms are highly productive, and exporting allows them to grow faster. Thus, over time, resource shifts into these higher-productivity plants increase economy-wide average productivity.

In sum, the weight of the evidence is overwhelming on the positive effect of openness on growth. Now we turn to the question of whether the usual strong association between growth and poverty reduction is somehow modified by openness.

Openness and the poor

There are strong reasons to suppose that trade liberalization will benefit the poor at least as much as it benefits the average person. Trade liberalization tends to reduce monopoly rents and the value of connections to bureaucratic and political power. In developing countries, it may be expected to increase the relative wage of low-skilled workers, who are likely to be scarcer in the more developed world economy than at home. Liberalization of agriculture may increase (relatively low) rural incomes. If, nonetheless, trade liberalization worsens the income distribution enough, then it is possible that it is not, after all, good for poverty reduction, despite its positive overall effect on growth.

After examining the cross-country evidence and reviewing some of the vast microeconomic literature on the effects of trade liberalization on income distribution, we find that there is no systematic relationship between openness and the income of the poorest, beyond the positive effect of openness on overall growth. The aggregate evidence shows that the income of the poorest tends to grow one-for-one with average income. Of course, in some countries, the poor sometimes do better than average, and sometimes they do worse. But, as Dollar and Kraay (2001) have shown, openness does not help explain which of these outcomes occurs. On the question of whether the poor benefit more or less than others, no clear pattern emerges from the numerous studies of individual liberalization episodes. This is not surprising, as any particular liberalization will change relative prices and incentives throughout the economy in idiosyncratic ways.

Positive spillovers

Much of the evidence in favor of openness spurring growth and reducing poverty is vulnerable to the criticism that the effect of openness has not been isolated from that of many other reforms that were often implemented at the same time. In our view, the fact that trade openness tends to happen at the same time as other beneficial reforms and, indeed, is associated with strong institutional environments is an econometric problem but also a policy opportunity. First, insofar as the evidence gives us a lead, it suggests that openness is a particularly important component of reform. Second, there is little evidence that other reforms must precede effective trade reform, though there are many reforms that are complementary. Finally, trade openness has positive spillovers on other aspects of reform so that, on the whole, the correlation of trade with other proreform policies speaks to the advantages of making openness a primary part of the reform package.

In our view, there are few true preconditions—that is, conditions in the absence of which trade openness is a poor idea. Openness seems to promote growth in the poorest countries at least as well as in others. For example, in closed economies, low initial income reduces potential benefits from economies of scale, suppressing growth. But trade openness, by allowing access to broader markets, helps overcome this impediment. To this extent, the poorest economies, with the smallest home markets, may benefit the most. More broadly, there is little evidence of a “growth trap” in the sense of a situation in which countries become too poor to take off. The growth miracles of the twentieth century occurred in countries starting far behind the richest.

Many factors can make trade reform more successful, or less so. For example, a more egalitarian initial income distribution implies that a given amount of average growth has a larger impact on the poverty rate, all else held equal. Certain factors, such as higher rates of education, may permit the poor to benefit more fully from growth. Of course, these are arguments not against trade reform but rather in favor of pursuing these complementary reforms as well.
The most important set of relationships, in our view, has to do with positive spillovers from trade reform. In many cases and in many ways, trade liberalization is itself a precondition or a complement to other sorts of reforms and thus facilitates their success. Openness provides powerful channels for feedback on the effect of various policies on productivity and growth. For example, competition with foreign firms can expose inefficient industrial policies. Trade raises the marginal product of other reforms, in that better infrastructure, telephones, roads, and ports translate into better performance of the export sector. Moreover, though less visibly, productivity for domestic goods rises as well. Trade liberalization may change the political reform dynamic by creating constituencies for further reform.

It is sometimes argued that an absence of adequate prior institutional reform may limit the gains from openness. In our view, strong institutions are likely to be a powerful complement to trade liberalization, but there is little or no evidence to suggest that waiting for institutional reform is a good idea. On the contrary, there is strong evidence that openness may encourage institutional reform and, in particular, reduce corruption. Corruption is higher in countries where domestic firms are sheltered from foreign competition, and the estimated size of this effect is large.

**Conclusion**

Openness is not a “magic bullet”; much else matters for growth and poverty reduction. But this conclusion should not distract us from the importance of trade liberalization in developing countries. Trade is only one aspect of the development process. However, the breadth of evidence on openness, growth, and poverty reduction, and the strength of the association between openness and other important determinants of high per capita income, such as the quality of institutions, should give long pause to anyone contemplating the adoption of a novel (or tested and failed) development strategy that does not center on openness to trade.

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Reference:

Financial Globalization 69
How has the increased participation of many developing countries in international trade affected their economic growth rates, and what implications has this had for the international distribution of income and the incidence of poverty?

The world has become a much smaller place over the past two decades. International trade has grown twice as fast as worldwide income during this period. Spurred by advances in information technology, a growing share of this trade is in services rather than merchandise, especially among rich countries. International direct and portfolio equity investment has also surged tremendously during the same period.

What are the implications of international integration—or globalization—for inequality and poverty? In recent research (Dollar and Kraay, 2001b), we have explored this question by studying the experiences of a group of developing countries that have significantly opened up to international trade during the past two decades. We provide evidence that, contrary to popular beliefs, increased trade has strongly encouraged growth and poverty reduction and has contributed to narrowing the gaps between rich and poor worldwide.

We illustrate our main points by focusing on the experiences of a small group of developing countries that have seen large increases in trade over the past 20 years. We refer to these countries (see table) as the “post-1980 globalizers.” We first exclude the member countries of the Organization for Economic Co-operation and Development (OECD), as well as the East Asian tigers (Hong Kong SAR, the Republic of Korea, Singapore, and Taiwan Province of China), and Chile, whose experiences with trade liberalization in the 1960s and 1970s are well known. We then ranked the rest of the developing world according to their increases in trade as shares of their GDPs over the past 20 years and selected the top one-third as our globalizers. As a group, these countries saw their trade as a share of GDP double to 33 percent, while trade relative to GDP actually declined among the nonglobalizers. The 24 globalizers contain many well-known trade liberalizers, including Argentina, China, Hungary, India, Malaysia, Mexico, the Philippines, and Thailand. Because China, India, and several other large countries are included, more than half of the developing world’s people live in this group. But it also includes some anomalies, such as Haiti and Rwanda. These serve to remind us that changes in trade reflect many factors other than trade...
policy, as we discuss below. We have used the experiences of these globalizers to make four points.

**Growth rates have increased**

Per capita GDP growth in the post-1980 globalizers accelerated from 1.4 percent a year in the 1960s and 2.9 percent a year in the 1970s to 3.5 percent in the 1980s and 5.0 percent in the 1990s (Chart 1). This acceleration in growth is even more remarkable given that the rich countries saw steady declines in growth from a high of 4.7 percent in the 1960s to 2.2 percent in the 1990s. Also, the nonglobalizing developing countries did much worse than the globalizers, with the former’s annual growth rates falling from highs of 3.3 percent during the 1970s to only 1.4 percent during the 1990s. This rapid growth among the globalizers is not simply due to the strong performances of China and India in the 1980s and 1990s—18 out of the 24 globalizers experienced increases in growth, many of them quite substantial.

Although these experiences are suggestive of the growth effects of trade, they are hardly conclusive. In recent research, we have studied the growth effects of trade more systematically using a large sample of developed and developing countries. Although a large body of literature has examined the effects of trade on growth (and many of these studies have found substantial growth effects of trade), this evidence has recently been subjected to criticism, most influentially by Rodriguez and Rodrik (2000).

