UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

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No. 167
January 2004

DISCUSSION PAPERS

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UNCTAD/OSG/DP/2004/1

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JEL classification: F15, F36, F43, O10, O15

GLOBALIZATION RELOADED: AN UNCTAD PERSPECTIVE

Richard Kozul-Wright and Paul Rayment

Abstract

This paper rejects the characterization of globalization as an autonomous and irresistible process driven by the impersonal forces of the market and technical progress. Whether domestic or global, market forces are shaped and controlled by policy choices and the institutional frameworks in which they are made. In the absence of adequate institutional frameworks and productive capacities, rapid liberalization is as likely to lead to stagnation and unemployment as to growth and rising incomes per head. We show that the major economic forces presumed to be crucial for spreading the benefits of globalization have been less global than often presented, have proved to be much weaker than widely predicted and carry potentially damaging effects as well as benefits. Accordingly, and without denying that by the late 1970s many developing countries needed to find new ways of inserting themselves into the international economy, we argue that the new policy orientation of macroeconomic stringency, downsizing the public sector and the rapid opening of developing country markets to foreign trade and capital after the debt crisis, has failed to produce an economic environment that supports faster economic growth and strengthens productivity performance. In suggesting the outlines of a more strategic approach to economic development the emphasis is on the need for domestic investment to be mobilized as the basis for industrialization and for a gradual approach to integration with the global economy.

I. Introduction: Globalization in Context

The idea of globalization as a process rather than just an alternative term for the aggregation of cross-border interactions of one kind or another seems to have emerged in the early 1960s. But as a catch-all term to describe what was felt to be a new and encompassing economic reality, it has only really come into fashion in the wake of the neo-liberal policy agenda first introduced in the United States and the United Kingdom in the early 1980s which then spread, somewhat fitfully, to other OECD members over the remainder of the decade. In many parts of the developing world the debt crisis of the 1980s was a major catalyst of similar policy changes, while the collapse of the Berlin Wall gave this agenda a truly global reach.[1]

In the wake of these developments, and in combination with a revolution in information technology, which greatly reduced the costs of information processing and international communications, and the growing influence of transnational corporations (TNCs), the progressive liberalization of trade, under way since World War II, was accelerated and amplified. Multilateral trade negotiations launched under the Uruguay Round in the mid-1980s added further momentum and more importantly extended the liberalization agenda to new areas. However, trade has not been the only force, or even the most significant, recasting international economic relations over the past two decades. The deregulation of financial markets in the 1970s and the subsequent and considerable increase in capital mobility has been a more striking feature of economic globalization and the one that marks the sharpest break with the international policy framework that was in place from the end of World War II until the collapse of the Bretton Woods regime some thirty years later. That collapse, and the shift by the advanced industrial economies to floating exchange rate regimes, created significant arbitrage opportunities for international capital and encouraged a proliferation of new financial instruments to hedge against exchange rate risks. Simultaneously, concerted and rapid moves to deregulate financial markets and open the capital account led to the dismantling of legal and other obstacles to cross-border flows of capital.

There is little doubt that the combination of freer trade, technological progress and increased capital mobility has intensified international competition and increased the interdependence of national economies to the point where none can ignore the influence of events and policies in other parts of the globe. But running across much of the debate on globalization is a presumption that the direction set for the world economy points to a radically new future, where firms and financial institutions operate transnationally, i.e. outside the confines of national boundaries, where factors of production and financial assets are almost perfect substitutes everywhere and where it would be no longer possible to consider states as distinct economic entities with autonomous decision-making power in the pursuit of national objectives. In such a truly global market economy the prices of goods, factors of production, equities and interest rates in different national markets would converge, and policies in individual countries would be designed as if they were part of the same political unit. Core economic institutional forms would also converge on a standardized pattern compatible with the pressures of unhindered market competition and "public" goods needed to maintain this open market system, such as a stable

[1] McLuhan (1960, 1962) coined the term "global village" to describe the power of television and electronic media to make knowledge of events and ideas simultaneously available across the globe. According to Temin (1999: 76) the Oxford English Dictionary also dates the first usage of the term in the early 1960s. However, using citations from the New York Times as his measure, Fischer (2003) found that the term globalization was absent in the 1970s, became more frequent in the 1980s but only really captured the debate on the direction of international economic relations in the 1990s.

monetary system, would also become a global responsibility. A second presumption is that all this is as desirable as it is unstoppable; in particular, the combination of openness and technological progress promises to truly level the global economy, as incomes converge rapidly thanks to faster growth in the world's poorer countries.

While some have boldly pronounced an end to history and geography, more sober contributors recognize that a terminal point in international economic relations has not yet been reached. Indeed, a good deal of the conventional economic discussion is taken up with identifying possible sources of resistance to globalization, whether through ill-conceived policy choices or from potential losers in that process, and devising effective policy responses and the best sequence of reforms (Williamson, 2002).[2] In this respect, the pursuit of policy conformity has been a prominent, and on many accounts the key feature of globalization in the last two decades or so.[3] Global policy making is conducted for the most part in the Bretton Woods institutions – the World Bank and the International Monetary Fund (IMF) – and the World Trade Organization (WTO), which have seen a considerable extension of their surveillance over domestic policy makers and a strengthening of their disciplinary measures. Consequently, the authority of these institutions has been greatly extended in recent years to areas previously considered the preserve of national governments (Kapur and Webb, 2000). Thus, countries seeking financial aid or debt re-scheduling from the Bank or the IMF must now not only adopt approved macroeconomic stability programmes but also agree to "structural" and political reforms which extend the influence of markets – via liberalization, privatization, deregulation etc. – and reduce the economic role of the state. Similarly, the Uruguay Round of trade negotiations extended the authority of the WTO far beyond the domain of its predecessor, the GATT, to embrace services, agriculture, intellectual property and trade-related investment measures. WTO members which fail to align their domestic laws and arrangements with WTO agreements may be subject to sanctions on their exports (Shukla, 2002). These institutions, and to a lesser extent the OECD, have become the principal vector for diffusing neo-liberal economic policies.[4]

Emphasizing the role of policies, and of the international economic institutions in promoting one set rather than another, is an important counterweight to the view of globalization as an autonomous, irresistible and irreversible process driven by the impersonal forces of the market and technical progress. The latter are undoubtedly important, but essentially they are released and shaped by selective policy choices and the institutional framework in which they operate; the latter providing both incentives for preferred outcomes and sanctions for the undesirable. It is a dangerous delusion to think of the global economy as some sort of "natural" system with a logic of its own: It is, and always

[2] For a taste of bolder pronouncements on globalization see Fukuyama, 1989; O`Brien, 1992 and Giddens, 2002.

[3] See the various papers in Toye, 2003, especially the introduction.

[4] The new policy course had its antecedents in the work of a generation of more liberally-minded development economists who resisted the dirigiste turn after World War II. This was particularly true for trade economists working in the World Bank (Toye, 1989 and Edwards, 1992). More recently, these policies have been developed and diffused under the rubric of a so-called "Washington Consensus" on economic policy, initially designed to correct specific economic imbalances in Latin America after the debt crisis. While some contest the link, it is difficult to separate the debate triggered by the "rights" and "wrongs" of this approach to the wider globalization discussion (Stiglitz, 1998a and 1998b, 2002, and Williamson, 2000, 2002). The influence of the advanced countries, and particularly the most powerful, in recasting development policy, including through their grip over the Bretton Woods institutions, was frankly acknowledged by the former United States Secretary of State, Dr. Henry Kissinger when he observed that "what is called globalization is really another name for the dominant role of the United States" (Kissinger, 1999). Irma Adelman remarks that had the Washington Consensus been imposed on South-East Asian countries during the period from the 1950s to the early seventies "there would not have been an East Asian miracle" is a reminder of the centrality of this experience to much of the policy debate on development strategies in a globalizing world (quoted in Rayment, 2002).

has been, the outcome of a complex interplay of economic and political relations in which one or two major powers have usually been dominant.

Recently, the unanticipated consequences of such complexity have eroded some of the earlier confidence in a rapid and uniform pattern of liberalization. A more nuanced account of market-driven globalization has begun to emerge with a stress on institution building and more room for qualified policy outcomes; even accepting the "higher-order economic principles" behind market-oriented globalization this has turned the emphasis of debate away from inevitability and uniformity towards feasibility and diversity (Rodrik, 2002, 2003). And just as there are differences about the nature of market-driven globalization, there are also diverse critics and opponents of what is perceived to be the present structure of the world economy and the policies that are believed to have produced it. Since some of these critics reject economic integration altogether and would also like to dismantle the existing structures of international economic institutions, it will be useful at the outset to sketch the broad lines of our critique, leaving more detailed discussion until later. Four basic principles underpin the subsequent analysis in this paper:

First, the potential benefits of increased trade and foreign investment, and of greater integration with the world economy in general are recognized, but the actual experience of the last two to three decades suggests that they will not be realized by simply unleashing market forces on the developing economies. This is, in part, because many of these economies lack the institutional and productive capacities to respond quickly to the opportunities created by greater openness to world markets and to cope with the competition from more developed economies. But it is also because one-dimensional and technocratic approaches to the design of market-friendly development strategies fail to prepare policy makers for the difficult choices and trade-offs facing most developing-country governments in a more interdependent world.

Secondly, while there is no disputing that international trade and factor movements have increased considerably in the wake of liberalization over the last two decades, there can be no presumption that the trend is synonymous with a less distortionary economic environment facing developing countries. In fact, the process has been highly selective and has progressed on terms dictated by the developed countries: International trade in goods has been greatly liberalized but the exceptions (agriculture and food products, textiles, clothing and a range of labour-intensive products) favour vested interests in the developed countries; international financial markets are liberalized but the free movement of labour is greatly restricted; and the agenda for further liberalization, covering a wide range of "trade-related" matters in the WTO for example, is again largely driven by developed country interests.

Thirdly, and given existing biases and asymmetries in international economic relations, moves towards a more open and integrated economic space are just as likely to reinforce as they are to diminish the gaps between developed and developing countries. In particular, the capacity to respond to liberalization favours the already developed countries, which, because of first-mover advantages, economies of scale and learning capabilities, are able to acquire and reinforce dominant positions in developing country markets. Implicit in our approach is the idea that economies are subject to processes of cumulative and circular causation: whether global market forces establish a virtuous circle where domestic economic growth and integration into the global economy reinforce one another; or a vicious one where the exposed economy falls further behind, will depend on the initial conditions at the time of exposure and the effective design and implementation of policy to manage the integration process. In the presence of cumulative processes of growth there can no longer be any presumption that free trade and capital will benefit all participating countries.

Finally, and following from the previous points, in a world where growth and development prospects hinge on an uncertain mixture of (unbalanced) global market forces and (varied) local productive capacities and experiences, institutional diversity and policy experimentation will be key in establishing a more virtuous blend of economic forces. While in a more closely interdependent world such blending is likely to be a richer process than in the past, institution-building and the incentive, regulatory and coordination structures required to encourage productive investment, manage structural changes and facilitate integration with the global economy will have to maintain a strongly national dimension in which the State, far from becoming a diminished player, has a major role to play. This is not to defend the many misguided interventions by the State in the past or to downplay the need for competent administration and effective government, but it does mean the transformation of the institutions of the State in order for it to play a key role – not the marginal one envisaged in the neo-liberal agenda – in the development and integration process.

Inevitably, the number of potential issues that might be discussed under the heading of "globalization" is large: they include such topics as crime, international migration, public health, culture, the environment, and so on. Many of these are interrelated and many will be directly influenced by the economic variables discussed in this paper. However, while many of the criticisms of market-driven globalization have been concerned with a weak or missing social dimension, the central focus of this paper is on its faulty economics. The paper is organized as follows: the next two sections will set out the main elements of an alternative interpretation of developments in two key areas of the globalization process, namely international trade and the international capital markets. These are followed by a brief assessment of the extent to which the processes of liberalization have actually contributed to improved economic performance and, in particular, to a relative improvement of per capita incomes in the developing countries, and how far the term "global economy" is really an accurate description of current international economic relations. The final section draws together the various policy proposals emerging from this analysis of developments over the last two decades, and which fall into two broad groups: those for strengthening national strategies for development and those for reforming the global policy framework.

II. Trade and the Global Economy

A. The liberalization of international trade

Trade liberalization, or the process of moving towards a system of unrestricted cross-border flows of goods and services, has always been one of the principal tenets of economic liberalism and since the late 1970s has been regarded as one of the pillars of globalization. The standard argument in favour of free trade is that by specializing according to their comparative advantage, countries reap efficiency gains from moving to a better allocation of existing resources, with the optimal re-allocation brought about by the stimulus of increased competition to domestic enterprises. In this respect, the immediate push for trade liberalization in developing countries following the debt crisis of the early 1980s was initially seen as a way to correct the widespread failure of many developing countries to create competitive enterprises behind high levels of import protection.[5]

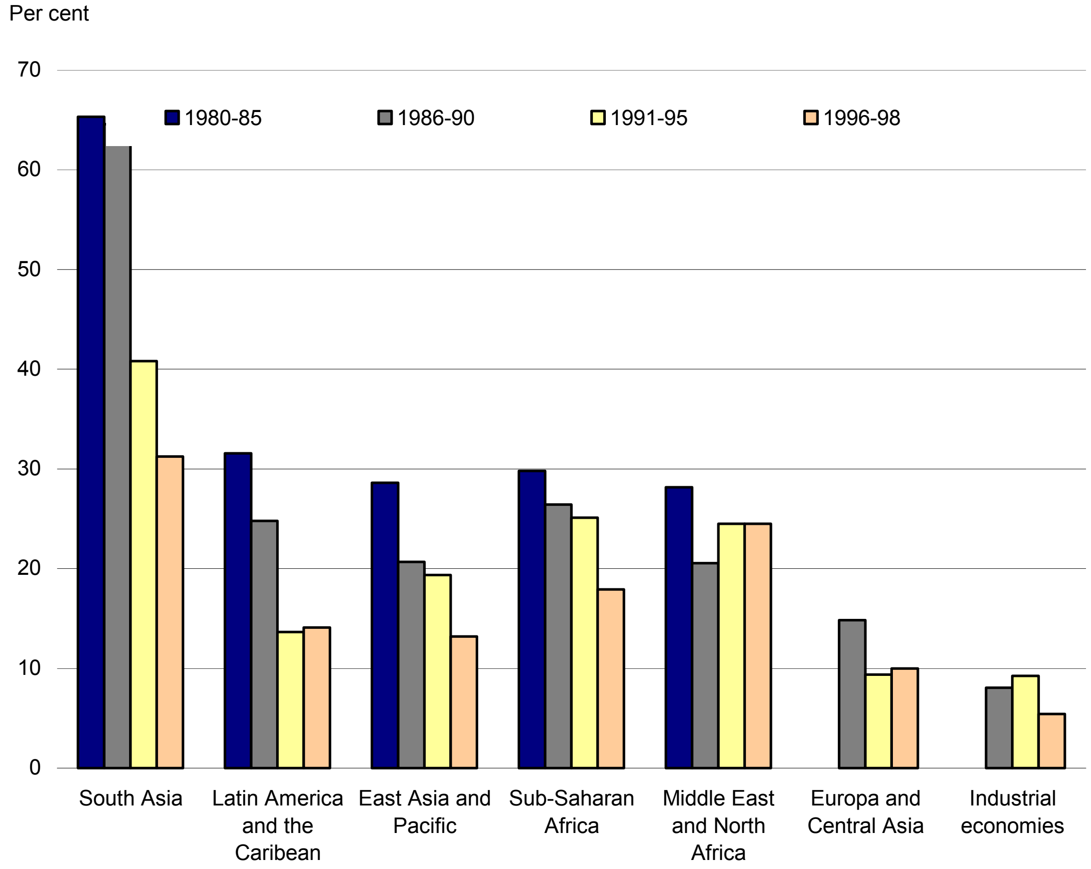
However, the arguments for trade liberalization also place considerable emphasis on the dynamic gains to be had from economies of scale, from an expansion of learning-by-doing and from an increasingly fine division of labour, which are made possible by an enlargement of the potential market facing individual countries. Indeed, many advocates of free trade see this as the principal route by which the developing countries can reestablish an investment-friendly climate and sustain faster rates of economic growth (Bhagwati and Srinivasan, 1999: 31–32; Stern, 2001). From this perspective, trade liberalization should improve the quality of investment through heightened competition and the import of more productive technologies. But a more indirect link has also been stressed through attracting FDI and hosting TNCs, whereby improvements to the investment climate in developing countries come with their integration into a more complex vertical division of labour spread across the globe (World Bank, 2003). From this perspective, rapid liberalization of trade, accompanied by the more or less simultaneous freeing of international capital flows, would enable developing countries to overcome the constraints they face on fixed investment and economic growth: their exposure to increased competition would boost efficiency and competitiveness which in turn would underpin a more rapid growth of export earnings to pay for necessary imports of capital goods and intermediate inputs. This process would be further strengthened by increased flows of FDI (with their accompanying package of technology, skills and other productive assets) attracted by the greater openness of the developing countries and their better prospects for economic growth. The promise of rapid trade liberalization is thus the establishment of an "export-investment nexus" involving a positive and cumulative interaction between the two in which exports, domestic saving and fixed investment would all be rising, both absolutely and in relation to GDP.[6]

General and rapid trade liberalization in the developing countries began in the mid-1980s (chart 1), and although the rhetoric propelling this shift emphasized "global interests" and the prospect of positive-sum outcomes it was largely driven by developments in the industrialized market economies, and especially by TNCs seeking to enlarge their markets and exploit the new information technologies which increased their ability to coordinate activities over ever larger geographic distances. This combination of a belief in the efficiency gains from trade with the interests of the corporate sectors of the developed world helps to explain why three-quarters or so of the World Bank's Structural Adjustment Loans (SALs) included demands for trade policy reform, and why similar conditions were attached to IMF stabilization programmes.

