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## Is financial globalization harmful for developing countries?

**W**ith the findings of a recent IMF staff study serving as a starting point, a panel of IMF staff and distinguished outside researchers on May 27 debated financial globalization's benefits and risks. Panelists were Eswar Prasad (IMF Asia and Pacific Department), Shang-Jin Wei (IMF Research Department)—two of the study's authors—and C. Fred Bergsten (Director, Institute for International Economics (IIE)), Jeffrey Frankel (Professor, Kennedy School of Government at Harvard University), and Daniel Tarullo (Professor, Georgetown University Law Center). Kenneth Rogoff (IMF Economic Counsellor and Director of the Research Department), also an author of the study, moderated. Participants suggested ways to contain the downsides of globalization; two of their recommendations—developing domestic financial sectors and strengthening institutions prior to liberalization—drew wide support.



Left to right: Eswar Prasad, C. Fred Bergsten, Shang-Jin Wei, and Kenneth Rogoff.

Since the mid-1980s, intensifying financial globalization has induced a surge of international capital flows, particularly from industrial to developing countries. These capital flows have been associated with high growth rates in some cases but also costly crises, particularly in *(Please turn to the following page)*

## Revisiting the fiscal deficit–inflation puzzle

**G**overnments that run persistent budget deficits must sooner or later finance those deficits through money creation, thus producing inflation. So says a well-

established macroeconomic theory, but empirical work has had little success proving this. A recent IMF Working Paper by Luis Catão and Marco E. Terrones of the IMF's Research Department reexamines this issue and finds evidence to support the theory. The authors talk with the IMF Survey about their findings.



Luis Catão (left) and Marco E. Terrones: "Fiscal rectitude helps keep inflation at bay, especially in developing countries with histories of chronic inflation."

**IMF SURVEY:** Macroeconomic theory tends to associate fiscal deficits with inflation. Why have most empirical studies been unable to uncover a strong connection between the two?

**CATÃO:** Most of your readers will probably find this as puzzling as we did when we started working on this topic. The inflation literature seems to suffer from a kind of split personality. Well-established theories postulate that fiscal deficits eventually lead to inflation. But living side by side with these well-established theories are empirical studies that show that there *(Please turn to page 156)*

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## How financial globalization affects growth



Kenneth S. Rogoff

(Continued from front page) emerging markets. Does this mean that, on balance, opening capital accounts to financial flows causes more harm than good? A recent IMF staff study “Effects of Financial Globalization on Developing Countries: Some Empirical Evidence,” undertook a systematic and critical examination of the evidence on this question (see *IMF Survey*, No 9, May 19).

In some quarters, the paper’s findings on financial globalization have been received as a revolutionary recantation of the IMF’s previous position. But Rogoff opened the forum by setting the record straight, reiterating that the study builds on work carried out by the Research Department and elsewhere over the past 20 years. As the IMF’s Eswar Prasad noted, capital account liberalization by itself will not deliver the benefits, or protect countries from the risks, of financial globalization. Development of the domestic financial sector and institutions is a crucial precondition. This is consistent with the message the IMF has always delivered.

### Assessing the impact

The IMF’s Shang-Jin Wei asked whether financial integration helps foster economic growth. In theory, he said, it can boost economic growth through direct channels (by augmenting domestic saving, reducing the cost of capital also through better risk allocation, transferring technologies, and developing financial sectors) as well as indirect channels (through specialization, inducement for better macroeconomic policies, and increased capital flows brought about by improved government policies). But empirical evidence, Wei added, has yet to verify this causal relationship. In fact, some countries have achieved fairly high growth rates without having opened their capital accounts in all dimensions, and other relatively financially integrated countries have failed to achieve high growth rates.

Recent studies suggest that most of the differences in per capita income across countries stems not from differences in capital-to-labor ratios but from differences in total factor productivity, which are strongly influenced by such variables as the degree of corruption, the rule of law, and the quality of financial supervisory and other institutions. This finding contrasts with most studies on trade integration, which find that it does indeed promote economic growth in developing countries.

Still, it is hard to argue with the facts that advanced countries tend to be financially open and that most developing countries, once they have gone down the

path of financial integration, seldom reverse course. This suggests that financial globalization may provide long-run gains but perhaps at the cost of some short-run pain, notably in the form of increased macroeconomic volatility.

Economic theory is ambiguous about the effect of financial integration on income volatility but predicts that financial integration should reduce consumption volatility. Reality, however, shows a strikingly different result, Prasad said. Their study found that, while consumption volatility in industrial and less financially integrated economies was less in the 1990s than in the 1980s, it increased both in absolute terms and relative to income volatility in the more financially integrated economies—precisely those that undertook financial integration. A possible explanation for this, Prasad observed, is a threshold effect. It may be that countries experience lower consumption volatility only beyond a certain level of financial integration.

### Policy prescriptions

Given that some degree of financial globalization is inevitable, the panel concentrated on offering policy-makers some suggestions on what could be done to harness financial integration’s benefits and minimize the frequency and severity of the most severe manifestations of volatility—namely, financial crises.

