

Globalization: getting the "process right" for convergence and rising world income

Heiner Flassbeck¹

Massimiliano La Marca²

Abstract

The increasing global dimension of trade, financial flows and of knowledge diffusion involving both developing and advanced economies is the source of potential gains and challenges that differ according to the stage of development and the economy's idiosyncratic features. Can global integration be a win-win game for its participants? Is a benefit-maximizing and cost-minimizing "integration process" possible under a realistic assessment of its distributional and institutional effects? The paper reviews critically the orthodoxy of open markets and confronts them with the existing "consensus" empirical evidence in order to identify the emerging actual forces that shape the alternative patterns of integration, their costs and benefits.

¹ United Nations Conference on Trade and Development, Division on Globalization and Development Strategies.

² United Nations Conference on Trade and Development, Division on Globalization and Development Strategies, massimiliano.la.marca@unctad.org

Introduction: the age of diverging integration

The process of economic integration has recently gained a global dimension and an unprecedented depth involving a large number of diverse economies and a variety of new traded final and intermediate goods, services and financial instruments. Trade and financial integration is not a new process if we consider the large flows within European nations and with their colonial extensions until the early 20th century. However, it was the modern revolution in the transportation and communication systems and the new possibilities of the delocalization of productive processes arising from modern manufacture and service production that allowed the change in the scale and scope of the trade and financial exchange of sovereign nations.

Indeed, the most salient feature of modern globalization appears to be the policy reforms, the market deregulation and liberalization undertaken almost simultaneously by many developing countries and transitional economies in the last decades. Post-socialist economies and countries that once relied on heavy protective measures pursuing an import-substituting industrialization strategy underwent a process of domestic and external liberalization. As part of a larger package of policy and institutional reforms the process aimed at improving efficiency by redirecting resources from uncompetitive tradable and inefficient non-tradable production and government spending to the sectors where the comparative advantages supposedly rest. In addition, an open capital market would provide finance for development and poverty reduction to poorer economies and more profitable investment opportunities for richer and aging countries.

Another striking feature of globalization is the emerging radical divide between those economies that are narrowing their income and technology gap with the most industrialized ones and those that are not. Indeed, "falling behind" phenomenon has been the most common experience of latecomers rather than catching up (UNCTAD, TDR 2003). We are experiencing an age of "diverging integration" (Pritchett, 1997), where alternative approaches to opening up to trade and financial flows and alternative development strategies seem to explain the differences in the success to reap the potential gains of globalization.

Figure 1 shows the income dynamics of some single economies, group of countries and regions relative to the most industrialized countries and provides some striking evidence on the outcomes of the alternative integration patterns. The impressive converging trend of the first-tier Newly Industrialized (mostly South East-Asian) Economies (NIE) and the diverging pattern of Latin

American economies, both sharing the same starting relative income in 1970, are accompanied by lower volatility of the former group compared to the latter, with the exception of the large swings of the late 1990s Asian financial crisis. The second-tier NIE and China have improved their relative position though starting at a much lower income level. Where the traditional policy reforms fared the most, notably in Latin America and in some Sub-Saharan country, the relative income worsened³.

Therefore, alternative models of integration into the world economy, compared to the indiscriminate liberalization of the current and capital account, have to be considered. It should not be forgotten; today's most developed economies achieved industrialization by recurring to heavily protectionist measures and other kinds of unorthodox policies (Chang 2002) while the first-tier NIE pursued outer-oriented strategic trade and industrial policies that selectively oriented resources to dynamic industries rendering them more internationally competitive with a mix of incentives and discipline (Amsden 1989, 2001; TDR 1996, 2003).

[Figure 1, about here]

To recognize and to explain the failure of internal and external liberalization to deliver successful integration into the world economy, we have to reconsider our traditional economic wisdom and take a critical perspective. Some logical structures, deeply rooted in the orthodox economic knowledge, appear to be ill suited to help us understand the complex dynamics of prices and quantities in an integrated world economy. That is why the traditional neo-classical approach faces a more and more "puzzling" reality.

Section 2 of this paper provides a critical view on our conventional wisdom and suggests different ways to interpret the complex dynamics affecting the outcome of economic integration. In section 3 the traditional case for free trade and financial liberalization is given a reality check by looking at some broadly shared empirical evidence. Section 4 describes alternative thinking and the solutions the world has found to deal with volatile capital flows. Section 5 draws some conclusions regarding the design of a new multilateral system.

The integration process in the traditional view

³ As pointed out in the Trade and Development Report 2006 the outcome of the liberalization strategy is generally judged disappointing (TDR 2003; World Bank 2005). In any case, the annual rate of real economic growth averaged about 2.0–2.5 per cent in Africa and Latin America during the 1980s and 1990s (i.e. a level only about half that of these countries' growth performance during the 1960s and 1970s).

In the most popular and most quoted view, the core of economic activity in market economies can be described as activities to lead to "efficient allocation of scarce resources under alternative uses." This simple view, that appears quite intuitive in modern economics, captures the essence of the whole edifice of received standard theory built in centuries of overlapping contributions and systematic reinterpretations. Obviously, it shapes to a large extent the methodology underlying the way to see the world with economic eyes.