- First, many existing studies measure trade openness simply as the share of a country’s trade in its GDP. However, differences in countries’ trade shares reflect their geographic characteristics (for example, countries that are small and close to major markets tend to trade more than countries that are large or remote) to a much greater extent than their trade policy decisions. As a result, it is difficult to draw conclusions from many of these studies, which rely on cross-country evidence, about the effects of trade liberalization on growth. Worse, the observed correlation between trade and growth may simply reflect geographical determinants of growth. Efforts to use more direct measures of trade policy (such as average tariffs or nontariff barriers) have shown mixed results, although this may simply reflect the difficulties in systematically measuring these indicators of trade policy.

- Second, it is often difficult to disentangle the effects of trade liberalization from other domestic policy choices—after all, many countries that liberalize trade often simultaneously embark on other domestic reforms that can also have sizable growth benefits. Without adequately controlling for other policies, one risks confounding the effects of trade liberalization with other growth-enhancing policies.
Third, it is difficult to identify the direction of causation in many existing studies—does trade cause faster growth or do economies that grow quickly also trade more? While conclusively identifying causal effects of trade on growth is likely to remain elusive for some time, it is possible to improve on many existing studies that ignore the issue entirely.

In our recent research, we have attempted to address some of these concerns. In order to eliminate the geographically determined component of trade, we have estimated the effect of trade on growth using decade-over-decade changes in countries’ trade as shares of their GDPs. This, by definition, removes the spurious effect of geography on trade and growth (because countries’ geographic characteristics do not change over time) and, in our view, gives a cleaner (although still far from perfect) measure of the policy-induced component of trade. To control for the effects of other contemporaneous changes in policies and institutions that may affect growth, we include measures of the stability of monetary policy, financial development, and political instability. Finally, we use an econometric technique for which the results are less likely to reflect reverse causation running from growth to trade. The evidence that emerges from this analysis is consistent with the experiences of the post-1980 globalizers. We found a statistically significant and economically meaningful effect of trade on growth: an increase in trade as a share of GDP of 20 percentage points increases growth by between 0.5 and 1 percentage point a year.

Inequality has not increased systematically

Although the growth benefits of trade are increasingly recognized, many analysts are legitimately concerned about the effects of trade liberalization on income distribution. In our research, however, we document that the growth benefits of increased trade are, on average, widely shared—we have found no evidence of a systematic tendency for inequality to increase when international trade increases (see Dollar and Kraay, 2001a). Chart 2 illustrates this point by plotting changes in a measure of inequality (the Gini coefficient, which ranges from 0 to 100, with a higher coefficient indicating greater inequality) on the vertical axis, and changes in trade volumes on the horizontal axis. This figure reflects the experiences of more than 100 developed and developing countries, with changes in trade and changes in inequality measured over periods of at least five years in order to capture the medium- to long-run relationship between trade and inequality.

Chart 2 exhibits a striking absence of any simple correlation between changes in trade and changes in inequality. In our other research, we have examined the validity of this simple result in several dimensions. We considered a wide variety of measures of openness, including direct measures of trade policy and international capital flows, as well as trade volumes themselves. We also searched for nonlinearities in this relationship, allowing for the possibility that the effects of trade on inequality are different in rich and poor countries and in countries with different factor endowments. The conclusion that emerges from this—that there is little evidence of a systematic tendency for inequality to either increase or decrease with increased trade—is consistent with the simple evidence presented in Chart 2.

This evidence is also consistent with the experiences of the post-1980 globalizers. While several of our globalizers have seen increases in inequality (most notably China, where the Gini coefficient increased from around 32 in the early 1980s to 40 in the mid-1990s), several others have seen decreases (for example, Malaysia, where the Gini coefficient fell from 51 to 48 during the same period). And, in many countries, large shifts in income distribution can arguably be linked to influences far removed from international trade. In China, for example, domestic liberalization, restrictions on internal migration, and agricultural policies have played a much larger role than increases in international trade.

Poverty has declined

The combination of increases in growth and little systematic change in inequality in the globalizers has considerably boosted efforts to reduce poverty. In Malaysia, for example, the average income of the poorest fifth of the population grew at a robust 5.4 percent annually. Even in China, where inequality did increase sharply and the income growth rate of the poorest fifth lagged behind average income growth,
incomes of the poorest fifth still grew at 3.8 percent annually. The fraction of the population of these countries living below the $1 a day poverty threshold fell sharply between the 1980s and the 1990s: from 43 percent to 36 percent in Bangladesh, from 20 percent to 15 percent in China, and from 13 percent to 10 percent in Costa Rica, to name a few.

**Gap between rich and poor has narrowed**

We have already seen that income inequality within countries is as likely to decrease as increase with increased trade. But is globalization leaving poor countries behind and widening the gap between the richest and poorest countries? Our evidence on the growth performance of the globalizers relative to the rich countries and the non-globalizing developing countries suggests otherwise. The rapid growth of the globalizers relative to the rich countries means that the globalizers are narrowing the per capita income gap. Moreover, because most of the globalizers—especially China, India, and Bangladesh—were among the poorest countries in the world 20 years ago, their growth has been a force for narrowing worldwide inequality.

The top panel of Chart 3 provides a rough estimate of trends in worldwide inequality over the past 40 years, using the mean log deviation measure of income inequality (the mean log deviation can be interpreted as the percentage difference between the income of a randomly selected “typical” individual and worldwide average income). To construct this figure, we used cross-country differences in real per capita GDP adjusted for differences in purchasing power for more than 100 countries as a measure of income differences between countries. To measure inequality within countries, we used the nearest available Gini coefficient for each five-year period for each country.

Worldwide interpersonal inequality has been quite stable over the past forty years, showing at most a weak downward trend that is unlikely to be statistically significant, given the immense difficulties of measurement inherent in such calculations. More interesting for our purposes is the effect of the rapid growth of the post-1980 globalizers on this inequality measure. To illustrate this, the top panel of Chart 3 first divides worldwide inequality into inequality between countries and inequality within countries. Consistent with the findings of other studies, most worldwide interpersonal income inequality can be attributed to the large differences in average incomes between countries, rather than to inequalities in the distribution of income within countries. And since many of the globalizers were initially poor, their rapid growth over the past 20 years has contributed to reducing income inequality between countries. This can be seen in the bottom panel of Chart 3, which takes the between-country component of inequality and further subdivides it into the globalizers, the rich countries, and the rest of the world. Much of the decline in the between-country component of inequality can be seen to be due to the rapid growth of the globalizers, most notably China and India, whose economies’ vast size has given them substantial weight in these calculations.

**Conclusions**

The integration of the world economy over the past twenty years has been dramatic. The experiences of the post-1980 globalizers show that the process can have great benefits, contributing to rising incomes and falling poverty and enabling some of the poorest countries in the world to catch up with richer countries. The real losers from globalization are those developing countries that have not been able to seize the opportunities to participate in this process.

At the time of writing, David Dollar was a Research Manager in the Development Research Group of the World Bank’s Development Economics Vice Presidency. Aart Kraay was a Senior Economist in the Development Research Group of the World Bank’s Development Economics Vice Presidency.

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The world economy has been expanding strongly, with widespread, healthy growth in both employment and labor productivity. But unemployment remains a problem in many countries. Globally, almost half the unemployed people are young (ages 15–24), although they make up only 25 percent of the working-age population, according to the International Labor Organization (ILO).

In 2005, the world’s labor force ages 15 and older—comprising those in work and people seeking jobs—topped 3 billion, up almost 17 percent from 1995. Of these, 2.85 billion had jobs. The ratio of global employment to population stood at 61.4 percent, down 1.4 percentage points from a decade earlier, with most of this decline taking place in the late 1990s.

The global unemployment rate in 2005 was 6.3 percent, lower than the peak of almost 6.6 percent of the labor force in 2002, but up from the 6.0 percent level of a decade earlier. Nearly 192 million people were unemployed in 2005, an increase of 2.2 million since 2004 and 34.4 million since 1995. Of the 192 million, 79 million were women.