[5] This approach was supported, for example, by a seven-volume study by the World Bank which was convinced that the benefits of open trading had been "sufficiently demonstrated and described by economic historians and analysts" (Papageorgiu et al., (1991). In fact it is by no means clear that trade analysis or history provides such a clear endorsement, nor that the benefits of free trade have been "sufficiently demonstrated" by this study: In a careful review, it was pointed out that the considerable diversity of developing country experience did not support the "extravagant" claims made for the generality of the study's conclusions (Greenaway, 1993; and references in footnote 20).

[6] It is worth noting at the outset that including this nexus sits awkwardly with the conventional theory of free trade, which tends to treat monopolistic power and dynamic scale economies as examples of "market failure", and to prescribe a narrow policy agenda confined to the pace and scale of liberalization measures. Ocampo (1993: 122) has noted that the new theoretical contributions "have had little impact on prevailing orthodoxies regarding trade liberalization and industrial restructuring in developing countries. In view of the influence that this type of analysis has had on the structural adjustment programmes of the World Bank, this aloofness is both surprising and problematic. The usual recommendation to create neutral trade incentives and to adopt laissez-faire industrial policy, in particular, clearly conflict with the conclusions derived from these new theories" (see also Gomery and Baumol, 2000). The efforts, by proponents of conventional trade theory, to find consistency between "new" trade theories and "old" trade policies have usually resorted to ad hoc institutional comparisons of the relative cost of government failures (Kreuger, 1997 and Krugman, 1990).

Chart 1
Changes in average unweighted tariffs by region, 1980–1998

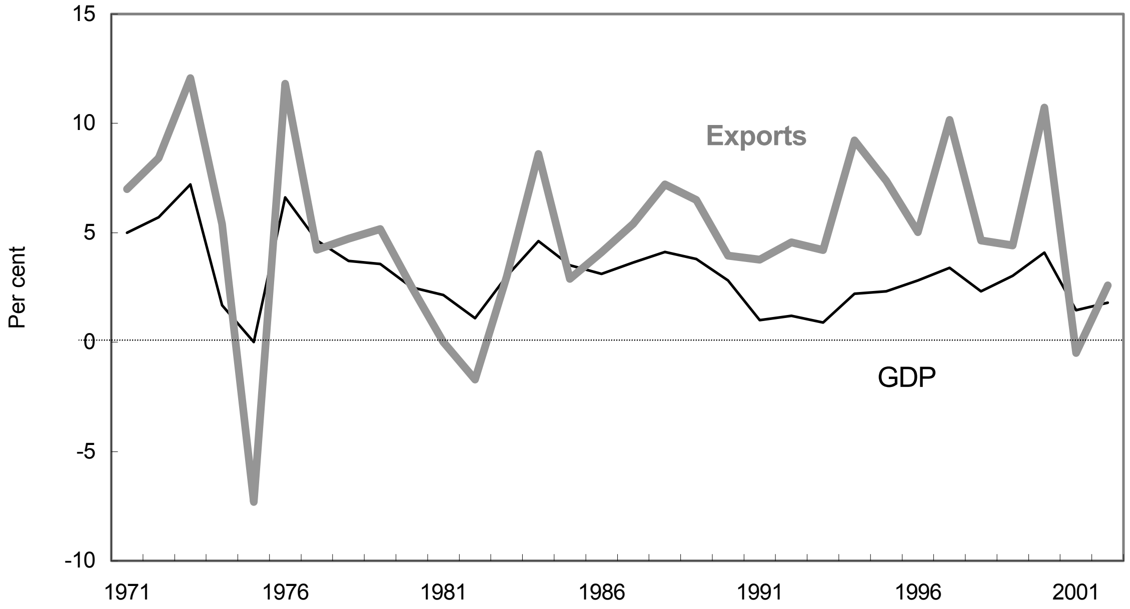


Source: World Bank and World Trade Organization data.

A faster pace of liberalization since the mid-1980s has coincided with international trade growing more rapidly than output, both globally and for developing countries (chart 2). In the latter, merchandise exports grew on average by over 10 per cent per annum between 1985 and 2000.[7] Moreover, trade among the developing countries themselves has also become more important, rising from just over 20 per cent in the mid-1970s to just below 40 per cent by the end of the 1990s. This growth in developing country exports has been accompanied by large changes in their structure (chart 3). The share of agricultural products in the total has halved, from about 20 per cent at the end of the 1970s, and that of minerals and oil has also fallen although with greater fluctuations due to the greater instability of prices (especially of oil). The significant change from the point of view of longer-run development prospects has been the considerable rise in the importance of manufactures, from some 20 per cent in the decade or so to the early 1980s to around 70 per cent by the end of the 1990s. This rapid growth of manufactures has been closely linked to the integration of many developing countries into the international production networks of TNCs, within which parts of the same final product may cross and re-cross national boundaries more than once, contributing to the expansion of

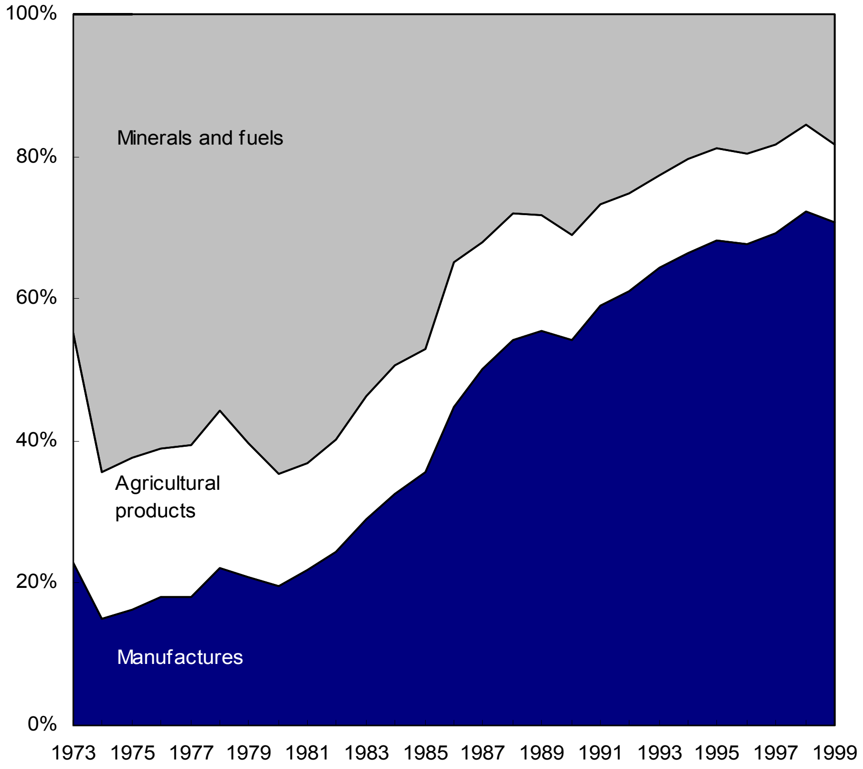
[7] This was true for every year between 1985 and 2000, with the growth in trade exceeding that of output by as much as 7 percentage points in some years (UNCTAD 2003: 45). A similar differential also marked the 1960s and early 1970s.

Chart 2
Changes in the volume of world merchandise exports and real GDP, 1971–2002
(Per cent change over previous year)



Source: UNCTAD *Trade and Development Report, 2003*.

Chart 3
Composition of merchandise exports from developing countries, by major product group, 1973–1999



Source: United Nations *Monthly Bulletin of Statistics* database.

intra-industry trade and somewhat inflating the gross values of global trade.[8] There also appears to have been positive results insofar as the shares of medium- and high-skill and technology-intensive products in developing countries' exports have risen sharply – from just under 20 per cent in 1980 to nearly 50 per cent by 1998, their share of world exports of the same product categories rising from under 47 per cent to nearly 60 per cent. Thus developing countries appear to have succeeded in moving into some of the most dynamic product categories in world trade, notably computing and office equipment; telecommunications; audio and video equipment; semi-conductors; and clothing.[9]

On the face of it, trade liberalization since the mid-1980s seems to have strengthened a number of the conditions widely regarded as essential for sustained growth and closing the income gaps with the industrialized countries. But a closer look at what lies behind these aggregate developments reveals a more complex and less encouraging picture. First, there are many countries, especially in Africa, which are still largely or heavily dependent on primary commodities and these, with some exceptions, facing relatively stagnant markets and declining terms of trade, are being increasingly marginalized in world trade. Moreover, in a number of middle-income countries, particularly in Latin America, the shift away from commodity exports has slowed in recent years, or in some cases even reversed, leaving such exports accounting for a high share of their overall trade (table 1).

Secondly, the rise of manufacturing exports from developing countries over the past two decades has been very heavily concentrated in the East Asian NIEs, and in resource-based or unskilled labour-intensive products. In principle, this is a sensible strategy in the early days of development when there are reserves of surplus labour to be absorbed, as it can provide the basis for the rapid development of manufacturing capacity. The strategy, however, faces a number of systemic constraints which appear to be tightening for the current generation of exporters. Most of the markets for labour-intensive manufactures are slow-growing and so a rapid growth of exports is only possible for an individual country if it can increase its share of world markets. But this is difficult for two reasons. In the first place, exports of these products are still restrained by significant trade barriers in the developed countries including quotas, tariff peaks (i.e. rates above 15 per cent for imports defined at the 6-digit level of the Harmonized System), high rates of tariff escalation or effective protection, anti-dumping actions and other forms of contingent protection, as well as a variety of new barriers relating to labour and environmental standards. The products most affected by such restrictions include textiles, clothing, footwear, leather and leather goods, and travel goods. No great improvement in this respect emerged from the Uruguay Round (Finger and Scuknecht, 1999; Finger and Nogues, 2001).

[8] Although such trade is often presented as a characteristic feature of contemporary globalization, it was a feature of trade among the industrial countries throughout the post-World War II era, and probably before (Rayment, 1983 and Bairoch and Kozul-Wright, 1999).

[9] See further UNCTAD, 2002, chapter III. For the *medium* skill and technology categories the shares in developing country exports were 8.2 and 16.8 per cent in the same two end-years, and of world exports 26.4 and 29.6 per cent. For the *high* skill and technology categories the shares were 11.6 and 31 per cent and 20.2 and 30.2 per cent, respectively.

Table 1
Commodity structure of exports from selected developing economies, 1980–2000
(Percentage of total non-oil exports)

		Argentina		*Brazil*		*Chile*		*Colombia*		*Mexico*	
Commodity group		*1980*	*2000*	*1980*	*2000*	*1980*	*2000*	*1980*	*2000*	*1980*	*2000*
Group I		76.0	59.9	60.3	39.8	91.4	83.8	79.6	43.0	40.6	7.5
	Food	51.7	39.9	40.2	17.4	17.0	21.9	73.5	32.2	21.2	4.3
	Non-ferrous metals	1.8	1.9	0.5	3.3	51.8	29.9	0.1	0.7	6.3	0.9
	Other primary commodities	22.6	18.1	19.6	19.0	22.6	32.1	6.1	10.1	13.1	2.3
Group II		8.7	8.8	9.4	12.9	1.8	5.2	13.2	22.1	8.7	12.8
Group III		3.1	4.9	6.4	8.6	2.0	1.4	1.3	6.2	2.2	4.5
Group IV		5.4	14.9	15.0	19.3	0.9	3.0	2.5	8.6	19.4	43.6
Group V		6.7	11.1	8.3	18.8	4.0	6.3	2.8	18.7	24.9	29.3

		Cõte d'Ivoire		*Morocco*		*Turkey*		*Egypt*		*Ghana*	
Commodity group		*1980*	*2000*	*1980*	*2000*	*1980*	*2000*	*1980*	*2000*	*1980*	*2000*
Group I		93.3	81.6	75.3	33.5	70.6	16.9	69.6	36.3	98.4	84.0
	Food	60.8	61.5	28.2	22.1	41.4	10.7	18.4	13.5	78.3	49.5
	Non-ferrous metals	0.0	0.0	2.1	1.5	0.6	1.4	2.1	5.8	14.0	15.6
	Other primary commodities	32.5	20.1	45.0	9.9	28.7	4.8	49.1	17.0	6.2	18.9
Group II		3.2	8.8	12.8	39.8	22.2	44.2	26.5	36.9	0.6	9.0
Group III		0.5	1.4	0.2	1.0	1.4	9.9	1.9	5.3	0.2	1.1
Group IV		1.6	2.6	0.6	4.7	3.0	16.4	0.1	5.5	0.2	4.3
Group V		1.4	5.2	10.8	20.4	2.4	10.3	1.7	13.1	0.5	1.3

		Republic of Korea		Taiwan Province of China		Malaysia		China		India	
Commodity group		*1980*	*2000*	*1980*	*2000*	*1980*	*2000*	*1980*	*2000*	*1980*	*2000*
Group I		9.9	4.0	10.7	3.6	74.9	10.3	..	8.7	40.9	18.9
	Food	6.7	1.5	8.7	1.2	4.8	1.9	..	5.1	25.2	12.9
	Non-ferrous metals	0.5	1.2	0.3	1.1	12.0	1.0	..	1.4	0.2	0.7
	Other primary commodities	2.7	1.3	1.8	1.3	58.1	7.3	..	2.2	15.5	5.3
Group II		42.5	14.8	40.6	14.1	6.7	9.3	..	33.2	38.5	52.6
Group III		19.1	11.5	8.6	10.5	0.7	1.9	..	8.4	5.7	6.6
Group IV		8.2	21.5	12.3	19.5	3.0	10.9	..	15.7	7.0	6.6
Group V		16.8	46.3	18.6	48.2	14.3	66.1	..	26.2	5.1	11.7

Source: UNCTAD secretariat calculations based on United Nations Commodity Trade Statistics tapes; and estimates by the United Nations Statistical Office.

Note: Total non-oil exports refer to SITC sections 0–8, less section 3. ***Group I*** refers to primary commodities; ***Group II*** to labour-intensive and resource-based manufactures; ***Group III*** to low-skill and technology-intensive manufactures; ***Group IV*** to medium-skill and technology-intensive manufactures; and ***Group V*** to high-skill and technology-intensive manufactures (see further UNCTAD 2002, chapter 3).

Another major problem is that the more countries seek to diversify from primary commodities by switching into labour-intensive manufactures, the greater is the risk of a “fallacy of composition”, that is, a strategy or action that is sensible for any single country may cease to be so if everyone adopts it. On its own a small country can rapidly expand its exports in a given market with negligible impact on overall supply and prices – the “importance of being unimportant” – but once a large number of countries, or just a few large economies (such as India and China) follow the same route there will be an increased risk of oversupply, declining terms of trade for the exporters, and of increased protectionist pressure in the importing countries. In several respects the markets for many labour-intensive products have come to resemble those for primary products on which the developing countries have been seeking to reduce their dependence: that is, they consist increasingly of internationally standardized goods, often tradeable at arm’s length, tending to oversupply in highly competitive markets with declining price trends, which, in some cases such as electronic goods, are more volatile than those for similar goods traded among the developed countries. Indeed, such a process seems to be already visible in the terms of trade of those developing countries most dependent on exports of manufactures. These have been falling by about 1 per cent a year since the early 1980s, and in trade with the European Union the net barter terms of trade of developing countries’ manufactures have fallen much faster. [10]

These pressures appear to be particularly intense in some middle-income countries, caught between relatively high wage and relatively low productivity levels. In many Latin American countries, weak investment has stunted productivity growth and upgrading in recent years, and particularly in the more labour-intensive industries, such as textiles and clothing, where the pressure from low-cost producers elsewhere has increased sharply. Consequently, the rapid opening up to international competition and FDI has tended to shift production structures away from sectors with the greatest potential for productivity growth and technological dynamism towards those producing or processing resources for more static markets.

Thirdly, diversifying into manufactures by joining international production networks in anticipation of establishing higher value-added activities, for which global demand is more dynamic and market access easier, also faces serious constraints. In the first place, the apparent change in the structure of exports by factor intensity, which is often implied by the higher skill content of the goods produced in these networks, is misleading as for the most part developing countries’ involvement in skill and technology intensive products is confined to the labour-intensive parts, frequently just assembly, of

[10] For empirical evidence of these trends, see UNCTAD, 1993, 1999 2002, Maizels, et al., 1998 and Maizels, 2000. The Prebisch-Singer hypothesis, on which all such empirical work builds, was that technical progress in the developed countries led to higher wages and living standards of those employed but not to lower prices, including those for goods exported to developing countries; in contrast, in the developing countries increased productivity tended to result in lower prices for the goods exported to developed countries rather than to better real wages. Hence, there was a secular tendency for the terms of trade to move against developing countries and especially for those exporting primary products. The general pre-war evidence on which Prebisch built his initial argument is still the subject of dispute (Bairoch, 1993; Hadass and Williamson, 2001; Blattman et al., 2003). More specific evidence in support of this argument has been found for a range of agricultural and mineral products and is behind the policy advice to diversify from primary commodities to manufactures, which were presumed to face higher price and income elasticities of demand.

vertically integrated production systems.[11] This is not necessarily a problem where, in the early stages of development, such integration with international production networks can help to raise employment and incomes and widen the range of activities from which a broad-based pattern of growth can be launched. But there is a very real risk that such FDI may lead to manufacturing enclaves with few, if any, backward linkages to the rest of the domestic economy. Indeed, without significant spillovers from TNCs to the rest of the economy, the transition to a more skill-intensive and sustained pattern of industrial growth is unlikely to occur. However, the kinds of spillovers that developing countries need and which are often promised, namely technology, skills, a range of know-how etc., are precisely those which the TNC will seek to preserve within the enterprise as these are the sources of its competitive advantage. It will be the more able to do this when barriers to entry are high, not least because of the costs of managing and co-ordinating complex production networks, when intellectual and other property rights are strongly protected, and when the capacity of local enterprises to absorb know-how and skills from TNCs is limited or non-existent.[12]

The available evidence shows that competition has heightened markedly in those labour-intensive sectors where developing countries have become significant exporters and that increases in the developing countries' share of world manufactured exports have not been matched by a corresponding rise in their share of global value added or income (chart 4). In fact, while developing countries are becoming increasingly similar to major industrial countries in the structure of their exports, this is not the case for the structure of their manufacturing value added. Moreover, the disparity between the two is greatest for countries participating in international production networks, and still greater in Latin America than in East Asia (UNCTAD, 2003); while the latter region has increased its share of manufactures commonly associated with industrial upgrading (such as electrical machinery, non-electrical machinery and transportation equipment) this has not been the case in Brazil, Chile, Mexico and particularly Argentina (Amsden, 2001).[13] For some developing countries their share of global manufacturing income has actually fallen over the past decade or so, while for others it has risen by much less than their share of world exports of manufactures (table 2).

