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## *Chapter III*

### **OPENNESS, INTEGRATION AND NATIONAL POLICY SPACE**



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## **OPENNESS, INTEGRATION AND NATIONAL POLICY SPACE**

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### **A. Introduction**

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The move to unrestricted cross-border flows of goods, services and capital has always been one of the principles of globalization. Since the late 1970s, “the propensity to truck, barter and exchange one thing for another” (Adam Smith), unhindered by political boundaries, has been regarded as the cornerstone of a global system that would produce efficiency gains from allowing resources to be directed to their most efficient use, and specialization gains from accessing a greater variety of intermediate and capital goods. If improved institutional quality and technology spillover are added, trade and capital openness should automatically allow for catch-up growth in poorer countries and bring about income convergence at the global level (see, for example, IMF, 2002; WTO, 1998; World Bank, 2002; Winters, 2004). But the empirical evidence supporting this approach has been elusive. In fact, most of the evidence suggests that the impact of trade openness has been highly uneven, and contingent on a variety of institutional factors, and that there is room for discretionary policy measures at the micro and macro level.<sup>1</sup>

A more balanced perspective, also taking its cue from Adam Smith, links a process of success-

ful integration back to productivity gains from specialization, gains that are amplified through innovation, the use of better equipment, scale economies at the firm level and by “externalities” such as learning and improvements in human capital. This ties economic success to a heightened degree of economic interdependence through the mutually reinforcing interactions between expanding markets and an increasingly complex division of labour (Young, 1928). Extending and deepening such interactions depends on new investments under conditions of objective uncertainty. To improve and expand existing capacity as well as to introduce new products and processes, a “profit-investment nexus” is needed that requires supporting financial arrangements, including accommodative monetary policy and relatively stable legal institutions.<sup>2</sup> Under the right conditions, high profits will increase the incentive of firms to invest, as well as their capacity to finance new investment; this in turn boosts profits by enhancing the rates of capital utilization and the pace of productivity growth. For most countries, this nexus is closely linked to industrialization, where the presence of scale economies, externalities and an array of indivisibilities and complementarities in production and consumption are strongest, and

from where productivity growth feeds into a wider process of structural change as labour shifts out of lower value-added sectors into more capital- and technology-intensive activities and complementary service activities.

At the same time, as the increasingly interdependent nature of industrial activity heightens the gains from specialization, it also exposes more and more individuals, firms and communities to an increased threat from discontinuities and disruptions. Ruptures occur from myriad shocks and coordination failures across imperfectly functioning (or missing) factor and product markets.<sup>3</sup> As a result, a successful and sustained “take-off” requires the evolution of a range of complementary norms, policies and regulations that help discipline and restrain the more destructive and nurture the more creative forces of the emergent industrial economy. A general lesson from history is that “policy space” expands considerably with the transition from a world dominated by agriculture, slow-moving technology and small-scale business to one dominated by manufactured goods, rapidly evolving technology and big firms.<sup>4</sup>

Hence, the potential benefits from participating in a more detailed international division of labour must be weighed against the coordination and adjustment costs arising from the heightened interdependence accompanying further specialization in, and fragmentation of, economic activities. Indeed, the fact that interdependence is now taking place across borders adds new constraints, rivalries and risks to sustained economic progress. However, there remains a basic challenge for economic policymakers: to decide whether and to what extent market forces can be left alone to ensure that progress is consistent with increased participation in the international economy, and when and what kinds of policies and institutional arrangements might be needed to better manage the process.

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The evolving international division of labour is further complicated as large national firms in more advanced economies acquire the capabilities and the possibilities to organize and control their production activities across borders (Hymer, 1976; Dunning, 1981). While the timing and the direction will vary among countries and sectors, the decisive elements in the internationalization of production are firm size, control over rent-creating strategic assets and market penetration. Since large firms tend to have more capital at their disposal and more control over market forces, they will do the most overseas investing.

Finally, the growth of trade and the rise of international firms accelerate the mobility of capital and extend the reach of financial institutions. At the domestic level, these institutions essentially help to channel resources for investment purposes by reconciling the differences between borrowers and lenders in the timing of payments, and transforming short-term liquid liabilities into long-term illiquid assets. The efficiency of the system will be reflected in its ability to minimize the liquidity premium and the risk of erroneous investment decisions (*TDR 1991*). As international trade and production expand, specialized financial institutions are joined by international banks seeking to widen the scope and reach of their services to sovereign and local governments, to local financial institutions and non-bank firms. They concentrate their borrowing in markets with the lowest interest rates and their lending in markets with the highest, with funds moving whenever the differential is greater than the transaction costs.

The resulting cross-border flows of capital can help deepen the international division of labour by offsetting structural weaknesses resulting from persistent trade deficits, and allowing a faster pace of investment than might otherwise be possible from domestic resources. In poorer economies, such flows can thereby reinforce a

catch-up growth dynamic. However, these flows are highly information sensitive, and vulnerable to information asymmetries, contract-enforcement problems and macroeconomic risks. They also tend to be more footloose than other cross-border economic flows, in part, because of its openness to innovative techniques in search of the preferred combination of liquidity and returns. Under these conditions, both the direction and the terms of borrowing can become major sources of discontinuity across the international division of labour. Moreover, an expanding international economy presents new and riskier profit opportunities, allowing liquid capital a greater margin to seek out short-term arbitrage positions and speculative gains. As a result, such flows can be extremely volatile and subject to pro-cyclical bandwagon effects; they can cause gyrations in security prices, exchange rates and trade balances, and make financial crisis a “hardy perennial” of the international market economy (Kindleberger, 1975).

Thus, integration is not just, or even most importantly, about the efficient use of given resources, but rather about extending and reinforcing

the cumulative gains of local dynamic growth forces through exports and capital flows. However, and as at the domestic level, those forces introduce discontinuities, shocks and potential conflicts of interest, which can generate sizeable adjustment costs for national economies participating in the international division of labour; they may even trigger divergence away from leading economies. From this perspective, the real challenge is not so much about the extent or the sequencing of liberalization, but about finding the particular combination of international market forces, policy space and collective action needed by countries with different institutional and industrial capacities, to ensure that the integration process is welfare-enhancing for all participants in the international division of labour.

Historically, finding that balance has proved difficult, making for an ebbing and flowing of the integration process. The following sections examine a number of episodes where incoherence has arisen as a result of a lopsided emphasis by policy-makers on openness, at the expense of policy space and coordinated actions.

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## B. Unbalanced integration in the 1920s

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The inter-war period is often flagged as a warning of what can happen when the virtues of openness are foregone in favour of narrower national and sectoral interests. From this perspective, a series of ill-judged interventionist measures, particularly a retreat into tariff protection, but also misguided monetary interventionism by central banks, excessive social spending and restrictions on labour mobility, have been blamed for plunging the world economy into a destructive pattern of autarkic development (Crucini and Kahn, 1996; World Bank, 2002; Wolf, 2004).