**Liberalize financial sectors first.** The IIE’s Fred Bergsten suggested that more attention be paid to development of the domestic financial sector in developing countries. He argued that the IMF’s findings were “curiously unsatisfying” because the study had, in fact, “misspecified the issue.” It is more fruitful, he suggested, to differentiate between financial sector and capital account liberalization. Financial sector liberalization, he hypothesized, is much more important for growth and development, and this has a number of policy implications.

The financial sector can be opened to foreign participation, for example, without necessarily opening up the economy to capital flows. At a minimum, Bergsten added, financial sector liberalization should precede capital account liberalization, and countries should perhaps even confine themselves to liberalizing the financial sector for an extended period of time before opening up their capital account. This is what China seems to be doing, with some good results.

According to Bergsten, however, in recent years the U.S. government seems to have muddied this issue. He cited free trade agreements negotiated between the United States and Chile and Singapore, in which the U.S. government insisted not only on



C. Fred Bergsten



Jeffrey Frankel

opening up the financial sector, which is appropriate for a trade agreement, but also on liberalization of their capital accounts, which is extraneous to the trade deal and not necessarily of benefit to the countries involved.

**Employ compensatory policies.** Bergsten also added that a number of Asian and other emerging market economies have instituted a range of compensatory policy changes that would help them avoid, or respond more effectively to, 1990s-style crises driven by capital flow reversals. The most important of these have been greater exchange rate flexibility and large increases in holdings of foreign exchange reserves. Certainly, Rogoff said, hasty and perhaps premature capital account liberalization contributed to the Asian crisis, but had these countries adopted a flexible exchange rate before the turbulence began, it could have resulted in a mini, rather than a maxi, crisis.

**Tinker at the margins.** Financial markets are like superhighways, Jeffrey Frankel of Harvard University observed. Although they get you where you want to go more rapidly, you can, of course, have nasty accidents. On balance, the superhighways are worthwhile. But do we come out ahead with financial integration? We do, Frankel and Wei suggested, if we take safety precautions. Both stressed the value of good governance. And Frankel also emphasized the importance of transparency and the supervision of banks and the financial system, adding that reforms in these areas should take place ahead of financial liberalization.

There can be real problems, Frankel cautioned, if superhighways' exit ramps simply dump traffic into a village where the roads are not yet paved.

In addition, Frankel suggested that policymakers should allow "some tinkering at the margins"—for example, Chilean-style restrictions on capital inflows or Malaysian-style controls on capital outflows—and encourage competition in the domestic financial system from foreign banks and other financial institutions. He also urged countries to keep a close eye on the composition of capital flows. If these flows are short term, intermediated through banks, and denominated in foreign currencies, they are much more likely to lead to a crisis than if they are long term, denominated in domestic currency, and in the form of foreign direct investment.

Also high on Frankel's list of recommended actions is countercyclical fiscal policy. Many emerging market countries, particularly in Latin America, pursue procyclical fiscal policies. When their economies and tax revenues boom, they spend a lot more. In recessions, policymakers then find themselves with no choice but to cut back sharply, which makes the downturn worse.

**Introduce interim regulations.** Daniel Tarullo of Georgetown University took a different tack, suggesting that policymakers take another look at the challenges associated with the "transition in legal regime"—that is, significant changes in applicable laws or enforcement of those laws, or significant changes in private actor capabilities or propensities that change, in major ways, the outcomes of the application of existing laws.

Successful capital account and financial sector liberalizations entail multiple stages that usually call for different sets of regulatory approaches before, during, and after. Failure to tailor these regulatory approaches may, Tarullo said, cause a country to endure unnecessary pain in the short term or even retard its move toward the desired state.

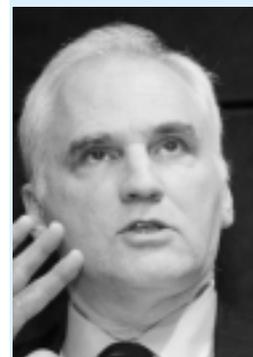
Because problems and likely market responses will differ substantially depending on the particular legal and market context, it is very difficult to develop generalized prescriptions. The imposition of fairly inflexible rules, such as the complete elimination of capital controls, surely seems misguided. Furthermore, problems may have a range of solutions, calling into question the application of "best practices." He cited the Basle Accord II as an example of best practices that are currently being promulgated but may not be best practices for all countries, particularly for emerging markets.

### Future trends

Looking further ahead, Prasad noted that demographic developments, particularly the aging of industrial country populations, could lead to a resumption of capital flows to the developing countries because of pressure on pension managers to place funds where the return to capital is high—that is, in developing countries, which are typically capital-poor.

Bergsten, on the other hand, speculated that in 10 to 20 years, economists may be analyzing the impact of capital flows from emerging markets to the industrial countries as population aging leads to bigger budget deficits and, perhaps, external deficits. The United States, for one, is already heavily dependent on capital inflows, to the tune of half a trillion dollars or so a year—much of it coming from emerging markets. ■

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Daniel Tarullo



Eswar Prasad



Shang-Jin Wei