Thus in today's more open and interdependent global economy, the route to development through building strong export-investment-growth linkages still appears to be very difficult, despite all the talk of a new global economic paradigm. The constraints are familiar. For most developing countries, liberalization in the mid-1980s was followed by larger current account deficits in relation to GDP than in the 1970s and, crucially, without an acceleration in rates of economic growth. These deficits are explained largely by the failure of exports to keep up with the rapid growth of imports. In the 1970s and 1980s, exports generally rose much faster than imports, although in the 1980s both decelerated sharply as a result of the global slowdown and the debt crisis. There was a strong recovery of export growth in the 1990s but under the combined pressures of rapid and asymmetric trade liberalization, the

[11] The classification of internationally traded goods by relative factor intensity and other characteristics is generally based, because of data limitations, on the characteristics of those products in developed countries, usually the United States. Applying the same classification to other countries implicitly assumes that the categories are homogeneous with respect to the characteristics in question and that there are no factor intensity reversals among countries. In practice it is the heterogeneity of the standard product categories rather than factor intensity reversals that limits the usefulness of applying such classifications to other countries.

[12] For spillovers from TNCs to occur on a scale sufficient to boost long-term economic growth, the technical content of FDI cannot be too far removed from that prevailing in the local economy; if the former is too advanced or too complex, backward linkages – the emergence of local suppliers of intermediate products and of qualified indigenous personnel, for example – are unlikely to emerge and the TNCs production network will remain dominated by complementarities with enterprises in the developed countries; on the lack of evidence on such spillovers, see Greenaway and Gorg, 2001.

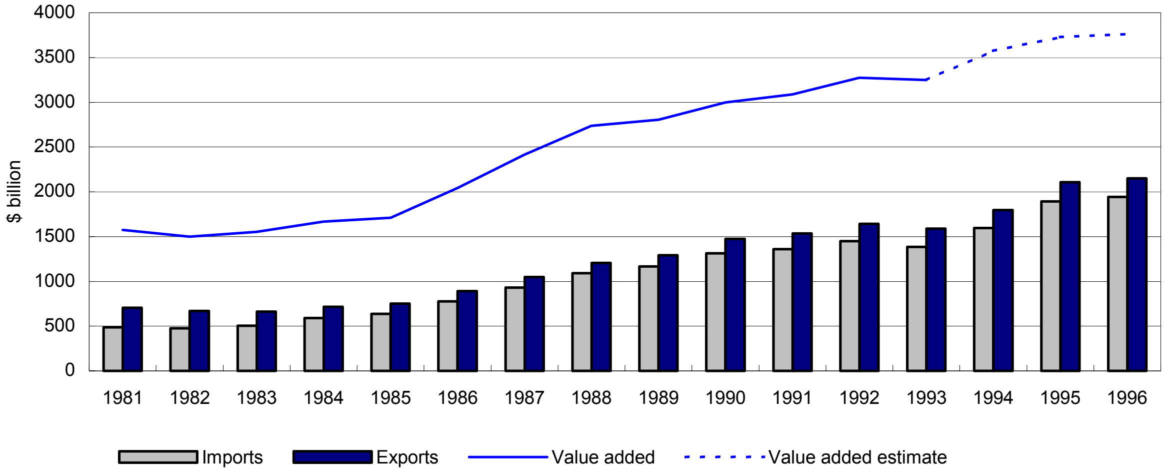
[13] Chile has a distinct profile in the region by achieving faster growth through a changing composition of its primary exports. However, and like elsewhere, backward and forward linkages in the technologically sophisticated segments of manufacturing have weakened, raising concerns about longer-term growth prospects (Albala-Bertrand, 1999).

Chart 4

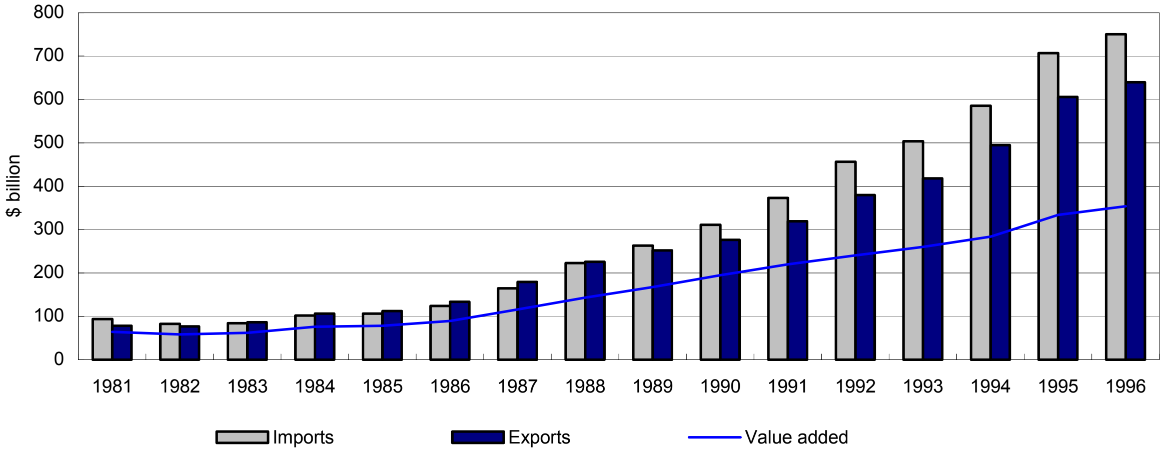
Trade in manufactures and value added in manufacturing for selected groups of economies, 1981–1996

(Billions of dollars)

G-7



D-7[a]



Source: UNCTAD, *Trade and Development Report 2002*.

Note: Manufactured goods as defined by the SITC. Value added data for the period after 1993 was not available for all countries. The estimates for G-7 value added during the period 1994–1996 are based on data for four countries (Canada, Japan, the United Kingdom and the United States) and on the assumption that value added for the G7 as a whole grew at the same rate as in these countries.

a Hong Kong (China), Malaysia, Mexico, Republic of Korea, Singapore, Taiwan Province of China, and Turkey.

Table 2
Share of selected regional groups and developing economies in world exports of manufactures and manufacturing value added, 1980 and 1997
(Percentage share)

Region/economy	*Share in world exports of manufactures*		*Share in world manufacturing value added*	
	1980	*1997*	*1980*	*1997*
Developed countries	82.3	70.9	64.5	73.3
Developing countries	10.6	26.5	16.6	23.8
Latin America	1.5	3.5	7.1	6.7
Argentina	0.2	0.2	0.9	0.9
Brazil	0.7	0.7	2.9	2.7
Chile	0.0	0.1	0.2	0.2
Mexico	0.2	2.2	1.9	1.2
South and East Asia	6.0 [a]	16.9	7.3	14.0
NIEs	5.1	8.9	1.7	4.5
Hong Kong (China)	0.2	0.6	0.3	0.2
Republic of Korea	1.4	2.9	0.7	2.3
Singapore	0.9	2.6	0.1	0.4
Taiwan Province of China	1.6	2.8	0.6	1.6
ASEAN – 4	0.6	3.6	1.2	2.6
Indonesia	0.1	0.6	0.4	1.0
Malaysia	0.2	1.5	0.2	0.5
Philippines	0.1	0.5	0.3	0.3
Thailand	0.2	1.0	0.3	0.8
China	1.1 [b]	3.8	3.3	5.8
India	0.4	0.6	1.1	1.1
Turkey	0.1	0.5	0.3	0.4

Source: UNCTAD secretariat calculations based on UNIDO *Handbook of Industrial Statistics* (various issues); UNIDO, *International Yearbook of Industrial Statistics*, various issues; World Bank, *World Development Indicators 2000* (table 4.3); UN/DESA, Commodity Trade Statistics database; and UN/DESA, *Monthly Bulletin of Statistics* (various issues).

Note: Calculations in current dollars. Value-added data are based on the definition of manufactures used in the industrial statistics, while export data are based on the definition of manufactures used in trade statistics. However, calculating the share in world manufactured exports based on the definition of manufactures used in industrial statistics yields very similar results for countries for which both sets of data are available.

[a] Excluding China.

[b] 1984.

high import content of exports by TNCs and a marked shift in income to groups with a high propensity to import consumer and luxury goods, the acceleration of import growth was even greater. In addition, rapid trade liberalization was generally followed by the opening up of capital accounts and the mismanagement of exchange rates. Instead of maintaining exchange rates favourable to the preservation of international competitiveness and the encouragement of long-term investment, a stable nominal exchange rate was often seen as the way to establish domestic price stability, instead of the other way round, and to attract international capital flows. In most cases the rapid trade liberalization of the mid-1980s was followed by large inflows of foreign capital, the subsequent appreciation of exchange rates, and rising trade deficits.

Thus economic growth in many parts of the developing world is generally accompanied by larger trade deficits than in the past. For the non-oil developing countries their trade deficits are about the same proportion of GDP as in the 1970s but their average growth rate is some two percentage points lower. Only a few countries deviate from this general picture. China is one. Economic growth accelerated in the 1990s but a large trade deficit in the 1980s has been transferred into a surplus (although the latter has been reduced by a large fall in net incomes from invisibles since the mid-1990s). Also in East Asia, although imports grew faster than exports in the 1990s, the difference is much less than elsewhere and the relation between economic growth and the trade deficit is still much the same as in the 1970s. Thus, overall, the results of the efforts of most developing countries to lower the current-account constraint through market-friendly structural reforms and export-led growth have been disappointing.

B. Trade liberalization and convergence

The prediction that the efficiency-enhancing properties of unrestricted market forces should, given the global re-allocation of resources, favour poorer countries rests on strong theoretical supports. Moreover, liberalization should also give a strongly egalitarian dimension to catch-up growth, as the demand for abundant unskilled labour rises relative to other factors. However, as demonstrated in the previous section, the trade performance of the developing countries after the liberalization of the 1980s has been highly uneven, and generally accompanied by a deterioration in their trade balances. In general, this is because rapid trade liberalization has failed to ignite the kind of export-investment nexus on which successful integration rests, and more specifically, it has, in most cases, not led to increased exports of manufactures where the biggest and most dynamic gains from trade are found. And even where such increases have occurred, they have tended to be accompanied by increased imports rather than higher levels of manufacturing value added.

The principal exceptions to this overall picture are the first-tier East Asian NIEs, and the persuasiveness and credibility of many of the empirical studies reporting a close link between increased openness and faster growth rests on their experience. However, one of the main reasons these economies managed to avoid the relatively negative outcomes experienced by other developing countries in the 1980s is that they were never subjected to a “big bang” or shock liberalization of trade in the first place. Moreover, their industrialization had long preceded the liberalization of the 1980s and had advanced on the basis of a wide range of trade and industrial policies specifically designed to encourage the emergence of higher value-added per head activities and the production of high-tech and capital intensive products. These strategies were outward oriented, without adopting wholesale trade liberalization. Selective barriers to imports were common and policies deliberately sought to link the development of international trade to investment and technological improvement.[14] The broad strategic objective was to create domestic capacities which would lay the foundations for sustained growth and develop the strengths required to survive the eventual challenges of global competition. In all these economies, the close association between the rise of manufacturing and a strong export performance was underpinned by robust productivity growth, both in the aggregate and at the sectoral level. [15]

[14] It is important to stress that openness, the removal of all restrictions on international trade, and outward orientation are not the same although they are often equated. “Outward orientation” usually describes a strategy that stresses the importance of world markets for domestic producers but which is often accompanied by significant and selective restrictions on imports. Much of the evidence that is quoted to support a causal link running from trade liberalization to rising shares of exports and imports in national output and rapid rates of economic growth is heavily influenced by the inclusion of these East Asian NIEs, which did not in fact adopt the standard set of liberal trade policies as part of their industrialization strategies (Johnson, 1982; Amsden, 1989; Wade, 1990 for seminal accounts of these experiences).

[15] See UNCTAD 1996 and 2003. While the East Asian NIEs share important common characteristics, such as their sustained growth of fixed investment, they do differ in terms of their resource endowments, institutional histories, policy orientations and overall economic performance. It is helpful, and adopted in this paper, to divide the East Asian economies into three groups: First-tier NIEs (Republic of Korea, Taiwan Province of China, and Hong Kong); second-tier NIEs (Indonesia, Malaysia, and Thailand); and China.

A fast and sustained pace of capital accumulation was key to this successful pattern of integration and was only briefly interrupted by the debt crisis of the early 1980s; given large tradeable goods sectors and substantial industrial capacity built up during the 1960s and 1970s, modest currency depreciations and temporary wage restraint supported quick recoveries from the shocks of the late 1970s and early 1980s. The East Asian NIEs were thus able to contemplate their trade liberalization in the 1980s from a position of strength. They were also in a better position to adopt a more strategic approach to FDI and to ensure that it supported domestic efforts to continue strengthening and upgrading domestic productive capacities. The Republic of Korea, Taiwan Province of China, and Singapore have all succeeded in diversifying into the higher skill, and more rapidly growing, segments of the IT sector and related software products. Foreign firms are dominant only in the export sectors of Singapore and, to a lesser extent, Hong Kong (China) where the backward linkages from TNCs to the domestic sector have often been weaker than expected by national policy makers. Nevertheless, in all the first-tier NIEs except Hong Kong (China), value added in manufacturing industry rose as fast, or faster than, the growth of exports and imports throughout the 1980s and 1990s.[16]

Similar linkages between capital accumulation, industrial upgrading and export performance elsewhere in the developing world have been far less common, and even where they have emerged they have tended to be a good deal weaker. Investment has remained subdued in most of Latin America and Africa despite their opening up after the debt crisis, and even where FDI has been attracted it has been less export-oriented, has often come at the expense of public investment, and has failed to bring wider improvements in the investment climate (UNCTAD, 2003). Concomitantly, productivity performance has been weak and often, where gains have been made, this has been in the context of slow growth and declining employment rather than greater investment, innovation and job creation. In a few cases, notably, Mexico and the Philippines, exports have risen despite weak investment and productivity growth, thanks largely to their participation in the low-value added activities of expanding international production networks.

The great variety of developing country experience with trade liberalization suggests that the relationship between trade policy and economic growth is neither simple nor unidirectional (Freeman, 2003). At a minimum, the relationship is likely to depend on a country's initial level of development and its position in the international division of labour. Three aspects of the relationship are worth emphasizing here. First, while the recent revival of interest in how markets interact with some of the more intangible components of the growth process, such as knowledge and innovation, allows the nesting of trade relations in a more complex institutional and geographical environment (Rodrik, 2003), this does not mean that the complete institutional framework of a developed market economy must be in place before development can take off. Indeed, such institutions, including efficient product and factor markets, are more the outcome of successful development than a pre-condition for it. At the early stages of development, however, institutions and policies that favour enterprise creation and expansion need to be given priority; and for that, the role of an effective and developmental state is crucial.[17] In countries with underdeveloped or non-existent industrial sectors, with weak systems of administration and lacking the minimum of effective institutions required to support a market-based economy, rapid trade liberalization is more likely to lead to unemployment and stagnation than to economic growth and positive structural change.

[16] Hong Kong's (China) exceptionalism followed a hands-off policy towards FDI and it has been the least successful of the East Asian NIEs in up-grading its manufacturing output and export structures. It's prosperity, however, was underpinned first by its position as a major entrepôt centre and then as a major financial centre.

[17] On the key role of the business enterprise rather than the market as the leading "actor" in the development process, and on institutions and efficient markets as an *outcome* of that process, see Lazonick, 2001: 59–72.