But while there can be no doubting the scale or extent of economic damage from the crisis that engulfed the global economy in the early 1930s, or the political turmoil that followed in its wake, such accounts are often guilty of painting the inter-war economic experience in unduly simple terms. In particular, they downplay the relatively strong recovery in international economic relations in the 1920s, marked by an overall rise in the share of trade in world GDP, as well as a revival of capital flows, notably a boom in sovereign borrowing and some growth in FDI (tables 3.1 and 3.2). They

**Table 3.1**

<b>MERCHANDISE EXPORTS AS A SHARE OF GDP, 1913 AND 1929</b>		
<i>(Per cent)</i>		
	1913	1929
Western Europe	16.3	13.3
France	7.8	8.6
Germany	16.1	12.8
Netherlands	17.3	17.2
United Kingdom	17.5	13.3
United States	3.7	3.6
Canada	12.2	15.8
Latin America	9.5	9.7
Asia	2.6	2.8
Japan	2.4	3.5
World	7.9	9.0

**Source:** O'Rourke (2002: table 2).

**Table 3.2**

<b>FOREIGN DIRECT INVESTMENT, 1913 AND 1938</b>		
<i>(Outward stock of FDI/GDP, per cent)</i>		
	1913	1938
Canada	6	14
France	23	21
Germany	11	1
Japan	11	21
Netherlands	82	91
United Kingdom	49	38
United States	7	8

**Source:** Twomey (2000).

also ignore the general policy direction taken by the international community to reorganize post-war economic relations around the goal of openness, and, consequently, fail to consider how that policy agenda contributed to mismanaging the return to stability.

Although the end of the First World War left Europe in a state of political and moral uncertainty,

economic policy-makers held up the economic order in the period before 1914 – the *belle époque* – as a state of “normalcy” which needed to be restored as quickly as possible (Bayen, 1954). Indeed, this was seen as the most fundamental step to achieving wider peace and stability, and was premised on restoring the pre-war international monetary system, which was expected to guarantee price stability under a system of fixed exchange rates tied to gold.

From this starting point, a policy consensus was forged, which aimed at restoring flexibility at the microeconomic level through the elimination of trade barriers and other market distortions erected during the war, and the establishment of harmonious trade conditions around the principle of non-discrimination (as proposed in Article 3 of the Versailles Peace Accord). It also aimed at recovering stability at the macroeconomic level by first reducing the high level of public debts acquired during the war, through fiscal surpluses achieved by an initial round of expenditure cuts and increased taxes, followed by tight restrictions on any subsequent efforts to expand government spending. At the same time, monetary policy would be put back in the hands of technocrats working through independent central banks, and in accordance with the requirements for freely flowing international capital.

Primary responsibility for implementing this agenda rested with domestic policy-makers. However, it was acknowledged that, as a consequence of the war, privileging international market forces might cause political resistance, and that, consequently, pressure could usefully be brought to bear on policy-makers to push them in the desired direction. The initiative was taken in a series of international economic conferences beginning in Brussels in 1920, and followed up over the next 13 years in Genoa, Portorose, Geneva, Lausanne and London (Pauly, 1997). Efforts were also made to bring about closer central bank cooperation (Eichengreen, 1996). More radically still, in cases where economic imbalances and political uncertainties were particularly pronounced, stabilization would be achieved through adjustment programmes managed by the League of Nations.

By assuming an underlying “natural” state of fully employed resources, adjustments accom-

panying economic openness were expected to be small in scale and short in duration, allowing international markets to establish the right price incentives, and bringing about a rapid return to growth and stability. With eyes firmly fixed on the past, the sequence of reforms aimed to get long-term capital flowing again before opening up trade, although it was generally accepted that success ultimately hinged on re-creating the mutually supportive pattern of trade and capital flows that existed before 1914.

With economic policy-makers expecting the gold standard to deliver long-term growth and stability, the room for policy action to bring about an orderly adjustment in and across countries was squeezed between measures to regain and maintain the confidence of financial markets and to allow competitive pressures to re-establish external balance. Little attention was given to whether pre-war monetary arrangements were appropriate for the emerging post-war pattern of economic integration, or whether the steps taken by individual countries to regain stability might actually add to the incoherence in international economic relations.

The belief that marginal adjustments through the marketplace would bring global stability clouded the judgement of policy-makers as to the scale of investment, both private and public, needed to rebuild and modernize a European economic space transformed by the dislocations of war, the break-up of old empires and the rising voice of organized labour. In particular, the economic consequences of accumulated wartime debts and German reparations were greatly underestimated. In the absence of their cancellation, highly indebted countries were faced with the onerous task of generating both a fiscal and a trade surplus to meet their international financial obligations, even as they struggled to repair the damage to productive capacity and investment prospects. Moreover, the problem was not just one of managing sovereign debt; in many countries, bank capital, depleted by post-war inflation, had to be shored up by foreign borrowing, and corporate debts accumulated during the war increased further under the post-war restructuring efforts through both foreign bond issues and bank borrowing supported by foreign loans (Kregel, 1996a); in agriculture too, which remained a major source of foreign-exchange earnings and employment for many countries – in-

Table 3.3

**AVERAGE TARIFF RATES ON  
MANUFACTURED PRODUCTS FOR  
SELECTED COUNTRIES, 1913–1931**

*(Weighted average in percentage of value)*

	1913	1925	1931
Belgium	9	15	14
France	20	21	30
Germany	13	20	21
Italy	18	22	46
Japan	30	..	..
Sweden	20	16	21
Switzerland	9	14	19
United Kingdom	0	5	..
United States	44	37	48

**Source:** Bairoch (1993).

cluding the United States and France – rising levels of indebtedness anticipated a pattern of instability previously confined to primary exporters on the periphery.<sup>5</sup>

As the constraints on investment were underestimated, so the prospects for strong and rapid export recoveries were overestimated, particularly for the industrial heartland of Europe, where a rapid return to pre-war export performance was essential to meet financial obligations without further damaging the domestic economy. A disappointing trade performance cannot, however, be explained simply as being the result of an unforeseen protectionist wave. In fact, trade policies were broadly re-established along pre-war lines: quantitative controls were quickly abolished, tariff levels returned to earlier levels – which were quite high, particularly for manufactures (table 3.3) – and the commitment to non-discrimination (in the form of most-favoured-nation (MFN) treatment) was generally confirmed.<sup>6</sup> In Germany, a severely weakened manufacturing sector faced added obstacles, as newly independent economies in Eastern Europe looked to support their own infant industries through tariff protection, and the persistence of high tariffs in surplus economies, notably the United States, dampened prospects for an export-led recovery (Chang, 2002). In the case of Britain, the loss of markets in key sectors such

as coal, textiles and shipbuilding also reflected the rise of new competitors in its traditional colonial markets. But the real challenge facing these older industrial economies was to respond to the new and strengthened manufacturing capacity that had emerged elsewhere during the war through renewed investment in more dynamic industries.

Under these conditions, the decision of Europe's leading industrial centres to return to the gold standard at the pre-war parity level damaged prospects of a strong export recovery,<sup>7</sup> and the resort to tight macroeconomic policies to defend that decision further compromised efforts to re-establish a dynamic profit-investment nexus. The resulting sharp slowdown of growth in the European industrial heartland was itself an important contributory source of weak trade performance and a major reason why trade levels in 1929 were below what might otherwise have been expected. By contrast, countries that re-entered the gold standard with devalued currencies saw strong growth in trade, persistent surpluses, an earlier recovery in investment and comparatively lower levels of unemployment. This was notably true of France – which was still an industrial laggard – and Belgium, as well as other smaller European countries.

Given these conditions, and with no hope of a coordinated debt write-off, exposure to a series of unfamiliar dangers from rising debt charges, falling prices and the shifting sentiments of financial markets, made policy-makers in the 1920s a good deal more “balance-of-payments conscious” (ECLA, 1965: 15). Effective management of the resulting policy trade-offs was complicated by the shifting interests of leading creditor and debtor countries. Under the gold standard, long-term capital flows and an increasingly complex multilateral trading system were mutually supportive, largely because the United Kingdom's foreign lending was a substitute for its domestic investment. In addition, its deficit on

the trade account was offset by a surplus on the current account due to earnings on foreign investment, which allowed it to maintain open markets, even in the face of rising protectionism abroad.