Traditional trade theory, for instance, explains the patterns and gains from free international trade, the international production specialization and labour division assuming as given, at any point in time, the existing methods of production, consumption and input supply preferences and the "relative scarcity" of the given resources (typically unskilled and skilled labour or capital). This leaves to economic actors, within the existing market structures, the scope to determine by action based on individual preferences the composition of goods produced and exchanged and their relative prices. Growth theory in this context explains per capita income differences and changes by mainly focusing the changing "relative scarcity" of production factors and the resulting productivity dynamics. Open economy macroeconomics explains trade in goods, services, financial assets as the outcome of resources allocation driven by the relative real returns of the production of tradable or non-tradable goods and services, of consumption and saving and of portfolio and real investment.

The efficiency and optimality results characterizing the working of market economies emerging from such a theoretical setting basically rely on arbitrage arguments in their broadest connotation: the natural economic activity of an "atomistic rational utility-maximizing" agent, ultimately concerned with his/her consumption possibilities, is to reallocate real and financial resources from lower to higher-return employments up to the point where rates are equalized. The equalization of returns across productive sectors, across space (regionally or internationally) and time (with the decision to allocate resources from present consumption to future consumption through saving) indicates that there are no opportunities and welfare improvement left to be exploited, which represents the perfect coordination of self-interested market participants towards consistent and Pareto optimal plans.

The arbitrage logic not only unifies the various branches of economics with differing objects and scopes of investigation, but it also provides an immediate rationale for the main theoretical

prediction regarding global economic integration through external liberalization: fundamentally, economic openness broadens the possibility of efficient resource allocation and therefore the scope for arbitrage gains readily captured by market participants. The "integrated economy" is the locus where market forces can replicate the efficient outcome of a domestic liberalized economy on a global scale. As repeatedly pointed out by prominent academics and policy makers: "... fundamentally, the case for free trade is the case for the market system. The benefits come in the form of greater realization of the efficiencies available from specialization, from more rapid technology transfer and more productive allocation of resources, from comparative advantage, and from spur of competition. They show up in higher rates of economic growth, leading to higher wages and higher returns to capital, leading to higher standards of living" (Summers 1999, p.7).

The conditions for market efficiency, and lack thereof, have been widely addressed by the theory of market failure, the welfare and second-best economics. Although preserving the general equilibrium framework, they emphasize how an insufficient degree of information and rationality, the presence of increasing returns to scale, lack of perfect competition, and the role of institutions can affect the outcome of market forces and lead to suboptimal outcomes. Market failures and the role of aggregate demand, for example, are at the core of the traditional argument for industrial policy as in the classical works of Young, Rosenstein-Rodan, Hirschman, Myrdal, Kaldor and, more recently, in the empirical studies of late industrialization (e.g. Amsden 1989, 2001; UNCTAD, TDR 1996, 2003). As emphasized in UNCTAD (2006) a proactive industrial policy designed to support productive dynamism and technological upgrading becomes necessary when (i) there are significant dynamic economies of scale and learning that give rise to increasing returns at the firm level; (ii) complementarities in investment, production and consumption can result in market failure; (iii) when information externalities associated with investment in goods or modes of production exist which are new for the respective economy.

A more radical reconsideration of our conventional economic wisdom is required if we acknowledge that short-term outcomes, shocks and monetary conditions have permanent or long-run effects. While standard theory is fundamentally "a-temporal" and relies on a comparison of "static" production and trade configurations completed by the stable operation of market forces through the "arbitrage" mechanism, the alternative view insists that "path dependence" and "hysteresis" effects are ubiquitous in real economies.

As pointed out in Flassbeck (1987) and Palley (2003), any comparative advantage configuration needs to be supported by a well-behaved nominal adjustment process able to equilibrate the absolute competitive advantages among economies. In a high-productivity country that would enjoy otherwise absolute competitive advantages in all sectors, for instance, nominal wage and prices need to rise to the point that it will find convenient to import the goods in which it has a comparative disadvantage, and vice versa. Prices and/or exchange rates need to be consistent with the relative price configuration of the trade equilibrium. However, if price and wage changes are not consistent in this way with economic activity and if exchange rate volatility can lead to persistent misalignment, then the necessary nominal adjustment failure can have permanent real consequences. Flassbeck points to the inherent flaws of the information generating process of capital markets to explain these phenomena and Palley presents a number of other possible sources of hysteresis such as (i) habit based consumption (ii) fleet investment principle (iii) lock out through increasing returns and (iv) destruction of organizational capital. All of these factors can favour the persistence of contingent outcomes due to short-term and/or monetary conditions. In other words, if some productive activities face a temporary competition, then these activities and the associated know-how can get lost forever regardless of their original availability in the technology and factor endowment, even if the temporary competition - based on the Walrasian arbitrage logic – was unsustainable.

If valid, price and real return equalization as the equilibrium outcome of arbitrage forces should form the basis for the empirical manifestation of the efficiency of market allocation hypothesis. Hence, the law of one price (LOP) and the purchasing power parity (PPP) are the single most important rules that have to hold if the neo-classical theory can justifiably claim to hold the key for our understanding of globalization and international integration. The former states that, for any single commodity, prices are equalized across borders. If the LOP holds for a sufficient number of goods, the nominal exchange rates are tied by the Purchasing Power Parity (PPP), an equilibrium condition that, in its strongest version, requires cross-country equalization of traded goods price index levels expressed in the same currency and, in its relative version, simply requires that price inflation differentials across countries being offset by nominal exchange rate change. While the LOP rules out price competition by assuming that price differentials in similar goods are readily arbitrated away, the PPP represents the simplest real equilibrium money-neutral condition in the trade literature, and a building block of most monetarist macro models. A failure of the former can be interpreted as the manifestation of a constant tendency of trade of single goods to be affected by exchange volatility and monetary shocks. In this case production and trade strategies

have lost the almost natural setting of the comparative advantage equilibrium. In the same way, a failure of the latter implies the relevance of nominal exchange rate fluctuation and the overall monetary conditions on the relative aggregate price of goods and therefore the relevance of terms of trade shocks and consumption switching effects.