Secondly, efforts to reconnect trade policy with economic institutions need to focus particular attention on the link between profits, accumulation and exporting. A good deal of evidence suggests that after the initial stages of industrialization, when agricultural or merchant incomes are likely to provide the main sources of investment, capital accumulation is financed primarily by profits in the form of corporate retentions, rather than household savings. Over the long term, a high rate of corporate retention is almost always associated with a high rate of corporate investment and corporate dynamism.[18] In those economies that were able to generate sizeable resources for investment and successfully harness capital accumulation to achieve a strategic integration with the world economy, market forces were not left to dictate either the pace or direction of growth. Rather, a defining feature of successful development strategies was the design of effective "control mechanisms" to both encourage and discipline private investors by raising profits above those generated by competitive market forces, and to ensure those profits were used in ways to add to productive capacity, create jobs and help technological progress (Amsden, 2001). In many cases, these mechanisms were complemented by long-term ties between banks and large corporations that provided shelter from shocks, and helped to co-ordinate investment decisions, improve predictability and reduce the cost of finance.[19]

Thirdly, the severity of any post-liberalization shock will depend on how far domestic output, employment and relative prices have to change in response to the new competitive pressures from abroad, and that in turn will partly depend on the degree of outward orientation achieved prior to the shock. This helps to explain why, historically, more liberal trade policies in the present developed countries invariably followed rather than preceded improvements in their levels of industrialization and development. In general, the historical record provides little evidence that trade policy in itself has any significant independent effect on the pace of economic growth and development.[20] Moreover, allowing free trade and market forces to determine the levels and structures of production and consumption may only be politically feasible if governments are willing and able to intervene in order to handle adjustment and distribution issues. [21]

One of the major problems with the political debates and controversies over trade liberalization is that too much is claimed for the effects of trade policy, both when it is protectionist and when it is liberalizing. The costs and benefits of protection and free trade are difficult to estimate, and the estimates vary according to the model being used but in general, they prove to be quite small, although

[18] Further on the profit-investment nexus see Akyuz and Gore, 1996, UNCTAD, 1997, Ros, 2001.

[19] On the role of managed financial markets in the East Asian model see Akyuz, 1993; Singh, 1996; Stiglitz and Uy, 1996.

[20] It should be noted that this skeptical conclusion about the positive effects of trade liberalization *per se* on growth and development is supported by many economic historians and academic specialists in international economics. See, for example, Capie, 1983; Morris and Adelman, 1988; Bairoch, 1989a, 1989b; Clemens and Williamson, 2001; Rodrik, 1992; Taylor and Ocampo, 1998; Greenaway, Morgan, and Wright, 1998; Rodriquez and Rodrik, 1999; Panić, 2003, especially chapter 5; Yanikaya, 2003.

[21] From a welfare point of view, and other things being equal, trade liberalization will only be ambiguously welfare-improving if those who gain accept to compensate the losers while still remaining better off, an outcome which is possible if overall productivity has improved. This so-called "compensation principle", which applies to any change in economic policy, was first enunciated in Kaldor (1939). It has generated much controversy, especially over how the benefits of a policy change should be distributed, but it focuses on a major practical issue for those introducing reforms, namely, how to ensure that the benefits and costs of adjustment are not distributed so unequally as to provoke sufficient opposition to block the reforms altogether. This issue is usually ignored in the traditional trade theory, which assumes that economies are operating at full employment.

at full employment the benefits may still be worth having. Much larger benefits are sometimes claimed for the “dynamic” gains from trade – as opposed to the once-for-all benefits of static re-allocation of resources – but the estimates of these are even more sensitive to model specification and are anyway not independent of the rates of saving and investment, human capital formation, and technological innovation. Moreover, the exaggerated importance given to trade liberalization by many governments and international economic institutions is likely to be counterproductive. By promising a quick route to overcoming the obstacles to growth and development. it not only risks a backlash from disappointed expectations but also neglects the importance of other policies which need to be coordinated in a coherent strategy for development. Trade policy is essentially one policy instrument among several with which countries pursue their objectives for growth and economic development, and the key question is whether and under what conditions it is effectual.[22]

III. Finance and the Global Economy

A. The liberalization of international finance

The Bretton Woods regime was designed to promote economic growth and employment via an open international trading system and the preservation of international financial stability. This was premised on the desirability of a managed interaction of national and international economic forces. The original design was informed by the decision facing macro- policy makers over which two of the three variables – an independent monetary policy, a fixed exchange rate, or international capital mobility (i.e. capital account convertibility) – they wanted to exert policy influence.[23] With the objective of avoiding a repetition of the failures of capitalism during the inter-way years firmly in mind, the choice was made for a system of fixed exchange rates with flexibility for domestic monetary policy, but with tight controls on international capital movements. Consequently, the original arrangements did not include rules and arrangements for capital mobility largely because this was considered incompatible with currency stability and the expansion of trade and employment. As in the case of trade liberalization and economic growth, these policy choices reflect deeper arguments over the ways in which market economies actually work.

One of the basic issues which has divided economists for a very long time is whether instability is inherent in international financial markets, and indeed in the market system in general, or whether it arises from inappropriate institutions and interference with market processes. One view, roughly the neo-liberal position, is that interfering governments and central banks suppress or distort market signals, and that left to their own devices, individuals, enterprises and financial institutions will coordinate their various activities in an orderly and predictable way. From this perspective, the call for developing and transition economies to deregulate the allocation of financial resources and liberalize their capital accounts is simply an extension of the argument for free trade in goods. Deregulated and open financial markets would not only increase the availability of investment finance from domestic sources but would also provide access to the savings of other countries.[24] By searching out the most profitable projects capital mobility would lead to a more optimal allocation of resources, increased

[22] As a leading trade theorist, Max Corden, has pointed out: “In relation to GNP, most policies other than macroeconomic ones have small effects … [Hence] the effects of trade policy changes are often overrated” (quoted by Panić, ibid.).

[23] For a useful history of how this thinking evolved in the context of the emergence of international financial arrangements see Pauly, 1997.

[24] For standard accounts see Shaw, 1973 and McKinnon, 1973.

investment, higher growth rates and a convergence of incomes. In recent years, an additional attraction of this approach for the governments of developed market economies has been the suggestion that private capital flows would reduce the need for official financial assistance.

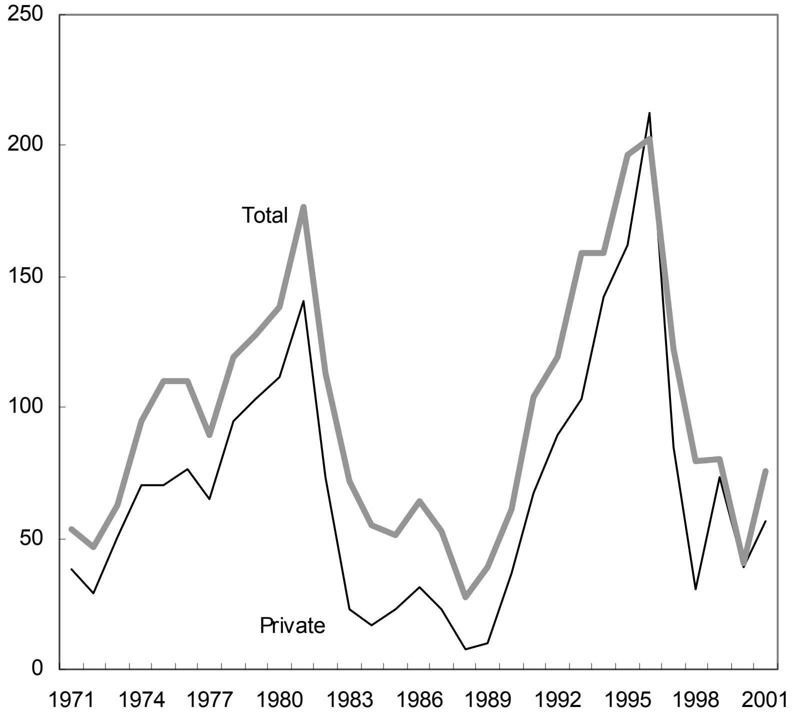
The other view, associated with, but not exclusive to, the Keynesian tradition, is that uncertainty and coordination failures are not exogenous but rooted in the very nature of the system. Contrary to the neo-liberal view, Keynes thought that government intervention was capable of reducing uncertainty, thereby bolstering the animal spirits of investors and stimulating economic growth.[25] From this perspective, not only can directed credit allocation in developing countries play a useful role in correcting domestic financial market failures, but international arrangements and regulations are essential for dealing with potential systemic failures.

The collapse of the Bretton Woods system of fixed exchange rates in the early 1970s, which transferred the management of foreign exchange risk to the private financial sector, encouraged the revival of the neo-liberal vision of the international financial system (Eatwell and Taylor, 2000). This was followed by the removal of capital controls and by a general move to financial deregulation in the developed economies in the 1970s. This agenda was transmitted very swiftly to the rest of the world, in no significant part thanks to the transformation of the international financial institutions from guardians of systemic financial stability to pioneers of financial globalization, concerned with building confidence in and extending the reach of loosely regulated private capital markets, including through the promotion of domestic structural reform in debt-ridden developing countries (chart 5). The removal of controls on international capital mobility was indeed followed by a considerable increase in the flow of capital to developing countries. In total, net capital flows to developing countries rose by a factor of 20 between 1970 and 1998 (to some $312 billion), although in terms of their purchasing power over imports the average annual increase was much less, and at some 12 per cent a year the increase in real flows in the 1990s was only slightly more than in the 1970s. This growth of capital inflows was also characterized by a marked shift in their structure. Private capital flows, freed from controls and attracted by privatization in many developing countries, rose sharply, particularly after the introduction of the Brady Plan, while official loans and assistance declined, in part reflecting fiscal consolidation in the developed countries. By far the greater part (two thirds or so) of these flows consisted of short-term investments: bank loans, equities and short-dated government securities, inter-bank and other deposits, and so on; portfolio flows account for 21 per cent (compared with a mere 2–3 per cent in the 1970s and 1980s); while bank loans and other private credit have remained fairly steady, accounting for 25 per cent of total net inflows.

While flows to developing countries account for a very small proportion of total, global flows of private capital – 5 per cent or less – in relation to size of such economies they are much larger and their consequences for macroeconomic stability have been highly significant. Moreover, during the 1990s a growing proportion of these flows has been absorbed by activities which add little to productive capacity. For every dollar brought in by non-residents, 24 cents were taken out by residents, compared with 14 cents in the 1980s, and more than 20 cents were put aside for the

[25] The distinction between the two approaches should not be made too rigidly. Similar policy conclusions may be reached from both perspectives – for example, that this or that government intervention is harmful or that better regulation of certain financial activities is desirable – but, in the main, the Keynesian tradition would argue the need for various controls on capital movements as a permanent element in the policy tool-box and not just for emergencies (Felix, 2003).

Chart 5
Real net capital inflows to developing countries, 1971–2001
($ billion)



Source: IMF, *World Economic Outlook*, 2003 database; World Bank, *Global Development Finance, 2003*.
Note: Real flows are nominal flows adjusted for changes in the United States GDP deflator.

accumulation of reserves as a safeguard against speculative attacks on the currency and reversals of capital flows. The latter come at a particularly high cost, since reserves are borrowed at much higher interest rates than they can earn in international financial markets.

During the 1990s, FDI flows to developing countries rose sharply and now account for 34 per cent of the total net inflow (compared with 9 per cent in the latter half of the 1970s and 18 per cent in the 1980s). Factors behind this expansion include the acquisition of privatized assets, especially in Latin America in the early 1990s, the growth of the newly industrializing economies of South East Asia, and the opening up of the Chinese economy. Indeed, China accounted for about one third of all FDI in developing countries in the 1990s and about two thirds of the total going to East Asia. This reflects a more general pattern of highly concentrated FDI flows in just a few countries: three-quarters of the inflows in the 1990s went to just 10 emerging market economies, and China, Brazil and Mexico together took nearly one half.[26] Other developing regions – sub-Saharan Africa, South Asia, North Africa and the Middle East – have marginal shares in the total, and in the case of sub-Saharan Africa a sharply falling one.

The extent to which this has added to the productive capital stock of the host countries is not very clear. A large proportion of FDI in the 1990s – between one half and two thirds – was due to cross-border mergers and acquisitions (M&A), and although this may lead to additional fixed investment

[26] Such a high degree of concentration has changed little since the early 1970s.

and productivity gains it is essentially a transfer of ownership over existing assets.[27] "Greenfield" investment, which does increase the host country's capital stock, is a small proportion of the total and was not on a rising trend during the 1990s. Although it is widely assumed to be a more stable source of external finance than portfolio flows, the M&A component of FDI may also include speculative flows attracted by the prospect of quick capital gains during periods of crisis. This appears to have been significant during the Asian financial crisis of 1998. The equity component of FDI inflows since the mid-1980s has actually fluctuated considerably, undistributed profits and parent loans providing relative stability in the total. Indeed, empirical evidence on the volatility of FDI flows vis-à-vis other forms of private capital flows is far less conclusive than often presumed. For instance, at the time of the East Asian financial crisis, the Bank for International Settlements (BIS) noted that FDI contributed to an unstable investment pattern in the region based on less-than-solid risk to return characteristics (BIS, 1998: 35). A recent review of the business cycle in 15 developing countries for the period 1970–1997 found that FDI inflows were a volatile component of those cycles, and a good deal more so than aid flows (Rand and Tarp, 2002). According to another study of 103 countries for the period 1980–1996, portfolio investment was only slightly more volatile than FDI, and among 85 emerging market economies over the same period the levels of volatility were actually equal.[28]

It seems doubtful that FDI can offer a reliable substitute for official financing in the development process of many poorer countries.[29] Indeed, FDI is essentially a lagging variable in the development process, generally attracted to countries where the institutional framework provides an acceptable degree of security and predictability for conducting business and where the prospects for future economic growth are favourable. In other words, FDI tends to go to economies where development is already under way.[30] Attempts to attract FDI with tax incentives, subsidies and other concessions are often justified on the grounds that it stimulates the domestic economy via technology transfer and other spillovers. However, as discussed above, the evidence for such positive spillovers is not very strong. In the absence of more comprehensive and coherent strategies for development, such subsidies may simply attract foot-loose investment, which moves elsewhere as soon as the subsidies run out.[31] Some countries nevertheless see FDI as providing a significant source of financing of current-account deficits. In the short run a surge in FDI may very well provide this, but when eventually profit repatriation begins to accelerate the net effect on the balance of payments may be negligible or negative. This might not be a matter for concern if the FDI were adding to the host country's capacity to export, although as discussed in the previous section even then it must be remembered that FDI

[27] Usually, acquisitions of 10 per cent or more of voting stocks are treated as FDI, those below are classified as portfolio equity investments. There are many gaps and inconsistencies in the statistics of FDI, which are considerably more problematic than those for international trade. For a good survey of the issues, see Sutcliffe, 1998. The figures for FDI are often significantly distorted by "round-tripping". A recent estimate is that up to half of China's FDI consists of Chinese capital that has been re-routed through off-shore tax havens and Hong Kong (China) in order to benefit from the special privileges given to foreign investors (*Oxford Analytica*, 2003). A similar phenomenon occurred in Eastern Europe, in Hungary for example, in the 1990s. It should also be borne in mind that the OECD statistics on FDI by direction show a large "unallocated" proportion.

[28] See UNCTAD 2003: 78.

[29] It is sometimes argued that potential rates of return in many developing countries are much higher than in developed countries, and therefore the small flows of capital from the latter to the former are a sign of capital market imperfections. Such imperfections may well exist, but the incentive of such differential rates of return in favour of the developing country is likely to be considerably reduced or even eliminated when adjusted for differences in labour productivity and risk premia (Lucas, 1990).

[30] The principal exception to this pattern is the attraction of FDI to the minerals sectors, including oil, in developing countries. But this has not in general proved to be a precursor of sustained development.

[31] France and the United Kingdom have recently discovered this with their assistance schemes for regional development. A stress on the link between FDI and development has received a growing amount of attention in the globalization literature, even as doubts about the strength of that link have grown (UNCTAD, 1996, 1997 and 1999; Milberg, 1999; Hanson, 2001; Carkovic and Levine, 2002.

tends to have a very high import content. But a feature of much FDI in Asia and Latin America during the 1990s was its growing concentration in non-tradeable services, a development which is unlikely to strengthen the links between FDI and export growth (UNCTAD, 1999).

This increased mobility of capital in the 1990s has frequently led to comparisons with a previous period of globalization, the age of the Gold Standard that ended in 1914. Whether or not markets were more global or more integrated then need not detain us here.[32] The important point is that the nature of financial flows in the earlier period was different from those in the 1990s and today. The greater part of contemporary financial flows reflects international portfolio diversification, hedging and risk-sharing among the developed countries themselves. The greater part of global FDI (some 80 per cent) is also accounted for by flows among the developed countries, much of it linked to mergers and acquisitions rather than fixed investment in new assets.

The globalization of capital flows is thus somewhat of a misnomer since the developing countries receive only a small proportion of the total; their share of global FDI in 2000 was some 16 per cent, and of total global capital market flows less than 7 per cent. Indeed, on balance, the liberalization of capital movements has had little impact on *net* flows of capital to the developing countries, but at the same time it has created considerable instability and increased their vulnerability to financial crisis. Indeed, the bigger picture of the flow of resources, taking into account net payments on foreign investment income, including interest payments on outstanding debt, increases in reserve holdings and profit remittances, has been particularly bleak for developing countries since the Asian financial crisis of 1997 with a cumulative outflow to 2002 in excess of $700 billion according to one recent estimate (UNCTAD, 2003).