Moreover, a general sense of credibility centred on confidence in the stability of the pound sterling, allowing short-term capital flows to play a complementary stabilizing role, at least in the core countries (Eichengreen, 1996).<sup>8</sup>

With no clear leadership of the financial system and persistent worries about a gold shortage, economic uncertainty was added to the political doubts of the post-war world, thus delaying further any recovery in long-term capital flows. In the absence of policy coordination between surplus and deficit countries, the system relied increasingly on short-term capital, through portfolio flows and bank lending, to maintain a degree of balance and to bolster reserves. Such flows occurred on an unprecedented scale, led by United States investors who were attracted by high returns thanks to tight European monetary policies and minimal exchange rate risks. These flows introduced a much more speculative dimension to the recovery, which had started in the second half of the 1920s following the Dawes Plan and the restoration of the gold standard in the United Kingdom. Indeed, with limits to an export-led recovery, and domestic expansion restricted by high domestic interest rates and persistently high levels of unemployment, capital inflows were used increasingly to meet debt repayments in a Ponzi-type of financing<sup>9</sup> (Bayen, 1954).

Thus, the international economy which took shape in the 1920s was very different from the one that had collapsed in 1914. The combination of exchange rate risk, volatile capital movements and a high and rising debt stock meant that deflationary pressures, financial fragility and the threat of contagion were closely intertwined. Under these circumstances, a country's balance-of-payments position and its reserve situation became

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By assuming an underlying “natural” state of fully employed resources, adjustments were expected to be small in scale and short in duration.

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much more prominent indicators of economic vulnerability and distress, and triggers for short-term capital movements.<sup>10</sup> The boom in the second half of the 1920s failed to stimulate productive investment or create sufficient jobs in the leading industrial economies; it provided only a temporary cover for these structural problems, even as trade expanded and the openness agenda was given a renewed sense of vigour.

In 1927, with the gold standard back in place, the attention of policy-makers shifted to trade openness. Although the International Economic Conference in Geneva produced few concrete outcomes, it added momentum to extending the principles of the “Manchester School” and the advantages of free competition to the trading system through a “beefed-up” League of Nations secretariat (Pauly, 1997: 55–61). But within six months after that Conference, capital flows from the United States to Europe dropped off sharply following an equity surge on Wall Street, and continued to fall when United States interest rates were hiked in an effort to curb “irrational exuberance”. The result was a further tightening of monetary policy in Europe. At the same time, agricultural prices, which had been falling for some years, showed a marked downward fall in 1929, as exporters intensified their efforts to generate foreign exchange in the face of dwindling capital inflows and mount-

ing payment difficulties on outstanding loans. The remaining policy option, of deflationary measures to counter widening imbalances in external payments by cutting imports, simply shifted the problem elsewhere. This made a bust in heavily indebted European economies inevitable, and once it happened, it ensured there was little to stop it spilling over into “twin” banking and currency crises.

With sensible collective responses ruled out by an absence of leadership at the international level, and little thought given to the peculiar circumstances under which the international financial and trading system had operated before the war, the idea of a return to “normalcy” in international economic relations was, from its inception, built on unstable foundations. Still, economists’ belief, propagated through international conferences, that the only option was to build the confidence of financial markets as a prelude to the recovery of international capital flows and the reduction of trade barriers, led to an unhealthy restriction on policy space at home, even as it promoted a blind faith in international market forces as a means to regaining stability. Given the size and nature of adjustments to be made, such thinking contributed to a destabilizing mix of deflationary pressures and volatile capital flows, which eventually culminated in the “beggar-thy-neighbour” policies of the 1930s.

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### **C. Recasting multilateralism: development challenges and the origins of UNCTAD**

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The post-World War II multilateral agenda arose from the desire to avoid deflationary adjustments and beggar-thy-neighbour policies of the kind that had severely disrupted the inter-war economy. It was premised on an expanded policy space which would allow policy-makers to combine a reasonable degree of price stability with

full employment and growth. But, perhaps just as importantly, the inter-war period had confirmed that industrial countries were too specialized and interdependent to achieve economic stability and lasting improvements in economic welfare without the establishment of some kind of new international economic order. Thus, and quite unlike

the years following the First World War, policy-makers were not only willing to consider a range of more active international policy instruments and measures – an international currency, provision of international liquidity, multilaterally negotiated trade rules, a managed exchange rate system, controlling of destabilizing capital flows – but to discuss what kinds of international arrangements would be needed to manage these most effectively.

Discussions about these were already under way in the late 1930s, and as plans on the reorganization of post-war international economic relations advanced, the institutional arrangements proposed included:

- An international monetary fund to ensure an orderly system of multilateral payments by means of stable but adjustable exchange rates, in conditions of strictly limited private international capital flows;
- An international bank for reconstruction and development to provide long-term capital for post-war reconstruction by encouraging and supplementing private capital flows;
- An international trade organization to provide a rules-based framework to facilitate multilaterally negotiated reductions in trade barriers, as well as to coordinate national economic policies to ensure adequate levels of global demand and employment in support of the development of low-income member countries;
- An international commodity stabilization fund for bringing about stability of prices of raw materials and primary commodities through the creation of international buffer stocks; and
- An international employment agreement which would commit countries to full employment along with the requisite international measures and arrangements to oversee and implement such an obligation.

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Common to the proposed mandates of all these institutions was the recognized need for coordinated policy efforts to create an open multilateral trading system that would benefit, rather than threaten, domestic income and employment, and tether unruly capital flows to ensure financial and exchange rate stability (*TDR 1984*). This institutional project was never completed; the final outcome reflected prolonged (and noticeably asymmetric) negotiations between the passing global hegemonic power (the United Kingdom) and the ascendant

one (the United States). In the end, only the International Monetary Fund (IMF) was established, on the lines of a stabilization fund proposed by Harry White and the United States delegation, along with the (under funded) International Bank for Reconstruction and Development (IBRD). An international agreement on employment was strongly opposed by the United States (as a purely domestic issue), but was eventually tied to the trade agenda through a proposed charter for an International Trade Organization (ITO). However, this subsequently failed to gain ratification in key countries, notably the United States. A limited portion of the ITO mandate was reworked into the General Agreement on Tariffs and Trade (GATT), but the idea of a Stabilization Fund for commodities was dropped altogether.<sup>11</sup>

The formative years of these multilateral arrangements produced mixed outcomes. The GATT negotiations were primarily concerned with the exchange of tariff concessions extended on a multilateral basis under the unconditional MFN clause. A series of tariff-reducing rounds between 1947 and 1956 saw average tariffs fall, albeit front-loaded on the opening Geneva Round (when the United States reduced its tariffs by an average of 20 per cent on all dutiable imports); while their immediate economic impact was probably not significant, they did help to establish the principle of a tariff-based multilateral system and a commitment to a measured liberalization process (*TDR 1984*: 63). By contrast, the scale of the reconstruction challenge, and the transition back to a situation where the IMF could begin to fulfil its

Table 3.4

**ECONOMIC PERFORMANCE BEFORE THE FIRST WORLD WAR AND  
AFTER THE SECOND WORLD WAR IN SELECTED COUNTRIES**

(Average annual growth rates)

	1870–1913			1950–1973		
	Investment	Export	GDP	Investment	Export	GDP
Canada	..	3.1	3.8	5.5	7.0	5.2
France	..	2.8	1.7	4.5	8.2	5.1
Germany	3.1	4.1	2.8	6.1	12.4	6.0
Italy	2.5	2.2	1.5	5.1	11.7	5.5
Japan	2.7	8.5	2.5	9.2	15.4	9.7
United Kingdom	1.4	2.8	1.9	3.9	3.9	3.0
United States	4.7	4.9	4.1	4.0	6.3	3.7