According to Froot and Rogoff (1995), Rogoff (1996), and Sarno and Taylor (2002) the “consensus” empirical evidence is that the real exchange rate tends to the PPP in the very long run only, while single-traded goods analyses show very high volatility and persistent deviations from the LOP parity; in both cases the large and volatile deviations are of the same order of magnitude as those of the nominal exchange rate. Thus, the persistence of the deviations cannot be explained by the temporary effects of price stickiness, and, even more importantly, the short-term volatility of real exchange rates cannot be ascribed to real shocks.⁴

Therefore, while PPP and LOP can preserve a central role to explain arbitrage based models, the puzzling evidence for both may form the surface of a more complex explanation of real economic dynamics, where production structure and trade are constantly changing due to the contingent economic conditions.

Under this perspective it is clear why unregulated market forces often appear unable to coordinate arbitrage seeking actors and do not automatically lead to the optimal configuration of production on a global scale. However, if capital flows have adverse effects on exchange rates or influence monetary policies in a way that permanently affects the production and trade patterns - regardless of the existing potential for specialization and world welfare improvement – globalization is not such a smooth exercise as envisaged by the traditional and mainstream approach.

Integration through liberalization of the capital account?

The traditional case for financial integration is based on the benefits of pooling and allocating savings towards the most productive uses across countries. The principle of comparative advantages and mutual gains from free trade in goods is extended to the trade in financial assets along three main dimensions: countries can benefit from financial integration if (i) they have different capital endowments and different risk-free returns to capital and benefits (neoclassical

⁴ Most of the following empirical assessments on the outcomes of liberalized trade and financial flows reported here have been produced by mainstream leading economist of World Bank, IMF and North-American Universities that have shaped or supported what has been labelled as "Washington Consensus". The empirical evidence falsifying most of the expected outcomes of the policies can be therefore taken as an element "consensus" with the critics of the "Washington Consensus" itself. Nevertheless, the interpretations on the causes of the empirical results differ.

convergence argument), and/or (ii) have desired consumption and savings time patterns not “in line” with their available income (intertemporal trade argument) and (iii) face different potential fluctuations of production that affects their consumption possibilities (risk-sharing argument).⁵

The standard open economy neoclassical-Solow model has provided the first and the most lasting argument for capital account liberalization and financial integration (Summers 2000, being an example). If technical knowledge is diffused across countries, and if technology displays the traditional decreasing returns to capital, then risk-adjusted returns to investment is a decreasing function of the capital endowment. Under financial openness, the real interest rate differential between capital-abundant developed countries and capital-scarce developing economies would ignite spontaneous arbitrage forces and generate a flow of funds that would provide developing countries with the additional foreign savings required for new investment and growth. The convergence in the asset returns, capital intensity, technology and per capita incomes is assured through temporary current account deficits or net capital inflows.

Standard theory, therefore, implies a strong correlation between capital inflows, new productive capacity and convergence. Given the absence of any form of relevant uncertainty on the profitability of capital, savings generate their own investment by direct "transmutation," as in the open economy Solow model. Similarly, foreign savings inflows are supposed to reduce the risk-free rate and the equity premium through better risk diversification. Lower cost of equity capital would in turn stimulate investment. In both cases financial openness would directly induce capacity building and growth through capital accumulation (Fischer 1998; Henry 2003).

A second argument for financial liberalization rests on the mentioned intertemporal approach to the current account where free trade in commodities and in financial assets are the most efficient way to "buffer" expected and unexpected income variations and to "smooth" consumption through net lending and borrowing between countries. Free capital flows, in this framework, not only permit better productive allocation of financial wealth but also a reduction of the effect of real shocks on consumption and therefore improve overall aggregate welfare. In the intertemporal approach of the current account, popularized by Obstfeld and Rogoff (1995, 1996) for instance, current and capital account imbalances are the intentional means to transfer income over time. Countries would arbitrage away the "returns" of having "consumption today instead of tomorrow"

⁵ Economists such as Bhagwati (1998) and Rodrik (1998) have criticized this naïve analogy arguing that while free trade in commodities is naturally beneficial, free trade in capital is inherently unstable and prone to crises

by allowing “desired misalignments” between income and spending. In this world, the pattern of trade is passively determined by capital flows.

Global financial integration would also allow countries to share the production risk associated with exogenous idiosyncratic shocks. The "risk sharing" argument in international finance is basically a global scale extension of the well-known portfolio allocation theory: national productive capital is conceived of as a risky asset whose return depends on volatile production that can be sold abroad in the form of shares of domestic firms. Countries with different production structures, which are therefore subject to uncorrelated shocks in production, can improve their national welfare by trading assets, reducing the asset return volatility and consequently reducing the volatility of their consumption levels.⁶ If risk is perfectly shared among economies, any country's GNP (gross national product) is uncorrelated to its GDP (gross domestic product) and depends only on global production. Consumption growth rates are correlated across countries and less volatile than domestic output. If output volatility becomes irrelevant for welfare, national production can even become more specialized and benefit from scale economies and comparative advantages. Under this perspective developing countries could be advised to further reduce their production diversification in order to increase and stabilize their consumption levels!