B. The siren call of quick fixes; shocks and crises in unregulated financial markets

Despite a widespread belief that a more open economic environment would demonstrate the superiority of markets over government intervention and the benefits of unrestricted capital mobility, the period since the collapse of the Bretton Woods system has been marked by the increasing incidence of financial crises in both developed and developing countries, and their growing virulence in terms of lost output and jobs (Eichengreen and Bordo, 2002). Paradoxically, these crises have led to increased intervention by governments and the international financial institutions, mainly to provide a safety net for western finance (Plender, 2002). All these crises have followed a broadly similar pattern. Financial market deregulation and capital account liberalization are introduced alongside currency regimes that maintain a stable nominal exchange rates and tight monetary policies. The resulting interest rate differential attracts liquid and short-term capital flows which initially reinforce confidence in the stability of the exchange rate. The newly deregulated banking sector expands into new areas of business internally, and domestic firms borrow abroad to take advantage of lower interest rates,

[32] Before 1914 the international financial markets were concerned with intermediating a surplus of domestic savings in Europe to meet the demands for funds for productive and fixed investment in North America, Latin America and other wealthy primary producing countries such as Australia and New Zealand, as well as some smaller newly-industrializing economies such as Sweden. This earlier period of globalization cannot therefore be seen in current terms as integrating a poor South with a rich North. In fact, incomes per head in the capital receiving countries were often as high, and sometimes higher, than in the capital exporting countries. Large parts of today's developing world were under colonial rulers who tended to block any significant attempts to develop domestic industries that might eventually challenge the dominance of those in the metropolitan countries. There has been an outburst of studies looking at the similarities and differences between the workings of international financial markets currently and in this earlier period, see for example, Taylor, 1996; Bordo et al., 1999; Eichengreen and Bordo, 2002; Kozul-Wright, 2003.

thereby exposing themselves to exchange rate risks. The new policy combination eventually begins to put upward pressure on the exchange rate, at the same time as sterilization of capital inflows puts more pressure on interest rates alongside a deteriorating fiscal position. These deteriorating balances begin to erode confidence and eventually expectations shift triggering a rapid outflow and raising the potential for a widespread crisis as a result of a falling exchange rate, corporate bankruptcies and an increasing threat to the solvency of domestic banks.

The precise circumstances in which the vulnerability of individual countries to the reversal of capital inflows arises and the subsequent impact on economic growth and stability vary from region to region and among individual countries. The contrast between Latin America and East Asia highlights some of the differences. In Latin America, strategies of import substitution had led to rapid rates of growth in the two decades or so following World War II, and this success was already attracting foreign capital in the late 1960s. Those inflows, largely in the form of syndicated bank loans, accelerated in the mid-1970s in the wake of the first oil shock. However, in most cases, these loans were not used to finance restructuring of the productive sectors and thus failed to bring about increases in export capacities on a scale sufficient to meet the mounting debt-servicing burden.[33] Consequently, when the United States suddenly switched its monetary policy to a strong anti-inflationary stance at the end of the 1970s, leading to a global recession and a collapse in commodity prices, Latin America sank into a profound payments and debt crisis. The subsequent restructuring of debt at the end of the 1980s under the Brady Plan greatly accelerated the shift in policies begun earlier under structural adjustment programmes. Strategies of import substitution were abandoned and replaced by a rapid liberalization of the markets for goods and of the capital account. But while the switch of policies did bring about a rapid lowering of inflation, the resulting increase in real incomes and wealth, before productive capacity had been rationalized and expanded, fuelled a consumer boom which sucked in a growing volume of imports leading to a growing current account deficit. But in the absence of a new development model to convert export earnings into increased investment in competitive manufacturing industries, such deficits had to be financed by foreign investors attracted by the promise of high returns and low exchange rate risk.

This recent Latin American experience continues a long history of boom-bust cycles in foreign capital flows and abrupt changes in development strategy brought about either by internal political pressures or external events.[34] As such, it stands in contrast to East Asia where development policies have generally been more stable, gradual and comprehensive, including specific policies to reduce their dependence on foreign capital and to incorporate what FDI they did import into a broader framework of domestic investment and technological upgrading. Strategic use of tariff protection and government direction of investment ensured a commensurate growth of export capacities and helped to ensure that ratios of debt service to export earnings never reached the levels that created severe problems in Latin America. By the mid-1990s, however, as a result of various internal and external factors, including domestic financial liberalization, foreign bank lending to private sector borrowers was rising sharply, amplified by low United States interest rates in the early 1990s, bringing large inflows of international interest rate arbitrage funds. Most of the lending was non-syndicated, much was short term, and a significant proportion was lent to banks and property companies. This accumulation of short-term foreign debt left the Asian economies increasingly vulnerable to a turn in foreign sentiment, irrespective of the fact that, unlike Latin America, the basic macroeconomic fundamentals were sound

[33] The predominance of sovereign debt emerged only after the restructuring of foreign debt in the 1980s (Diaz-Alejandro, 1985).
[34] See Marichal, 1989; Fitzgerald, 2003; UNCTAD 2003.

and fiscal policies prudent. Once the shift in market perceptions occurred in mid-1997, the East Asian economies suffered a similar transition from boom to bust in foreign capital flows and hence a major financial crisis. But in contrast to Latin America, the recovery of the Asian economies from the crisis was relatively fast and complete. It was supported by expansionary macro-economic policies and by the high degree of regional integration that amplified the effect of the increases in exports that followed the exchange rate devaluations.

When the Asian financial crisis broke out in 1997, many western commentators were quick to criticize the Asian approach to economic development, blaming it for excessively close relationships between government, banks and business and for protecting private enterprise from the discipline of market forces, and claiming that the model was no longer appropriate in the face of global market forces (World Bank, 2000). This argument, however, gives insufficient attention to the role of systemic instability. The easy supply of low cost borrowing fuelled an investment boom in many of the South East Asian economies where the manufacturing industry was under increasing competitive pressure from lower cost producers in other developing countries. But the drive to boost productive capacity and regain market share mainly added to global excess supply and exacerbated the fall in prices, especially in the IT sector. At the same time banks, subject to little or no regulation, moved into new areas of lending, real estate, as in previous crises elsewhere, proving to be one the most attractive. Banks, manufacturing companies, and the property sector thus became extremely vulnerable to a rise in interest rates or a fall in the exchange rate.

The crisis that started in Thailand in May 1997 appears to have been triggered by the expectation of a rise in Japanese interest rates. But once a fragile situation has been created almost any change in the conjuncture can lead to a sudden reversal of foreign capital and massive downward pressure on the exchange rate. Foreign lenders, seeing the increased exchange rate risk, started to call in loans as they fell due, and domestic borrowers sought to reduce their exposure by hedging their foreign debts or repaying them. As firms struggled to maintain solvency they simply triggered a downward spiral, typical of a debt deflation, by driving the exchange rate and asset values even lower. The falling exchange rates led to contagion throughout the region as the pattern of relative competitiveness was disrupted.

Although the crisis in South East Asia had not been caused by budget deficits or a loss of competitiveness due to accelerating domestic inflation, by treating it as a traditional payments crisis, the international financial institutions not only failed to halt the fall in the exchange rate and reverse the capital outflows, but actually intensified the debt deflation and pushed the economies into a deeper recession. There was certainly some case for a managed reduction in domestic absorption in Thailand, but the actual policies adopted simply increased the degree of financial instability. The essential issue was that, at the new exchange rates, the foreign debt of banks and companies was too large to be serviced by their expected income – and so there occurred a collapse in their asset prices. Given the high savings rates and strong export capacities in South East Asia, there should have been few doubts that their debts would be repaid within reasonable time. Instead, high interest rates and large exchange rate devaluations led to sharp falls in output and income, rising unemployment and considerable social distress.[35]

[35] For accounts of the crisis and its aftermath, see Akyuz, 2000; Furman and Stiglitz, 1998 and the various papers collected in Chang et al., 2001.

Thus even in countries with a strong track record of sound domestic management and sustained growth, rapid financial liberalization without alternative institutional arrangements for supervision and regulation led to reckless borrowing abroad with disregard of the exchange rate risk, and so exposed those countries to the herd-like vagaries of international finance. Although there is plenty of room for improvements in regulatory systems, particularly in the banking and financial sectors of the region, the core of the problem is systemic and therefore needs to be addressed at the global level.

As with the case for rapid trade liberalization, the arguments for unfettered mobility of capital simply promise too much. But unlike the case for free trade, for which serious attempts, however controversial, have been made to quantify the likely benefits, efforts to quantify the benefits of capital account convertibility are, as one leading international economic specialist has pointed out, virtually non-existent; more a matter of repeated assertion than careful analysis (Bhagwati, 1998; see also Gourinchas and Jeanne, 2003). Certainly, the experience of the last two decades or so suggests that the actual benefits have fallen far short of the presumed benefits. Domestic investment and national savings rates remain closely correlated across countries, so that differences in prospective rates of return to investment persist and are not equalized by foreign capital flows. The bulk of international capital flows is motivated more by hedging and risk-diversification between the developed countries than by flows of savings from the rich countries into fixed investment in developing countries. The claim that the mobility of capital is an encouragement to those countries that seek to attract it, to adopt responsible and disciplined macroeconomic policies and thus avoid major policy mistakes, is belied by the prevalence of herd behaviour on the part of international investors and by the evidence of the Asian financial crisis of 1997 when undisciplined capital flows were among the factors that undermined macroeconomic stability and contributed to the crisis. Indeed, a recent IMF survey concluded that “it has proven difficult to find robust evidence in support of the proposition that financial integration helps developing countries to improve growth and to reduce macroeconomic volatility” (Prasad et al., 2003: 11). From this perspective, the basic lessons of the “Asian model”, its emphasis on the mobilization of domestic fixed investment as the basis of successful industrialization and on the need for a gradual approach to integration in the global economy, remain valid.

IV. Globalization Revisited

The radical change in the direction taken by economic policy-making in the early 1980s promoted the view that the best way, regardless of historical and economic circumstances, to ensure macroeconomic stability and improve growth prospects, was to give wider play to market forces. This meant removing a large array of restrictions and government interventions which allegedly inhibited the workings of free markets. By getting rid of these various “distortions”, the growth of the world economy was expected not only to accelerate but also to draw into the process countries and communities which had hitherto been left behind. Poorer countries would begin to close the income gap with the richer countries, along with reduced levels of inequality within these countries. The liberalization of international trade would enable countries to better exploit their comparative advantages. Where this was constrained by a lack of investment, the liberalization of international capital markets would ensure that investment funds would flow from the capital-abundant North to the relatively capital-scarce developing countries. From this perspective, the successes of globalization have tended to be presented in terms of increasing volumes of international capital flows, rising trade to GDP ratios, and the increased presence of TNCs in national economic activity. But it is also clear from the arguments in favour of liberalization that changes in the spatial distribution of trade and capital flows should begin to increase the links of interdependence among the partner countries and to weaken geographical concentration or clustering.

In fact, as described in the previous sections, the two major economic forces presumed to be crucial for spreading the benefits of globalization appear to be less global than often presented, have proved to be much weaker than widely predicted and carry potentially damaging effects as well as benefits. These features of the process already raise serious doubts about the promised economic gains to poorer countries associated with market-driven globalization. But in describing a world in which externally generated shocks and constraints on growth in poorer countries make them particularly vulnerable to pernicious traps and cycles, questions are also raised about the longer-term development prospects of developing countries.

A. Catching up, falling behind and growing apart

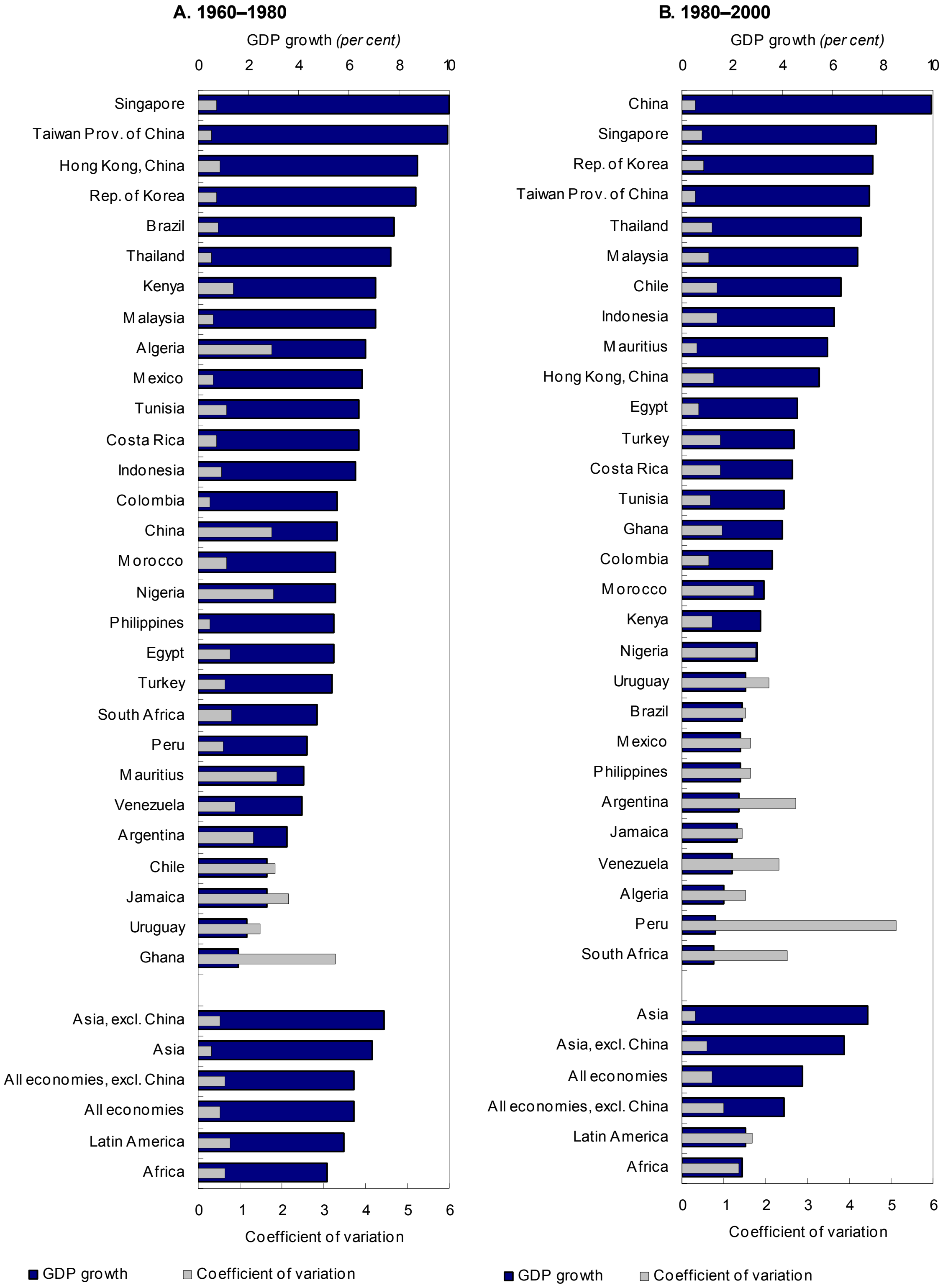
The case for rapid liberalization of trade and international finance is an economic one. Efficiency-enhancing market forces should stimulate faster, more stable and better distributed growth among the developing countries and lead to a reduction of income inequality between and within countries. But with the conspicuous exception of the East Asian economies, growth in most developing countries slowed sharply in the late 1970s and early 1980s and since then has been erratic and fragile. The intensity of the slowdown following the debt crisis together with high levels of instability made the 1980s a lost development decade for many countries. Latin American economies did enjoy a brief renaissance in the early 1990s with the intensification of structural reforms and a return to international capital markets but since 1997 things have again turned sour producing a "lost half decade" (Ocampo, 2002a). Sub-Saharan Africa, like Latin America, also suffered a "lost decade" of development in the 1980s and its recovery in the 1990s was generally weak, if less erratic. This was partly due to the unfavourable trends for primary commodity prices and the stagnation of official financial assistance. There was generally little or no inflow of private capital into the region, and no abrupt reversal at the end of the decade, its relative poverty thus providing it with some defence against the instability of foreign capital (UNCTAD, 2000, 2001). China and, albeit more cautiously, India, became the new hubs of industrialization in the 1990s, and although their starting points were low the pace and unprecedented scale of their transformation carries significant if uncertain consequences for the global economy.[36] However, other putative showcases for neo-liberalism such as Mexico and the Philippines have recorded annual per capita growth rates between 1990 and 2002 well below those of the 1960s and 1970s. In general terms, it seems that the frequency of strong growth episodes was a good deal more common prior to the debt crisis than subsequently (Berthelemy and Soderling, 2001; Rodrik, 2003). Indeed, outside the Asian NIEs, perhaps only Chile sustained a sharp improvement over past growth performance, albeit not matching the Asian pace.[37] On a regional basis (excluding China), growth slowed everywhere between 1980 and 2000 and became more volatile (chart 6).

[36] For a discussion of the Chinese experience see UNCTAD, 2002; Nolan and Yeung 2001.

[37] Some small island economies such as Barbados, Mauritius and Seychelles also saw sustained accelerating growth after the debt crisis, although many had enjoyed earlier growth episodes.

Chart 6

Average annual real GDP growth and volatility in selected developing economies and regions, 1960–2000



Source: World Bank, *World Development Indicators, 2002*.
Note: Calculations are based on GDP in constant 1995 dollars. Coefficients of variation for all developing economies and regions are weighted averages for the countries listed.

Thus, despite the slowdown in most advanced countries over the past two decades, an increasingly globalized world has failed to ignite catch-up rates of growth. The ways and extent to which the policy switch since the debt crisis has adversely impacted on growth is the subject of ongoing debate.[38] However, what is less in doubt is that such policies have failed to produce the kind of growth environment needed by poorer countries.

