

GLOBALIZATION: “GETTING THE PROCESS RIGHT” FOR CONVERGENCE AND RISING WORLD INCOME

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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.

GLOBALIZAÇÃO: “AJUSTANDO O PROCESSO” EM DIREÇÃO AO AUMENTO E À CONVERGÊNCIA DA RENDA MUNDIAL

A dimensão do aumento global do comércio, dos fluxos financeiros e de difusão de conhecimentos envolvendo as economias em desenvolvimento e avançadas é a fonte de ganhos potenciais e desafios que diferem, de acordo com o estágio de desenvolvimento, as características idiossincráticas da economia. A integração global pode ser um jogo de ganha-ganha para seus participantes? É um benefício de maximização e minimização de custos do “processo de integração”, sob uma avaliação realista de seus efeitos distributivos e institucionais? O artigo analisa criticamente a ortodoxia de mercados abertos e os confrontam com o consenso “existente” de evidências empíricas, a fim de identificar as forças emergentes reais que moldam os padrões alternativos de integração, seus custos e seus benefícios.

1 INTRODUCTION: THE AGE OF DIVERGING INTEGRATION

The process of economic integration in the last two decades and before the financial crisis gained a global dimension as well as unprecedented depth. It has involved a large number of diverse economies and a variety of newly-traded final and intermediate goods, services and financial instruments. Trade and financial integration is not a new process if we consider the large flows between European nations as well as, until the early 20th century, between those nations and their colonial extensions. However, it was the modern revolutions in transportation and communication systems, along with new possibilities for delocalizing productive processes arising from modern manufacture and service production, which enabled the change in the scale and scope of trade and financial exchange among sovereign nations.

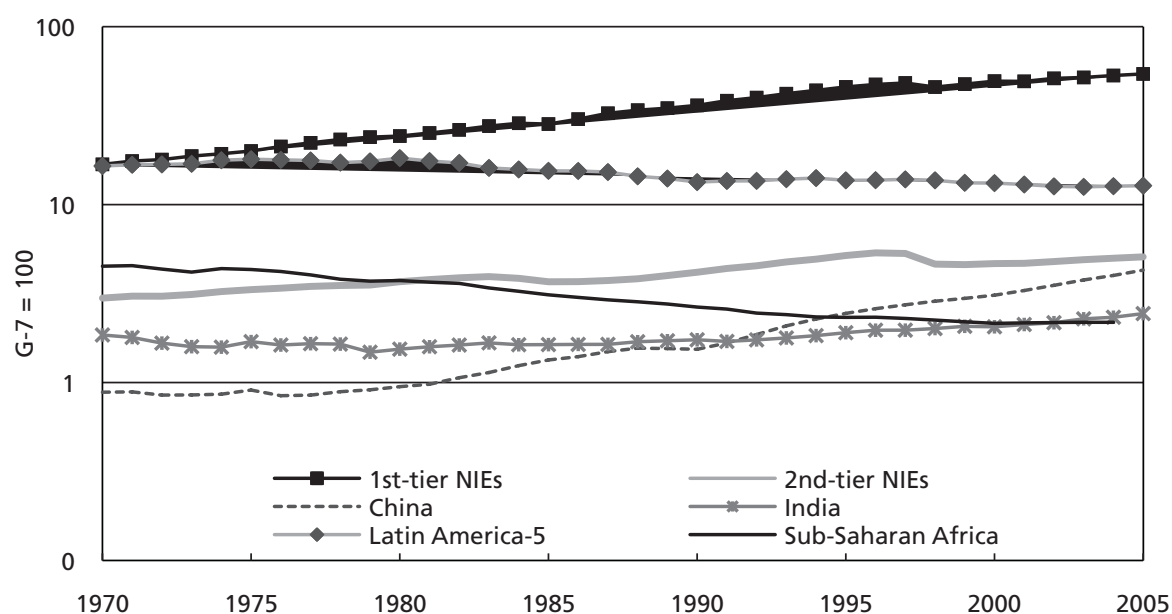
Indeed, the most salient feature of modern globalization has been the combination of policy reforms, market deregulation and liberalization undertaken almost simultaneously by many developing countries and transitional economies during the last decades. Post-socialist economies and countries that once relied on heavy protective measures while pursuing an import-substitution industrialization strategy underwent a process of domestic and external liberalization. As part of a larger package of policy and institutional “market friendly” reforms, the process of external liberalization aimed at improving efficiency by redirecting resources from uncompetitive tradable and inefficient non-tradable production and government spending toward sectors of supposed comparative advantage. In addition, capital market openness was expected to provide finance for development and poverty reduction for poorer economies and more profitable investment opportunities for richer, aging countries.

