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# TRADE AND DEVELOPMENT REPORT, 2004

*Part Two*

**INTRODUCTION**



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## INTRODUCTION

Beginning in the mid-1980s, many developing countries made close integration into the international trading system a pillar of their economic reform agenda. They sought to achieve this not only through active participation in multilateral trade negotiations, but also through rapid unilateral trade liberalization. In many countries, trade liberalization was accompanied by an opening up of their financial sector and capital account. Rapid liberalization and increased exposure to international market forces and competition were expected to boost efficiency and competitiveness, which in turn would underpin a more rapid rate of economic growth and a narrowing of the income gap with developed countries. However, by the early 1990s there were many instances where the outcome of this policy strategy did not live up to expectations.

The prevailing analysis suggests that the often disappointing developmental effects of closer integration into the world economy are due to persistent market access barriers to a number of key developing-country exports. They are also due to the absence in many developing countries, and particularly the poorest among them, of appropriate governance and institutional frameworks and to a lack of productive capacities to respond quickly to export opportunities, even when they benefit from preferential market access conditions.

The disappointing developmental effects of closer integration led to increasing pressure on developed countries to abolish market access barriers to products of export interest to developing

countries. At the same time, developing-country policy-makers began to be encouraged to adopt measures designed to strengthen the supply capacity of their economies with a view to building competitive industries and benefiting from improved access to world markets. Increasing attention was given to improving macroeconomic and exchange-rate management; appropriate sequencing of liberalization of the trade, financial and capital-account regimes, underpinned by prudential regulation and financial sector reform; reinforcing domestic institutional capacity; and attracting foreign direct investment (FDI). This policy package was expected to enable developing countries to overcome the constraints they face with regard to fixed investment and technological upgrading, and to raise productivity.

Underlying the advice to adopt this policy package is the assumption that all economies, regardless of their size, institutional histories or level of development, respond in much the same way to a uniform set of price incentives. Further, there is an implicit suggestion that achieving such a uniform set of price incentives and keeping it free from distortions is best guaranteed by allowing international markets to set prices. It is argued that this is in large part because the higher degree of competition in those markets comes closest to an ideal level of “contestability”, and because the absence of government interference helps minimize the distortive impact of “rent seeking” or “directly unproductive profit-seeking” activities. Proposing this development strategy – which may be called the “openness model” – implies the view

that coherent policy-making is based on a shared understanding of a uniform set of instruments of trade, macroeconomic, financial and development policies. It has also meant, in practice, that developing countries trade discretionary policy measures for the promise of improved access to international markets for their goods, and to finance and technology. On this account, while making this bargain work depends principally on actions taken “at home”, it also implies strengthened policy surveillance from, and more effective collaboration among, international economic institutions (Mussa, 1997; Winters, 2001).

To date, adopting this strategy has still not enabled most developing countries to establish the virtuous interaction between international finance, domestic capital formation and export growth, which underpinned the catching-up process of Western Europe after the Second World War and of the East Asian newly industrializing economies (NIEs) during the 1980s and early 1990s. Critics have attributed this to the uniform application of neo-liberal policies, which does not take account of the diversity of economic conditions and challenges found in low and middle-income economies. Others have pointed to growing social tensions accompanying rapid opening up, which have had an adverse impact on efficiency and growth. Moreover, in an increasingly interdependent world, the very idea of a spontaneous economic order in which developing countries, by putting their own house in order through opening up to international market forces can guarantee the kind of stability needed for sustained growth in incomes and employment, appears to many as decidedly “utopian” (Rodrik, 2002: 24).<sup>1</sup>

Part Two of this Report suggests that efforts at designing a feasible development agenda require a more complex analytical and policy framework than that offered by the “openness model”. This framework must explore how the virtuous interactions between export activities, domestic capital formation and structural change are established. It should further consider potentially destabilizing interactions between trade and other elements of the integration process, particularly those associated with international finance. And it should explicitly include the legitimate role that economic institutions at the national level play instead of relying on a vision of the world in which indi-

vidual economic agents will react to prices that reflect relative scarcities of goods and production factors at the global level. In this way, it would provide a framework for identifying the combination of domestic policy-making and collective actions at the international level needed to manage the potential adjustment costs and tendencies towards economic divergence that accompany deeper integration, particularly where it brings together countries at very different levels of development.

In what follows it is suggested that a policy package based on the concept of “coherence” will enable better management of contemporary globalization processes in the interest of economic development. It is shown that the “openness” approach, in order to work, requires coherence between national development strategies and global processes and disciplines, as well as policy coherence between and within the various aspects/sectors of the global economy that impact on development prospects of developing countries. All these are lacking to some extent in today’s global economy.

A coherent treatment of the interdependence between trade, development and financial issues was an important element in the debate leading to the set-up of the post-war international economic system. This debate arose from the desire to avoid deflationary adjustments and beggar-thy-neighbour policies of the kind that had severely disrupted economies in the inter-war period.