This rather fundamental conclusion has all too often been lost in the flurry of literature on the links between globalization, inequality and poverty. As in all cases where causality is multiple and complex, the dynamic interaction between growth and income levels and gaps raises controversial analytical issues among economists (Fields, 2001). In addition measuring inequality is fraught with data problems, particularly where cross-country comparisons are involved (Sutcliffe, 2003). On some estimates, significant improvements have been recorded in global equality over the past two decades, while others have documented little change or a worsening situation, with a good deal hanging on the inclusion of China's performance.[39]

The contentious measurement of inter-country inequalities over the past two decades has been accompanied by a clearer trend of increasing income differences within countries, both developed and developing (Firebaugh, 2003; Krugman, 2004). Among developing countries inequality rose sharply in the 1990s; in Latin America the large increases in the 1980s were not reversed during the recovery from the debt crisis; and, inequality also increased in many of the East Asian countries in the second half of the 1990s in the wake of financial crises. In developing countries the richest 20 per cent of the population, which tends to capture a larger proportion of total income than the same quintile in the developed countries, has tended to increase its share since the early 1980s at the expense of the middle class as well as those at the bottom of the scale; in many countries this reversed the pattern of relative gains before 1980. In more than half the developing countries the richest 20 per cent now receive more than one half of national income (UNCTAD, 1997). The close synchronization in the timing of such distributional changes in very different economies suggests that they are influenced by factors in common and perhaps global, including through the generalized trend in liberalization.[40] Beyond the empirical disputes, there is an emerging consensus that existing inequalities in developing countries are likely to be politically destabilizing and that advanced countries will find it increasingly difficult to protect themselves from the shocks and instability this creates. Moreover, hitting the kind of growth targets in developing countries needed to make a systematic dent in their poverty will require a policy framework that includes distributional goals at both the domestic (Dagdeviren et al., 2001) and international levels (UNCTAD, 2001).

[38] A growing econometric literature testing the success of neo-liberal policies has produced inconclusive results in terms of the extent of the damage done to growth. However, there is almost no evidence that these policies have able to generate the pace of growth needed by poorer countries to tackle their development deficit; for generally critical assessments of the impact of these policies see Killick, 1995; Mosley, 1999; Przeworski and Vreeland, 2000; Barro and Lee, 2002; Rodrik, 2003. The next section will suggest some of the damaging channels of transmissions.

[39] See *inter alia* CEPR, 2002 and Sala-I-Martin, 2002a, 2000b for a more favourable interpretation of trends; and Wade, 2001 and Milanovic, 2002a, 2000b for a less favourable one.

[40] A good deal of debate has taken place over the negative impact of increased North-South trade on labour market performance in the North. Much of this discussion abstracts from broader macroeconomic and institutional changes in the advanced countries over the period of rising imports from the South. Similarly, rapid trade liberalization has led to increased wage dispersion in many, but not all, developing countries with the wages of unskilled workers not only falling behind those of the skilled but also often falling absolutely in a context of falling employment (ILO, 2001). For a critical assessment of this literature, see Akyuz et al., 2003 and Atkinson, 2001. Again, exceptions to this pattern were in East Asia where a more measured liberalization and integration with the world economy, at least until the financial crisis of 1997, was accompanied by increased productivity, higher levels of employment, and a fall in wage dispersion.

B. Investment shocks and structural stagnation

It is possible that the disappointing record in terms of growth and distribution reflects temporary adjustments to a more open economic environment. If this is so, making the rich richer will eventually bring large gains both because they have a much higher propensity to save and invest than other sections of society and because they are more likely to protect the moves towards greater openness which should bring growth dividends to all. However, while some degree of inequality is probably unavoidable in the process of raising domestic savings, if it is not to give rise to political and social tensions that could undermine stability and the incentives to invest, the distribution of incomes and wealth must be seen as legitimate and socially acceptable. What is acceptable will vary from society to society, but a crucial factor is whether the prevailing distribution is seen to benefit society as a whole and especially its poorest members.[41] The role of capital formation is, in this respect, key in underpinning cohesion and stability. Moreover, this depends not simply on the availability of savings and its efficient use, but on the way the rich dispose of their incomes.[42] Consequently, as Hirschman (1958) insisted nearly half a century ago, it is difficult to divorce distributional issues from the forces that determine investment in developing countries. Productive investment on a sufficient scale, by acting as a tax on profits that restricts their use for personal consumption, makes for lesser inequality in consumption and income, thereby providing both a social as well as an economic justification for the concentration of an important part of national income in the hands of a small minority. Such investment simultaneously generates income, expands productive capacity and underpins a robust labour market. It also stimulates strong complementarities with other key factors of growth, and with institutional deepening. Moreover, due to the sensitivity of the investment decision to the level and stability of economic activity, investment plays an important bridging role between the cyclical and longer-term features of economic development. And perhaps most importantly, because investment performance is susceptible to policy influences, it offers tangible criteria for designing and assessing development strategies.[43]

These links are key to understanding the successful development strategies adopted in East Asia, which deployed selective import controls, taxed luxury consumption, targeted credits and fiscal subsidies, fostered close relations between government, business and finance and strategically managed foreign investment in an effort to boost savings, profits and fixed investment. Significantly, this approach proved relatively impervious to the shocks of the early 1980s.

[41] The “difference principle” of John Rawls’ theory of justice: “Social and economic inequalities are to satisfy two conditions: first, that they are to be attached to offices and positions open to all under conditions of fair equality of opportunity; and second, they are to be to the greatest benefit of the least-advantaged members of society” (Rawls, 2001).

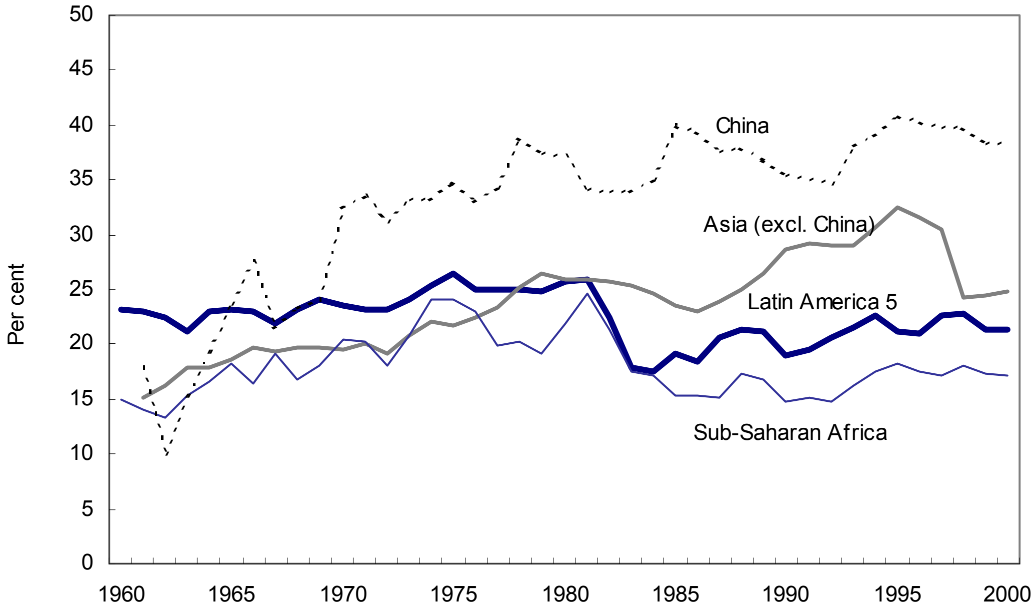
[42] Keynes (1919: 16–17) saw the repressed consumption habits of the “new rich” as key to the legitimacy of the 19th century system, “If the rich had spent their new wealth on their enjoyments, the world would long ago have found such a regime intolerable. But like bees they (the rich) saved and accumulated, not least to the advantage of the whole community.”

[43] Following these leads does not appear to be of interest to those linking poverty alleviation to the investment climate in developing countries. According to Stern (2001: 2) “The word investment in our title will evoke memories – in some – of the development philosophies of the 1950s and the 1960s, when the emphasis was on growth through capital accumulation. There was a mistrust of the private sector and little mention of entrepreneurship or social inclusion … Since those early days of development economics, I hope we have learned much”.

Chart 7

Gross capital formation in selected developing regions and China, 1960–2000

(Per cent of GDP)



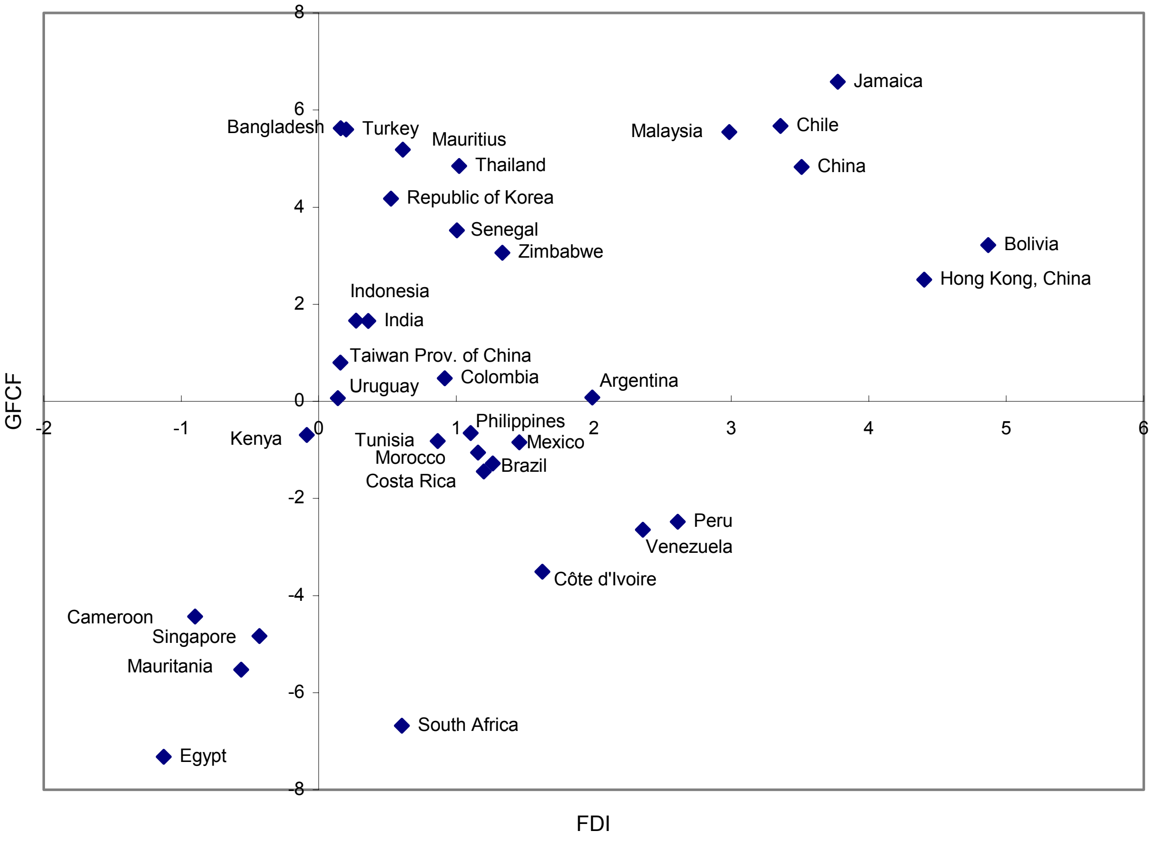
Source: World Bank, *World Development Indicators, 2002*.
Note: Ratios are calculated on the basis of values in constant 1995 dollars. Latin America 5 comprises Argentina, Brazil, Chile, Colombia and Mexico; the first-tier NIEs comprise Hong Kong (China), Republic of Korea, Singapore and Taiwan Province of China; the second-tier NIEs comprise Indonesia, Malaysia, the Philippines and Thailand. Sub-Saharan Africa excludes South Africa.

Outside East Asia, however, investment trends since the debt crisis belie the claim that the policy changes implemented over the past two decades have been good for capital formation. In many countries, the investment pause of the 1980s has been followed in the 1990s by, at best, weak recoveries. But these have failed to match earlier peaks (chart 7), and have often failed to cross the thresholds needed for strong and sustainable growth (UNCTAD, 2003; ECLAC, 2000). Weak overall levels of investment have been associated, in many cases, with a falling share of public investment in GDP which, in most cases, has failed to crowd-in private investment, although in some FDI has surged. The contrast between Asian and Latin American investment regimes is particularly striking regarding the link between FDI and domestic capital accumulation. In both regions, there have been significant increases in inflows of FDI since the mid-1980s. However, while in Asia this has been associated with a rising share of investment in GDP and increased investment in machinery and equipment, in Latin American countries there has been little or no improvement in the level or composition of investment. In fact, in most countries in that region, the investment ratio fell while FDI increased (chart 8). In this respect, a narrow policy agenda aimed at achieving macroeconomic stability seem to have been successfully implemented at the expense of domestic capital formation. Large increases in nominal and real interest rates not only tended to increase production costs, particularly where enterprises were heavily dependent on borrowing to meet their needs for fixed investment and working capital, but also biased investment decisions in favour of financial assets over restructuring. The impact on costs also tends to be greater for firms in the export sector which face strong competition on world markets, whereas the non-tradeable sectors, usually operating in

Chart 8

Changes in gross domestic fixed capital formation and FDI in selected developing economies, 1990–2000 and 1980–1990

(Per cent of GDP)



Source: UNCTAD, *World Investment R*eport database; World Bank, *World Development Indicators, 2002*; and Thomson Financial Datastream.

Note: GFCF as a percentage of GDP was calculated using data in current prices, except for Argentina, where constant 1995 prices were used.

oligopolistic markets, can easily raise prices to compensate for the higher cost of capital. Moreover it was difficult to offset the impact on exports with devaluation, for fear of triggering an inflationary spiral.

While capital accumulation helps raise per capita income simply by allowing a fuller use of underutilized labour and resources without altering underlying efficiency, longer-term economic success depends on sustained improvements in productivity. In this respect, a virtuous circle of accumulation and growth is invariably associated with structural change, and in particular the scale and pace of industrial development and diversification. While East Asian economies, since the debt crisis, have continued to industrialize at a rapid pace and to upgrade to higher skill and technology sectors, with some first-tier NIEs already close to industrial maturity, many Latin American and sub-Saharan African countries appear to have experienced a “premature” deindustrialization. In Latin America, this has taken place in the presence of a marked slowdown in growth and weak productivity performance, and in the context of market-based reforms.[44] Sub-Saharan Africa exhibits the same

[44] Deindustrialization has been a “natural” product of success in the advanced industrial economies in a context of strong productivity growth in manufacturing, full employment and rapid output growth. It typically took place at a per capita income around $8000–$9000 (measured at constant 1986 prices) and became a visible trend in the early 1970s (Rowthorn and Ramaswamy, 1999).

tendencies if from a considerably lower base. Moreover, while rapid opening up has exposed the limitations of some import substitution industries, it has not led to a creative readjustment in the pattern of accumulation and structural change. On the contrary, there has been a reversion to natural resource based and capital intensive industries, often with a strong FDI presence, and a reduction in the range of dynamic middle-ranking industries, such as metalworking, which have traditionally played a pivotal role in building strong backward and forward linkages (table 3).

Table 3
Manufacturing output as a share of GDP, by region, 1960–2000
(Per cent)

Region	*1960*	*1970*	*1980*	*1990*	*2000*
Sub-Saharan Africa	15.3	17.8	17.4	14.9	14.9
West Asia and North Africa	10.9	12.2	10.1	15.6	14.2
Latin America	28.1	26.8	28.2	25.0	17.8
Southern Cone	32.2	29.8	31.7	27.7	17.3
South Asia	13.8	14.5	17.4	18.0	15.7
East Asia (excluding China)	14.6	20.6	25.4	26.8	27.0
First-tier NIEs	16.3	24.2	29.6	28.4	26.2
China	23.7	30.1	40.6	33.0	34.5
Developing countries	21.5	22.3	24.7	24.4	22.7
Developed countries	28.9	28.3	24.5	22.1	18.9

Sources: UNCTAD secretariat calculations based on data on manufacturing output; GDP at current prices from the World Bank, 1984 and 2003; and Government Statistical System of the Republic of China, online.

Note: ***Sub-Saharan Africa*** includes Benin, Botswana, Burkina Faso, Cameroon, Central African Republic, Chad, Congo, Côte d'Ivoire, Democratic Republic of the Congo, Gabon, Ghana, Kenya, Lesotho, Malawi, Mauritania, Mauritius, Niger, Nigeria, Rwanda, Senegal, South Africa, Togo, Zambia and Zimbabwe. ***Latin America*** includes the Southern Cone countries and Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay and Peru; Southern Cone includes Argentina, Brazil, Chile and Uruguay. ***West Asia and North Africa*** includes Algeria, Egypt, Morocco, Oman, Saudi Arabia, Tunisia and Turkey. ***South Asia*** includes Bangladesh, India, Pakistan and Sri Lanka. ***East Asia*** includes Hong Kong (China), Indonesia, Malaysia, the Philippines, the Republic of Korea, Singapore, Taiwan Province of China and Thailand.

C. Globalization vs regionalization

In an increasingly liberalized world, the strength of geographical ties should be inversely related to the strength of market forces. However, although a number of aggregate indicators – the growth of trade and foreign investment, the shares of trade in national output, etc. – do suggest the world economy has become more integrated over the last two decades. Integration nevertheless appears to have proceeded more intensely within regions, especially those of North America, Western Europe and Eastern Asia. At the beginning of the 1990s, over two thirds of West European exports and imports consisted of intra-European exchanges, although that figure dropped somewhat over the subsequent decade. This is often attributed to the effects of the creation of the Common Market (and later the European Union). Between 1928 and 1935, however, 55 per cent of exports and 46 per cent of imports were already intra-European.[45] This trade is dominated by manufactured products and especially by intermediate and capital goods.[46] The figure is lower elsewhere – among NAFTA countries intra-regional exports stood at 55 per cent of total exports in 2000 and 46 per cent in East Asia (Sakakibara and Yamakawa, 2003). Altogether, trade in all commodities among the developed market economies accounted for nearly 60 per cent of total world trade at the start of the 1990s and for manufactures the proportion was about two thirds (table 4).