Beyond these main arbitrage arguments there are less direct channels through which trade and financial integration through liberalization is supposed to stimulate growth and convergence: (i) technological spill-overs generated by FDIs which are undertaken after a more informed evaluation of the intrinsic profitability and are more stable than bank lending and portfolio flows, (ii) the positive influence of openness in the development of domestic financial markets through competition, enhanced liquidity and introduction of new forms of financial intermediation, and (iii) the discipline (a “tie-your-hands” policy) that markets would impose to a lax public sector by restraining monetary arbitrariness and stimulating investment friendly tax reforms. The two last arguments share the same logic that external competitive pressures can discipline and improve the efficiency of institutions and policies and that the efficiency gains will largely offset any eventual adjustment costs (Gourinchas/Jeanne 2003).

⁶ Any country can diversify its portfolio and reduce its GNP risk by selling part of its GDP in the form of shares of productive capital and buying parts of other economies' GDPs through capital outflows. The assets' extra-returns would offset each other so that bad production years in one country are compensated by good “harvests” in the others.

However, the supposed outcomes of financial liberalization do not find much support even in the "consensus" empirical evidence. Prasad, Rogoff, Wei, and Kose (2003) sum up the existing literature and assess that "...an objective reading of the result of the vast research effort undertaken to date suggests that there is no strong, robust, and uniform support for the theoretical argument that financial globalization per se delivers a higher rate of economic growth...[and] the volatility of consumption growth has, on average, increased for emerging market economies in the 1990's" (Prasad et al. 2003, p. 3) so that "... while there is no proof in the data that financial globalization has benefited growth, there is some evidence that some countries may have experienced greater consumption volatility as a result" (ibid., p. 1).

A weak association of better growth performance with financial openness between groups of countries (industrialized compared to developing and more financially open developing countries compared to less open countries) does not provide any causal relation between integration and growth, nor does the former seem to be a sufficient condition (as in the case of Venezuela South Africa, Jordan and Peru) or even a necessary condition for the latter (as in the case of China and India). Financial openness could be an advantage for mature or already sound and stable economies. Prasad et al. show that even correcting for initial income, schooling, average investment-to-GDP ratio, policy instability and regional location there is basically no association between capital account openness and growth rates.

According to Mody and Murshid (2002), "...the weakening, over time, of the relationship between aggregate capital flows and investment is consistent with an increase in the share of portfolio flows in long-term capital...[and] 'merger and acquisitions' – as distinct from the traditional 'Greenfield' foreign investments - have become more prominent, implying that more of the foreign capital is being used to purchase assets rather than finance new investments." (Mody and Murshid 2002, p. 5). However, a positive association of FDI and growth cannot be taken for granted: it has been pointed out that FDI can be associated with crowding out of "domestic" private investment, while human capital and knowledge accumulation through FDI spillovers can be of a second order magnitude. Indirect negative effects on investment can also be generated by the current account difficulties a country may incur by the repatriation of profits and intermediate input imports associated with the FDI (TDR 2003).

A large body of evidence also finds an increase in macroeconomic volatility, which represents a failure of the risk-sharing effect of global diversification and financial integration. Indeed, the implications of the theory have never found support in the data, giving rise to another "puzzle" in

international finance: there is a higher correlation of aggregate consumption to domestic output than to global production and consumption, while national outputs also tend to commove (Tesar/Werner 1995; Backus/Kehoe/Kydland 1992; Obstfeld 1994). Moreover, Kose, Prasad and Terrones (2003) show that the volatility of consumption relative to output increases with financial integration, while O'Donnell (2001), using data ranging between 1971 and 1994, finds that OECD countries seem to benefit from further integration while non-OECD countries experience higher output volatility. Obviously, output and consumption volatility measures are affected by the episodes of banking and financial crises of the 1990s that hit relatively more financially open economies. Those currency crises led to large and persistent output and consumption contractions (Calvo/Reinart, 2002).

Integration processes for convergence and rising world income

While there might be some agreement on the fact that capital inflows are sterile or can even increase macroeconomic volatility if not coupled with the national institutions and policies that are able to channel them into investment or technological improvement, there is much more divergence on the role of the institutional reform agenda concerning the international financial system needed to link capital with income growth and catching-up.

National policy reform proposals have moved further from the traditional recipe of "sound macroeconomic, liberalization and privatization" to reforms with a deeper institutional content (the so called "second generation of reforms") claiming the role of domestic financial market development to allow a more effective channelling of portfolio flows and bank lending into productive investment. The institutional set up should therefore allow for more "absorptive capacity" and induce a more favourable selection of financial flows capable of producing technological spillovers, reduce volatility and increase growth.