Although unemployment fell markedly in developed economies in 2005 to an average of 6.7 percent from 7.1 percent a year earlier, it continued to rise in the former Soviet bloc countries. The Middle East and North Africa have the highest regional rate (13.2 percent), while East Asia has the lowest (3.8 percent).

Almost half of the world’s unemployed are under 25 and young people are more than three times as likely as adults to be jobless. Within their age group, the share of employed young people fell to 46.7 percent in 2005 from 51.7 percent in 1995. Youth participation in the labor force also fell, partly because of the increasing proportion in education.

*Commonwealth of Independent States.
Agriculture still accounts for 40 percent of global employment, but jobs are shifting, particularly to the services sector. If trends over the past decade continue, the services sector will soon overtake agriculture as the largest provider of employment, reflecting the migration of workers from rural to urban areas.

Global labor productivity (measured as output per worker) rose by 2.6 percent in 2005, compared with 3.0 percent in 2004. Since 1995, it has grown at an annual average rate of 2.0 percent, while GDP has risen by an average of 3.8 percent a year. The least progress is being made in sub-Saharan Africa, the Middle East and North Africa, and Latin America and the Caribbean.

Women make up some 40 percent of the world’s workforce. While the gap between the proportion of women employed versus men has narrowed, it still remains wide: some 52 percent of adult women versus 81 percent of adult males. And participation rates (the proportion either working or looking for a job as a percentage of working-age women) are declining, after increasing in the 1980s and early 1990s. Male participation rates have also fallen.

The proportion of workers and their families who are living on $2 or less a day per family member has fallen to 48 percent of the global employed workforce from 55 percent in 1995. But absolute numbers increased to 1.37 billion in 2005 from 1.35 billion 10 years earlier. Trends in extreme working poverty (those living on less than $1 a day) varied by region, with Asia showing strong falls, but with absolute numbers in sub-Saharan Africa and Latin America and the Caribbean rising.

In world trade negotiations there is a constant tension between attempting to establish a set of universally applicable rules and allowing certain opt-outs, or exceptions, particularly for developing countries. The World Trade Organization (WTO) attempts to manage this tension through what is known as special and differential treatment (SDT). SDT spans promises by high-income countries to provide preferential access to their markets, the right to limit reciprocity in trade negotiating rounds to levels “consistent with development needs,” and greater freedom to use otherwise restricted trade policies. The underlying premise is that industries in developing countries need assistance for some time in both their home market (protection) and in export markets (preferences).

But SDT is controversial. Many economists argue that the existing SDT “package” has not been very beneficial: preferences have been of limited value for most developing countries as a result of exceptions, nontrade conditionality, and supply capacity limits, while nonreciprocity and weaker disciplines on trade barriers have impeded more rapid integration into the world economy (as continued protection biases incentives against exporting and improving productivity). Others argue that preferences are needed because industrial countries have consistently thwarted the development potential of the trading system by maintaining high barriers to developing country exports and that rich countries have historically intervened in trade in ways that the WTO now constrains. Thus, SDT is necessary to give developing countries the same opportunities.

Restrictive trade policies may help support the development of domestic industry. For such industries to become efficient, however, they need to be able to source inputs from the most competitive suppliers and confront competition in the markets for their products. Whatever one’s views on the effectiveness of trade policy to support domestic industry, both theory and experience suggest that, over time, trade barriers should be lowered to ensure this. By establishing a mechanism through which countries negotiate the reduction of trade barriers, the WTO can be regarded as pro-development.

What then is the problem from a development perspective? First, the WTO is driven by mercantilism: the desire of members to improve their terms of trade through better access to the markets of other members. The focus is not on the welfare or growth prospects of members, or on the identification of “good” policy, but on ways that national policies impose costs on other countries. It may be the case, for example, that there is a rationale for subsidies (to offset a market failure), even if they are to the detriment of other countries.

Second, the ambit of the WTO increasingly extends beyond trade policy. Domestic regulatory policies (or their absence) may have a strong economic efficiency rationale even if they entail some negative spillovers on others. Intellectual property protection is an example—limited enforcement may well be the best option for poor countries (see Box 1). Regulatory disciplines may also give rise to high and asymmetric implementation costs, with the burden falling disproportionately on poorer countries. Longer transition periods—the basic instrument adopted in the Uruguay Round—are an inadequate response.

Third, little effort is made to identify what the preconditions are for benefiting from specific WTO agreements or whether they have been satisfied. Nor is there a mecha-
nism to monitor the effectiveness of policies justified under SDT provisions or to identify alternative policies (including development assistance) that might be more efficient in attaining the objectives of a poor country. To return to the subsidy example, assuming there is a case for intervention, subsidies or taxes are generally more efficient than trade barriers in addressing market failures, but governments may not have the capacity to use them, resulting in the use of more distorting (costlier) trade policies.

Finally, traditional SDT has resulted in significant discrimination among developing countries, incentives by recipients of preferences to oppose liberalization, and less certainty and predictability of trade policy.

The current approach to SDT in the WTO places the primary focus on detailed negotiation of opt-outs, rules, and exemptions from specific agreements. An example is the Doha Round proposal that developing countries be permitted to designate special products and use special safeguard procedures for agricultural products. This approach requires poor countries to determine on an issue-by-issue basis the specific provisions that would be beneficial. What these are may not be clear, and the ability to get agreement from developed countries on such proposals is constrained by mercantilist calculus: the perceived cost to them of a proposal, not whether it makes sense from a developmental point of view. This article proposes a new approach that would imply major changes for both developed and developing countries. It would make the WTO more supportive of development and enable developing countries to better integrate into the global trading system by having all WTO members accept a set of core commitments while allowing latitude in other areas.

A development-friendly WTO

How can WTO trade agreements become more supportive of development? Arguably, such agreements should

- remove foreign barriers to trade for products that poor countries produce;
- lower domestic barriers that raise the prices and reduce the variety of goods and services that firms and households consume; and
- support the adoption of complementary regulations and institutions that enhance development.

Political economy forces constrain realization of the first objective. Small, poor countries have little to offer in the mercantilist WTO exchange to induce large countries to remove policies that harm them. The preferential access dimension of SDT was motivated in part by this observation. Many of the poorest countries today have not been able to use SDT to expand and diversify their exports. Moreover, preferences are not an enforceable commitment under the WTO. Instead, they are “best endeavor” promises that, in practice, have been subject to many restrictions and conditions. The second objective requires domestic reforms—here the question is how to mobilize political support for such reform, given fiscal constraints, industrial policy objectives, and the fact that nonreciprocal preference programs may imply that exporters already have free access to major markets. The third objective may be impeded by the fact that the rules adopted have often been developed
in high-income countries. WTO rules on intellectual property protection are a good example.

The challenge is to introduce flexibility when it is desirable, while at the same time strengthening the trading system. An important role of the system should be the adoption of good policies—in part by increasing transparency and reducing uncertainty regarding the policies confronting traders. This function of the trading system is of great value to developing as well as developed economies.

Proposed new approach

Making the WTO more supportive of development could involve three basic elements:

- First, unconditional acceptance by developing countries of a core set of disciplines relating to market access—including the most-favored-nation (MFN) principle, binding of tariffs and commitments to reduce tariffs in the future—as well as acceptance, in principle, of the WTO as a whole.
- Second, permitting countries not to implement “non-core” WTO rules on development grounds, in the context of multilateral consultations with representatives of the trade and development communities (donors, financial institutions) on the effectiveness and impact of the policies concerned. Assessments of these policies should consider negative spillovers and should be published in the relevant countries to increase the accountability of governments.
- Third, a shift away from discriminatory trade preferences as a form of “trade aid,” coupled with strengthened grant-based financing targeted predominantly at the poorest countries to improve trade supply capacity and the competitiveness of local firms, and to redistribute some of the gains from trade liberalization.