Table 4
Intra-regional trade as a share of world trade
(*Per cent*)

	1980	*1985*	*1990*	*1995*	*2000*
			(a) All commodities		
DMEs[a]	54.8	55.7	59.2	50.3	45.3
Northern America	5.1	7.0	5.1	5.3	6.2
Western Europe	32.7	28.0	34.3	28.3	23.0
Eastern Europe	0.9	1.9	0.8	0.6[b]	1.1[b]
Africa	0.1	0.1	0.1	0.2	0.2
Latin America	0.3	0.5	0.5	0.9	3.1
East Asia	1.9	2.9	4.3	6.8	7.2
NIEs (Second- tier)	0.1	0.1	0.1	0.2	0.2
Western Asia	0.2	0.4	0.2	0.2	0.2
Total	*58.3*	*61.6*	*65.2*	*59.3*	*57.8*
			(b) Manufactures		
DMEs[a]	71.5	66.2	65.7	53.0	47.8
Northern America	6.4	8.5	5.4	5.4	6.2
Western Europe	43.6	31.9	38.0	29.3	23.5
Eastern Europe	1.0	1.6	0.6	0.4[b]	0.6[b]
Africa	0.1	-	0.1	0.1	0.1
Latin America	0.3	0.3	0.4	0.7	3.7
East Asia	1.6	2.4	4.5	7.4	8.1
NIEs (Second-tier)	-	-	-	0.1	0.2
West Asia	0.1	0.2	0.1	0.1	0.1
Total	*74.6*	*70.7*	*71.4*	*61.8*	*60.8*

Source: UN COMTRADE database, 24 July 2003. The regional figures are those in the cells on the diagonal of the trade matrix for each year.
[a] Total includes Japan, Israel, Australia, New Zealand.
[b] Includes CIS.

[45] Data from League of Nations, *Statistical Yearbook 1941/42,* Geneva 1943, Annex III and WTO, *Annual Report 1998 and 1999 – International Trade Statistics.* On the long-term decline in the relative intensity of West European trade with developing countries, see UN/ECE, 1984: 481–515.

[46] Although intra-industry trade is frequently quoted as a characteristic of the new globalized economy it appears to have always been an important feature of trade among industrialized economies (Rayment, 1983).

At first glance the last two decades of liberalization appear to have produced a change of direction in these trends. Between 1990 and 2000, the share of intra-regional flows in world trade fell from 65 per cent to 58 per cent and for manufactures from 71 to 61 per cent, indicating relatively large changes in just ten years. There are three broad factors behind these movements. First, the overall decline in the share of intra-regional trade is largely due to Western Europe. But this appears to be mainly an effect of its relatively weak growth in the 1990s, when compared with North America and East Asia, rather than a change in the underlying structure of its international trade. The share of total West European exports to other West European and Central European countries has remained virtually unchanged since the early 1980s (at around 70 per cent), while the share of imports remains only slightly lower (around 68 per cent). A second factor, which has weakened the intensity of intra-regional trade, is the rapid growth of East Asian exports to the rest of the world. The share of East Asia in total North American imports of manufactures rose from 24 per cent in 1990 to 31 per cent in 2000, and in West European imports from just under 7 per cent to more than 13 per cent.[47] Japan's relations with East Asia have strengthened considerably over the decade. In 2000 nearly two thirds of its imports of manufactures came from East Asia, compared with just under one third in 1990, and some 48 per cent of its exports went there against 37 per cent in 1990. Japan's closer trade relations with East Asia points to a third factor behind the change in intra-regional trade shown in table 5, namely that there has been a "realignment" of economic neighbours normally grouped together in the standard regions of the United Nations trade statistics. Thus Japan has moved closer to its geographic neighbours in the wake of their rapid industrialization; Western Europe has embraced Central and Eastern Europe after the collapse of communism; and North America is trading more intensively with Latin America. If regions are re-defined as in table 5 it is clear that intra-regional trade has risen sharply in the Americas and East Asia in the 1990s. Although table 4 shows some movement towards a more even global distribution of trade, table 5 suggests that the change is quite small and that the underlying tendency is still for the links to strengthen with close neighbours and to weaken with the rest of the world once industrialization gets under way. Thus comparing 1980 and 2000, intra-regional merchandise exports for East Asia, European Union and NAFTA countries as a share of world exports has risen from under 35 per cent to close to 46 per cent (Sakakibara and Yamakawa, 2003).

Table 5
Intra-regional trade of East Asia, the Americas and Europe as a share of world trade
(Per cent)

	All commodities		*Manufactures*	
	1990	*2000*	*1990*	*2000*
North and Latin America [a]	9.1	13.9	8.5	13.7
East Asia [b]	12.2	17.2	12.2	18.8
Europe [c]	37.8	27.5	43.1	28.3
Total	*59.1*	*58.6*	*63.8*	*60.8*

Source: As for table 1.
[a] North America and Latin America.
[b] East Asia, Second-tier NIEs and Japan.
[c] Western Europe and Central and Eastern Europe (but not including the CIS).

[47] United Nations COMTRADE database, as for table 1.

The regional concentration of trade is repeated, if less sharply, in the distribution of foreign investment.[48] Data for FDI by provenance and destination are much less reliable than trade statistics, but OECD sources show that nearly 60 per cent of all West European FDI stayed within Western Europe, with nearly 4 per cent going to Eastern Europe and 17 per cent to North America. The proportion going to developing countries rose from just under 9 per cent in the 1980s to just under 13 per cent in the 1990s. In a longer perspective, the change in concentration is especially marked. In 1914, at the end of a previous period of globalization just under 19 per cent of the gross value of West European capital invested abroad went to other parts of Europe, 40 per cent was invested in Latin America, Asia and Africa, 27 per cent in Western dominions, and 14 per cent in Eastern Europe.[49] The figure for intra-NAFTA FDI flows is smaller – 25 per cent of United States direct investment flows went to Canada and Mexico in 2001. Japan, although a later arrival as a significant source of FDI, has also been investing quite heavily in neighbouring countries at the same time as it has remained relatively impervious to FDI from elsewhere. Perhaps more significantly, the sharp rise in FDI from the first-tier NIEs beginning in the mid-1980s has also had a strong regional focus, in many cases overtaking Japan as the dominant investor.[50] While one of the most important developments in the world economy over the last two decades or so has been the emergence of East Asia as a major economic force, its pattern of regional integration has been less balanced than the Western European example, encompassing a greater range of countries at different levels of development and including greater reliance on export markets outside the region, particularly the United States. In this respect, the importance of international production networks has introduced a distinguishing feature of their integration process, and the inclusion of China has added an additional uncertain feature.

The regional concentration of FDI goes against popular perception of TNCs spreading across the globe while the concentration of trade often causes alarm among analysts who see it as a result of regional trade agreements which frustrate the emergence of a truly global economy. However, as will be argued in the next section, in a world of imperfect information, dynamic economies of scale and cumulative growth, these perceptions will need to give way to more strategic approach to economic development if both trade and FDI are to contribute to a more equitable world.

V. Globalization Reloaded

However broadly developmental goals are defined, there can be little doubt that their realization must be underpinned by robust growth (United Nations, 2000). Despite the reluctance of economists to set targets in this respect, most would – given population growth, structural constraints and poverty goals – probably accept that a 5 per cent figure is a minimum for most developing countries. Two decades of intensifying neo-liberal reforms have failed to help most countries to cross that threshold on a sustainable basis.

[48] On the regional trend in FDI see Hufbauer et al, 1994; Kozul-Wright and Rowthorn, 1998, Dicken, 2003.

[49] Based on Maddison (1995, table 3-3). In other words, West European foreign investment was much more globally oriented before 1914 than in the 1990s.

[50] A comparison of the trade and FDI intensity index provided in Sakakibara and Yamakawa (2003) for the European Union, NAFTA and Asia confirms that FDI has a regional pull, albeit weaker than for trade. This has increased in recent years in the European Union and Asia, although not in NAFTA. In the latter case FDI is the more intense than anywhere else with its near-regional neighbour in Latin America.

Sustained and rapid rates of economic growth invariably require a transformation of economic structures reflecting both shifts in economic activities across agriculture, industry and services and upgrading of economic activities within these sectors through the introduction of new products and processes. Such changes will be conditioned by a variety of "inherited" factors, including resource endowments, country size and geographical location. But they will also depend heavily on factors susceptible to policy influences, such as rates of fixed investment, trade orientation and expectations of continued growth. In countries with limited or non-existent capital goods industries, such investment will require imports of capital equipment and intermediate products, and these will have to be financed by export earnings or by capital inflows (private and/or official) and transfers. Since the latter will tend to fall away with rising deficits, and as the demand for imports of machinery and equipment is likely to endure for a long time, the expansion of exports will be a necessary condition for avoiding balance-of-payments constraints on growth in most rapidly developing countries. But sustained export growth requires a steady expansion of competitive, productive capacities which, in turn, requires an increasing share of export earnings to go into domestic savings rather than leaking away into imports of consumer goods. Eventually, the external financing gap will diminish if both domestic savings and exports grow faster than fixed investment. The fact that none of this is likely to be smooth or without conflicts implies that the management of integration is a key factor in the design and implementation of successful development strategies.

The importance of raising investment and exports is fully recognized, of course, by those who support the rapid liberalization of international trade and capital markets. The crucial disagreement is over whether the mutually reinforcing links between trade, investment, and economic growth can be brought about spontaneously by the rapid liberalization of market forces. The evidence from the previous sections suggests that not only is such spontaneity missing, but that rapid liberalization can itself be a cause of instability, failure and retreat. In part, this is because the pace and pattern of opening up has been a lop-sided process, beholden to the interests of the advanced economies who effectively insist that developing countries must integrate on their terms. But it is also because the latter are increasingly constrained in their freedom to choose what is best suited for themselves by the intrusion of international rules and standards into areas hitherto regarded as the domain of national policy makers alone. That domain has been further constrained by a principle limitation of the drive to policy conformity behind market-driven globalization which fails, or is unwilling, to acknowledge the wide differences among countries in their initial economic conditions and their national preferences as well as the importance of institutional "rootedness" to effective policy design and implementation (Berger and Dore, 1996). Such "rootedness" implies that institutional reforms are unlikely to come from large "shocks" or to "travel well" and that policy packages to stimulate growth must form around "local capabilities, constraints and opportunities" and with sufficient space to allow a certain amount of experimentation to discover what will work (Rodrik, 2003: 17–18). Such "rootedness", also implies that institutional deepening, both of a formal and less formal nature, is path dependent. In all these respects, the national state has a pivotal role in imagining and building an economic future (Anderson, 1991). That role will, of course, shift over time. Still, because growth and development essentially involve a societal, not just an economic, transformation, a nation's perception of where it wants to go should be treated with some respect.[51] Arguably, the identification of the state in developing countries as "millstone around otherwise efficient markets" has done much to prevent serious thinking about the developmental responsibilities of the State (Mkandawire, 2001). Thus a basic challenge facing policy

[51] In this spirit, Johann von Thünen once argued, that savings also reflect a society's capacity to imagine a future and create it.

makers in most developing countries is how to regain the required degree of policy space for more development-oriented economic strategies, consistent with an increasingly open and integrated world.

A. Strengthening the export-investment-profits nexus

In the early stages of industrialization a basic objective is to create a net surplus in the agricultural sector that can be used to develop the nascent manufacturing industries. There are no quick or general solutions to this, but a first consideration is to create an effective set of incentives for farmers to raise productivity and diversify output structures. Exchange rate and pricing policies can be used to reduce income instability and influence the relative profitability of different activities. Extension services need to focus on specific supply side problems, improving the technical knowledge of farmers, making it easier for them to obtain better inputs as well as credit, and encouraging diversification and the improvement of marketing skills. Productivity and market extension can be greatly enhanced by basic infrastructure investment, but this will require local government reforms to ensure taxes are collected fairly and efficiently and that they are well spent in support of local development.

As industrialization gets under way, rapid growth will imply increasing dependence on imports of capital and intermediate goods which in turn will require a rapid growth of export earnings and a steady expansion of export capacities. As discussed earlier, East Asian countries achieved very high rates of fixed investment based on high rates of retention of corporate profits. This resulted from a pro-investment strategy based on specific sets of policies designed to provide firms with large profits and to encourage them to re-invest them to further expand productive capacities. While easy imitation is proscribed by country specifics, a number of broad lessons can be carried forward for other developing countries. First, fiscal instruments, such as tax breaks and accelerated depreciation allowances, directly boosted profits, and firms were allowed to set up various reserve funds against risk which made it possible to defer paying taxes on profits. The effects of such policies can be amplified if they encourage commercial banks to make loans more easily available for investment. Secondly, and even more important, the State created rents by raising enterprise profits to levels above those that would have emerged from a purely free market. A number of measures have been used to do this: selective import protection; controls over interest rates and the allocation of credit; and managed competition involving government encouragement of specific mergers, restrictions on entry into certain sectors, the screening of imported technology, and the promotion of cartels for particular purposes such as product standards or export promotion.

Such a range of measures define a comprehensive strategy for industrialization and, as most of the fiscal and other instruments can be applied deliberately to specific industries at specific times, also involve a fairly coherent projection of an industrial future. Investment should be especially promoted in industries with the greatest potential for skills upgrading, economies of scale and productivity growth, thus increasing the rates of return on investment. Total investment can also be boosted by favouring sectors with important forward and backward linkages to the rest of the economy. Such policies can lay the basis for a dynamic manufacturing sector which, in turn, can greatly ease the balance-of-payments constraint on the import of capital goods.

There are a number of factors which appear to be important for the success of such policies and whose absence helps to explain the failure of past efforts in other developing countries. First, the rents created by these measures should be provided only to productive activities that support the broader national economic strategy. Second, subsidies and rents should be made available only as a condition of enhanced performance, especially of exports and of technological upgrading. Third, large, diversified business enterprises together with close, interlocking ownership relationships with banks enable firms to escape from the pressures to meet short-term profit goals and instead to invest for the longer term. This form of business organization can be particularly effective in countries with relatively weak endowments of capital, entrepreneurship and skills, and it can help the Government in its co-ordination efforts by facilitating the exchange of information and reducing the risks of investment. Fourth, the effectual implementation of such an industrial strategy depends on the creation of an appropriate structure of public and private institutions and, not least, on the development of a strong and competent bureaucracy. Finally, industrial policy needs to be linked to labour market policy from an early stage of development; one possible arrangement in supporting the investment-profits nexus is profit-related pay which can help to promote stable levels of employment, thereby improving the distribution of incomes, as well as raising levels of saving by workers and of investment by enterprises. [52]

As was noted earlier, one of the problems in developing countries is that highly unequal distributions of wealth and income are often accompanied by weak propensities to save and invest by the rich. Instead, they tend to have a strong propensity to consume luxury goods and services with high import contents. A strategy to boost profits by creating rents and encouraging the retention of corporate profits could thus run the risk of intensifying the consumption of luxury goods and the acquisition of foreign financial assets. Measures to curb luxury consumption may therefore have a useful role to play in the early stages of industrialization: these may include import controls of varying severity, differential rates of value added or sales taxes, credit controls, and government propaganda encouraging the rich to exercise self-restraint when much of the rest of the population is enduring much lower standards of living. A complementary line of approach is to encourage the domestic production of luxury goods such as motor cars and consumer durables which are known to have strong backward linkages to the rest of the economy. After an initial period of serving a limited domestic market to acquire experience, exports can be encouraged to grow faster than output by combining the incentives mentioned already with measures to reduce domestic consumption.[53] This contrasts with the more usual experience where TNCs establish local plants behind import barriers either to produce for the local market, which will tend to lower domestic savings without necessarily creating the basis for eventual exports, or to assemble imported components for export, which generally involves a very high level of imports, low domestic value added and weak backward linkages.

The sectors where initial policy efforts need to be focused are broadly prescribed by a country's labour and resource endowments. However, moving into these sectors and up their value-added scale still requires a rapid rate of fixed investment, and fiscal and other incentives still have a role to play in encouraging the growth of more sophisticated industries. Additional measures will also be needed to encourage the creation and expansion of technological capacities such as local research and development facilities, the expansion of educational institutions and a wide range of vocational training. This is arguably a far more demanding policy regime which will have to continue beyond the stage of unskilled labour-intensive activities. A key element of the strategy is that success depends on building a strong local enterprise sector capable of instigating a dynamic process of development and

[52] Bonuses in East Asia tended to be paid as periodic lump sums and, in general, the marginal propensity to consume out of what is regarded as transitory income is significantly lower than for regular income. The system also helps to introduce a degree of labour market flexibility which does not depend on firing people in response to a downturn or other external shocks: instead of unemployment leading to a loss of skills, the greater stability of employment preserves skills and the bonus system helps to encourage learning by doing.

[53] This was the approach adopted to develop the auto industry in the Republic of Korea see Amsden, 1989; and for a comparison with the Mexican experience in this sector see Mortimore, 1999.

change so that eventually it will be able to cope with international competition and respond to changes in the global environment.