Institutional analysis, however, showed the impossibility to clearly detect neither a one-to-one correspondence between desired economic outcomes and institutional setup nor a set of institutional "blue prints" generally applicable to developing countries (TDR 2006). Institutional soundness, economic performance and effective integration appear to be linked in a virtuous circle, with strong evidence that industrialized economies benefited more from financial integration, while even the most integrated and more industrialized developing economies suffered from more volatility. Thus, financial openness is not a precondition for setting off a

catching up process. This is not only due to highly systemic global financial instability, but also due to the fact that capital accumulation, product differentiation and technological upgrading are induced by forces other than simple arbitrage.

To grasp the complexity of economic systems under “objective uncertainty” (J. M. Keynes) we have to drop the assumption of the representative agent’s maximizing behavior and Walrasian adjustment. “Expenditure changes” and “expenditure switching” due to price shocks in traded goods and internal relative prices, wage determination and overall profitability are instead critical factors for one country’s competitiveness and the incentive to investment and built capacity. These issues can only be sensibly addressed by including into the theoretical framework the complex interactions of economic groups such as workers, firms and shareholders in a world of uncertainty that is permanently bombarded by unforeseen shocks.

For instance, in the saving-determined-growth and current-account-balance theory "if saving falls short of desired investment, "...foreigners must take up the balance, acquiring, as a result, claims on domestic income or output." (Obstfeld/Rogoff, 1996, p. 1734). Thus, in this world, an increase in the saving rate of private households and a corresponding drop in consumption demand do not lead to an immediate fall of companies' profits and accumulation. However, real world experience is that firms do not invest more if they have already piled up unsold stock as involuntary inventories (and therefore incurred in larger costs) and/or the capacity utilization is lower than before as an immediate outcome of falling consumption demand. In a world of money and uncertainty, the decision to save more and to consume less can have grave repercussions on the goods market before it impacts on the capital market.

The decision, as Keynes has put it, "not to have dinner today" depresses the business of preparing dinner today without immediately stimulating any other business. If the saving rate of private or public households suddenly rises, companies, faced with falling demand and falling profits will react with falling investment if they do not possess more systemic information than just the information about the drop in demand. That is why the secular decline in the saving rate of private household in the industrialized world that started at the beginning of the 1990s of the last century – the savings rate of the G-7 countries almost halved, falling from around 9 % in 1992 to 4 ½ % in 2005 is mirrored in the secular rise of the savings of corporations from 8 ½ % to 11 ½ %. Hence, thrift of private households is not a virtue per se but has to be analyzed in the context of all the other forms of saving by other agents including the saving of companies.

The failure of market participants to coordinate and clear markets in a Walrasian fashion brings to the fore the role of the independence of savings and investment decisions and the role of profits as the savings of companies, the importance of the exchange rate on the one hand, and of labour market conditions and labour productivity changes on the other. For example, in a world of differing productivity performances of companies and the rule of LOP on the labour market, prices are sticky, but profits rates are varying with the level of economic activity. Moreover, the relocation of production to low-wage countries in most cases takes place by moving the existing capital-intensive technology of the high-wage country to a low wage location. Thus, not the smaller quantity of capital and the reduction in overall capital costs determine the relocation, but the chance to realize a temporary monopoly rent, which is the higher the lower the wage level of the capital importing country and the smaller its overall growth rates of productivity and wages are.

In this world, a current account deficit or a growing “inflow of foreign saving” can emerge in the wake of negative shocks on the goods market, for example due to falling terms of trade or a lasting real appreciation. A real appreciation directly diminishes the revenue of companies if market shares are protected by a pricing-to market strategy. If companies try to defend their profit margins, a fall in market shares, and as a rule, a swing in the current account towards deficit is unavoidable. Higher net inflows of foreign savings, that correspond to an increase of net-imports, do not automatically lead to higher investment which is instead negatively affected by falling real income and profits. In that case, net capital flows would therefore be the symptom of a negative shock. On the contrary, if current account surpluses are the result of growing exports and rising market shares, with profits fuelled in the export sector, there can be second-round positive effects in the domestic sector's output and investment. Crucial, therefore, are the effects of the emergence of a current account surplus (induced by rising exports, import substitution or an improvement in the terms of trade) on profits and jobs for the creditor country, or the other way round.

The nature of short term capital flows and the role of interest rates, nominal and then real exchange rates as main transmission channels is the most important source of consumption and output volatility. There is no monetary autonomy in an open economy. The traditional “impossible trinity” (fixed exchange rates, open capital account and monetary autonomy) has to be replaced by an “impossible duality” (Flassbeck 2001). Reserves and liquidity increase under a pegged exchange rate or under a managed float when, facing a flush of capital flows in the domestic

financial system, monetary authorities intervene to prevent excessive appreciation. Obviously, no intervention means “excessive” and that implies unwanted appreciation of the domestic currency with all its effects on growth and income generation. Appreciation means to stimulate the consumption of non-tradable goods and imports. The competitiveness of production and the current account is weakened; capital formation is penalized by falling profitability and the borrowing risk increase, until a "sudden stop" of flows and devaluation become inevitable again.

If interest rates are fully used to respond to external shocks they cannot perform their adjusting role between saving and investment and guarantee full employment. Additionally, the industrialized world has seen other cases of external shocks. During the oil-price shocks interest rates did not fall despite falling capacity utilization as monetary policy was fighting higher inflation induced by the ensuing negative supply shock. Interest rates may even go up in a cyclical downturn if financial markets dictate higher interest rates to a developing country due to increasing risks of a default. The negative effects of falling private demand on profits may be aggravated by pro-cyclical fiscal policy in developing countries if "the markets" expect a quick reduction of public budget deficits.