**Source:** Maddison (1982: tables 3.2, 3.7 and 5.4).

responsibility to promote exchange rate stability and manage orderly balance-of-payments adjustments, were greatly underestimated, and transitional arrangements were required to manage the process. However, the predicted return of economic stagnation did not materialize, so that the problems of short-term adjustment were easier to solve, and United States authorities and financial institutions were able to assume a pivotal role in managing the system.<sup>12</sup>

While the reliance of the system on the economic fortunes of the dominant economic power was inevitable in the short run, it left a series of weaknesses and shortcomings; some of these would only become fully apparent once post-war economic relations stabilized in the late 1950s (Panic, 1995; Eichengreen, 2004). The arrangements were, nevertheless, successful in bringing together a club of similar economies that had been converging on each other for some time (Baumol, 1986), and their economic closeness made the task of learning to work together easier. The combination of favourable economic conditions, a consensus on policy objectives with sufficient policy space, and supportive multilateral institutions provided a climate of predictability and stability

in an increasingly interdependent international economy. It also allowed the building of a strong nexus between investment and exports. Recovery led to rapid and sustained growth, which ensured that the adjustment costs associated with closer trade integration were contained and the benefits broadly shared (*TDR 1997*). The result was a quarter of a century of unprecedented economic growth and stability (table 3.4).

For those outside this club, the kind of export-based profit-investment nexus underpinning growth in the more advanced economies appeared to be weak or absent. Moreover, while the obstacles to growth facing developing countries had surfaced in the context of wartime military and political alliances, these remained marginal in the Bretton Woods negotiations.<sup>13</sup> A truly development *problématique* did not begin to take shape in the World Bank until the mid-1950s, and was not really completed until the early 1960s when the International Development Association (IDA) was established. Moreover, the World Bank's original mandate as a guarantor of medium- and long-term loans meant it lacked an independent capacity to create development finance, and its dependence on funds raised from the main capital markets ham-

pered its ability to meet the emerging structural needs of developing countries (Akyüz, 2004).<sup>14</sup> Perhaps more damaging still, in this respect, was the failure to adopt the Havana Charter, which contained a number of elements of more immediate interest to poorer countries.

Consequently, the first real strides in development policy analysis occurred outside the Bretton Woods institutions. They drew heavily on the newly emerging discipline of growth theory, but were conceived more broadly in the context of a transition from industrial “backwardness”. The resulting development strategy was built around two main challenges facing low-income economies: the shortage of capital was seen as the biggest constraint on the structural transformation needed in poorer countries to sustain faster growth; and it was believed that breaking that constraint could not rely on market forces alone. Given low private domestic savings rates, along with low income, a non-inflationary way to close the gap between domestic savings and investment was found in external flows of capital from rich to poor countries in the form of private investment, loans and development assistance. But the scale of the challenge was underestimated. While early estimates by the United Nations put the resource requirements of developing countries from foreign sources at \$15 billion a year, World Bank loans averaged between \$200 million and \$400 million annually during the 1950s, with bilateral flows averaging \$2 billion annually from 1950 to 1955, rising to over \$4 billion by the end of the decade (*TDR 1984: 90*).<sup>15</sup> Private capital flows were even more limited, and almost exclusively took the form of direct investments in the commodity sector. Moreover, as economic thinking on development grew in sophistication, and was deepened and refined by academics and policy-makers from the developing countries themselves, efforts to

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measure the size of the resource gap revealed developing countries to be net exporters of capital, once the repayment of loans, terms-of-trade losses and capital flight were included in the calculation.<sup>16</sup>

With international private capital flows constrained and development assistance still limited (and often tied), increasing attention was focused on the role of international trade as a more dependable means of removing the resource constraints on economic growth in poorer countries. This marked something

of a break with the trade pessimism which had been a powerful current both before and after the war (Rayment, 1983), particularly in developing countries, where the collapse of the trading system in the 1930s had forced a greater reliance on the domestic market. However, neither the multilateral trading arrangements, where the GATT had become a largely technical instrument for managing trade between rich countries, nor the most dynamic regional trading arrangements, notably the evolving European Common Market (*TDR 2003*), were appropriate venues for improving developing-country participation. Between 1950 and 1960, the share of developing countries in world trade fell from 31 per cent to 21 per cent, and even in primary commodities, their share fell from

41 per cent to 29 per cent. As a result, the kind of export-based profit-investment nexus that was underpinning the successful pattern of interdependence among advanced economies, appeared to be weak or missing altogether in the developing world.

An examination of the comparative trade performance of rich and poor countries published by the GATT in 1958

and prepared by the noted economist Gottfried Haberler, confirmed that tariff and other barriers, particularly against food-exporting developing countries, was one source of the problem.<sup>17</sup> Still, the Haberler Report reflected conventional think-

ing on the trade openness model, “based on the classic concept that the free play of international economic forces by itself leads to the optimum expansion of trade and the most efficient utilization of the world’s productive resources” (UNCTAD, 1964: 18); its assumption of near equality of initial conditions leading to convergence and common trading interests was inconsistent with the burgeoning literature on economic development. As Nurkse (1959: 26) noted at the time,

In a world in which (outside the Soviet area) over nine-tenths of the manufacturing and four-fifths of the total productive activity are concentrated in the advanced industrial countries, the ideas of symmetry, reciprocity and mutual dependence which are associated with the traditional theory of international trade are of rather questionable relevance to trade relations between centre and periphery.

The point in the international trading system where asymmetries between centre and periphery appeared in sharpest focus was in the terms of trade for primary exports. Empirical studies reported a long-term decline, coupled with high instability, in the terms of trade between primary and manufactured exports. The explanation pointed to price and income inelasticity for the demand of primary commodities. This, combined with competitive market conditions, meant that investment and technical progress, which, in the developed countries, led to higher wages and living standards of those employed, in the developing countries tended to result in lower prices for their exports. The secular tendency for the terms of trade to move against developing countries and especially for those exporting primary products, seriously constrained the capacity of developing countries to import the capital goods needed to accelerate capital formation and to diversify into more dynamic areas of international trade. Given that industrial development offered the best chance of raising productivity growth (through scale economies and innovation), and producing a virtuous growth circle between demand expansion and development of productive capacities, a basic objective of development policy was to find ways of redressing the structural constraints on catch-up growth.<sup>18</sup>

Raul Prebisch developed the policy options for countries locked into a pattern of slow growth

and adverse terms-of-trade movements. Already in the mid-1950s as head of the then Economic Commission for Latin America (ECLA), he had organized a series of country studies examining the disappointing results of the inward-oriented industrialization model adopted in Latin America in the inter-war years. A 1956 report on the Argentinean economy prepared under his guidance outlined an outward-oriented growth strategy which aimed for a better balance between agriculture and industrial development, whilst shifting the orientation of industry from domestic to foreign markets to achieve more dynamic scale economies (Rosenthal, 2003: 181–183).<sup>19</sup>

Linking trade prospects to a structuralist development model also cast the working of the international trading system in a different light. If the consistent application of liberalization measures through universal trade rules and principles, combined with the gradual absorption of imported technologies, could not be relied upon to eliminate the external imbalances accompanying economic development, or to bring about rapid productivity growth and income convergence along the lines achieved by the late industrializing economies in the late nineteenth and early twentieth centuries, then a rules-based system supportive of an industry-led growth strategy for poorer countries would have to accommodate an element of asymmetrical integration into the world economy. As noted in the Report of the Secretary-General of UNCTAD (UNCTAD, 1964: 19),

The request for reciprocity in negotiations between countries that have no structural disparity in their demands is logical. In the case of trade between the developing and the industrial countries, the situation is different. Since the former tend to import more than they export – owing to the international disparity in demand – concessions granted by the industrial countries tend to rectify this disparity and are soon reflected in an expansion of their exports to developing countries. In other words, the developing economies, given their potential demand for imports, can import more than they would otherwise have been able to do had these concessions not been granted. Thus there is a real or implicit reciprocity, independent of the play of conventional concessions.