Another striking feature of globalization in the last decades was the emerging radical divide between those economies that were narrowing their income and technology gap with the most industrialized ones as compared with those that were not. Indeed, the phenomenon of “falling behind” rather than catching up has been the most common experience of latecomers (UNCTAD/TDR, 2003; Pritchett, 1997). Even before the crisis we have been experiencing an age of “diverging integration”, where alternative approaches to opening up to trade and financial flows, associated with more broadly-defined alternative development, seemed to explain the differences in countries’ success in reaping potential gains from globalization.

Figure 1.1 shows the income dynamics of some single economies, groups of countries and regions, relative to the most industrialized countries. It provides some striking evidence with regard to the outcomes of alternative integration patterns. The impressive converging trend of the first-tier newly industrializing (mostly South-East Asian) economies (NIEs) and the diverging pattern of Latin American economies, both sharing the same relative starting 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 NIEs and China have improved their relative position, although starting at a much lower income level. Where traditional policy reforms were instituted the most, notably in Latin America and in some sub-Saharan countries, relative income worsened.

FIGURE 1.1

GDP per capita (log scale) in selected developing countries and regions compared to the G-7, 1970 – 2005



Source: UNCTAD and United Nations with the exception of sub-Saharan Africa whose source is World Development Indicators 2006, World Bank. Calculations are based on constant GDP (1995 US\$).

Note: Latin America-5 comprises Argentina, Brazil, Chile, Colombia and Mexico; the first-tier NIEs comprise Hong Kong (China), the Republic of Korea, Singapore and Taiwan Province of China; the second-tier NIEs comprise Indonesia, Malaysia, the Philippines and Thailand. South Africa is not included in sub-Saharan Africa.

Therefore, there is a need for defining an alternative model for integrating a country into the world economy that does not rely on indiscriminate liberalization of the current and capital accounts. It has been shown widely that today's most developed economies achieved industrialization by relying on heavily protectionist measures and other kinds of unorthodox policies (e.g. Chang, 2002). In the same way it has been shown how the first-tier NIEs pursued outer-oriented strategic trade and industrial policies that selectively oriented resources toward dynamic industries with a mix of incentives and discipline, rendering them more competitive internationally (Amsden, 1989 and 2001; UNCTAD/TDR 1996 and 2003). First-tier and second-tier NIE economies and China appear to have found sustainable ways of narrowing the income gap with developed economies; Latin America and sub-Saharan Africa have not.

Though historical experience cannot be emulated tout court due to constantly changing world political and technological conditions, historical evidence should help us shape our common wisdom on viable development and integration processes.

In order to identify and explain the reasons for the failure of internal and external liberalization in realizing sustainable integration into the world economy, we have to reconsider our traditional economic wisdom and take

a critical perspective. Some logical structures, deeply rooted in orthodox economic knowledge, appear to be ill-suited to help us understand the complex dynamics of prices and quantities in an integrated world economy, raising more “puzzles” than explanations.

Section B of this chapter provides a critical review of conventional wisdom and suggests different ways to interpret the complex dynamics affecting the outcome of economic integration. In section C the traditional case for free trade and financial liberalization is given a reality check by looking at some broadly-shared empirical evidence. Section D underlines the complex dynamic interaction between institutional change, policy determination and economic performance, relating the sources of development with the issues of integration and local determination of institutional forms. Section E sheds some light on how macroeconomic determinants can lead to lasting developmental effects. Section F draws some conclusions regarding the design of a new multilateral system.

2 THE INTEGRATION PROCESS IN THE TRADITIONAL VIEW

In its most popular and quoted definition, the core of economic activity in market economies would consist of actions that “rationally” lead to “efficient allocation of scarce resources under alternative uses.” This simple view, which appears quite intuitive in modern economics, captures the essence of received standard theory built during centuries of overlapping contributions and systematic reinterpretations. Obviously, to a large extent it shapes the methodology underlying the way one sees the world from an economic perspective.