The intention should not be to make the WTO a development organization. This is not desirable, even if it were feasible. Instead, the objective is to put in place an enabling mechanism to foster greater integration of developing countries into the WTO.

WTO is a binding contract: commitments are enforceable. This gives the WTO its value—traders have greater certainty regarding policy, and governments know what they are “buying” when they make commitments. Allowing for “policy space”—or leeway for countries to pursue policies that would otherwise be subject to multilateral discipline—will increase uncertainty and could reduce the willingness of major trading countries to make commitments in the first place. Agreement that a core set of WTO disciplines would constitute binding obligations on all members would help address this concern. Thus, violations of core rules would be enforced through existing dispute settlement mechanisms.

Negotiations would need to define what this core comprises. Arguably, it includes transparency, MFN treatment, the non-use of quotas, the binding of all tariffs, and the willingness to make commitments to lower such tariffs over time in the context of trade rounds. Why these? Because they constitute the fundamental principles on which the trading system is based, and are beneficial to all countries regardless of their level of development. If this were accepted, it would imply stronger multilateral commitments in the core areas than exist now. In

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**Box 1**

**Cambodia: tripping up over TRIPS?**

Recent case studies illustrate the potential payoffs of greater flexibility in the WTO’s regulatory enforcement. One example is Cambodia, which has made significant efforts to adopt legislation consistent with the Trade-Related Aspects of Intellectual Property Rights (TRIPS) agreement and has trained government officials and the private sector in enforcement. The government drafted laws on trademarks, patents, copyright, protection of trade secrets, unfair competition, and plant variety protection. It set up training courses for lawyers, judges, law enforcement, and customs officers. And it expedited the drafting of laws and implemented regulations, publishing Khmer books on the subject.

While most of this was paid for by donors, it is questionable whether the benefits offset these costs, given that Cambodia is unlikely to be a producer of high-tech or pharmaceutical products for many years to come. Indeed, the economic price tag of strong enforcement of intellectual property rights may be a multiple of the direct administrative costs and the opportunity costs in human resource terms of devoting so much attention to this area. It is an open question whether these laws constituted priorities from a development perspective and whether the costs incurred would have passed a cost-benefit analysis. This was not undertaken, because complete adoption of TRIPS was seen as a requirement for accession to the WTO.

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**Box 2**

**IF as a model**

The Integrated Framework for Trade-Related Technical Assistance to Least Developed Countries (IF) is an unlikely name for a model of future cooperation. But it is a good basis on which to develop a policy dialogue on trade. It brings together key multilateral agencies working on trade development issues with donors and recipient countries. More than 40 of the least developed countries (LDCs) have applied for assistance under the scheme.

The basic purpose is to embed a trade agenda into a country’s overall development strategy and ensure that trade-related adjustment and capacity building are in line with the trade policy aims of the country concerned and prioritized with other development assistance needs. Although the IF has raised awareness of trade issues within the LDCs, many countries need additional resources to implement the recommendations of their trade integration strategies.

The IF has a steering committee with rotating membership—spanning six multilateral agencies, contributing donors, and recipient countries—as well as an interagency working group that handles diagnostics and follow-up.
Consultations would assess and its application—the focus is not on the economic ratio—
tees focus mostly on (changes in) implementing legislation
quent (every 6+ years). Agreement-specific WTO commit
WTO consistency of observed policies, and impacts within
t transparency exercise that arguably is underutilized because the
secretariat is not permitted to form judgments regarding
Assessing whether instruments are achieving development
objectives and whether less trade-distorting ones can be
identified inherently requires judgments regarding appropri-
ate sequencing and the need for complementary reforms and
investment. These must be made by the concerned govern-
ment but can be informed by
inputs from other members and
from development and financ-
ing institutions. The involve-
ment of the latter would be
necessary and desirable for a
number of reasons. First, they
have the mandate, experience,
local presence, and capacity to
provide policy advice. Second,
these organizations generally
take the lead in developing and
financing projects and programs
in developing countries. The
WTO should not move into
project design and financing.
A major advantage of the
proposed mechanism could
be improved communication
between the development and
trade communities—identifying
where development organizations should help and where
WTO disciplines may not be optimal for a country. In any
such process, development organizations must have a seat
at the table. The launch of the first version of the Integrated
Framework for Trade-Related Technical Assistance to Least
Developed Countries (IF) at the WTO’s 1996 ministerial
meeting in Singapore shows that initiatives by trade ministers
are doomed to fail if they are not coordinated with (owned
by) the development institutions that will be asked to provide
assistance and the countries that will use it.
That said, if the membership of a monitoring mechanism
were to span all WTO signatories as well as relevant inter-
national development institutions, it would probably not
be effective. One option would be to build on the revamped
IF—which has now become a unique example of interna-
tional collaboration in the trade area, following a major
rethinking and redesign in 2000 (see Box 2). If extended
beyond the least developed countries, the IF agencies and
donors would overlap to a very great extent with the set
of players one would expect to engage in any trade-related
policy dialogue.
Recognizing spillovers. Whether a policy imposes signifi-

cient negative financial costs on other countries should be part
of the terms of reference of the consultation process, as is the
identification of possible policies that are less trade distorting.
For example, as mentioned, basic economics suggests that sub-
particular it would imply the end of nonreciprocal trade pref-

erences by developed countries. There are both systemic (the
MFN principle) and developmental rationales for this. The
evidence suggests that those countries that can benefit from
trade preferences have already done so, while those that have
not confront domestic constraints that impede them from
fully exploiting these opportunities. The primary need is to
address those constraints and to remove trade-distorting pol-

cies that affect developing countries disproportionately on a
nondiscriminatory basis. Thus, a trade-off for acceptance of
the core principles by developing countries is that higher-income
countries augment and gradually replace preferences with expanded
development assistance to bolster trade capacity. Another trade-off is
that non-core disciplines become eligible for the policy flexibility
mechanism.

How policy flexibility would work
Differentiation among developing countries in the application of
SDT has been a sensitive topic in the WTO. Many more advanced
developing countries oppose suggestions that SDT be limited to a
subset of poorer and more vulnerable countries. A major advan-
tage of a development framework that is explicitly designed as an
enabling mechanism is that assumptions about who is eligible
can be avoided. One way to allow this would be for any (self-
designated) developing country to be able to invoke the pro-
cess, but to accept as well explicit consideration of a “spillover
test” as part of the consultations—the extent to which a spe-
cific policy has negative effects on other countries. This would
introduce differentiation on a de facto basis, and is discussed
further below.

Judging non-core policies. Consultations would assess
the impact and effectiveness of nonconforming policies
(non-core). This first requires identification of such poli-
cies. Traditionally, this is left to dispute settlement and, in
the case of small and poor countries, the dispute settlement
procedure is unlikely to be invoked. (This is, in fact, a weak-
ness of the status quo, in that poor countries are ignored.)
Currently, there are only two WTO mechanisms that identify
inconsistent policies of smaller countries: the Trade Policy
Review and committees that oversee the operation of spec-
cific agreements. The former constitutes a valuable trans-
parency exercise that arguably is underutilized because the
secretariat is not permitted to form judgments regarding
WTO consistency of observed policies, and impacts within
and across countries are not considered. The process is infre-
fquent (every 6+ years). Agreement-specific WTO commit-
tees focus mostly on (changes in) implementing legislation
and its application—the focus is not on the economic ratio-

“A trade-off for acceptance of the core principles by developing countries is that higher-income countries augment and gradually replace preferences with expanded development assistance.”
sidies are more efficient instruments to address market failures than trade policies. If binding budget constraints in a developing country preclude the use of (temporary) subsidies, development assistance may be used to overcome them if there is agreement that it would help address a market failure. Linkage to aid may also help establish a credible exit mechanism, a key condition to prevent capture and control rent seeking.