Multilateral efforts at designing this new trading geometry culminated in the First UNCTAD

Conference in 1964. The Report to the Conference, entitled *Towards a New Trade Policy for Development*, set out to show that the free play of international economic forces would not by itself lead to the most desirable utilization of the world's productive resources, given the structural obstacles to growth at the domestic and international levels. It also spelt out the implications for trade and related finance if the minimum target of 5 per cent growth for developing countries was to be achieved.<sup>20</sup> In specifying what was to be done, the Report rejected both the import substitution model handed down from the inter-war period and the openness model embodied in the GATT. Instead, it spelt out an alternative strategy which would help poorer countries develop outwardly through strong capital formation and continuing and accelerated expansion of exports – both traditional and non-traditional. Central to that agenda was the idea that if developing countries were to rely on their own efforts, they would need to have sufficient policy space to accelerate capital formation, diversify their economic structures and give development a greater “social depth”. There would also need to be a change in the orientation of international cooperation to ensure that this strategy was consistent with the international goal of poverty alleviation (UNCTAD, 1964: 64).

This reorientation would require a much more flexibly managed trading system to accommodate countries at different levels of development. In a sense, a case for greater flexibility had already been accepted by advanced industrial economies in the GATT when they sought more orderly adjustments for their own peripheral areas and sunset activities.<sup>21</sup> Such flexibilities were provided by non-application of the Agreement between particular Contracting Parties under Article XXXV and the Grandfather Clause, under which original contracting parties to the GATT agreed to apply major obligations of the agreement only to the extent of their consistence with existing national legislation. This was most notably applied in the case of agriculture. Favourable terms were also extended to textiles and clothing, which were eventually accorded their own separate trade regime. Extending

this idea of preferential treatment to industries in developing countries would, however, have to accommodate the wider productivity gaps – due to structural differences and differing technological densities – which existed with the advanced economies. Allowing more favourable access to their markets would be one way to overcome initial cost disadvantages. Additionally, appropriate fiscal support and other incentives for infant industries would be needed, along with supplementary measures, where possible, to ensure a more effectively managed exchange rate. All such measures would have to be carefully monitored and subject to clear bounds in line with improving technological capacities and productivity improvements.

The UNCTAD agenda also addressed the interdependence of trade and finance, given that, particularly in the early stages of industrialization, imports would almost certainly grow faster than exports, and that financing the resulting trade gap would be key to accelerating growth. This would require additional development assistance or compensatory finance for deteriorating terms of trade and debt relief. The Report to UNCTAD I also recognized

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that any new trade geometry in support of development would hinge on fast and stable growth in the developed countries, and that the international financial arrangements would require sufficient resources to prevent disruptive stop-go cycles in those countries. Furthermore, it raised concerns about the adequacy of balance-of-payments financing in light of the growing volume of trade, persistent trade surpluses in some economies, and the need to supplement gold reserves with new instruments to allow for additional credit expansion by international financial institutions.

In the absence of sufficient finance for meeting the structural demands of developing countries, external equilibrium could only be maintained through the suspension of commitments made in the multilateral trading system (Johnson, 1967: 114–115). The GATT had accepted this principle for developed countries in support of the post-war full-employment agenda. For example, Article VII provided for exchange controls and trade restric-

tions when the currency required to finance external imbalances was declared “scarce”.<sup>22</sup> This implicit acceptance of the priority of meeting financial obligations over the observance of commitments to free trade was reflected in GATT Articles XII (Restrictions to Safeguard the Balance of Payments) and XV (outlining the terms of GATT and IMF collaboration on exchange rate questions). These exemptions were granted, essentially, to address temporary liquidity problems. Similar exemptions for longer run adjustments, included in the ITO proposals, had not been incorporated into the GATT, and were only seriously considered after the creation of UNCTAD. It was only in 1979 that special and differential treatment was accepted as a general requirement for enabling the beneficial participation of developing countries in the post-war international trading and financial system.

The creation of UNCTAD was part of the post-war reformist wave, which extended the search for multilateral solutions to the economic challenges of an interdependent world to encompass development problems largely ignored at Bretton Woods. Its starting point was the need to address the structural obstacles to catch-up growth, and particularly those enforced through international market forces. Rebalancing the system required a strategic pattern of integration in line with levels of industrial development and favourable terms of market access, as well as appropriate levels of development finance. But just as importantly, as noted by Edward Heath, Head of the British delegation to UNCTAD I, it required that the richer countries begin to see “fuller cooperation and greater interdependence” as common allies in the fight for a more prosperous and fairer world.

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## D. Interdependence after Bretton Woods

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As noted in the previous section, a central feature of the Bretton Woods system was affording sufficient space to policy-makers to meet employment, inflation and growth targets, accepting that, in an increasingly interdependent global economy, policies should be employed with a clear sense of any potential negative externalities they might generate.<sup>23</sup> This was achieved through a system of fixed but adjustable exchange rates, with tight controls on international capital movements along with the global provision of liquidity, enabling countries to pursue expansionary policies that would bring positive externalities for trading partners (Stiglitz, 2003). On this basis, an early Washington policy consensus – articulated by Treasury Secretary Morgenthau and the chief United States negotiator at Bretton Woods, Harry White – allowed for restrictions on destabilizing

capital flows and placed clear limits on the surveillance and conditionality attached to international lending. According to White, as cited in Felix (1996: 64),

To use international monetary arrangements as a cloak for the enforcement of unpopular policies, whose merits or demerits rest not on international monetary considerations as such but on the whole economic program and philosophy of the country concerned, would poison the atmosphere of international financial stability.

This consensus quickly unravelled with the collapse of the Bretton Woods system in the early 1970s, and the transfer of the management of foreign exchange risk to the private financial sector (Eatwell and Taylor, 2000). The collapse was fol-

lowed by the removal of capital controls, and by a move to financial deregulation in the developed economies, which was transmitted swiftly to the rest of the world, in no small part thanks to the efforts of the international financial institutions to lock in “the freedom of capital movements already achieved and encourage wider liberalization” (Camdessus, 1995). These efforts implied a shift in focus from guaranteeing systemic financial stability to catalysing private capital flows by building confidence, including through intrusive adjustment programmes in debt-ridden developing countries.

This change of direction assumes that financial deepening, brought about by the liberalization of domestic financial markets and the opening up of the capital account, would lead to a more efficient allocation of resources and faster and more stable growth.<sup>24</sup> The removal of controls over international capital was followed by a marked increase in flows to developing countries, beginning with syndicated bank lending in the mid-1970s, and, since the late 1980s, in equity flows and FDI (*TDR 1999*). This has frequently led to comparisons with the earlier period of rapid globalization under the gold standard, when large private capital flows underpinned strong economic performances, including on the periphery. This parallel implies the presence of a number of features in current arrangements: first, capital flows are predominantly long-term, triggered by productive profit opportunities in an emerging international division of labour, and supported by complementary trade and labour flows; second, stability rests on strong domestic capital accumulation, which is not sacrificed to emerging trade imbalances; and third, short-term capital flows play a subordinate and stabilizing role.