2.1 The resource allocation mechanism

Traditional trade theory, for instance, explains the patterns of free international trade, along with associated gains derived from international production specialization and labour division, by assuming that the existing methods of production, consumption and input supply preferences are given at any point in time, along with the “relative scarcity” of given resources (typically unskilled and skilled labour or capital). This leaves economic actors the scope to determine, by action based on individual preferences within existing market structures, the composition of goods produced and exchanged as well as their relative prices. Growth theory in this context explains per capita income differences and changes by focusing mainly on changes in the “relative scarcity” of production factors and resulting productivity dynamics. Open economy macroeconomics explains trade in goods, services and financial assets as the outcome of resource allocation driven by the relative real returns of the production of tradable or non-tradable goods and services, along with consumption, and saving as well as 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 and 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 for 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 having 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, i.e., that economic openness fundamentally broadens the possibility of efficient resource allocation and therefore the scope for arbitrage gains that can be 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 the 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: 7).

The conditions for market efficiency, and lack thereof, have been widely addressed by the theory of market failure as well as by 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 expressed 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 and 2001; UNCTAD/TDR 1996 and 2003). As emphasized in UNCTAD/TDR (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) information externalities associated with investment in goods or modes of production exist that are new for the respective economy.

A more radical reconsideration of conventional economic wisdom is required if we acknowledge that short-term outcomes, shocks and monetary conditions have permanent or long-run effects. While neoclassical 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 (1988) 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 for instance, that would otherwise enjoy absolute competitive advantages in all sectors, nominal wages and prices need to rise to the point where the country will find it 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 with economic activity in this way, and if exchange rate volatility can lead to persistent misalignment, then the necessary nominal adjustment failure can have permanent real consequences. Flassbeck (1988) points to the inherent flaws of the information-generating process of capital markets to explain these phenomena and Palley (2003) 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 temporary competition, then these activities and the associated know-how can get lost forever regardless of their original availability in technology and factor endowment, even if the unsustainable competition - based on the Walrasian arbitrage logic - is temporary in nature.

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 the market allocation hypothesis. Hence, the law of one price (LOP) and 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 to 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, nominal exchange rates are tied to 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 be 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, 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 in 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 comparative advantage equilibrium. In the same way, a failure of the latter implies the relevance of nominal exchange rate fluctuation and 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 PPP only in the very long run, while single-traded goods analyses show very high volatility and persistent deviations from LOP parity; in both cases 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.

Therefore, while PPP and LOP can preserve a central role in explaining 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 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 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 mainstream approach.

3 INTEGRATION THROUGH LIBERALIZATION OF THE CAPITAL ACCOUNT?

The traditional case for financial integration is based on the benefits of pooling and allocating savings toward the most productive uses across countries. The principle of comparative advantage 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 convergence argument); and/or (ii) have desired consumption and savings time patterns not “in line” with their available income (inter-temporal trade argument); and (iii) face different potential fluctuations of production that affects their consumption possibilities (risk-sharing argument).

3.1 Capital integration in theory

The standard open economy neoclassical-Solow-Swan model has provided the first and the most resilient argument for capital account liberalization and financial integration (Summers, 2000, being an example of its lasting influence). If technical knowledge is diffused across countries and if technology displays its traditional decreasing returns to capital, then risk-adjusted return on investment is a decreasing function of 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 would be assured through temporary current account deficits or net capital inflows.

Standard neoclassical theory, therefore, implies a strong correlation between capital inflows, new productive capacity and convergence. Given the absence of any form of relevant uncertainty concerning 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 inter-temporal approach to the current account, where free trade in commodities and in financial assets are the most efficient ways of “buffering” expected and unexpected income variations and of “smoothing” 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 inter-temporal approach of the current account, popularized by

Obstfeld and Rogoff (1995 and 1996) for instance, current and capital account imbalances are the intentional means of transferring income over time. Countries would arbitrage away the "returns" of having "consumption today instead of tomorrow" 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, which 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. If risk is perfectly shared among economies, any country's gross national product (GNP) is uncorrelated with its gross domestic product (GDP) 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. From this perspective, developing countries could be advised to reduce further their production diversification in order to increase and stabilize their consumption levels!

Beyond these main arbitrage arguments there are less direct channels by which trade and financial integration through liberalization is supposed to stimulate growth and convergence: (i) technological spillovers generated by foreign direct investments (FDIs) that are undertaken after a more informed evaluation of their 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 on a lax public sector by restraining monetary arbitrariness and stimulating investment-friendly tax reforms. The last two arguments share the same logic, e.g., that external competitive pressures can discipline and improve the efficiency of institutions and policies and that efficiency gains will largely offset any eventual adjustment costs (Gourinchas and Jeanne, 2003).

3.2 Some empirical evidence

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: 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.: 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 cases of Venezuela, South Africa, Jordan and Peru) or even a necessary condition for the latter (as in the cases 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: 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 "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 (UNCTAD/TDR 2003).