**Settling disputes.** Although the process of determining the impact and effectiveness of a particular policy that is inconsistent with a non-core WTO discipline should enhance both transparency and accountability of governments, such policies may inflict substantial harm on other WTO members. If they are also developing countries, policy space may imply robbing Peter to pay Paul. This again points to the importance of identifying less trade-distorting policies to pursue the government’s objective. If these do not exist or are not adopted, countries ultimately have recourse to the standard WTO remedy: dispute settlement.

Larger developing countries are more likely to impose relatively larger spillovers on trading partners, whether developed or developing. This suggests that the spillover assessment proposed above may be an effective way to differentiate between countries in terms of the extent to which they can invoke “policy space” for development purposes. While spillovers imposed by a small country on large WTO members will be small by definition, they may be relatively large for another small country. Thus, a development mechanism should complement dispute settlement and not replace it. In effect, developing countries would be granted immunity as long as policies do not create significant negative spillovers, with a higher threshold for the impact on higher-income countries.

**Building capacity.** The proposed mechanism should also help address supply capacity constraints in poor countries by going beyond their identification to include an expansion of aid funds for this purpose. In particular, consideration could be given to a binding commitment by richer countries to transfer a share of the gains realized from multilateral trade reforms (under the Doha Round) to developing countries. Such gains are potentially large, depending on the extent of liberalization commitments made. For example, part of the tariff revenue collected on goods that are due to be liberalized over time or part of the budgetary allocation for agricultural subsidies that is to be eliminated under a Doha agreement could be made available to fund trade capacity improvements in developing countries. Especially in small low-income countries that already have relatively free access to major markets, using aid to address constraints that reduce their competitiveness can have high payoffs. That said, a major lesson of World Bank experience with projects and programs in this area (and most others) is that

country ownership and leadership at the highest levels are critical factors in ensuring concrete and sustained follow-up in removing constraints to trade expansion. As noted, the proposed mechanism could help mobilize such engagement within the context of overall poverty reduction strategies.

**Worth the attempt**

Would the establishment of a mechanism to allow greater flexibility on a country-specific basis, with all its complications, be of value? The potential upsides from the approach sketched out above are significant. Small developing countries are rarely subjected to litigation by developed economies due to their size. While that suggests a policy flexibility mechanism is not really needed, this fact in itself illustrates the need for change: greater engagement with poor countries on their trade policies would be beneficial. Acceptance of core principles by all developing countries, including MFN, and thus the (gradual) demise of trade preferences, and explicit agreement by high-income countries to put greater weight on the policy objectives of developing countries by taking the supply-side capacity agenda seriously through an augmented IF-type mechanism would be other significant changes.

A major advantage of the WTO is that it is a single-issue organization: the focus is always on trade. This is not the case at other international organizations. Creating a focal point for a constructive, as opposed to adversarial, interaction among governments could do much to raise the domestic profile of the trade agenda in developing countries. It would also add to information on the effects of existing policy instruments—a necessary condition for adopting better policies—and ensure that trade-related policy actions and investments are considered by decision makers. Although there will certainly be greater human resource costs, much of the required work could be undertaken in the context of the activities and diagnostics of the Integrated Framework.

In a nutshell, there is a fundamental choice to be made regarding the development dimension of trade agreements. It is a choice that goes beyond the WTO, extending to North-South regional trade agreements as well. The same tension arises there, with asymmetries in both power and size that are often much greater than in the WTO. The type of mechanism proposed above could also be considered in the context of regional trade arrangements such as the Economic Partnership Agreements the European Union is negotiating with the African, Caribbean, and Pacific countries.

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ECONOMISTS are sometimes chastised for their inability to reach a consensus view. George Bernard Shaw, the Irish playwright, captured the mood rather neatly when he wrote: “If all economists were laid end to end, they wouldn’t reach a conclusion.” If he were writing today, he would be forced to concede the rider “unless they were discussing the benefits for the poor of openness to trade.”

“Openness” has become the great religion of the globalization era. No meeting of international financial institutions is complete without a homily to its benign effects. In the view of the IMF, the World Bank, and most northern governments, removing barriers to trade is one of the most powerful things that governments can do to give the poor a bigger stake in global prosperity. As a World Bank research report published in 2001 concluded, openness explains why “globalization leads to faster growth and poverty reduction in poor countries.” Expressed differently, openness—along with associated free market reforms—holds the key to making globalization work for the poor.

Some critics respond by asserting that globalization can never work for the poor and that integration into global markets will inevitably cause more poverty and inequality. Widespread as it is, such “globophobia” is unjustified. International trade has the potential to act as a powerful catalyst for poverty reduction, as the experience of East Asia demonstrates. It can provide poor countries and people with access to the markets, technologies, and ideas needed to sustain higher and more equitable patterns of growth.

But if globophobia is unjustified, so too is “globophilia”—an affliction, widespread on Nineteenth Street in Washington, that holds that increased integration through trade and openness is an almost automatic passport to more rapid growth and poverty reduction.

Growing income inequalities

Bluntly stated, the argument that globalization is working for the poor does not deserve to be taken seriously. Between 1988 and 1998, the incidence of global poverty fell by the derisory rate of 0.2 percent a year. Already-obscene global income inequalities are widening. At the end of the 1990s, high-income countries representing 14 percent of the world’s population accounted for over three-fourths of world income—roughly the same as at the start of the decade. The world economy ended the 1980s more unequal than any national economy, and since then it has become even more unequal (the global Gini coefficient rose by 3 points between 1988 and 1993 alone). These figures come from a 1999 World Bank report, “True World Income Distribution, 1988 and 1993,” authored by Branko Milanovic of the World Bank Development Research Group. Of course, they can be disputed. Some economists, on the basis of no credible evidence, assert that the incomes of rich and poor countries are starting to converge. Surely, the real issue is that current patterns of global inequality are inconsistent not just with civilized values but also with the international commitment to halve poverty by 2015.

International trade is reinforcing income inequalities. Because exports are growing faster than global GDP, they have an increasingly important bearing on income distribution. And world trade shares mirror income
distribution patterns. Thus, for every $1 generated through export activity, $0.75 goes to the world’s richest countries. Low-income countries receive around $0.03. Unless developing countries capture a far larger share of exports, trade will continue to fuel widening gaps in absolute income.

Within many developing countries, globalization is exacerbating inequalities at various levels. Income gaps based on access to markets, productive assets, and education are widening, acting as a brake on poverty-reduction efforts. At the same time, integration into global markets is reinforcing other forms of deprivation, notably in relation to gender. Globalization has drawn millions of women into employment, but increased income has gone hand in hand with extreme forms of exploitation, the erosion of workers’ rights, and increased vulnerability to global markets. “Flexibility” in labor markets has become a euphemism for stark violations of basic rights. As one Colombian flower worker recently interviewed by Oxfam put it: “Yes, I have more money, but I have lost my health. I have a job—but I have no rights and no security.”

One of the problems with the current debate on globalization is that the non-income dimensions of poverty—such as self-respect, security, and health—have been ignored.

### The problem with openness

The champions of openness claim that a renewed commitment to liberalization holds the key to making globalization work for the poor. Econometric survey results have been cited as evidence of the scientific veracity of this claim. Confidence in that evidence is reflected in policy conditions on trade liberalization attached to IMF–World Bank loans and in the advice of northern governments to their southern counterparts. One recent IMF review of seven Poverty Reduction and Growth Facility programs found that each loan came with seven trade policy conditions attached. Following the 1997 financial collapse in East Asia, the IMF’s rescue loans again came heavily laden with import-liberalization requirements. Most northern governments fully support this approach. For example, the U.K. Department for International Development’s white paper on globalization provided a ringing endorsement of trade openness—as ever, citing World Bank “evidence.” Unfortunately, the evidence in question is based on dubious economics and a highly selective interpretation of data and does not justify the confidence in policy prescription.