Income growth can therefore be achieved only by constantly managing the dynamics of open economies to achieve investment plans exceeding saving plans ex-ante. In such a world, even with the private incentive to "thrift" left unchanged, the economy as a whole may expand vigorously. The "savings" corresponding to the increased investment are generated through investment and the original investment may be “financed” through liquidity created by bank credit based on expansionary central bank policy. Increased investment stimulates higher profits, as temporary monopoly rents of the company sector rise. These profits provide for the macroeconomic savings required from an ex post point of view to “finance” the additional investment (or repay the bank credit).⁷

Some of these lessons have been learned by developing countries, some of them in the hard way. Figure 2 shows the change in the number of economies, grouped by region, that are running a current account deficit. In 1996, before the financial crises in Asia and Latin America, South Asia and South-East Asia economies were experiencing large net capital inflows and 17 out of the 22 countries of the region had a current account deficit, while in 1998 all 19 Latin American countries had an external deficit. After the 1997 and 1998 crises that respectively affected the two

⁷ This is the position UNCTAD, in its Trade and Development Reports, has called the “profit-investment-nexus”.

regions, the number of deficit countries has sharply declined and each region is running a current account surplus as a group. This can be interpreted as a fundamental change in the perception of globalization and of development strategy of these two crisis-stricken regions. From a strong reliance on foreign capital inflows they moved towards a policy of preserving favourable monetary condition, such as slightly undervalued exchange rate and low interest rates and thereby favouring growth by stimulating export demand, competitiveness and productive investment.

[Figure 2 about here]

This solution has to be seen as a self-defence mechanism against the most important threat of the globalised economy: the systemic financial instability arising from short term volatility of capital. The accumulation of reserve of surplus countries, in a very narrow perspective, may be suboptimal, but it is the necessary outcome of the lack of a global financial system that could complement and make more effective the global trading system (TDR 2006). A reasonable global financial architecture that would set rules for the management of capital flows and exchange rates would not only allow for larger international financial stability, but also for smaller global imbalances, which means smaller current account surpluses of emerging market economies and a smaller deficit of the United States.

Conclusions

Although world output is expanding vigorously in the last four years, with a 6.2 per cent growth rate for developing and a 2.7 rate for developed countries (TDR, 2006), only few economies are actually closing the gap between the two groups. World economic integration, on the contrary, has been a much more widespread phenomenon and has been tried under various historical circumstances and with various forms of policy reform. The results have been disenchanting for an overly simple view of the world, the pure market approach. Those countries that have undertaken indiscriminate lowering of barriers for trade and financial flows and abstained from any proactive policy of industrialization and integration strategy have fared the least. Conventional wisdom provides us with predictions on the nature and gains from free capital and trade flows based on well-established and self-consistent basic principles of arbitrage and flexibility of prices. However, the power of these principles to explain real world markets is clearly limited. Indeed, uncertainty, the general scarcity of knowledge and information and the influence of contingent conditions, institutions and history seem to nullify the role of reallocation

of resources compared to the adoption of new technologies and new investment in permanently changing structures of production.

Moreover, the lack of instantaneous and well-behaved nominal adjustment renders any underlying real equilibrium configuration irrelevant because comparative advantages are not realized, real investment returns are not equalized, and prices do not settle to their parity level before new shocks set in. On the contrary, temporary nominal and real outcomes of monetary policies, exchange rate misalignment and external shocks, permanently affect the direction and the quantity of economic change. Hysteresis and path dependent features of real market economies, together with the existence of market failures call for a role of proactive policies in industrial, trade and macroeconomic management at a domestic and at the global level. Competitiveness of countries is extremely relevant in such disequilibrium dynamics, but it has to be put under international scrutiny to avoid "races to the bottom" and international trade wars.

The "right process" of integration is one of effective outer-oriented development in combination with a growth strategy. It requires a clear understanding of the limits and potentialities of market forces, the effectiveness of national macroeconomic and industrial policies, and the right balance between discipline and flexibility in the multilateral global governance.

References

Amsden, A. H. (1989). *Asia's Next Giant: South Korea and Late Industrialization*. Oxford: Oxford University Press.

Amsden, A. H. (2001). *The Rise of "the Rest": Challenges to the West from Late-Industrializing Economies*. New York. Oxford University Press.

Backus, D., Kehoe, P., and Kydland, F. (1992), "International Real Business Cycles," *Journal of Political Economy*, 100, 745-75.

Bagwati, J. (1998), "The Capital Myth," *Foreign Affairs* May/June, 1998, pp. 17-12.

Bosworth, B. and Collins, S. (1999), "Capital Flows to Developing economies: Implications for Saving an Investment," *Brooking Papers on Economic activity*: 1 p. 43-69.

Calvo, and Reinhart, (2002), "Fear of Floating," *Quarterly Journal of Economics*, vol.117, pp. 379-408.

Chang, H-J. (2002). *Kicking Away the Ladder—Development Strategy in Historical Perspective*. London: Anthem Press.

Eatwell, J. and Taylor, L. (2002), "Introduction," in Eatwell and Taylor (eds), *International Capital Markets: systems in transitions*, Oxford, Oxford university Press.