4 THE ROLE OF POLICIES AND INSTITUTIONS IN THE DEVELOPMENT AND INTEGRATION PROCESS

The dismal evidence relating financial integration, growth and income volatility and the overall disappointing economic performances of many reforming countries have induced a radical rethinking of the relevance and effectiveness of standard policy reforms. Macroeconomic stability, privatization and both domestic and external liberalization were regarded for a couple of decades as the key reforms able to realign actual economic performance with the undistorted incentive structure of an ideal self-regulated "market economy".

It has been claimed recently that the Washington consensus reform policies did not work because of poor regulatory and supervisory institutions, inflexible labour markets, ineffective judiciaries and poor governance in the reforming countries. It is claimed

that reform policies did not find the proper institutional environment to deliver the expected results. The “institutional prerequisites” that make external trade and financial liberalization work would come about with a broader agenda of “second generation” reforms including major changes in economic, political, and judicial institutions.

Policies and institutions are indeed the fundamental determinants of economic change and their mutual interaction is a fundamental analytical key for explaining alternative experiences in the development process.

For instance, it is quite uncontroversial to say that capital inflows are sterile or can even increase macroeconomic volatility if not coupled with national institutions and policies that are able to channel them into investment or technological improvement. Questions arise as to what kind of financial institutions should be developed in order to gain from financial openness and whether financial openness should follow, or is instead a precondition for, implementing sound macroeconomic and financial institutions.

A standard argument is that the domestic financial market should be developed 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, reducing volatility and increasing growth.

Moreover, financial liberalization would represent a catalytic factor able to induce institutional reforms and policy discipline (Kose et al. 2006). External liberalization would provide “potential collateral benefits” that would outweigh the traditional positive effects of capital mobility by forcing a proper policy and institutional environment. The latter argument reflects traditional economic categories such as creative power arbitrage in the allocation of resources to competing ends. Institutions and well-behaved policies would act as pre-existing articles to be picked up from existing menus under the pressure of international competition in the same way that pre-existing technologies are chosen through market signals and driven to efficiency through competition.

Unfortunately, the evidence that economies with sound financial institutions enjoy benefits from openness does not provide any causal direction between outcomes and preconditions. Institutional analysis has shown the impossibility of clearly detecting either a one-to-one correspondence between desired economic outcomes and institutional setup or a set of institutional “blue prints” generally applicable to developing countries (UNCTAD/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 increased volatility.

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

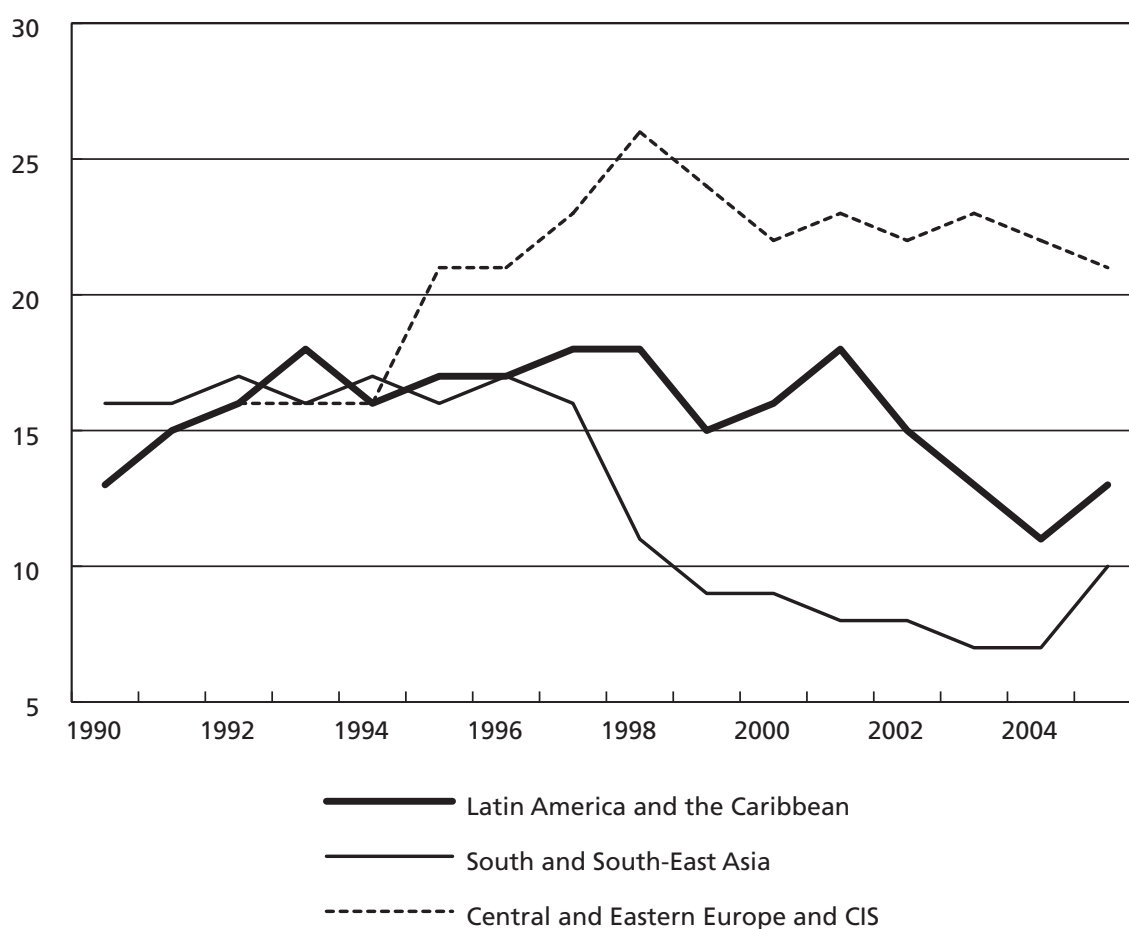
The endogeneity and the dynamic role of policies and institutions in determining short-run outcomes with long-run consequences are analysed next.