Under the gold standard, such flows and adjustments were managed through a “socially-constructed” monetary arrangement that included a simple set of rules around which core lenders and borrowers could build expectations of a stable future. It also included a willingness to subordinate domestic policy goals in times of crisis; and there was a lead economy with a vested economic

interest in maintaining a stable currency and free trade, even as it was channelling domestic savings abroad.<sup>25</sup> Strong States channelled funds into productive public investment, while they used policy space to manage a fast pace of capital accumulation and to encourage exporting that could help service the capital flows needed to cover large trade deficits.

The diversity of economies that make up the contemporary international financial system – at least as measured by income gaps between the main debtors and creditors – is probably greater than under the gold standard (World Bank, 1999). However, the greater part of contemporary financial flows are short term, among the developed countries themselves, and even the greater part of global FDI is accounted for by mergers and acquisitions (M&As) amongst the advanced industrialized countries. On balance, the liberalization of capital movements has had little impact on levels of development finance, and the balance-of-payments constraint of developing countries has not been removed. Moreover, no major region has successfully forged strong linkages between net capital inflows, capital formation and industrialization.

Behind these trends lies an emerging picture of transnational finance (Kregel, 1994), with activities focused on providing hedging on foreign-exchange risk across a diversified international portfolio of foreign assets, and with a greatly expanded capacity to operate in a global market for funding sources, borrowing in any currency and lending in any other currency. While the extent of transnational finance remains the subject of ongoing empirical analyses (Felix, 2001), there has been a trend of de-linking international trade and financial flows. This is most clearly the case with short-term flows, where over 80 per cent of transactions relate to round-trip operations of a week or less, motivated by hedging, arbitrage and speculative considerations. But it is also true of some longer term flows. A significant share of FDI flows has been absorbed by M&As and the increased capacity of transnational corporations (TNCs) to combine financial and locational engineering in

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The removal of controls over international capital was followed by a marked increase in flows to developing countries in the 1970s.

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international production networks has often produced footloose productive assets and ambiguous effects on balance-of-payments positions (Kregel, 1996b; *TDRs 1999* and *2002*). Moreover, and despite the belief that a more open economic environment with unrestricted capital flows would demonstrate the superiority of markets over government intervention, the period since the collapse of the Bretton Woods system has been marked by an increasing incidence of financial crises (in both developed and developing countries), and their growing virulence in terms of lost output and jobs (*TDRs 2000* and *2001*; Eichengreen and Bordo, 2002).

After the rapid opening up of their economies in the 1980s, many developing countries became increasingly preoccupied with ensuring sufficient flows of external funds, rather than improving domestic resource accumulation and productivity growth. In particular, foreign capital flows were regarded as an instrument for accelerating growth. The monetary conditions created by these flows and the policies to attract them were not considered to hinder domestic investment. It was believed that high nominal and real interest rates, a rather stable nominal exchange rate and fiscal restraint should attract capital inflows and assure foreign investors about the seriousness of policy efforts to leave the legacy of hyperinflation behind. In some countries, domestic monetary policy was completely abandoned, and the exchange rate anchor was supposed to stabilize the price level through competition from cheap imports. In addition, it was expected that the sale of State assets and a reduction of government intervention would improve the overall efficiency of the market system. But, the flip side of this “sound policy approach” was that it directly lowered profits and profit expectations of domestic companies and prevented the profit-investment nexus from evolving. Eventually, the efficiency gains of the pro-market policy could not make good the overall restrictive stance of economic policy and the pressure from foreign competitors.

An imbalanced concentration on sound economic policies to fight inflation, and on “getting

relative prices right” by increasing the efficiency of resource allocation, came at the expense of the overall dynamics of the economy, because macroeconomic prices – the real interest rate and the real exchange rate – were not appropriate to this end. Thus, the necessary conditions to foster productivity growth and to combine international competitiveness with strong growth of domestic demand and company profits were not in place. The “sound macroeconomic fundamentals” did not translate into sound fundamentals capable of producing an environment for firms that was conducive to increasing investment, introducing new technologies and expanding exports.

Macroeconomic policy was successful in fighting and eliminating hyperinflation, but once price stability had been achieved, it did not take account of the fact that, in the global market, competition puts downward pressure on prices via cost competition and the creation of excess supplies; this shifts the balance of risks from inflation and excess demand towards deflation and lack of demand. Under these conditions, the increasing importance of international production chains did not allow the rapid introduction and full exploitation of technology for upgrading domestic industry, because most basic research and the more technology- and skill-intensive slices of the production chain remained in the more advanced economies.

The “consensus” during the 1990s has been that there was no alternative to these orthodox policies. Many observers presumed that interest rates and monetary policy cannot be relaxed without a loss of exchange rate stability, price stability and positive capital inflows. However, the combination of low-income growth, an overvalued exchange rate and high interest rates inhibited investment incentives and the restructuring of the domestic productive sector. It also made

it virtually impossible to meet the conditions required to stabilize or reduce the debt burden relative to national income (as real interest rates remained above real growth rates) in the medium term.

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After the rapid opening up of their economies in the 1980s, many developing countries became increasingly preoccupied with ensuring sufficient flows of external funds.

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Because considerable emphasis was placed on fighting inflation through the establishment of sound macroeconomic fundamentals, such as fiscal restraint, control of monetary expansion and anchoring of the nominal exchange rate, the negative impact on the sustainability of the external balance was neglected. Although external balances generally improved during periods of declining inflation, this was usually achieved by reducing overall income growth sufficiently to compress imports, rather than by raising exports. This is precisely the opposite of the justification for opening the economy to make trade an engine of growth, more specifically to expand manufactured exports in order to be able to increase imports of capital goods for investment and restructuring. These policies also had an adverse impact on the shift from State-led development to market-led development based on international competition. High interest rates were detrimental not only to the industrial sector, but also to primary commodity producers' attempts to modernize their machinery and equipment. Overvalued exchange rates often gave foreign competitors an absolute advantage that could not be compensated by endeavours at the micro level.

In the presence of free capital flows it has been difficult for many developing countries to avoid overvaluation, whether because of excessive optimism about domestic prospects or because of excessive pessimism about prospects in developed countries. Although the international trading system of rules and regulations has always included clauses that allow countries to opt out of their obligations and commitments to free trade when they are faced with extreme balance-of-

payments difficulties and dangerous declines in their foreign-exchange reserves, these clauses were not applied. Moreover, there were no regulations allowing a country to temporarily opt out of free international capital flows when such flows created excessive movements in exchange rates that had an impact on its external competitiveness and its balance of payments. Measures to keep outflows to magnitudes that are commensurate with

a country's ability to maintain external balance have not been part of the rules and regulations of the international trading system and of the international financial system in the post-Bretton Woods era.<sup>26</sup>

Overall, establishing a virtuous interaction between international finance, domestic capital formation and export growth has proved surprisingly uncommon since the collapse of Bretton Woods. In de-

veloping countries, dependence on external capital flows has led markets to impose a risk premium on domestic interest rates that has reduced the space for domestic economic policy and, in some cases, constrained growth, fixed investment and job creation. As a profit-investment nexus failed to take root, development policies became hostage to maintaining a steady increase in capital inflows and to retaining the confidence of the financial institutions providing them. This is highlighted by Latin America which has exhibited a particularly high foreign-debt-to-export ratio and a greater vulnerability to external shocks (IMF, 2002). Additionally, this combination of forces pushes policy-makers to pursue policies that enhance the short-term ability to pay, but they will pay the price of maintaining the confidence of financial markets in terms of reduced policy space to manage any future shocks (Kregel, 1996b).