Flassbeck, H. (2001), *The exchange rate – Market price or economic policy tool*, UNCTAD discussion paper No. 157

Fischer, S. (1998), "Capital Account liberalization and the role of the IMF," *Princeton Essays in International Finance*, 207, PP. 1-10.

Gourinchas, P. O. and Jeanne, O. (2003), "On the Benefits of Capital Account Liberalization," *IMF Working Papers*, Washington.

Froot, K. and Rogoff, K. (1995), Perspective on PPP and Long-Run Real Exchange Rates, in Grossman G. M. and Rogoff K. (eds), Handbook of International Economics, volume 3. ch. 32, 1647-1688.

Henry, P. (2003), "Capital Account Liberalization, the Cost of Capital and Economic Growth," American Economic Review, Papers and Proceedings, Vol. 93, (May), p. 91-96.

Kose, M., Prasad, E., and Terrones, M. (2003), "Financial Integration and Macroeconomic Volatility," IMF Staff Paper.

Lucas, R. (1982), "Interest rates and currency prices in a two-country world," Journal of Monetary Economics, 10 (November) 335-60.

Lucas, R. (1990), "Why Doesn't Capital Flow from Rich to Poor Countries?" American Economic Review, 80, 92-96.

Mody, A. and Murshid, A. (2002), "Growing Up with Capital Flows," IMF Working Paper, 02/75.

Obstfeld, M. (1994), "Are Industrial Countries Consumption-Risk Globally Diversified?," in Leiderman, L., and Razin, A. (eds), Capital Mobility the impact on Consumption Investment and Growth, Cambridge, Cambridge University Press.

Obstfeld, M. and Rogoff, K. (1995), "The Intertemporal Approach to the Current Account," in Grossman G. and Rogoff, K. (eds) Handbook of International Economics, Ch. 34, Vol. 3, Elsevier, North-Holland.

Obstfeld, M. and Rogoff, K. (1996), Foundations of International Economics, Cambridge, Massachusetts, MIT press.

O'Donnel, B. (2001), "Financial Openness and Economic Performance," (Unpublished: University of Dublin).

Palley, T. (2003), "International Trade, Macroeconomics, and Exchange Rates: Re-Examining the Foundations of Trade Policies," unpublished Discussion Paper (November, 2003) presented at the conference on Globalization and the Myths of Free Trade held at the New School for Social Research, New York, NY, April 18, 2003.

Prasad, E., Rogoff, K., Wei, S., and Kose, M. (2003), "Effects of financial globalization on developing countries: some empirical evidence," IMF, Occasional Papers Series.

Printchett (1997), "[Divergence, Big Time](#)," [Journal of Economic Perspectives](#), vol. 11(3), pages 3-17, Summer.

Rodrik, D. (1998), "Who Needs Capital Account Convertibility?". Princeton Essays in International Finance, 207, pp. 55-65.

Rogoff, K. (1996), "The Purchasing Power Parity Puzzle," *Journal of Economic Literature*, XXXIV, June, 647-668.

Romer, P (1994), "The Origins of Endogenous Growth," *The Journal of Economic Perspectives*, Vol. 8, No. 1. (Winter, 1994), pp. 3-22.

Sarno, L. and Taylor, M. (2002), "Purchasing Power Parity and the Real Exchange Rate," IMF Staff Papers, Vol. 49, pp. 65-105.

Schumpeter, J (1911), *Theory of economic Development: An Inquiry into Profits, Capital, Credit, Interest, and the Business Cycle*, Cambridge, MA, Harvard University Press (English Translation 1934).

Summers, (2000), "International Financial Crises: Causes, Prevention, and Cures" *American Economic Review Papers and Proceedings*, 90, pp. 1-16.

Taylor, L. (2001), *External Liberalization, Economic Performance and Social Policy*, Taylor, L. (ed.), Oxford University Press.

Tesar, L. L. and Werner, I. (1995), "Home bias and High Turnover," *Journal of International Money and Finance*, 14, (August) pp. 467-92.

TDR (Various Issues), UNCTAD Trade and Development Report, United Nations, New York and Geneva.

World Bank (2005). *Economic Growth in the 1990s. Learning from a Decade of Reform*. The World Bank. Washington DC.