The most widely cited case for openness has been set out by David Dollar and Aart Kraay of the World Bank. Briefly summarized, their case rests on two core arguments. The first is that openness is associated with higher growth. Dollar and Kraay identify 24 developing countries that have seen large increases in openness, defined as a rising share of trade in GDP. These “globalizers”—a group that includes Brazil, China, India, Mexico, and Thailand—achieved per capita growth rates that were 4 percent higher than those of non-globalizers in the 1990s, a huge difference. The second argument is that increased trade is not associated, on average, with a systematic tendency to increased inequality: the poor share in growth in proportion to their existing share of national income. Other things being equal, the combination of higher growth and no change in income distribution translates into more rapid poverty reduction.

Some of the problems with this approach stem from the use of large samples to derive weighted averages. Using an unweighted average, the per capita growth rate for the “globalizers” falls to 1.5 percent (roughly the same as the non-globalizers)—and 10 of the 24 countries in the group record growth rates for the 1990s of 1 percent or less. Hardly an impressive foundation for sustained poverty reduction.

The more serious problem concerns what is being measured. Essentially, Dollar and Kraay are capturing an economic outcome in the form of a trade-to-GDP ratio. They then proceed to use changes in this ratio as a proxy for changes in trade policy. The implicit assumption is that trade liberalization is responsible for successful integration, with success in this case being defined as faster growth and poverty reduction.

In reality, this is little more than a speculative leap of faith. Countries such as China, Thailand, and Vietnam may be premier globalizers. They also have a strong record on economic growth and poverty reduction. Yet they have liberalized imports very slowly and still have relatively restrictive trade barriers. Conversely, countries such as Brazil, Haiti, Mexico, Peru, and Zambia have been world-beaters when it comes to import liberalization, but have a weak record on growth and poverty reduction. In short, many first-rate globalizers have fifth-rate records on poverty reduction.

The point here is not to replace an openness blueprint with a protectionist one. But surely we need to look more closely at such issues as the sequencing, pace, and structure of import liberalization. To the extent that any broad lessons emerge from East Asia, one of the most important appears to be that export liberalization and promotion were pursued both in advance of, and far more aggressively than, import liberalization.

The position of Latin America is striking. Governments in the region have liberalized imports far more rapidly than in any other region, turning their countries into models of

“What really matters for the debate on globalization is why some countries have been more successful than others in combining export growth with poverty reduction.”
Working on a hand loom in Afghanistan.
trade openness. The returns in terms of poverty reduction have been abysmal. At the end of the 1990s, some 15 million more people were living below the $1 a day poverty line than in 1987, despite economic recovery. In much of Latin America, rapid import liberalization has been associated with further concentration of already-extreme inequalities. For example, in Peru, the livelihoods of the rural poor have been adversely affected by surges of cheap—often subsidized—food imports, while large-scale commercial farms have the resources to take advantage of export opportunities. On the balance sheet of winners and losers from trade liberalization, the poor are all too frequently to be found on the wrong side of the ledger.

What Latin America demonstrates is that distribution does matter. To assert that, on average, the incomes of the poor rise on a one-to-one basis with economic growth is to miss the point. Countries with low levels of income inequality can expect to register far higher rates of poverty reduction than highly unequal countries. The reasons are obvious. If the poor account for only a small share of national income, the rate of poverty reduction will be far slower. A highly unequal country like Brazil has to grow at three times the rate of Vietnam to achieve the same average income increase among the poorest one-fifth of its population. In Uganda, the ratio of economic growth to poverty reduction was 1:1 in the first half of the 1990s, compared with 1:0.2 in Peru. While it is true that rising inequality can be counteracted by rapid growth—as in China—it also reduces the rate of poverty reduction.

What really matters for the debate on globalization is why some countries have been more successful than others in combining export growth with poverty reduction. Increasing the share of the poor in market-based growth requires strategies that range from land redistribution to investment in marketing infrastructure, improved access to education and health care, and measures to tackle corruption. It may also require policies that have become anathema in the “openness” era, including border protection for smallholder farmers and (on a selective and temporary basis) for infant industries, the restoration of basic labor rights, and minimum-wage protection.

The critical point is that openness in and of itself is not a poverty reduction strategy. Poverty Reduction Strategy Papers (PRSPs), the documents prepared by governments entering IMF–World Bank programs, provide a real opportunity to develop a genuinely poverty-focused approach to trade policy. Unfortunately, that opportunity is being lost. Most PRSPs do little more than restate the familiar mantras on the benefits of openness, often with grave implications for poverty reduction. For instance, Cambodia’s interim PRSP envisages rapid across-the-board import liberalization, with tariffs being lowered to an average of 5 percent even for sensitive agricultural products, such as rice. Yet, in a country where one-third of the population lives below the poverty line, it offers no assessment of the implications for rural poverty and income distribution, notwithstanding the fact that rice is the mainstay of the rural economy.

Selective openness

In one respect, openness is a curious economic doctrine. Northern trade and finance ministries are among its most ardent exponents, especially when directing policy advice to poor countries. Yet when it comes to their home economies, the principles of free trade are honored more in the breach than in the observance. The underlying ethos is “do as we say, not as we do,” which is not a constructive basis for more inclusive globalization.

The costs of northern protectionism to developing countries have been well documented. On a conservative estimate, they are losing $50 billion annually. When poor countries enter global markets, they face tariffs some four times higher, on average, in industrial countries than those faced by other industrial countries. The most punitive tariffs are to be found in precisely those areas—such as labor-intensive manufacturing and agriculture—where developing countries enjoy the strongest potential advantage. Nowhere are the double standards more staggering than in agriculture. While developing countries liberalize, industrial countries spend $1 billion a day subsidizing overproduction and export dumping, destroying on an epic scale the livelihoods of vulnerable smallholder farmers in the process. The beneficiaries of this jamboree are a handful of politically influential large-scale farmers, such as the grain barons of the Paris Basin and the peanut magnates of Georgia.

One analytical tool that throws some light on the extent of northern hypocrisy is the IMF’s Trade Restrictiveness Index (TRI)—a scale of openness that ranks countries from 1 (completely open) to 10 (completely closed). The countries of the European Union and the United States and Japan measure 4 on the TRI. Meanwhile, countries as poor as Uganda, Peru, and Bolivia measure between 1 and 2.

Uneven liberalization is one of the reasons that industrial countries continue to capture the lion’s share of the benefits from globalization. Developing countries are absorbing the costs of adjusting to more open trade regimes, while northern protectionism excludes them from market opportunities. Current approaches to IMF–World Bank loan conditionality are reinforcing this unequal trade bargain. It is certainly hard to imagine the governments of France or the United States accepting liberalization conditions in agriculture routinely applied in poor countries.

Toward a new consensus

If we are to meet the challenge of poverty reduction, the sterile debate between globophobes and globophiles needs to be consigned to its proper place in the dustbin of the last decade of the old millennium. Governments, international financial institutions, and civil society need to engage in a real dialogue over how to make globalization work as a more powerful force for poverty reduction and social justice. At a national level, trade policy has to be brought into the mainstream of national strategies for poverty reduction and redistribution.

At the global level, northern governments need to do far more to create the conditions under which developing countries can capture a larger share of the benefits from
KEVIN WATKINS’s article, “Making Globalization Work for the Poor,” contains much that is consistent with our article in *Finance & Development* (September 2001), which was based on our working paper, “Trade, Growth, and Poverty.” We agree with Watkins that globaphobia is unjustified and that international trade, rather than causing more poverty and inequality, can be a powerful catalyst for poverty reduction by providing poor countries with access to the markets, technologies, and ideas they need for faster and more equitable growth. And, although it is not the subject of our paper, we do agree with Watkins’s emphasis on the costs for poor countries of rich country protectionism—a view also expressed in the World Bank’s *World Development Report 2000/2001: Attacking Poverty*.