The present institutional set-up has its roots in the arrangements that resulted from the reorganization of international economic relations after the Second World War. The set-up of the post-war international trade regime was predicated on the belief that, in conditions of strictly limited private international capital flows, an international monetary system on an intergovernmental basis with convertible currencies at fixed, but adjustable, exchange rates would provide a stable environment conducive to trade and investment. Under the aegis of the General Agreement on Tariffs and Trade (GATT), this regime considered the tariff as the only legitimate trade policy measure. Other trade measures (i.e. those affecting quantities or the fixing of import prices) were prohibited, except in certain clearly defined circumstances. The convertibility of currencies at fixed, but adjustable, exchange rates supported the GATT approach,

as participants in international trade negotiations could predict the full extent to which the competitive position of domestic industries would be affected by tariff cuts without having to be unduly concerned about other exogenous factors or resorting to competitive devaluations to balance unanticipated adverse consequences of trade liberalization.

The rules-based system of trade negotiations in the form of the GATT was all that survived from the initially proposed charter of the International Trade Organization (ITO), whose mandate would also have included to coordinate national economic policies to ensure adequate levels of global demand and employment in support of the development of low-income countries. As such, the specific problems of developing countries participating in the post-war international trading system were largely absent from the mandates of the inter-governmental institutions created immediately after the Second World War. Multilateral efforts to remedy this neglect culminated in the First UNCTAD Conference in 1964. Central to that discussion was the idea that developing countries can base economic development on their own efforts only if they have sufficient policy space to accelerate capital formation, diversify their economic structure and give development a greater “social depth”. This discussion also emphasized the interdependence between trade, macroeconomic and financial policy issues.

The need for a coherent treatment of these issues has gained in importance with the abandoning of the system of fixed, but adjustable, exchange rates and the adoption of widespread floating, combined with a return of private international capital flows to levels similar to those that had caused instability in the inter-war period. Indeed, there are growing concerns about the adverse impact on trade of exchange rate instability created by financial factors, in particular, in the context of the financial crises that have hit a number of emerging-market economies over the past decade. The risk of sharp currency depreciations, which, as demonstrated by the Asian crisis, can arise even in countries with sound macroeconomic and external positions, increases the perceived cost and uncertainty of trade, and discourages governments from lifting trade restrictions. In practice, large currency depreciations by some crisis-hit coun-

tries have provoked claims of “unfair trade” from import-sensitive sectors in some of their main trading partners and pressure for a trade policy response. This runs counter the generally recognized principle that trade restrictions should not be used to offset a rise in the international cost competitiveness of competitors resulting from fluctuations in exchange rates.

There is no disputing that trade must continue to occupy a central place in an effective global partnership for development, or that all countries have a mutual interest in the effective functioning of the multilateral trading system. However, trade and financial linkages with the world economy can only complement, but not substitute, for domestic forces of growth. Moreover, these linkages need to be coherent with national development strategies designed to generate virtuous interaction between domestic capital formation and export activities. Establishing such virtuous interactions can be achieved by a national development strategy that is successful in augmenting the existing stock of physical and human capital, enabling the use of more efficient technologies, and shifting resources away from traditional, low-productivity activities towards activities that offer a high potential for productivity growth. Under some circumstances, and particularly when a period of real currency appreciation has hampered export performance, real currency depreciations can improve international cost competitiveness and boost exports. On the other hand, sizeable exchange rate volatility can offset annual gains in domestic productivity and drastically alter international cost competitiveness virtually overnight. Moreover, sharp and abrupt depreciations can make it difficult for exporters to take advantage of the rise in international cost competitiveness resulting from such depreciations. The fact that sizeable exchange rate volatility and major exchange rate depreciations have typically been associated with shifts in the direction of short-term international capital flows shows that insufficient coherence in the international monetary and financial system can jeopardize the successful implementation of national development strategies designed to foster domestic supply capacities.

The following discussion documents the lack of policy coherence in today’s global economy and proposes ways to approach the issues of coher-

ence so as to maximize the developmental effects of integration into the world economy.

Chapter III first discusses the issues arising from greater trade and financial integration looked at from the perspective of interdependence between trade, macroeconomic and financial issues as well as between openness and integration in the world economy, and domestic policy space. Chapter IV shifts the focus to the impact of monetary and financial factors on the supply side of developing-country exports. It examines the particular effects caused by sharp and abrupt currency

depreciations on the trade performance of developing countries and goes on to analyse monetary policy options with regard to fixed or flexible exchange rates in the context of high volatility of short-term capital flows. The concluding section summarizes the main arguments and discusses policy challenges to enhance coherence between the international trading, monetary and financial systems with a view to establishing a virtuous interaction between international finance, domestic capital formation and export growth and maximizing the developmental effects of integration into the world economy. ■

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## Note

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1 For the evidence on growth performance, see *TDRs 1997 and 2003* and UNCTAD, 2002; on the problems of applying uniform policy advice, for Africa see *TDR 1998* and UNCTAD, 2001, for Latin

America see ECLAC, 2002, and for countries in Central and Eastern Europe see ECE, 1990. On the damaging social impact of these policies see UNDP, 1999; UN-HABITAT, 2003; and ILO, 2004.

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