Any strategy for such development must be framed around invigorating the profit-investment-exports nexus and putting into place a whole range of fiscal, trade, financial and competition policies designed to strengthen the dynamic interactions between these three key elements so that eventually the process will be self-sustaining. This is a development strategy where the central focus is on the creation of local enterprises with a high propensity to invest as a necessary prelude to closer integration with the global economy, and the role of Government is not so much to pick individual winners but to encourage the development of a business class that will eventually be able to maintain the dynamic of industrial change and technological upgrading on its own. [54] It also reflects a judgement that the "shock" exposure to the forces of global competition has not proved to be an effective way to encourage the creation of a competitive local manufacturing base. This does not mean, however, that the role of FDI and TNCs in the development process is ignored. But, as noted earlier, the potential benefits of FDI are not automatically available and the interests of TNC shareholders may not always coincide with national development objectives. It is therefore important that the Governments of host countries adopt a strategic approach to FDI, preserving a range of policies to ensure that it supports the objectives of domestic development. These may include restrictions on entry to certain sectors, prior approval for joint ventures, domestic content agreements, and so on. But a key point is that spillovers and other benefits from FDI are unlikely to occur without the presence of strong local firms able to take advantage of them. This goes somewhat against the more conventional strategies which continue to give a leading role in the development process to FDI and TNCs and against the policy stance of most developed countries which deplores any restriction to the free movement of foreign investment. Nevertheless, countries which have adopted policies to guide FDI within a national development strategy do not appear to have much difficulty in attracting it – coherent national policies and good prospects for growth seem to be the key attractions for TNCs while at the same time increasing the bargaining power of the host country.[55]

Another key element in any development strategy designed to enable a country to benefit from gradual integration into the global trading system is successful management of the exchange rate. Here the objective is to sustain a rate that will support competitiveness over the longer term and to retain enough policy autonomy to make orderly adjustments in the face of external shocks (Helleiner, 2003). The major obstacle to achieving such stability and autonomy, however, is the instability of private financial flows motivated by the prospect of arbitrage and speculative gains.[56] The greater part of these are unrelated to international flows of goods and services and fixed investment; as noted earlier, they

[54] On the kind of "development state" that is needed to manage integration into the global economy, see the various papers collected in the Special Issues of the *Journal of Development Studies* August 1998 on East Asia and the *Cambridge Journal of Economics* on Africa May 2000; also Richard Kozul-Wright and Paul Rayment, 1997: 641–661.

[55] Ireland and China are among the countries which have successfully managed FDI along these lines, albeit with potential difficulties in both cases still to be resolved. One country that was widely criticized in the early 1990s for its unwelcoming attitude to TNCs was Slovenia, but the IMF has recently reported that "its gradualist approach to structural reform" and limited foreign direct investment (until 2000) "did not impede the manufacturing sector from restructuring, raising productivity, and maintaining its export orientation. The pace of structural reform accelerated towards the end of the 1990s. Since then, capital account transactions have been fully liberalized …", IMF, *Public Information Notice (PIN) No. 03/54*, Washington, DC, 25 April 2003.

[56] The distinction between "short-term" and "long-term" capital has been largely eroded by the development of derivatives and other financial instruments. As pointed out earlier, FDI can also be unstable, subject to surges and sudden stops. The crucial aspect from the point of view of vulnerability to instability is liquidity rather than the maturity of liabilities.

have acquired a life of their own and are primarily driven by short-term gains. They make little contribution to a better allocation of resources or the diffusion of technology; instead they undermine stability and growth by creating general uncertainty, increasing real exchange rate fluctuations, sometimes impeding fixed investment, and increasing the risk of financial crises. No exchange rate regime – floating, flexible, currency boards, dollarization, or nominal peg – can deliver stable and competitive exchange rates. Nor will development strategies be able to combine steady growth with financial stability, in the presence of such capital mobility. The damage can be prevented, or at least limited, only if there is effective regulation and control over destabilizing capital flows. A key objective is to prevent a large build-up of foreign liabilities that can be quickly reversed. Controls on capital flows therefore need to be a permanent feature of the policy maker's tool kit. The techniques are well known and range from market-based measures – intervention in the foreign exchange market, more flexible exchange rate bands, non-interest bearing reserve requirements on foreign liabilities, or taxes to reduce the international arbitrage margin – to direct controls on, say, banks' net external positions, borrowing abroad by non-banks, or on foreign equity participation in domestic firms. A number of developing countries have used such measures to manage capital flows: the key to success is a flexible and pragmatic approach that will support stable exchange rates without deterring trade-related capital flows and FDI. Indeed, a coherent and transparent approach to managing short-term capital flows should help to improve the environment for both trade and FDI.

Direct credit allocation at preferential rates, as noted earlier, played an important role in the successful industrialization of the Asian NIEs in the 1960s and 1970s. In a world economy where dynamic scale economies and prolonged learning processes are the rule rather than the exception, market-based allocation of financial resources on the basis of existing comparative advantages may simply prevent a developing country from moving into new industries and progressing towards higher value-added activities. Intervention to ensure that such an evolution is not frustrated by a lack of finance is a key element of a more sophisticated approach to infant industry protection. But market failures are widespread in finance, especially in developing countries, and the boom and bust cycles of international capital flows are highly detrimental to national development efforts. There is now a growing acceptance that financial liberalization is a very risky policy and should only be embarked upon with the greatest caution. And, as the experience of many countries in Asia and in Western Europe demonstrates, a failure to liberalize finance is not necessarily an obstacle to rapid rates of economic growth — indeed the contrary seems more likely, especially in developing countries.

To be effective, many of the measures required for a more strategic intervention in the international economy must be tailored to and embedded in their specific local setting. However, they might also find a complementary setting at the regional level. There is a considerable body of economics literature, mostly in the branch of international trade policy, that views the regionalization trend with alarm and sees it as the result of trade-diverting agreements which threaten to undermine the global trading system.[57] Regional trade agreements may have played some role in boosting regional trade at the expense of multilateral transactions, but it is far from clear that this is inevitably the case[58] and it also appears that there are more fundamental forces making for regionalization that tend to be ignored by mainstream trade theory. As mentioned already, intra-regional trade in Europe, North America, and, increasingly in East Asia, is largely dominated by intra-industry exchanges of intermediate manufactures and capital goods, and these reflect a very high degree of specialization in the various stages of the manufacturing production process. (As these intra-industry trading and production

[57] See, for example, the papers in Frankel, 1998.

[58] The development of an East Asian regional economy, for example, has been described as "open regionalism" (Kirkpatrick, 1994: 191–202).

networks are organized to a large extent by TNCs, this helps to explain why the pattern of FDI outside of primary producing sectors tends to follow closely that of trade in manufactures). Intra-industry trade tends to be most intense among industrialized (or industrializing) countries at similar levels of development and is driven by dynamic economies of scale and specialization and by the search for long production runs.[59] An increasingly fine division of labour, however, increases the risks of interdependence[60] and so enterprises will try to keep supply lines as short as possible, since geographical and economic distance increase those risks, and to remain close to the sources of specialized services. These processes tend to generate economies of agglomeration and to trigger cumulative processes that reinforce the degree of concentration over time. Once such processes are under way there will be pressure from producers within the region to lower or remove the various barriers to intra-regional trade, including bureaucratic red tape, conflicting legal restrictions and administrative procedures etc., as well as demands for better transport and communications infrastructure. These various demands are likely to be accompanied by the creation of institutions for closer regional co-operation as has happened for example in Europe and in East Asia.[61] At first, such co-operation will tend to focus on technical issues (trade barriers, standards and the like) but as regional production systems become ever more integrated, so the regional policy framework is likely to expand.

This brief sketch of the underlying forces for regionalization suggests that much of the alarmism about regional arrangements and regional blocs is misplaced. Most of the actions taken to enhance regional co-operation need not be associated with discrimination against outsiders. But the crucial point is that dynamic economies of scale and specialization lead to cumulative advantages in concentrating economic activities in particular locations. Mainstream economic theory tends to ignore these processes and so its adherents interpret regionalization as an obstruction to the realization of a truly global economy. It is significant, however, that rapid economic growth in East Asia has been accompanied by a marked increase in mutual economic interdependence among the countries of the region via intra-regional trade and investment. But while such interdependence can amplify the forces for growth, it can also increase the threat of contagion to external shock, as experienced during the 1997 financial crisis. Designing more formal regional financial arrangements to ensure future stability is thus likely to be a necessary complement to any search for alternative development strategies (Ocampo, 2002a).

B. The global architecture for trade and finance

The strategy for a measured integration of developing countries into the global economy is often portrayed as a reluctance to implement the necessary reforms required to compete in global markets. But this is a caricature based on a gross simplification of the problems faced by developing countries. The issue for them is not whether they want to integrate with the global system, but how to proceed and under what conditions.[62]

[59] Rayment, loc. cit.

[60] It is frequently overlooked that economic interdependence per se is a cost not a benefit; it is the "price" that is paid for securing the benefits of a finer international division of labour.

[61] Intra-industry trade in Western Europe was already important in the 1950s, but the drive to keep reducing transaction costs by removing administrative and other obstacles often came from the enterprise sector. This was the case with the 1992 Single Market programme. Economic co-operation in Asean, created as a security organization in 1967, started in 1977.

[62] The strategy does not imply however that the process should be linear. Thus, in the early stages of industrialization capital equipment will need to be imported as freely as possible. But, at a later stage, the development of a domestic capital goods industry will probably require a degree of protection.

Over the past twenty years developing countries have made considerable efforts to integrate more closely through trade and capital account liberalization. However the promises of liberalization – that it would stimulate faster growth, reduce poverty, and that per capita incomes would start to close the gap with developed countries – appear to have been met by only a few countries that had pursued a rather different strategy before the 1980s. Indeed, the international trading system remains systematically biased against the establishment of a dynamic profit-investment-export nexus in developing countries. Two specific areas need urgent attention. The first is that, despite the reduction of trade barriers in the Uruguay Round, the developed countries still heavily protect their domestic markets for a wide range of products in which developing countries have a clear comparative advantage – agricultural products, processed foods, textiles and clothing, and a range of light, labour-intensive manufactures. The willingness of the developed countries to liberalize their markets for such products, to eliminate peak tariffs, to end the abuse of anti-dumping actions, and to abolish their trade-distorting subsidies to their agricultural producers, will be the real test of the credibility of their commitment to a more open global trading system.

The second area where the trading system is increasingly biased against the developing countries is in the extension of global rules to matters that go far beyond the traditional domain of international trade policy. Thus, the Uruguay round removed or restricted the developing countries' ability to subsidize their local industries or to introduce investment promotion measures, such as local content rules or limiting imported inputs to a given percentage of exports (the TRIMS Agreement); and the TRIPS Agreement, obliging developing countries to protect intellectual property rights with the same rigour as the developed countries, will hinder both the absorption of modern technologies by developing country firms and their technological development. In addition, the current proposals for a new WTO trade round extending global rules to areas such as investment, competition policy, government procurement, and environmental standards should be rejected. The effect of such an extension of the rule-based system is to greatly reduce the policy options available to developing countries to promote their trade and development. Indeed, some of the measures employed successfully by the NIEs of South East Asia, and by the developed economies themselves at various times since World War II, are now being denied to developing countries.[63]

Despite the narrowing of developing countries' policy space there are still various financial, fiscal and macroeconomic measures that can be, but are not always fully, used to direct investment, promote exports, and to allow some degree of infant industry protection.[64] Still, the narrowing of policy choices allowed to developing countries is particularly disturbing because it implies that the options that remain are known to be sufficient for promoting growth and development. But this is very far from being the case. Moreover, although there is increasing agreement as to the crucial importance of the factors emphasized above, the precise ways and circumstances in which they will interact effectively in one country but not in another are very far from being well known or understood. Developing countries therefore need to be allowed more room to experiment, not less, in order to discover what will work in their own specific circumstances.[65] If nothing is done to address the systemic biases in the trading rules and if greater flexibility is not allowed to developing countries in their pursuit of effective development strategies then the legitimacy of the rules-based system will itself be undermined.

[63] See Chang (2002), for an excellent account of the array of trade and other policies employed by today`s advanced countries to allow them to achieve that position.

[64] See UNCTAD, 1996: 156–157; Amsden, 2000.

[65] It is salutary to be reminded that "all the thousands of pages of controversy about the causes of the Industrial Revolution have still not come up with one clear identifiable factor that Britain had and every other European (or Asian, or African) economy lacked", Ogilvie, 2000: 118.

The international financial system has also worked against establishing a dynamic profit-investment-export nexus in most developing countries. The destructive potential of unrestricted, international capital mobility and, in particular, its disruptive effect on trade and investment is now better appreciated.[66] But perhaps more damaging to longer-term prospects in developing countries has been the volatility of exchange rates, high real interest rates and the proliferation of arbitrage and unproductive rent-seeking opportunities that have emerged in a world of less regulated financial markets; the consequences in terms of sub-standard capital formation and stunted industrial restructuring have been described above. In these circumstances, the premature liberalization of capital accounts has not only been highly damaging to recent economic performance but threatens to lock many countries into a longer-term path of slow and erratic growth. Managing nominal exchange rates in order to reduce fluctuations in the real rate, combined with controls on short-term capital flows is, under these circumstances, a reasonable choice for developing countries and should be accepted as such by the international financial institutions and the developed countries. Avoiding pro-cyclical macroeconomic policies, particularly where shocks are triggered through the capital account, is also essential to building a stable growth environment in developing countries. This will almost certainly require an increase in the size of multilateral financial resources to match the growth of international economic transactions and the greater vulnerability that accompanies a higher level of interdependence. But the international financial institutions will also need to rediscover a more pragmatic and flexible approach in their promotion of developing country integration in the global financial system. This will, almost certainly, require a rolling back of conditionality and its more focused application to reflect whether domestic or international shocks are the reason for any required adjustments.[67]

Given the scale and unpredictability of capital flows, even a well-managed economy may still succumb to a sustained and major attack on its currency and a liquidity problem may then be transformed into an international debt crisis. The growing literature on managing such crises accepts the premise that international finance is under-regulated and that avoiding the downward spiral of a debt deflation, which would be the likely outcome if the standard remedy of raising interest rates and tightening fiscal policy were adopted, requires new responses (Eichengreen, 2002). This argument recognizes that large bailout operations organized by the international financial institutions have not been successful or equitable and that although domestic financial institutions and regulation need to be greatly strengthened this cannot be done quickly. It also recognizes that the burden of adjustment should be shared more equitably between borrowers and private sector creditors who tend to move in and out of individual countries in a herd and thereby increase the risks of transforming a liquidity squeeze into a solvency crisis and then a major recession. Rather, the appropriate response could combine an injection of liquidity with a debt standstill and a programme for restructuring the debt (UNCTAD, 2001). This proposal, inspired by Chapters 9 and 11 of the United States Bankruptcy Code, would stop such an escalation in its tracks. It would involve a temporary standstill on debt servicing, the IMF "lending into arrears", and provide a breathing space while debts were restructured. It is thus a proposal for preventing financial crises from being more serious than they need be and, by

[66] It is worth recalling, however, that this potential of unfettered capital flows to disrupt international trade and undermine financial stability was clearly recognized by those who set up the post-World War II international monetary system. Both John Maynard Keynes of the United Kingdom and Harry Dexter White of the United States took it for granted that controls on international capital would be needed in order to maintain an open international trading system and monetary stability.

[67] On how best to revise conditionality see Kapur and Webb, 2000; Ocampo, 2002b; Buira, 2003.

ensuring that private sector creditors share the costs of adjustment, it may even reduce the probability of such crises occurring in the first place.

The larger question, however, is whether a coherent international financial system can be said to exist at all when international currency and financial markets are dominated by speculative transactions and regular outbreaks of herd behaviour, and when there is virtually no coordination at all between the macroeconomic policies of the most developed industrialized countries. Most of the financial crises in the developing countries result from various shocks and policy changes that originate in the major reserve currency countries. But there is, at present, no system of multilateral surveillance that can insist on greater coherence in the latter's monetary and exchange rate policies. Until that situation is reformed, the developing countries will continue to be highly vulnerable to the vagaries of international finance. Global stability is still principally the responsibility of the developed countries.

VI. Conclusion

Actually existing globalization has been the product of policy choices. Without denying that by the late 1970s many developing countries needed to find new ways of inserting themselves into the global economy, we have argued that the new policy orientation of macroeconomic stringency, downsizing the public sector and the rapid opening of developing country markets to foreign trade and capital after the debt crisis, has failed to produce an economic environment that encourages and supports faster economic growth and the transformation of productive structures through higher investment and technological upgrading. This record is itself sufficient to open a discussion on alternative development strategies and, while proponents of the neo-liberal agenda persist in arguing that there are no such alternatives, this paper has tried to identify and elaborate some of their key elements and interrelationships.

But even if developing countries can find the political and ideological will to begin thinking about alternative development strategies, existing imbalances in the distribution of global economic power still mean that growth and stability in the developed economies are crucial for growth and stability in the rest of the world. On both counts, developed country performance has been uneven and deficient since the early 1970s, and a sense that the rules and procedures governing the global system should be regarded as a public good for the benefit of all has been too frequently missing from their interventions in international forums.

If the developing countries are to remain committed to integration with the global economy, to open markets, and to the market economy system itself, then the developing framework of rules and institutions also needs to be more balanced, and more just, in its treatment of poor countries, and more understanding of the particular problems they face. And if the global system is to acquire and maintain legitimacy in the eyes of all those who must participate in it, then room must be made for a much stronger representation of developing countries in the decision-making bodies that currently set and apply the rules of the system. If the present global economic system is to be a lasting and stable one then, like all social systems, it must meet three crucial conditions. First, the rules and procedures by which it is governed must be *legitimate*, that is, willingly supported by those who submit to them; second, it must be able to impose *order* by encouraging acceptable practices and sanctioning the unacceptable, and applying the criteria equally to all participants; and third, it must be capable of providing acceptable and equitable outcomes in terms of economic *welfare*. Thus the crucial question facing the liberal trading and financial system is not whether the globalization agenda should be extended to include new issues and mechanisms, but whether trust and confidence in the existing rules can be restored by applying them fairly and without numerous exceptions for the richest members of the system. If it cannot, then the present period of globalization will fail like its predecessors. As Adam Smith would undoubtedly remind us if he were to survey the contemporary global landscape, justice and the wealth of *all* nations go together.[68]

[68] "Society may subsist, though not in the most comfortable state, without beneficence; but the prevalence of injustice must utterly destroy it … Justice is the main pillar that upholds the whole edifice." (Smith, 1976: 86)

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