Although there is much that we agree on, naturally we do not agree with Watkins’s claim that our work is based on “dubious economics and a highly selective interpretation of data.” Our research on the links between trade, growth, and poverty reduction was partly stimulated by the globaphobes’ claims that increased flows of foreign trade and investment were making poor countries and the poor people in them worse off. We took these popular claims—as well as academic critiques of the evidence on trade and growth—seriously. Contrary to what some critics have been saying, we found that integration of poor countries with the global economy is associated with faster growth and poverty reduction. This does not mean that we subscribe to the simplistic view that “a renewed commitment to liberalization holds the key to making globalization work for the poor,” as Watkins suggests. Rather, our finding is that increased participation in world trade, together with good economic and social policies, has worked well for a diverse group of poor countries. To quote from our paper,

> It would be naïve to assert that all of this improvement in growth should be attributed to the greater openness of these globalizing economies: all of them have been engaged in wide-ranging economic reforms. . . . China, Hungary, India, and Vietnam . . . strengthened property rights and carried out other reforms. . . . Virtually all of the Latin American countries included in the grouping stabilized high inflation and adjusted fiscally . . . “ (pp. 9–10)

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**RESPONSE**

David Dollar and Aart Kraay

trade. They could usefully start with a bonfire of tariff and nontariff measures applied to developing country exporters. But this is only a first requirement. At present, the rules of the multilateral trading system are designed to concentrate advantage in the rich world. The major beneficiaries of World Trade Organization agreements on intellectual property rights will be northern transnational companies, not the world’s poor. Meanwhile, issues of vital concern to developing countries, such as the protracted crisis in commodity markets, do not even register on the global agenda. Making trade work for the poor requires rules that do something more than reflect the self-interest of the rich. ■
Watkins criticizes our work on the grounds that our “implicit assumption is that trade liberalization is responsible for successful integration, with success in this case being defined as faster growth and poverty reduction.” This is somewhat puzzling. To be clear, we define increased integration as a rise in the ratio of constant-price exports and imports to constant-price GDP, and we show that increased integration is associated with faster growth and poverty reduction. We also recognize explicitly, in our paper and in our Finance & Development article, that these changes in trade shares are only an imperfect proxy for measures of trade policy. Our only claim is that changes in trade shares are likely to be better proxies for changes in trade policy than levels of trade volumes are for levels of trade policy. It is also undeniable that some of the countries that have lowered trade barriers have not seen increases in trade and growth or a reduction of poverty; we recognize this in our paper. But this brings us back to another point on which we do agree with Watkins: “openness in and of itself is not a poverty-reduction strategy.” We do not claim that it is. The evidence suggests that a more liberal trade regime is one part of a policy package for successful growth and poverty reduction.

Finally, Watkins argues that personal income inequality is widening worldwide and points to globalization as the main culprit. We disagree on both points. First, Watkins selectively cites just one estimate of an increase in the global Gini coefficient of 3 points between 1988 and 1993. But other estimates, including our own, which are cited in the Finance & Development article, show either little change in inequality between the 1980s and 1990s or even a modest decline. And, as discussed in our article, given the vast measurement problems one encounters in constructing such estimates, none of these small changes in either direction over relatively short periods is likely to be statistically robust. In our view, what can be said robustly about global inequality is that it clearly rose between 1820 and 1980 and then stabilized, with perhaps a modest decline, afterwards. Similarly, concerning extreme poverty—the term used to characterize those living on less than $1 a day—the number of poor people continued to climb historically, until about 1980. Since 1980, the number of poor people has declined by an estimated 200 million.

Second, the experience of the countries we identify as globalizers has in fact been a force for reduced global inequality since 1980. The vast majority of the world’s poor in 1980 lived in China, India, and a few other poor Asian countries, such as Bangladesh and Vietnam. Rapid growth in these countries has narrowed the gap in living standards relative to the developed world for a large fraction of the world’s population, and all of these countries have reduced poverty significantly as they have integrated with the global economy. Their success makes a mockery of the extreme claims of the antiglobalization movement.

At the time of writing, David Dollar and Aart Kraay were Economists in the World Bank’s Development Research Group.
The outsourcing of services has received a huge amount of attention in the media and political circles in recent months, largely because media reports seem to equate outsourcing with job losses. In just five months, between January and May 2004, there were 2,634 reports in U.S. newspapers on service outsourcing, mostly focusing on the fear of job losses. But outsourcing, let alone its consequences, does not appear to be widely understood. The dictionary defines it as “the procuring of services or products . . . from an outside supplier or manufacturer in order to cut costs.” However, it is not clear what is meant by “outside.” Some people interpret it to mean outside the firm, and others outside the country. Media and political attention seems firmly focused on international outsourcing, even though domestic outsourcing is also common. Firms based in industrial countries that outsource services have been accused of “exporting jobs” to developing countries, with call centers and computing services in India the most frequently reported examples.

Many people would argue that outsourcing has been a normal part of international trade for decades—and they would be right. The growing outsourcing of services in industrial countries is simply a reflection of the benefits from the greater division of labor and trade that have been described for manufactured goods since the time of Adam Smith and David Ricardo. What is tradable depends on technology, and advances in technology (especially in information processing, communication, and transportation) are increasingly making it possible to trade services that previously were too costly to trade. Although, for a typical industrial economy, the international outsourcing of material inputs is still far greater than that of services, the current wave of anxiety is largely about services.

In the past, the service sector was largely considered impervious to international competition. For example, accountants could benefit from the cheaper imported manufactured goods that open trade allowed without fear that someone abroad would take their high-paying jobs. For this reason, service sector professionals were likely to be staunch supporters of open trade. With improvements in communication technology, such as the Internet, services can cross political borders. Jobs in fields ranging from architecture to radiology consequently seem much more at risk. Although firms were able to relocate abroad in the past, they had to give something up—their closeness to important markets, for example. With the new technologies, they can retain these links while also obtaining access to cheap but well-trained labor.

As a result, there does appear to be a backslide in support for free trade policies, particularly among white-collar workers. A study conducted by the University of Maryland found that, among individuals in the United States with incomes over $100,000, those actively supporting free trade slid from 57 percent in 1999 to 28 percent in January 2004. Furthermore, there has been a push in some industrial countries—for example, the United States and Australia—to introduce legislation that would limit the outsourcing activities of firms with government contracts. Given that little empirical work has been done to distinguish facts about outsourcing from exaggerated claims, we thought it would be useful to examine the trends in outsourcing and whether it really means job losses. On the whole, welfare
should improve, but in the process some groups or individuals could be made worse off. The finer the disaggregation of data in the analysis, the more likely we are to observe “winners” and “losers.” Drawing on the experiences of the United States and the United Kingdom, we can say that, in the aggregate, outsourcing does not appear to be leading to net job losses—that is, jobs lost in one industry often are offset by jobs created in other growing industries.

**Trade in services**

How extensive is service outsourcing? All the media hype would lead one to believe that service outsourcing is exploding. But the data reveal that, although service outsourcing has been steadily increasing globally, it is still at very low levels in industrial countries like the United States.

In its balance of payments statistics, the IMF reports imports of services, which include the categories that are most closely related to outsourcing—other business services and computing and information services. Other business services comprise accounting, management consulting, call centers, and other back-office operations; computing and information comprise hardware consultancy, software implementation, and data processing. According to these statistics, U.S. business service imports as a share of GDP have roughly doubled in each of the past several decades, from 0.1 percent in 1983 to 0.2 percent in 1993 and 0.4 percent in 2003 (see Chart 1). In the United Kingdom, the share is about 1 percent of GDP. India, reported to be the recipient of significant outsourcing, itself outsources a large amount of services. Its business services grew from 0.5 percent of GDP in 1983 to almost 2.5 percent of GDP in 2003.