4.1 Functional relations between determinants of growth and structural change

A detailed account of the possible interaction between institutions and other direct and indirect factors affecting one country's economic performance and structural change cannot neglect the cultural and historical specificity and complexity of each single economy. However, a general diagrammatic representation of the main causal linkages between the main determinants of institutional change and economic performance may highlight some common salient features of institutional functions along with internal and external constraints to economic change, providing a guideline for the following analysis (figure 1.2).

FIGURE 1.2

Number of countries with current account deficit



Source: UNCTAD secretariat calculations, based on WEO April 2006 database.

As emphasized in various issues of the Trade and Development Report, long-run economic growth and the associated sustained catching-up of developing economies are characterized by a rise in labour productivity and productive dynamism achieved through technological change and innovation embodied in new investment in physical and human capital (channel F, figure 1.2). Technological upgrading, productive dynamism and restructuring allowed by new investments are the main direct sources of economic performance, providing the source of productivity gains and income growth (channel G). Factor employment, accumulation and the process of technological change, under the influence of overall macroeconomic conditions – the original central focus of growth and development analysis – are however proximate causes or even manifestations of growth itself. In fact, as described more extensively in the following section, investment and technological progress are not passively generated by macroeconomic stability and exogenously-given saving behaviour but are mostly affected by the perception of the opportunities induced by the incentive structure that institutions and policy jointly provide (channels A, B and C).

For instance, industrial policies favouring productive dynamisms, technological upgrading and the system of institutions consistent with them may jointly allow for overcoming information and coordination externalities and other barriers due to dynamic scale economies (UNCTAD/TDR 2006, chapter VI) both directly and indirectly favouring macro and market conditions. The appropriate system of institutions includes the functions of property definition, market access regulation and price stability. The role of macroeconomic factors and their employment patterns (D) on the combined process of resource accumulation, along with the more direct role of macroeconomic variables in fostering investment (E), have been the object of a number of policy controversies during recent decades and will be dealt with in the following section.

The quantitative influence of geographical factors, directly on performances (L) and indirectly through institutions (M), have also been extensively explored and appear to depend strongly on country-specific natural and historical conditions. Conceptions of the nature and role of institutions merge with those concerning societal evolution in the understanding of the process of institutional change (K) as well as understanding how policies can affect institutions and the role of the latter in determining the effectiveness of the former (H).

Global interdependence is represented by the interaction of the external environment/rest of the world and the domestic economy both through the effect of competition affecting directly economic performance (I) and possible external shocks (exchange rate, diverse capital flows and FDIs) affecting the macro environment, investment, innovations and structural change conditions (J).

International institutions can provide global public goods such as international economic and financial stability, reducing the effects of financial crisis, preventing contagion and limiting negative international spillovers, beggar-thy-neighbour and any other self-interested policies undertaken by large, relatively influential economies. Moreover, international institutions can influence the effectiveness of domestic policies, both by influencing economic performance and by constraining domestic policies directly at the source.