Figures

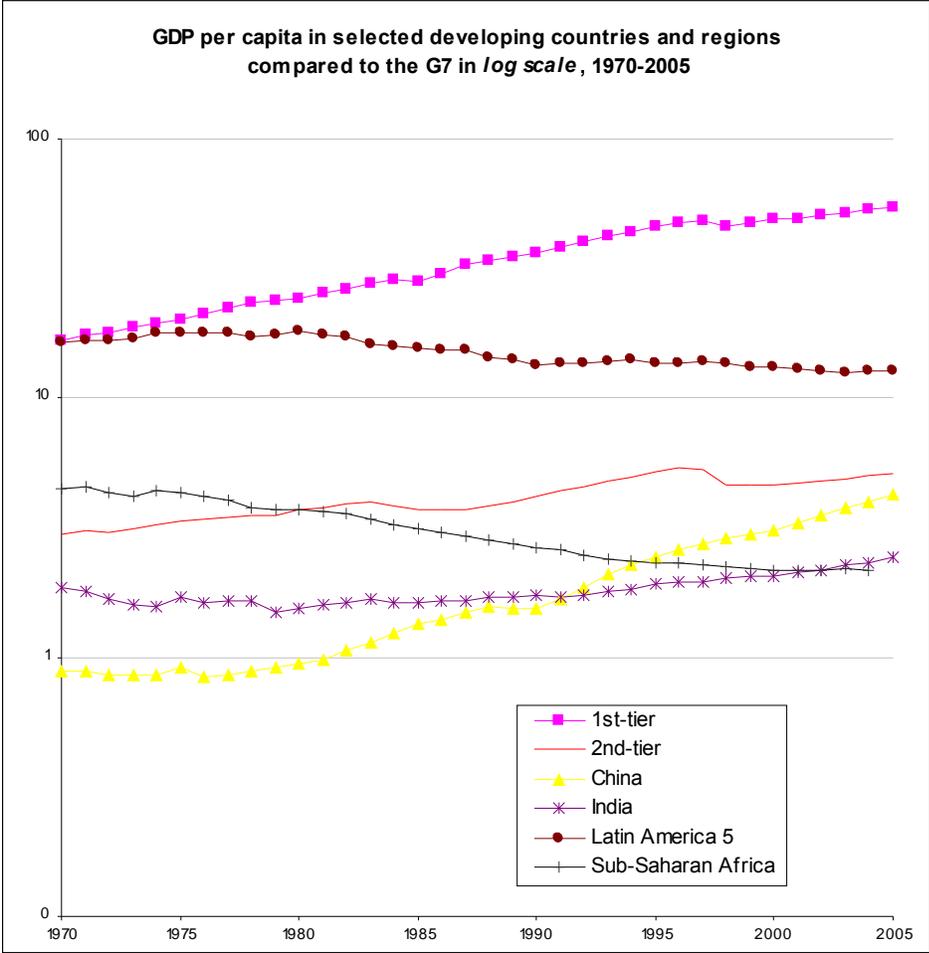


Figure 1: GDP per capita in selected developing countries and regions compared to the G-7 in log scale, 1970-2005.

First-tier and second-tier NIE economies and China appear to have found sustainable ways of closing the income gap with developed economies; Latin America and Sub-Saharan Africa do not.

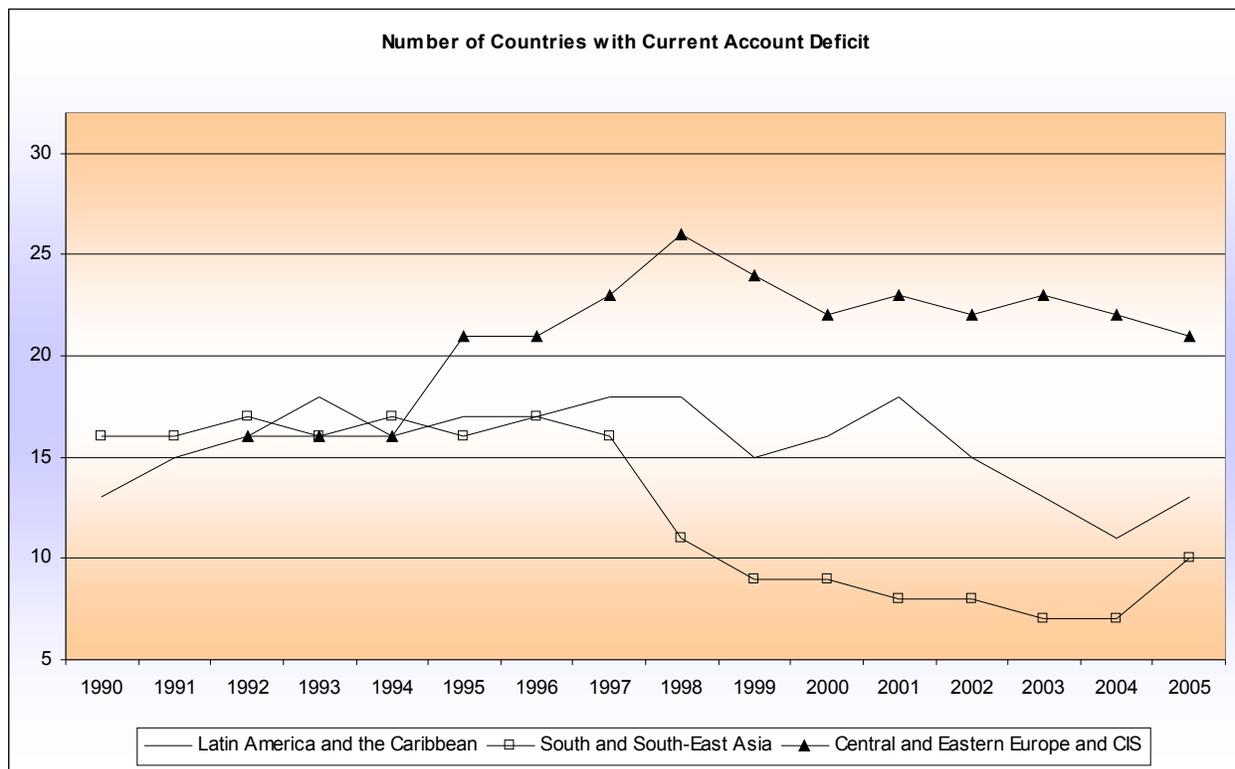


Figure 2. Number of developing and transition economies with current account deficit in selected regions, 1990-2005.