In value terms, the United States is the largest importer of business services. But, as a proportion of GDP, trade in business services—like trade in goods—is low compared with that of the rest of the world. In smaller countries, trade generally accounts for a larger share of GDP. Among the top 10 outsourcers of business services are small developing countries, such as Angola, Republic of Congo, Mozambique, and Vanuatu (see table). The pattern is similar for imports of computing and information services. Among the top outsourcing countries in that category are Guyana and Namibia but also small developed countries, like Belgium and Sweden. This should not be surprising since industrial countries have the capacity to produce domestically a large proportion of the services they need, whereas many of the developing countries do not have this capacity.

**Chart 1**

**Who’s outsourcing?**

Known as a major recipient of outsourcing, India is also a large outsourcer of business services.

(Imports of business services as a percent of GDP)

Trade is a two-way street

Like trade in goods, trade in services is a two-way street. In addition to being a large importer of services, the United States is also a large exporter of services. The United States has a net surplus in all services, in contrast to its goods trade, in which it has a net deficit. In fact, the United Kingdom and the United States have the largest net surpluses in business services (see Chart 2) and hence would suffer the most in terms of the forgone dollar value of such trade if other countries cut service outsourcing.

But that is not true of all industrial countries. The data reveal no clear pattern of developing countries being net service exporters and industrial countries net service importers or vice versa. For example, in addition to the United Kingdom and the United States, India also has a large net deficit in business services. Indonesia has a large net deficit in business services, but so do Germany and Ireland.

Who’s trading with whom? Contrary to popular perception, most U.S. trade in services actually takes place with other industrial countries rather than with developing countries. Using statistics from the U.S. Bureau of Economic Analysis, we found that the share of imports of “private services” from developing countries to the United States is low. (The category “private services” comprises education, financial services, insurance, telecommunications, business, professional and technical services, and other services.) In 1992, only 28 percent of U.S. imports of private services came from developing countries. Although this share increased between 1992 and 2002, it still remains quite low at 32 percent; 68 percent of these service imports originate in other industrial countries. Interestingly, only a very small proportion comes from India. In 1992, imports of private services from India were only ½ of 1 percent of total U.S. imports of private services. In 2002, imports of private services from India to the United States increased to nearly 1 percent of total imports of these services. There was a larger increase in U.S. imports from India in business services—a subcategory of private services—which has been the focus of most of the media attention. They increased from 0.45 percent in 1992 to nearly 2 percent of total imports of business services in 2002. The largest supplier of private services to the United States is, in fact, Canada.

Similarly, the bulk of U.S. exports are destined for industrial countries. Only 39 percent of total U.S. exports of private services go to developing countries. This fraction remained relatively constant between 1992 and 2002.

U.S. and U.K. realities

Are more jobs disappearing than are being created as a result of outsourcing? To gain some insights, we studied the effects of foreign outsourcing of services on employment and labor productivity in U.S. industries between 1992 and 2001. The sample included all manufacturing services and five service industries for a total of 100.

Our results show that increases in service outsourcing in U.S. manufacturing and services sectors go hand in hand with greater labor productivity. Why might this be? This is

Top outsourcers

Small countries often outsource more business, computer, and information services as a share of their GDPS (2003).

<table>
<thead>
<tr>
<th>Country</th>
<th>Business services</th>
<th>Country</th>
<th>Computer and information services</th>
</tr>
</thead>
<tbody>
<tr>
<td>Angola</td>
<td>44.50</td>
<td>Luxembourg</td>
<td>1.06</td>
</tr>
<tr>
<td>Mozambique</td>
<td>34.74</td>
<td>Guyana</td>
<td>0.91</td>
</tr>
<tr>
<td>Congo, Republic of</td>
<td>21.55</td>
<td>Belgium</td>
<td>0.43</td>
</tr>
<tr>
<td>Mali</td>
<td>21.35</td>
<td>Croatia</td>
<td>0.43</td>
</tr>
<tr>
<td>Vanuatu</td>
<td>17.32</td>
<td>Sweden</td>
<td>0.42</td>
</tr>
<tr>
<td>Ireland</td>
<td>13.90</td>
<td>Ireland</td>
<td>0.39</td>
</tr>
<tr>
<td>Seychelles</td>
<td>11.78</td>
<td>Slovenia</td>
<td>0.36</td>
</tr>
<tr>
<td>Singapore</td>
<td>10.68</td>
<td>Cape Verde</td>
<td>0.34</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>8.57</td>
<td>Namibia</td>
<td>0.32</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>8.03</td>
<td>Hungary</td>
<td>0.29</td>
</tr>
</tbody>
</table>

likely due to firms relocating their least efficient parts of production to cheaper destinations. For manufacturing firms, the largest category of outsourced services is, indeed, business services. Even if outsourcing leads to some shedding of labor, the increased efficiency could lead to higher production and an expansion of employment in other lines of work. For example, a firm might let some employees go because it imports its information technology services but then, as it becomes more efficient, it may decide to expand its research and development department, thereby creating new jobs.

When jobs in one sector are outsourced, other sectors could also be affected. As firms that outsource become more efficient, they produce more cheaply and, hence, can provide inputs to other sectors at lower prices. This, in turn, lowers other firms’ costs, reducing their prices and leading to higher demand for their products. This higher demand could be met by the increased productivity of existing staff, or, if demand growth is sufficiently strong, it could lead to further job creation, which could, in principle, offset the direct job losses caused by outsourcing. Of course, there could be a change in the skill mix of jobs.

In the final analysis, outsourcing does not lead to net job losses. Rather, our results indicate that, when looking at finely disaggregated sectors, you find that only a small number of jobs are lost as a result of service outsourcing. For example, when disaggregating the U.S. economy to 450 industries, there is a small negative effect on employment. But aggregating up to 100 sectors, there were no job losses associated with service outsourcing. This implies that a worker could lose her job due to outsourcing but then she, or an unemployed worker, may find a job in another firm within the broader industry classification. Hence, aggregated data would indicate that there are no net job losses when there is sufficient job creation in another sector, which indeed seems to be the case.

Are these results applicable to European and other advanced economies? To answer that question, we did a case study of the United Kingdom, examining data for 78 sectors (69 manufacturing and 9 service), between 1995 and 2001, which was the most disaggregated data available. There, too, we found no evidence to support the notion that sectors with higher growth of service outsourcing would have a slower rate of job growth. In fact, no uniform pattern emerged between service outsourcing and employment growth. For example, the “other transport equipment” sector (which includes the manufacture of bicycles and railway) had the second highest growth in employment and one of the highest growth in service outsourcing. The “preparation and spinning of textile fibers” sector had the largest net surpluses in business services and hence would suffer the most in terms of the forgone dollar value of such trade if other countries cut service outsourcing. The United Kingdom and the United States have the largest net surpluses in business services and hence would suffer the most in terms of the forgone dollar value of such trade if other countries cut service outsourcing.

Outsourcing doesn't equal job losses

Although service outsourcing is growing rapidly, it still remains a small fraction of industrial countries’ GDP. And it is not dominated by lopsided, one-way outsourcing from developed to developing countries. In fact, most industrial countries do not outsource more (when adjusted for economic size) than many developing countries. The United States, for example, which is a large importer of business services, is also a large exporter of these services and, as has been noted, has a growing net surplus in business service trade.

As for fears about job loss, our studies show that jobs are not being exported, on net, from industrial countries to developing countries as a result of outsourcing. In fact, the evidence suggests that job losses in one industry often are offset by jobs created in other growing industries.

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References:


Financial Globalization
The impact on trade, policy, labor, and capital flows