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**Establishing a virtuous interaction between international finance, domestic capital formation and export growth has proved surprisingly uncommon since the collapse of Bretton Woods.**

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## E. Interdependence, international collective action and policy space

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Pressures for greater openness, particularly in an uncertain economic environment and an era of dynamic structural change, have made it increasingly difficult for countries to pursue their own national policies for development and integration into the global economy. The openness agenda overlooks the fact that the advanced industrial economies engaged in very active economic policies in pursuit of their development, and it ignores their history of building “hard States” to guide that process (see Chang, 2002; and Bayly, 2003).<sup>27</sup> Instead, by concentrating on market forces and “getting prices right” to maximize the gains from a given pattern of factor endowments, the openness agenda has perpetuated a lopsided view of the forces driving economic integration. It stresses the potential gains from participation in international markets while downplaying adjustment costs, and it stresses convergence tendencies while ignoring potential sources of cumulative divergence.

As the previous sections have suggested, this approach has its limitations. Trade is just one among several interrelated factors shaping integration. Its impact is largely contingent on the presence of dynamic forces – specialization, learning and innovation, scale economies and capital formation – that do not respond in a simple or predictable way to the incentives generated from rapid opening up. Strengthening these forces requires a series of complementary institutional

reforms and discretionary macroeconomic, industrial and social policy measures. This implies considerable diversity in the pattern of integration, even among countries at similar levels of economic development.

Development strategies that successfully harness trade to a strong growth dynamic will necessarily lead to closer links with the wider international economy, especially with neighbouring economies. This will make the success or failure of those strategies increasingly dependent on

trends and policies elsewhere. Moreover, as more countries establish successful growth regimes, an expansion of trade will be accompanied by increased cross-border flows of investment, technology and finance. As a result, a country’s “internal performance”

(as measured by investment levels, productivity growth, employment creation and technological upgrading) and its “external performance” (as measured by the trade balance, net capital flows and exchange rate stability) become much more closely intertwined and the policy trade-offs considerably more challenging.

It is unlikely that the policy trade-offs will ever be satisfactorily resolved by privileging external goals, even as countries seek to maximize the benefits from closer participation in the international division of labour. Rather, stability will depend, in part, on the ability and willingness of

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**Trade is just one among a number of interrelated factors shaping integration.**

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individual countries to pursue policies that are compatible not only with their own national objectives, but also with the objectives and policies of other countries. It is therefore necessary to find common objectives among countries at varying levels of development around which a stable pattern of integration can be built.

The openness agenda has sought consensus around common policy instruments and universal price incentives. However, experience shows that there is a need for policy instruments specifically designed with the aim of helping countries at lower stages of development to converge on the levels of efficiency and affluence achieved by the more advanced economies, and to improve the welfare of all groups of the population. Making this the principle for policy design at both the domestic and the international level requires recognition of the fact that successful development and integration of the developing countries is in the mutual interest of all countries, as longer-term growth and trading opportunities of the more advanced economies also depend on the expansion of industrial capacity and markets in the poorer economies.

Under the gold standard, unprecedented private capital and labour flows helped establish mutually beneficial linkages between a wealthy industrial core, primary exporters and a small group of late industrializing economies. And even though the economic gap was relatively narrow, the latter were free to establish industrial capacity behind high and enduring levels of tariff protection, while exporters were allowed unrestricted access to the markets of the industrial core. The openness agenda during the inter-war period failed to strike the right balance between market forces, policy space and collective international action. Later, under the Bretton Woods system, both private capital flows and the movement of labour were sharply curtailed, but policy space was extended to allow both developed and developing countries to pursue a broad economic agenda, and an institutional framework was set up for collective international action in support of growth and stability and for managing economic integration.

As discussed earlier, this required a degree of flexibility in the workings of those arrangements in recognition of the differences in initial conditions and the varying pace of economic and industrial progress.

In today's world of increased interdependence dealing with the trade-offs between domestic and external objectives requires a much more pragmatic approach to policy-making than that suggested by the openness agenda. In the absence of easy growth and adjustment formulas for economic catch-up through industrialization, strategies that seek to make convergence a common policy objective have to allow a good deal more room for experimentation and discrimination in favour of countries with lower efficiency and income levels. To this end, policy-makers need to adopt a more pragmatic "rule of thumb" approach to designing useful interventions consistent with the practical world of politics (Krugman, 1987).

Since developing countries have become more vulnerable to external shocks, and the potential costs of adjusting to those shocks are significant and unevenly distributed, there is a danger that countries will try to use their available policy space to solve economic problems at the expense of other countries through

"beggar-thy-neighbour" policies. Accordingly, much like integration at the national level, which requires arrangements to ensure that all regions and social groups benefit from growth, efforts to bring progress, stability and predictability to an increasingly interdependent world also have to involve more collaborative and cooperative arrangements among countries.

As more countries seek to build domestic productive capacity and potential conflicts and rivalries increase, success in moving towards more open multilateral economic arrangements implies more than aiming at agreements dealing with reductions of tariffs, quotas and subsidies, and other impediments to the expansion of trade. And attracting more FDI is not a substitute for rapid domestic capital accumulation. Rather, the entire

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**The entire international economic system must be capable of supporting growth and convergence across a wide spectrum of countries making up the international division of labour.**

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international economic system should be capable of supporting growth and convergence across a wide spectrum of countries making up the international division of labour, with appropriate flexibilities built in to accommodate the diversity of conditions. Currently, only a handful of States are sufficiently large and dynamic enough to harness international forces to economic objectives, and even fewer are able to dictate the terms of integration and, consequently, to influence the prospects of other countries. Under such conditions, a critical ingredient of stable multilateralism is that the leadership of the strongest participants must be oriented in the right direction (Kindleberger, 1986).

Not only are the leading economies in a better position to bear the short-term costs of the collective actions needed to guarantee the long-term health of a more interdependent economic system, they also have an asymmetric bearing on growth prospects in the weaker economies through their share in world demand, their level of technological development and control over capital. They therefore have the added responsibility of pursuing policies in a way that does not damage the growth and stability of the weaker economies. Of particular concern are the potentially destabilizing and deflationary feedbacks between trade

and finance, which often create impediments to development. Financial crises in the developing countries frequently result, at least in part, from various shocks and policy changes that originate in the major reserve currency countries. But at present, there is no system of multilateral surveillance that can insist on greater coherence in the latter's monetary and exchange rate policies. In the absence of more balanced representation in multilateral institutions, there is a need for arrangements that make it possible to accommodate the kind of discretionary policy action on the part of countries at lower levels of efficiency and income that was an important ingredient of the successful integration of the more advanced economies into the international economy.