Competing models of development entail alternative ways of defining the relevant functions that institutions perform, their relation to policies and how they drive the incentives leading to accumulation, productivity increase and economic restructuring.

Evans (1998) has grouped the main competing ways of characterizing economic policies into (i) the “market-friendly model”, (ii) the “industrial policy model”, and (iii) the “profit-investment nexus”. The first approach would characterize the previously-mentioned process of “development by means of external liberalization” (World Bank, 1993) as an application of the rule of “getting the fundamentals right”. This is achieved through institutions and policies able to preserve macroeconomic stability, predictability, the transparency of market dynamics and the rule of law, while avoiding market-distorting subsidies and preventing rent seeking activities.

The second model would interpret the successful industrialization experiences of East Asian countries as the outcome of a performance-based control system of regulation and price distortions, along with the existence of organizational entities capable of providing industry-specific incentives for shifting resources to sectors of higher return and higher growth potential (Amsden, 1989). The third model focuses more on increasing the overall level of investment by fostering institutions and implementing policies for raising profitability through temporary and selective protection against international competition and by diverting profit from consumption and speculation (UNCTAD/TDR 1996, chapter II; 2003, chapter IV; and 2005, chapter I).

These partly competing, partly overlapping models can be analysed in terms of the functions performed by policies and institutions, their mutual relationship (channel H, figure 1.2) and their joint contribution to technological change and productive restructuring (channel A, B and C). This analysis of institutions and policies as means for shaping the incentives of actors, as well as shaping their constraints and their objectives, is the object of the following sections, along with the existing scope and degree of freedom for formulating policies and reshaping institutions consistently with the external dynamic environment.

5 GETTING THE "MACRO PRICES" RIGHT: SHORT-RUN CONDITIONS FOR LONG-RUN DEVELOPMENT

To grasp the complexity of economic systems under Keynesian "objective uncertainty" we have to drop the assumption of the representative agent's maximizing behaviour 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 for investment and for building capacity. There has been an increasing awareness of the need of 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 and Rogoff, 1995: 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 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 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 households in the industrialized world that started at the beginning of the 1990s – the savings rate of the G-7 countries almost halved, falling from around 9 per cent in 1992 to 4.5 per cent in 2005 – is mirrored in the secular rise of the savings of corporations from 8.5 per cent to 11.5 per cent. Hence thrift of private households is not a virtue per se but has to be analysed 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. It also highlights 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 profit rates vary 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 it is not the smaller quantity of capital and the reduction in overall capital costs that determine the relocation but rather the chance to realize a temporary monopoly rent, which is higher when the capital importing country's wage levels are lower and when its overall productivity and growth rates are smaller.

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 a swing in the current account towards deficit is unavoidable as a rule. Higher net inflows of foreign savings that correspond to an increase in 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 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, and vice-versa.

The nature of short term capital flows and the role of interest rates and exchange rates (nominal and then real) as the 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 accounts 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 leaving the capital inflows "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 risks 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 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).

Some of these lessons have been learned by developing countries the hard way. Figure 1.3 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 Asian and South-East Asian 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 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 regarding these two crisis-stricken regions. From a strong reliance on foreign capital inflows, they moved towards a policy of preserving favourable monetary conditions such as slightly undervalued exchange rates and low interest rates, thereby favouring growth by stimulating export demand, competitiveness and productive investment.

This solution has to be seen as a self-defence mechanism against the most important threat of the globalized economy: the systemic financial instability arising from short term volatility of capital. The accumulation of reserve in surplus countries, from 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 (UNCTAD/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 in emerging market economies and a smaller deficit in the United States.

6 CONCLUSIONS

With the unfolding of the financial crisis world economic integration has shown its positive and its negative side. Although the crisis originated in the developed world it quickly spread to developing countries and countries in transition. In the past globalization has been more of a success story in some parts of the world. Its results have been positive for some but disenchanting for others. Not only the crisis has dealt a major blow to an overly simple view of the world, the pure market approach. Those countries that have undertaken an indiscriminate lowering of barriers for trade and financial flows and have abstained from any proactive policy of industrialization and integration strategy have fared the least well. Conventional wisdom provides us with predictions about 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, as well as the influence of contingent conditions, institutions and history seems to nullify the role of reallocating resources as compared with 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 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 both the domestic and global levels. Competitiveness of countries is extremely relevant in such disequilibrium dynamics, but it has to submit to 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 multilateral global governance.

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