Thus, contrary to the thrust of the openness model, the search for economic stability and balance is not between autarky and surrendering national sovereignty to the expansive logic of markets. Nor does the latter provide the institutional standard against which development success should be judged. Rather, in an interdependent world, the balance between economic welfare at the national level and integration at the international level will continue to hinge on an appropriate mix of market forces, policy space and collective actions. ■

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**The search for economic stability is not between autarky and surrendering national sovereignty to the expansive logic of markets.**

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## Notes

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- 1 A recent review of the voluminous body of modelling exercises, country studies and regression analyses, all reporting a strong link between increased trade openness and economic welfare (both positive and negative), concludes that the whole case has been “exaggerated” (Freeman, 2003). For a review of the evidence see Kozul-Wright and Rayment, 2004.
- 2 For more on the profit-investment nexus in the development process, see *TDRs 1996 and 1997*; Amsden, 2001; and Ros, 2002.
- 3 Economic development is complicated by social and political changes, particularly where this involves the separation of large numbers of people from the land and their growing concentration in urban centres, and by the steady, albeit punctuated, rise of democratic institutions; for a seminal discussion, see Polanyi, 1944; and Moore, 1966.
- 4 The literature describing this history is vast; see, for example, Rowthorn and Chang, 1993; Reinert, 1999; Gomory and Baumol, 2000; and Bayly, 2003.
- 5 Over 40 per cent of the French labour force was in farming, and the figure was even higher on the European periphery and in the white-settler colonies. Even in the United States, where total farm mortgages had risen from \$3.3 billion in 1910 to \$9.4 billion in 1925, the agricultural sector accounted for a quarter of total employment and farm exports for over one quarter of farm incomes. With slower growth, weak international prices and protectionism in some leading markets, the burden of external debt-servicing rose steadily for most primary exporters in the 1920s (Kindleberger, 1987: 84–87).
- 6 According to Bairoch (1993: 4–5), the weighted average of customs duties on manufactures in continental Europe was 24.6 per cent in 1913 and 24.9 per cent in 1927, and the figures were almost certainly lower in 1928 and 1929. As Bairoch notes, however, there was plenty of variation around these average figures, as was the case before 1914.
- 7 Germany returned to its pre-war parity in 1924 as part of the Dawes Plan, and the United Kingdom a year later. Much of the debate in the United Kingdom at the time, and since, has been about whether prices had reached a level that justified returning to parity with the dollar. However, the return to pre-war parity was not motivated by trade considerations, but was part of the confidence-building exercise needed to restore London as the centre of international finance. In the changed post-war trading environment, and given the failure to re-establish an export-based investment-profit nexus, the consequence was that a growing share of the United Kingdom’s invisible earnings were absorbed by trade deficits, resulting in sharply reduced current account surpluses which failed to cover long-term security issues on London capital markets. Its need to resort to short-term borrowing to close this gap became its Achilles’ heel once the gold standard was restored.
- 8 This also allowed some room for a degree of counter-cyclical monetary policy (Kenwood and Loughheed, 1994: 113–115).
- 9 This term is derived from an investment swindle, whereby investments are pocketed and interest or profits are paid to investors out of new money flowing into the scheme.
- 10 This had been a familiar situation in peripheral economies under the gold standard, where erratic export earnings and doubts about the commitment to stay on gold could bring capital flows to a rapid halt and spark financial crisis. However, when shocks did occur on the periphery they were isolated and relatively easy to contain (Eichengreen and Bordo, 2002).
- 11 Strictly speaking GATT and ITO discussions were parallel negotiating tracks under the auspices of ECOSOC. The former was in fact the first to kick off, involving 23 countries, guided by the United States Trade Agreements Act of 1934 which allowed

- the United States Administration to negotiate reciprocal tariff reductions with other countries. The first session was successfully concluded in Geneva in 1947. It was presumed GATT would apply until the full ITO was concluded. Meanwhile, although international commodity schemes disappeared from the agenda, grants of commodities (produced predominantly in the United States) represented a significant component of the European Recovery Programme (Kenwood and Lougheed, 1994: 242).
- 12 This was helped by a degree of forced policy realism after sterling convertibility linked to the Anglo-American Financial Agreement ended in suspension in 1949, opening the way to a more general wave of devaluations to accommodate balance-of-payment distortions. The start of the Korean War in 1950 also acted as a timely global stimulus.
- 13 The majority of the 28 developing countries present were small South American economies; India and South Africa were still formerly under British rule and Egypt and Iraq were closely aligned; Cuba, Liberia and the Philippines were closely aligned to the United States. The protocol to implement the GATT was signed by 53 countries with a greater developing-country weight.
- 14 It is also worth noting that the World Bank lacked a mandate to deal with debt rescheduling or the management of capital flows, both potentially important concerns for developing countries.
- 15 Kenwood and Lougheed (1994: 254) estimate that between 1945 and 1960 around \$26 billion were granted in aid to developing countries (i.e. less than \$2 billion annually).
- 16 One of the first to voice this concern was Brazilian President Getulio Vargas in 1951, who complained that Brazil had experienced a negative net capital flow continuously from 1939 (with the exception of 1947) (Kregel, 2004). For further information on the structuralist approach, see Palma, 1989; and Rosenthal, 2003.
- 17 The Report led to a number of institutional changes in the GATT aimed at better addressing the concerns of developing countries, see Kenwood and Lougheed (1994: 276).
- 18 The empirical debate on the movement in the terms of trade has been running for some time, and the pre-war evidence on which Prebisch (and separately Hans Singer) built his initial argument is still a subject of dispute. For critical assessments of the early evidence, see Johnson, 1967; Bairoch, 1993; and Spraos 1980. More recently, Hadass and Williamson (2001) and Blattman et al. (2003) have taken a more favourable view of the Prebisch-Singer data; see also *TDR 2002*.
- 19 James (2000: 145–158) provides an interesting comparison of the divergent performance of Argentina and Brazil in the 1930s and Prebisch's own experience therein, which, at the time, cast him as an opponent of import substituting industrialization (ISI). On Prebisch's contribution and its distortion by mainstream trade theorists, see the various papers in ECLAC, 2001.
- 20 The Report's structural emphasis was complemented by a historical perspective, showing how structural growth forces had interacted differently in different periods: in the nineteenth century, when a resource-scarce and free-trading United Kingdom exported manufactures in exchange for food and raw materials from the periphery; in the inter-war period, dominated by a resource-rich and protectionist United States and by the collapse of trade following the Great Depression, growth followed a more inward orientation; and in the contemporary multilateral era, dominated by a rapidly modernizing Europe, openness and the application of reciprocity and mutual dependence reinforced first-mover advantages while it subjected late-comers to the problem of mounting indebtedness.
- 21 On the nature of managed trade under the GATT, see *TDR 1984*: 70–75; and Cornford, 2004.
- 22 The concept of currency scarcity was embodied in the IMF Charter, which allowed for its management under certain circumstances (Article VII. 3a, b and c).
- 23 Unlike the management of trade relations, where opinion over the choice of policies and institutions was quite sharply divided after the war, the failure of financial markets to prevent currency disorders and contagion in the 1930s was widely accepted as the basis for putting in place multilateral financial arrangements (Nurkse, 1944).
- 24 Much like the literature on the links between trade liberalization and growth, there has been a shift in emphasis from the direct benefits to growth from financial liberalization – which have proved difficult to detect – to the indirect benefits in terms of raising institutional quality (King and Levine, 1993; Prasad et al., 2003).
- 25 The extent of British dominance of the international financial system was unprecedented, not only relative to other financial centres but also relative to the United Kingdom's own domestic investment, when at times, in the early 1900s, it was investing a higher proportion of savings abroad than at home.
- 26 For much of the Bretton Woods era, under fixed exchange rate regimes and capital controls, the accumulated stocks of external sovereign debt remained very low, and the majority of capital flows involved direct investments. This could still give rise to a benign form of speculative financial fragility covered by official development assistance (ODA), although this appears to have been uncommon. Under these conditions, devaluation was equivalent to a partial default on debt service to non-resident holders of domestic assets. However, after the col-

lapse of this system in 1973, default on domestic-currency-denominated external commitments became acceptable in the form of flexible exchange rates, with the risk of default shifting onto the individual borrower.

27 The contrast between “hard” and “soft” States in the development process was first made by Gunnar Myrdal.

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